

# “ESTABLISHMENT”: A CORE CONCEPT IN CHINESE INBOUND INCOME TAXATION

*Wei Cui\**

*Analogous with the concept of a U.S. “trade or business” in U.S. federal income tax law, the concept of “establishment” under Chinese tax law determines the boundary between net-income and gross-income taxation of inbound investments. As central as the concept is, it has received surprisingly little interpretation.*

*This Article traces the cause of this under-interpretation to China’s traditional regulatory environment for foreign investment that was biased against portfolio investments and non-corporate business forms, and describes recent regulatory and commercial developments that may rekindle interest in elaborating the meaning of “establishment.” It then reviews the interpretations that have been given to the concept under existing law, as well as several areas of commercial practice where additional guidance is urgently needed. Finally, the Article examines what policy considerations should guide the further development of the concept.*

*This policy analysis considers the overall tax policy stance toward foreign portfolio investment that may reasonably be attributed to China. The country’s large surpluses in current and capital accounts and currency reserves make it doubtful that a dramatically more favorable model for taxing foreign investment is appropriate in the near term. Nonetheless, because tax policy plays a subsidiary role to other regulatory policy in the treatment of foreign investments, cogent arguments can be advanced for adopting an interpretation of “establishment” that allows foreign portfolio investment already identified as beneficial for China to proceed.*

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\* Associate Professor, China University of Political Science and Law, Beijing. I am grateful to Huang Zhen, Tong Yingying and Li Kaigeng for research assistance, and to Mr. Jeffery Kadet and Professor Adam Chodorow for very helpful comments on earlier drafts of this paper. Author email: wei.cui@aya.yale.edu.

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## INTRODUCTION

A basic similarity between the Chinese approach to international income taxation and that of many other countries is the two-tiered system China uses to tax inbound foreign investments: some items of income earned by foreigners are taxed on a gross-income basis, primarily by way of withholding, while others are taxed on a net-income basis, through the filing of annual tax returns that account for both income and expenses. In the U.S., as a comparative example, whether an item of income is subject to one or the other mode of taxation turns upon whether the foreign recipient of income is engaged in a "trade or business" in the U.S. and whether the income is "effectively connected" with such U.S. trade or business.<sup>1</sup> In China, a similar determination for a foreign non-individual taxpayer

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1. I.R.C. §§ 871, 881, 882 (2009).

depends on whether the foreign entity's income is effectively connected with an "establishment or site" (*"jigouchang suo,"* or "establishment" for short) in China.<sup>2</sup>

The existence of this point of resemblance between Chinese and American inbound income taxation is in itself unsurprising. There is, after all, the income tax treaty concept of "permanent establishment," which determines whether the business profits of an enterprise are taxable on a net-income basis in the country where the income arises.<sup>3</sup> This suggests that most countries adopt some combination of taxation on the basis of net and gross income for inbound investments. However, U.S. tax lawyers generally are careful in distinguishing between domestic and treaty law concepts. In the U.S., for example, the "U.S. trade or business"<sup>4</sup> concept carries most of the weight in determining whether foreigners might be taxable on a net-income basis, whereas the "permanent establishment" concept performs, for the most part, a secondary function in determining how a nonresident would be taxed in the U.S.<sup>5</sup> Similarly, it is prudent to expect that the "permanent establishment" concept would not capture how other countries draw the line between net- and gross-income basis taxation, and this determination for a foreign investor in China will rest on the interpretation of the domestic Chinese concept of "establishment." How China has drawn this line in the past, and how it might redraw it in the future, is the subject of this Article.<sup>6</sup>

The urgent need to clarify the legal definition and application of "establishment" in China stems from three sets of recent legal, regulatory and commercial developments. The first is a liberalization of foreign investment regulations to permit more foreign business activities to be conducted in non-corporate forms, *e.g.*, contractual joint ventures and partnerships.<sup>7</sup> Because the inflexibilities of China's law for corporations

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2. Enterprise Income Tax Law (10th Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), arts. 3(2), 3(3), *translated in* WORLDLII (last visited Feb. 14, 2010) [hereinafter EIT Law].

3. See Articles of the Model Convention with Respect to Taxes on Income and on Capital, arts. 5, 7 (Org. for Econ. Cooperation & Dev. 2005), *available at* <http://www.oecd.org/dataoecd/50/49/35363840.pdf> [hereinafter OECD Model Convention] (last visited Feb. 14, 2010).

4. I.R.C. § 864(b) (2009).

5. See I.R.C. § 894(a) (2009).

6. Whether any item of income received by a foreign entity may be taxed on a net-income basis also depends on whether the income is "effectively connected" with an "establishment." Thus, strictly speaking, having an "establishment" in China is only a necessary and not a sufficient condition for net-income basis taxation to apply. However, the examination of the law and practice of attribution of income to an "establishment" is beyond the scope of this Article.

7. See *infra* notes 45–57 and accompanying text.

have long constituted a burden for foreign investors, this regulatory relaxation is likely to be met with enthusiasm among investors interested in China.<sup>8</sup> Moreover, rapid developments in venture capital (VC) and private equity (PE), where the use of noncorporate forms prevails even in countries with flexible corporate laws, have also generated interest on the part of foreign investors in such forms in China.<sup>9</sup> Because in China, as elsewhere, whether a foreign person is taxed on a net-income or gross-income basis generally becomes an issue only when the person has an unincorporated business presence,<sup>10</sup> exploration of new business forms has raised new questions about the line between these two bases of taxation.

Second, foreign portfolio investment (FPI) in China, as opposed to foreign direct investment (FDI), is now viewed more favorably than before, and it is starting to play a greater role in China's capital markets.<sup>11</sup> For active business operations in a foreign country (typically associated with FDI), net-income taxation, borne by either a subsidiary or a branch, is generally a given. It is typically passive investment activities that are sensitive to whether net-income or gross-income taxation applies. For example, under China's new Enterprise Income Tax Law ("EIT Law") and its implementing regulations, the corporate income tax rate is 25%, whereas the withholding tax rate on dividends, interest, royalties, capital gains, etc., is 10%.<sup>12</sup> For most portfolio investors, despite the lack of deductions, investment income would be subject to a lower Chinese tax rate (further reducible under income tax treaties) if it were not treated as received by a Chinese establishment. As experience in the U.S. has shown,<sup>13</sup> when FPI becomes an important part of a country's domestic capital markets, delineating the boundary between net-income and gross-income taxation

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8. Nancy Marsh et al., *Partnerships in China: The New Frontier*, 14(4) IBFD ASIAN PAC. TAX BULL. 296, 296 (2008) (discussing the attraction of the partnership form as a way of circumventing the corporate form's limitations on capital structure).

9. See, e.g., Alan Tsoi & Pauline Zhang, *Venture Capital and Private Equity Funds in China*, 53 TAX NOTES INT'L 1211 (2009).

10. This is because business presence in the form of a corporate subsidiary is generally taxed under the regular income tax on a net-income basis. See *infra* Section I.A.1.

11. See *infra* Section I.B.

12. EIT Law, *supra* note 2, art. 4(1) (setting the corporate rate at 25%), art. 4(2) (setting the maximum withholding tax rate at 20%), art. 37 (providing for withholding on Chinese-source income); Enterprise Income Tax Law Implementation Regulations (promulgated by the State Council, Decree No. 512, Dec. 6, 2007, effective Jan. 1, 2008) art. 91(1), *translated in* LAWINFOCHINA (last visited Feb. 14, 2010) [hereinafter EIT Law IR] (reducing the withholding tax rate to 10%).

13. See generally Stanford G. Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 277 (1967); David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 TAX LAW 719 (2003).

also becomes crucial.

Third, the new EIT Law, effective since 2008, has dramatically limited the scope of tax holidays and concessions previously available to foreign investments.<sup>14</sup> In the absence of these concessions and tax holidays, Chinese tax planning for foreign investors will return to more traditional methods involving transaction structure, transfer pricing, and the like. These require more attention to technical applications of increasingly complex rules, in contrast to the previous singular focus of most FDI investors on obtaining tax holidays and other preferences. One of the many novel aspects of the EIT Law is that it has both rationalized and increased the complexity of the two-tiered structure of inbound taxation. At the center of this structure is the notion of “establishment or site.” Yet, as this Article explains, the notion of “establishment” has not been adequately interpreted under Chinese tax law and remains poorly understood by both taxpayers and tax authorities. In light of growing taxpayer sophistication, this lack of clarity will become increasingly noticeable.

This Article offers the first scholarly analysis of the essential Chinese tax concept of “establishment” in terms not only of its past and current interpretation but also of its likely treatment in the near future. In examining the latter, I will be particularly concerned with the design of appropriate tax rules for foreign portfolio investment. This focus reflects my belief that, more than other underlying economic causes for unincorporated business presences of foreigners, FPI in China’s capital markets will drive the development of the law relating to establishments.<sup>15</sup>

The Article will be organized as follows. In Section I, I describe the relatively unique legal, regulatory and commercial contexts in which “establishment” applies. These contextual configurations are important for tax practitioners and policymakers to understand because they significantly shape how tax issues arise and how the market and governmental authorities respond. In particular, I argue that the intertwining of organizational and regulatory law in China traditionally created a serious bias against unincorporated forms of foreign investment. This may be the single most important factor that explains the underdevelopment of the

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14. Tax holidays had been granted on the basis of the location and nature of the operation of the FIEs. They often covered at least firms’ initial five profitable years, and sometimes lasted even longer. See generally Jinyan Li, *Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes*, 61 BULLETIN FOR INT’L TAXATION 519 (2007).

15. Other underlying causes include natural resource explorations, short-term visits of professionals providing technological know-how, and so on. See ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE (Kluwer Law and Taxation 1991), at 13–17.

concept of "establishment" (compared to the elaboration of the concept's equivalent in other jurisdictions) in the past. In addition, significant barriers to foreign portfolio investment also limit the scope of application of "establishment." Although restrictions against unincorporated business forms and FPI have been significantly relaxed recently, the incremental fashion in which this is taking place also explains the slowness with which tax authorities have responded.

Section II turns to government-issued interpretations of the scope of "establishment" under Chinese statutes and regulations, as well as the areas of foreign investment in which the ambiguities associated with the concept have recently become most notable. While the government's interpretations of "establishment" remain incomplete, important examples can be found showing at least an awareness of the special problems posed by noncorporate business forms and portfolio investments. However, this awareness has yet to develop into a sustained recognition of an important policy issue. In the meantime, striking inconsistencies exist in the implicit approach the government has taken toward the interpretation of "establishment."

In Section III, I try to advance this area of policy by examining some of the choices facing the further development of the notion of "establishment." The first choice can be formulated as the following question: assuming that foreign portfolio investors favor the exclusion of passive investments from the definition of "establishment," would a comprehensive interpretation of "establishment" in this manner be appropriate in the near future? Because China is likely to continue to control capital accounts,<sup>16</sup> particularly in the face of increasing evidence of inflow associated with the expectation of continued appreciation of the renminbi (the Chinese currency) and global financial instability generally, the answer appears to be "no," at least for the short term. Assuming this answer to be correct, one may nonetheless raise the question: how can reasonable tax treatments be designed for forms of FPI, *e.g.*, private equity investments, that are already identified as beneficial for China? Using the currently-debated issue of the partnership-to-partner attributions of business nexus as an illustration, I argue that more specific policy considerations must be introduced to make advances in this area. Such considerations include whether a tax rule is aimed at affecting a binary decision by investors of investing or not investing, instead of at a marginal decision of how much more to invest, as well as whether the rule introduces dissimilar treatment of foreign and domestic investors that could easily lead to manipulation.

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16. See *infra* notes 171–184 and accompanying text.

While I believe that many of the empirical hypotheses and legal interpretations advanced in this Article are novel in some respects, the arguments in Section III are explorations in uncharted waters to an even greater extent than others. Especially because of different views about the nature of capital inflows and their impact on the Chinese economy,<sup>17</sup> it has become difficult in the past few years to find coherent articulations of China's overall economic policy toward inbound portfolio investment. Even rarer are discussions of what tax policies may be appropriate for the coming years. I believe this is largely attributable to the fact that economic and tax policies toward foreign investment fall within the jurisdiction of an at once insular and fragmented bureaucratic state, where there are few channels for public input and little inter-agency coordination. The bureaucrats in charge generally lack the incentives to confront larger policy issues and to process and integrate the information needed to resolve them. However, the politics of regulation-making in China is beyond the scope of this Article.<sup>18</sup> I nevertheless offer a tentative analysis of the considerations relevant to current tax policy toward inbound portfolio investment in the hope that the analysis (however inchoate) may shed light on where the government's and taxpayers' interests lie, so that technical discussions of treatments of particular transactions may take on a greater sense of purpose.

#### I. LEGAL, REGULATORY AND COMMERCIAL CONTEXT FOR THE CONCEPT OF "ESTABLISHMENT"

Non-tax legal and regulatory factors can sometimes shape tax law concepts in powerful ways. In China, as elsewhere, a locally formed corporation is treated as a domestic taxpayer even if owned wholly by foreign persons.<sup>19</sup> Thus, whether a foreign person is taxed on a net-income basis is an issue only when the person has an unincorporated business presence in China, and the concept of "establishment" applies only where unincorporated business operations are permitted by non-tax law. A crucial piece of background for understanding China's inbound tax rules is therefore that the country's FDI regulatory regime has traditionally displayed a substantial bias against unincorporated business forms.<sup>20</sup> This Section explores the manifestations and causes of this bias. It also examines a policy preference against foreign portfolio investment—another

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17. See *infra* notes 173–179 and accompanying text.

18. See generally VICTOR SHIH, *FACTIONS AND FINANCE IN CHINA* (Cambridge Univ. Press 2008).

19. See EIT Law, *supra* note 2, art. 2.

20. See *infra* Section I.A.

factor that in the past has impeded the development of tax rules concerning "establishment."

Besides providing the background to China's inbound tax rules, the bias in the choice of form in China's FDI regulation raises an interesting question for tax scholars. In the design of international tax policy, a fundamental question is whether tax law should give effect to the legal distinctness of corporate subsidiaries.<sup>21</sup> In the context of such discussion, it seems useful to know whether multinational corporations (MNCs), when they choose to invest in other jurisdictions, generally prefer to use corporate subsidiaries as opposed to branches. It is sometimes observed that, in fact, MNCs predominantly use the subsidiary form.<sup>22</sup> As we will see, while this observation also holds true in the context of foreign investment in China, it does not reveal anything about MNC preferences since in China, the branch form is generally not allowed.<sup>23</sup> Indeed, given the rigid capital structure requirements for the corporate form, many MNCs investing in China, unless they have very substantial operations there, would likely have a preference for non-corporate forms. More generally, there may be other countries like China, where a relatively rigid statutory limitation on corporate form would have created a preference for the branch form, but the branch or other non-corporate form was not available to achieve MNCs' economic goals. This suggests that the empirical question of what MNCs prefer is quite complicated, as it would need to take into account different countries' regulatory hurdles for different business forms.

#### A. *Historical Bias Against Unincorporated Forms*

While the limited availability of noncorporate business organizational forms in China has not gone unnoticed,<sup>24</sup> there is no official or well-known account of why this is the case. A plausible hypothesis would explain the phenomenon as follows. The early development of the FDI regime focused on corporate forms.<sup>25</sup> Because foreign invested

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21. See, e.g., Reuven S. Avi-Yonah & Kimberly A. Clausing, *A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project* (Univ. of Mich. Pub. Law, Working Paper No. 85, 2007) available at <http://ssrn.com/abstract=995202> (last visited Feb. 14, 2010).

22. See Daniel Shaviro, *Does More Sophisticated Mean Better?*, 54 TAX L. REV. 353, 360 (2001).

23. See *infra* notes 38–39 and accompanying text.

24. See Xinmiao Tang, *Inquiry into the Organizational Forms Available to Foreign Invested Enterprises*, INTERNATIONAL BUSINESS DAILY (China), February 22, 2002, at 8 (in Mandarin).

25. Since the late 1970s, China has erected a legal framework for FDI by adopting a series of laws and regulations, among which three statutes have set force the three major



enterprises (FIEs) are heavily regulated in China, with regulatory power over them assigned to powerful government agencies early on, the corporate forms of FIEs became associated with vested interests of the regulatory agencies.<sup>26</sup> These vested interests ensured that non-corporate forms were neglected in the legislative process and discriminated against in practice, since such forms would not enhance, and could even detract from, the authority of the agencies.

The juncture at which corporate law and regulatory interest become intertwined can be identified more precisely. A basic distinction between corporate and non-corporate business forms in China is the emphasis on a relatively stable capital structure for the corporate form.<sup>27</sup> Following a continental European model,<sup>28</sup> China's corporations are subject to registered capital requirements where both increases and decreases in equity capital require cumbersome procedures purported to facilitate monitoring by creditors.<sup>29</sup> These aspects of the corporate law, aimed at protecting creditors against shareholders, coincided with many early FDI regulatory concerns, such as that FIEs engaged only in business activities for which they were approved, that foreign investors actually contributed the capital and technologies that they promised, and that foreign investors

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permitted forms of foreign invested entities. The earliest of these statutory forms—the Chinese-foreign equity joint venture—was required to be corporate in nature. Although the two later forms (the Chinese-foreign cooperative joint venture and the wholly-owned foreign enterprise) theoretically allowed non-corporate variations, their legislation was contemporaneous with efforts to draft the Company Law, and well preceded the Partnership Enterprise Law and other business organizational law. *See, inter alia*, the Law on Chinese-Foreign Equity Joint Ventures (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, effective as amended Mar. 15, 2001), *translated in* ASIANLII (last visited Feb. 14, 2010) [hereinafter EJV Law]; the Law on Chinese-Foreign Contractual Joint Ventures (promulgated by the Nat'l People's Cong., April 13, 1988, effective as amended Oct. 31, 2000), *translated in* ASIANLII (last visited Feb. 14, 2010) [hereinafter CJV Law]; the Law on Wholly Foreign-Owned Enterprises (promulgated by the Nat'l People's Cong., April 12, 1986, effective as amended Oct. 31, 2000), *available at* <http://english.mofcom.gov.cn/aarticle/lawsdata/chineselaw/200411/20041100311068.html> (last visited Feb. 14, 2010) (as revised Oct. 31, 2000) (in translation); the Company Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective as amended Oct. 27, 2005), *translated in* ASIANLII (last visited Feb. 14, 2010) [hereinafter Company Law].

26. The most important of these agencies include the Ministry of Commerce and the State Development and Reform Commission (and their predecessors), as well as the State Administration of Industry and Commerce. DANIEL C.K. CHOW, *THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL*, 368–409 (2d ed. 2009).

<sup>27</sup>*See generally* Yan Liu, *Reflections on the Registered Capital System*, 51.31 PEKING U. LAW REV. (*zhongwai faxue*) 34 (1997); Xudong Zhao, *From Reliance on Capital to Reliance on Assets*, 25.5 CHINESE JOURNAL OF LAW (*faxueyanjiu*) 109 (2003).

28. *See generally* Zhao, *supra* note 27.

29. *Id.*

did not financially harm Chinese joint venture partners.<sup>30</sup> Therefore, FIE regulations tended to accentuate these aspects of the corporate model: for example, changes in capital structure of an FIE must not only be accountable to creditors, but also be approved by the government itself.<sup>31</sup> Even as the regulatory concerns gradually lost their relevance when China's economy became more open after the 1990s, government agencies seemed reluctant to surrender control. Enforcing the rigidities of corporate law allowed them to continue to wield power over FIEs; it is therefore not surprising that these agencies are at best ambivalent about the development of new, more flexible business forms.

This explanation of the regulatory entrenchment of the corporate form is consistent with the history of the development of the few non-corporate business forms available to foreign investors, including the representative office, the corporate branch, and the cooperative joint venture.

The most traditional type of unincorporated presence in China is the representative office (RO).<sup>32</sup> Initially, ROs were the only footholds foreign businesses could establish in China's closed economy.<sup>33</sup> They were meant to serve no more than liaison functions and were subject to light regulatory requirements. In a very few sectors, ROs were subsequently permitted to grow and perform more robust functions. For example, foreign law firms were explicitly authorized to provide certain legal services through ROs, and that is how most foreign law firms in China operate now.<sup>34</sup> But outside these sectors, ROs are prohibited from engaging

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30. See, e.g., EJV Law, *supra* note 25, at art. 5 (venture partner must warrant quality of equipment and technology); Regulations for the Implementation of the Law on Sino-foreign Equity Joint Ventures, art. 4 (promulgated by the State Council, Sept. 20, 1983, last amended July 22, 2001), available at [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/RegulationsonForeignInvestment/P020060620322890786346.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/RegulationsonForeignInvestment/P020060620322890786346.pdf) (last visited Feb. 14, 2010) (as revised July 22, 2001) (in translation) (stating that the government should review a joint venture contract to ensure that it is not "patently unfair to one party").

31. See Paul, Hastings Shanghai Office, *Using a Chinese Entity for an All-foreign Joint Venture in China—Does It Make Sense?*, CHINA LAW & PRACTICE, May 2005, at 28; see also generally CHOW, *supra* note 26, Chapter 10.

32. See Interim Provisions on the Administration of Resident Representative Offices of Foreign Enterprises (promulgated by the State Council, Oct. 30, 1980), translated in ASIANLII (last visited Feb. 14, 2010).

33. See OWEN D. NEE, JR., *Business Operations in the People's Republic of China*, B.N.A. TAX MGMT. PORTFOLIO 957-3d, A-25 to A-26 (2008).

34. In effect, therefore, law firm ROs are like branches, even though they are not labeled as such. Regulation on Administration of Representative Offices of Foreign Law Firms (promulgated by the State Council, Dec. 22, 2001, effective Jan. 1, 2002), available at [http://www.gov.cn/english/laws/2005-08/24/content\\_25816.htm](http://www.gov.cn/english/laws/2005-08/24/content_25816.htm) (last visited Feb. 14, 2010) (in translation).

in direct profit-making activities (including investing) and from performing other than ancillary functions.<sup>35</sup> Instead, profit-making activities must be pursued through the heavily regulated FIE forms.<sup>36</sup> In reality, the boundary between “support functions” and “direct” profit-making activities is vague; it is difficult for businesses to avoid and for the government to police. The ROs of many foreign businesses venture into grey areas far from the strictest interpretation of the officially sanctioned business scope for ROs.<sup>37</sup>

A second type of unincorporated presence is the corporate branch. Although China’s Company Law has allowed foreign companies to establish branches since 1993, it required the State Council to issue regulations for the approval of such branches.<sup>38</sup> Relevant regulations have been adopted for only a few sectors (including banking). Thus, the only foreign companies that have opened branches in China fall within those few sectors.<sup>39</sup> Note that in the few sectors in which either ROs are permitted to

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35. A 1995 regulation stated that, for ROs under its jurisdiction, none can engage in “direct” profit-making activities. Instead, they may only pursue “liaison, marketing support, information gathering and technology exchanges.” In other words, an RO generally is not allowed to pursue businesses of its own; it can only provide support to the business activities of the foreign company of which the RO is legally a part. Implementing Rules for the Examination, Approval and Administration of Resident Representative Offices of Foreign Enterprises (promulgated by the Ministry of Foreign Trade and Econ. Cooperation, Feb. 13, 1995), available at <http://www.pathtochina.com/chinabiz/2007/12/detailed-rules-of-the-implementation-of-the-examination-approval-and-administration-of-the-resident-representative-offices-of-foreign-enterprises-in-china/> (last visited Feb. 14, 2010) (in translation).

36. In a recent sign of liberalization of foreign investment regulation, the State Council has circulated a draft of the revised Administrative Measures for the Registration of Representative Offices of Foreign Enterprises (on file with the author), which states that a representative office may engage in profit-making activities to the extent provided by treaties or agreements that China has entered into with other countries.

37. Indirect evidence for this occurrence is a large number of circulars issued by the Ministry of Finance, the State Administration of Taxation and local tax agencies on the taxation of different types of income of ROs. See e.g., *Cai shui* [1985] 110 [Interim Provisions Concerning Imposition of Consolidated Industrial and Commercial Tax and Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises] (promulgated by the Ministry of Finance, May 15 1985); *Cai shui* [1985] 122 [Interpretation of Some Policy Matters Regarding the Interim Provisions for the Collection of Consolidated Industrial and Commercial Tax and Enterprises Income Tax on Resident Representative Offices] (promulgated by the Ministry of Finance, May 15 1985); *Cai shui wai* [1985] 197 [Additional Regulations on the Question Concerning Imposition of Consolidated Industrial and Commercial Tax and Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises] (promulgated by the Ministry of Finance and State Admin. of Taxation, Sept. 25, 1985).

38. Company Law, *supra* note 25, art. 11.

39. See State Council Decree [2006] 478 [Regulations on the Administration of Foreign-Invested Banks] (promulgated by the State Council, Nov. 8, 2006) (permitting bank branches); State Council Decree [2001] 336 [Regulation on the Administration of Insurance

pursue profit-making activities directly or foreign companies are allowed to set up branches, specialized agencies—including the Ministry of Justice (which regulates the legal profession) and bank and insurance regulators—are involved, in addition to the agencies generally in charge of foreign direct investment. This may suggest that unincorporated business pursuits were made possible in these sectors only because other bureaucratic voices superseded the voice of the pro-corporate-form, traditional FDI regulators.

Yet another story illustrating the same inhospitality toward non-corporate forms relates to the history of the cooperative joint venture (CJV), one of the three traditional forms of FIEs.<sup>40</sup> Before the CJV form was codified in 1988,<sup>41</sup> Chinese and foreign venture partners experimented with the form and, in some cases, indicated a preference for a CJV to take the “non-legal person” format—in other words, to be merely contractual in nature and not limited in liability as a matter of organizational law.<sup>42</sup> This preference, as well as the use of similar organizational forms in other countries, was recognized by the government when the CJV Law was drafted.<sup>43</sup> However, soon after the FIE regulatory regime established its authority over the CJV form, the use of the non-legal person CJV declined, reportedly because “government authorities [would] generally no longer approve such cooperative enterprises.”<sup>44</sup> This was so much the case that when the government revived the non-legal person CJV form for establishing domestic venture capital funds in 2003 (discussed immediately below), even the most experienced legal and tax practitioners in China confessed to unfamiliarity with it.

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Companies with Foreign Investment] (promulgated by the State Council, Dec. 5, 2001) (permitting insurance company branches); State Council Decree [1993] 131 [Regulation on Sino-Foreign Cooperation in the Exploitation of Continental Petroleum Resources] (promulgated by the State Council, Oct. 7, 1993, as amended by State Council Decree 317, Sept. 18, 2007) (permitting oil and gas company branches).

40. See CJV Law, *supra* note 25.

41. The Law on Chinese-Foreign Cooperative Joint Ventures (promulgated by the Nat'l People's Cong., Apr. 13, 1988, revised Oct. 31, 2000), available at <http://www.hecpb.gov.cn/english/news/display.php?id=1> (last visited Feb. 14, 2010) (in translation).

42. See Tuobin Deng, Minister of Foreign Trade and Econ. Cooperation, (7th Nat'l People's Cong. Mar. 31, 1988) (discussing the draft of the CJV Law submitted to the Nat'l People's Cong.).

43. *Id.*

44. NEE, *supra* note 33, at A-23 to A-24. Although the CJV (even in its legal person form) is widely perceived to be more flexible than the equity joint venture (EJV), the use of CJVs in general lagged behind the use of EJVs, likely due to the regulatory preference over the latter.

B. *Recent Advances in Partnership Forms*

In contrast to the historical bias against unincorporated forms of foreign investment, a remarkable surge of interest in such forms has taken place in the last few years. This began with a multi-agency effort to promote venture capital investing in China in the early 2000s.<sup>45</sup> Foreign VC operators were perceived to be crucial providers of expertise in the nascent industry, and after a few years of consultation, the government understood that foreign fund sponsors would only accept non-corporate means of fund formation.<sup>46</sup> Because China's Partnership Enterprise Law did not permit foreign or non-individual investors at that time, the government turned to the cooperative joint venture for organizing "foreign-invested venture capital investment enterprises," permitting the use of non-legal person CJV for this purpose.<sup>47</sup>

More recently, in 2006, China revised its Partnership Enterprise Law.<sup>48</sup> The revised Partnership Enterprise Law for the first time permits foreign investors to become partners in Chinese partnerships and provides a statutory framework for limited partnerships.<sup>49</sup> No particular government agency can be considered the backer or sponsor of the Partnership Enterprise Law's revision.<sup>50</sup> Instead, it was moved along by China's legislative elite (including legal academics, but with little participation from legal service providers) generally responsible for planning the development of China's statutory framework.<sup>51</sup> For this reason, although foreign investment in Chinese partnerships is now a statutory possibility, its actualization, like the actualization of the possibility of foreign corporate branches in China, still faces some uncertainty.

In particular, according to the Partnership Enterprise Law, foreign-

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45. See Jeff Wood & Richard Xu, *China's Revised Venture Capital Rules: Limited Partnerships with Chinese Characteristics?*, CHINA LAW & PRACTICE, Mar. 2003, at 18.

46. *Id.*

47. See Provisions Concerning the Administration of Foreign-Funded Venture Investment Enterprises (promulgated by the Ministry of Foreign Trade and Econ. Cooperation, Jan. 30, 2003, effective Mar. 1, 2003) available at <http://english.sohu.com/2004/07/04/78/article220847846.shtml> (last visited Feb. 14, 2010).

48. The Partnership Enterprise Law (promulgated by the Nat'l People's Cong., Feb. 23, 1997, as amended Aug. 27, 2006) available at <http://www.buyusa.gov/asianow/partnership.doc> (last visited Feb. 14, 2010) [hereinafter Partnership Enterprise Law].

49. See Marsh et al., *supra* note 8; Peng Tao, *Is It a Good Time to Form a Chinese Partnership Enterprise?*, CHINA TAX INTELLIGENCE, Oct. 2007 at 22.

50. Interview with Shuguang Li, Professor, China University of Political Science and Law, in Beijing, China (Aug. 10, 2006). Professor Li participated in the drafting of the Partnership Law.

51. *Id.*

invested partnerships (FIPs) can be established only pursuant to further regulations issued by the State Council.<sup>52</sup> In designing such regulations, which have not yet been issued, the State Council faces a dilemma. On one hand, the regulation of FIPs needs to generally conform to regulations governing other FIEs: if the former is significantly more relaxed than the latter, then many foreign businesses will abandon the traditional rigid FIE forms in favor of the more flexible partnership form.<sup>53</sup> This could lead to an opening in the FIE control regime with unpredictable consequences. "On the other hand, keeping FIPs in parity with traditional FIEs would largely deprive FIPs of the attractions of the partnership form, and essentially defeat the purpose" of enacting the legislation.<sup>54</sup>

However, in discussions preceding the adoption of the revised Partnership Enterprise Law, it was clearly understood that the partnership form was necessary for venture capital development.<sup>55</sup> Indeed, some of the strongest interest in the newly available partnership form has come from Chinese and foreign financial operators looking to establish onshore, RMB-denominated funds.<sup>56</sup> It is possible that regulations for establishing FIPs will be issued specifically for the VC and PE industries, much as regulations for establishing branches of foreign corporations were issued for select financial industries.<sup>57</sup> What is more difficult to predict is whether the recent and imminent advances in the use of non-corporate forms (non-legal person CJVs and partnerships) in the context of investment businesses will transform the general bias against unincorporated forms of FDI. Because of that bias, foreign companies (outside the few sectors where business operations through the RO and branch forms are permitted) have in the past been found to have establishments in China for tax purposes mostly in connection with the exploration and extraction of natural

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52. Partnership Enterprise Law, *supra* note 48, art. 108.

53. For further discussion of this dilemma and draft FIP regulations circulated in 2007, see Wei Cui, *China: Will Partnership Law Be Worth It?*, XXVII INT'L FIN. L. REV., Sept. 2008, at 30–32.

54. *Id.*

55. See Ruihua Sun, *China's Venture Capital at a Turning Point*, 130 NEW ECON. WKLY, April 3, 2007 (in Mandarin), available at <http://www.daokan.com/ArticleShow.asp?ArticleID=2310&ArticlePage=1> (last visited Feb. 14, 2010).

56. See Rick Carew, *China Cheers Private-Equity Home Teams*, WALL ST. J., Sept. 14, 2007, at C1; Rick Carew, *Chinese Private-Equity Fund's New Role*, WALL ST. J., Nov. 23, 2007, at C3; Rick Carew, *New Private-Equity Fund Targets Deals in China*, WALL ST. J., Feb. 4, 2008, at C3; *China Onshore Private Equity Funds* (Clifford Chance Client Briefing), Nov. 2007 (on file with author).

57. See Rick Carew, *Buyout Firms Race to Build Yuan Funds to Tap China*, WALL ST. J., Aug. 21, 2009, at C2 (reporting that draft rules governing yuan private-equity funds are in the hands of China's cabinet).

resources, construction and installation projects, and other activities of a relatively temporary nature.<sup>58</sup> The introduction of investment or operating partnerships (or partnership-like entities) would create significant new challenges for tax rules, as further discussed in Sections II.C and III.B, *infra*.

### C. *Increased Foreign Portfolio Investment*

Besides giving impetus to the development of non-corporate business forms, foreign investments in Chinese VC and PE funds also represent another trend with important implications for inbound taxation. Such funds often acquire significant stakes in target companies, and, on occasion, provide active financial and management services to the portfolio companies. For this reason, whether investment *by* a fund should be treated as passive investment may be subject to debate. On the other hand, the investments made *in* these funds by limited partners are more clearly characterized as passive investments, and therefore can be regarded as part of a broader pattern of increased foreign portfolio investment (FPI) in China.

Traditionally, official Chinese policy discounted the need for FPI. Because of the high domestic savings rate and other factors, China was not thought to need financial capital *per se*.<sup>59</sup> Instead, the attraction of foreign investment was the introduction of technologies and know-how (and until recently, the development of China's export economy), and this could happen only through FDI.<sup>60</sup> Thus China's foreign investment regime has been heavily biased toward equity as opposed to debt investments.<sup>61</sup> Even for equity investments, foreigners are encouraged to invest only in certain sectors where China's technological needs are obvious, and are restricted or prohibited from investing in disfavored sectors.<sup>62</sup>

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58. For a discussion of the tax rules in this area, see *Joint Oil and Gas Exploitation Between Foreign and Chinese Companies* (Deloitte World Tax Advisor), Mar. 20, 2009, available at [http://deloitte.12hna.com/newsletters/2009/WTA/a090320\\_1.pdf](http://deloitte.12hna.com/newsletters/2009/WTA/a090320_1.pdf) (last visited Feb. 14, 2010).

59. See Eswar Prasad & Shang-Jin Wei, *The Chinese Approach to Capital Inflows: Patterns and Possible Explanations*, in *CAPITAL CONTROLS AND CAPITAL FLOWS IN EMERGING ECONOMIES: POLICIES, PRACTICES AND CONSEQUENCES* 421 (Sebastian Edwards ed., 2007).

60. *Id.*

61. *Id.* at 433; see also Neal Stender et al., *Foreign Currency Debt and Conversion Controls Tightened for Strong RMB Era*, 18 *CHINA LAW & PRACTICE* 73, 73 (July/Aug. 2004) (summarizing the basic workings of cross-border borrowing by FIEs in China).

62. See generally Prasad & Wei, *supra* note 59, at 429; see also, generally, YASHENG HUANG, *SELLING CHINA—FOREIGN DIRECT INVESTMENT DURING THE REFORM ERA*

This policy has had two consequences. One is that is that FPI has lagged behind FDI in China in terms of volume. According to IMF data, by 2006, the stock of FPI into China was worth only a little over \$200 billion, much less than the official FDI stock of \$742 billion.<sup>63</sup> In comparison, the U.S. attracted slightly more equity FPI than FDI in 2007; the volume of each exceeded \$2 trillion.<sup>64</sup> The other consequence is that while the total amount of China-bound FPI is still significant, most such investments have taken place offshore, as Chinese companies listed their stock and debt securities in foreign exchanges in Hong Kong, the U.S., etc.<sup>65</sup> Given their offshore nature, very few of these investments contributed to the development of domestic capital markets.

More recently, the Chinese government has come to view FPI more favorably, precisely because of its potential benefit for China's onshore markets.<sup>66</sup> For example, there has been a shortage on China's stock market of experienced institutional investors with long-term investment objectives;<sup>67</sup> so in 2002, the domestic stock and bond markets were opened in a limited fashion to qualified foreign institutional investors (QFIIs).<sup>68</sup> In 2006 the QFII regime was further liberalized.<sup>69</sup> Similarly, in the field of PE

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(Cambridge Univ. Press 2003) (arguing that the above policy was not in fact effective, that what passed as FDI was in many cases financial investment, and that this occurred because Chinese domestic enterprises, faced with a dysfunctional domestic financial service sector, obtained foreign financing under the pretension of seeking technological know-how).

63. See International Monetary Fund, *Portfolio Investment: Coordinated Portfolio Investment Survey*, <http://www.imf.org/external/np/sta/pi/cpis.htm> (last visited Feb. 14, 2010) [hereinafter CPIS]; State Admin. of Foreign Exchange, *China's International Investment Position 2007* (in Mandarin), [http://www.gov.cn/gzdt/2008-06/21/content\\_1023491.htm](http://www.gov.cn/gzdt/2008-06/21/content_1023491.htm) (last visited Feb. 14, 2010) [hereinafter SAFE].

64. See CPIS, *supra* note 63; SAFE, *supra* note 63; Elena L. Nguyen, *International Investment Position of the United States at Year-End 2007*, Bureau of Economic Analysis Survey of Current Business Online, July 2008, at 9, available at [http://www.bea.gov/scb/pdf/2008/07%20July/0708\\_iip.pdf](http://www.bea.gov/scb/pdf/2008/07%20July/0708_iip.pdf) (last visited Feb. 14, 2010).

65. See International Monetary Fund, *Coordinated Portfolio Investment Survey Guide* (2001), at 11-12 (IMF data collection attempts to identify residence of issuer regardless of place of listing); ALICE DE JONGE, CORPORATE GOVERNANCE AND CHINA'S H-SHARE MARKET 56 (Edward Elgar 2008) ("By December 2003, a total of 93 Chinese companies had issued shares outside of China, raising 27.1 billion US dollars in total." This number should also have risen substantially by 2006.).

66. See Andrew McGinty & Andrew Godwin, *The Missing Piece of the Puzzle: New QFII Rules Open a Share Market*, CHINA LAW AND PRACTICE, Dec. 2002 at 10.

67. *Id.*

68. See *id.* Before 2002, foreigners were allowed to trade Chinese stock in the domestic exchanges only among themselves, in a separate market from where domestic investors traded. See also STEPHEN GREEN, CHINA'S STOCKMARKET 50-55 (Profile Books, The Economist Series 2003).

69. See Taylor Hui & Vivien Teu, *China QFII Rules Revised—Significant Developments for Foreign Fund Managers*, CHINA LAW AND PRACTICE, Nov. 2006 at 9.



and VC investing, it is thought that foreign institutions and professionals operating in such asset classes possess important expertise in evaluating and improving business performance and governance, and their participation is needed if the field is to develop quickly.<sup>70</sup> The latest signs of this policy orientation include the Ministry of Commerce's decision in March 2009 to delegate the authority to approve new foreign-invested venture capital enterprises with total capital not exceeding \$100 million<sup>71</sup> to provincial authorities, which are generally regarded as more eager to promote foreign investments than national agencies.<sup>72</sup>

Not surprisingly, because China's inbound taxation has traditionally focused on FDI (as has the rest of the regulatory system), its operation has faltered as FPI in China expands. For example, at the onset of the QFII regime, it was immediately unclear how withholding taxes would apply to income received by QFIIs.<sup>73</sup> Should the tax exemption then granted for repatriation of profits on FDI apply to dividends paid on stock held by QFIIs as well? Should the tax on capital gain applicable to the sale of FDI investments also apply to gain on the trading of stock where no suitable withholding mechanisms have been put in place? If China were to tax QFII income, how would it administer the granting of treaty benefits? Until quite recently,<sup>74</sup> in the absence of explicit guidance, QFIIs (and their customers on behalf of whom QFIIs invested and traded in China) did not have to pay Chinese income tax on many types of investment income without knowing whether there was any legal basis for this *de facto* exemption or how long it would last.<sup>75</sup> We will see further below that other forms of FPI in China, for example, real estate investments,<sup>76</sup> have generated their share of long-standing questions about appropriate tax treatments. While, unlike the onshore investment fund and QFII areas, there has been no significant liberalization in recent years in these other areas of FPI, if any momentum gathers for clarifying the tax treatment of

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70. See, e.g., Yan Zhou, *Blackstone Sets Up New Private Equity Fund in Pudong*, CHINA DAILY, Aug. 18, 2009, available at [http://www.chinadaily.com.cn/bizchina/2009-08/18/content\\_8581500.htm](http://www.chinadaily.com.cn/bizchina/2009-08/18/content_8581500.htm) (last visited Feb. 14, 2010).

71. See *supra* notes 45–47 and accompanying text.

72. See *Shang zi han* [2009] 9 [Notice Regarding the Approval of Foreign-Invested Venture Capital Enterprises and Venture Capital Management Enterprises] (promulgated by the Ministry of Commerce, Mar. 5, 2009); O'Melveny & Myers, *China Law and Policy Newsflash: Deregulation of Foreign-invested RMB Funds and Managers of Private Equity*, Mar. 17, 2009 (on file with author).

73. See Kehong Wu, *QFII Investments in Chinese Stock—A Feast of Tax Exemptions?* (in Mandarin), 2 INT'L TAXATION IN CHINA (*shewai shuiwu*) 73, 73–76 (2008).

74. See *infra* notes 144–49 and accompanying text.

75. See Kehong, *supra* note 73, at 74–75.

76. For a discussion of foreign real estate ownership, see *infra* notes 109–115 and accompanying text.

onshore funds and QFIIs, there may be implications for the whole range of FPI as well.

## II. STATUTORY CONCEPT OF "ESTABLISHMENT," ITS EVOLUTION AND IMPORTANCE

Before I examine the existing interpretations of "establishment," an explanation is in order regarding the statutory framework within which the concept has its place. China's enterprise income tax and the individual income tax (IIT) currently fall under two separate statutory regimes, and "establishment," a concept employed by the EIT Law, does not apply for IIT purposes.<sup>77</sup> In fact, not only is the concept inapplicable in connection with individual taxpayers, but the current structure of the IIT also renders the distinction between net- and gross-income taxation relatively unimportant for foreign individuals. Under China's Individual Income Tax Law and underlying regulations,<sup>78</sup> individuals are effectively classified as residents and nonresidents on the basis of domicile and physical presence in China,<sup>79</sup> with residents being subject to taxation on worldwide income.<sup>80</sup> Non-residents generally are not required to file income tax returns.<sup>81</sup> Their income from labor services performed in China, if not exempt under domestic or treaty law,<sup>82</sup> is taxed by way of withholding, and they are taxed on other income at flat rates, also via withholding, regardless of nexus to China.<sup>83</sup> Moreover, the IIT allows few deductions and credits, and

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77. The concept does not appear under the Individual Income Tax Law (promulgated by the Nat'l People's Cong., Sept. 10, 1980, as last amended on Dec. 29, 2007), translated in LAWINFOCHINA (last visited Feb. 14, 2010) [hereinafter IIT Law] or its regulations (Regulations on the Implementation of Individual Income Tax (promulgated by the State Council, Feb. 18, 2008, effective Jan. 28, 1994), translated in LAWINFOCHINA (last visited Feb. 14, 2010) [hereinafter IIT Law IR].

78. See IIT Law, *supra* note 77; IIT Law IR, *supra* note 77.

79. IIT Law, *supra* note 77, art. 1; IIT Law IR, *supra* note 77, arts. 2, 3 and 6.

80. IIT Law, *supra* note 77, art. 1.

81. See *Guo shui fa* [2006] 162 [Circular of the State Administration of Taxation Concerning Printing and Distributing the Measures for the Self-Declaration of Individual Income Tax] (promulgated by the Ministry of Commerce for Trial Implementation, Nov. 6, 2006) art. 4; see generally Wei Cui, *China's New Personal Income Tax Return-Filing Regime*, 45 TAX NOTES INT'L 977 (2007).

82. Domestic law, following the treatment of dependent services in income tax treaties, exempts compensation received by any nonresident individual who (1) is present in China for less than 90 days during the year, and (2) receives payment from a foreign employer, (3) the cost of which payment is not borne by a Chinese "establishment" of the employer. IIT Law IR, *supra* note 77, art. 7. Actual income tax treaties usually extend the length of the period in (1) to 183 days.

83. IIT Law, *supra* note 77, art. 3; IIT Law IR, *supra* note 77, arts. 4 and 5.

essentially only labor service income is taxed at progressive rates.<sup>84</sup> The only category of income received by an individual that is subject to genuine net-income taxation is self-employment income.<sup>85</sup> However, foreign individuals are largely precluded by non-tax regulatory law from engaging in activities that would generate such income.<sup>86</sup>

This might seem to limit the significance of the “establishment” concept for Chinese inbound taxation, but a fundamental feature of the EIT Law implies otherwise. The EIT Law treats all foreign entities in the same way, as though they are corporations.<sup>87</sup> No foreign pass-through entities are recognized even though domestically, the pass-through concept applies to partnerships and certain other entities.<sup>88</sup> Thus, foreign partnerships, trusts, etc., investing in China would all be subject to the test of whether they have a Chinese establishment. In addition, for regulatory reasons, outside the context of investments in real estate, foreign individuals rarely invest directly into China (whether the nature of the investment is FDI or FPI), and almost always use intermediate entities.<sup>89</sup> As a result, despite its absence from the IIT rules, the notion of “establishment” is relevant to foreign individual investors in China as well.

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84. See Li Jinyan, *China's Individual Income Tax: A 26-Year-Old Infant*, 43 TAX NOTES INT'L 297, 297 (2006).

85. IIT Law, *supra* note 77, art. 6.

86. See General Principles of the Civil Law (promulgated by the 6th Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) art. 26, *translated in* LAWINFOCHINA (generally, only citizens are permitted to register as “individual industrial and commercial households,” *i.e.*, sole proprietorships); *see also* Regulations on Individual Industrial and Commercial Households art. 2 (State Council draft regulation circulated for public comment, July 2009), *available at* [http://yjjian.chinalaw.gov.cn/lismsPro/law\\_download/fulltext/1248161068168.doc](http://yjjian.chinalaw.gov.cn/lismsPro/law_download/fulltext/1248161068168.doc) (last visited Feb. 14, 2010).

87. Article 1 of the EIT Law defines enterprises subject to the enterprise income tax as all organizations receiving income. Only specific types of entities formed in China (*i.e.*, partnerships and single-individual-owner companies) are excluded from the definition. *See* EIT Law IR, *supra* note 12, art. 2.

88. *See generally* Wei Cui, *The Prospect of New Partnership Taxation in China*, 46 TAX NOTES INT'L 625 (2007) [hereinafter *Prospect of New Partnership Taxation*].

89. Telephone Interview and written correspondence with both Lawrence Sussman, Partner, O'Melveny & Myers and Shaolin Luo, Partner, Simpson Thacher & Bartlett, in Beijing, China (Nov. 23, 2009) (written correspondence on file with author).

A. *Statutory and Quasi-Statutory Definitions*<sup>90</sup>

Ever since the first tax statute applicable to foreign and foreign-invested companies was enacted in 1981,<sup>91</sup> Chinese tax law has used the concept of "establishment." Under that statute—the Foreign Enterprise Income Tax Law—income derived from a Chinese "establishment" was taxed, after appropriate deductions, at graduated rates (with the top rate at 40%),<sup>92</sup> whereas in the absence of an establishment, a foreign company would be taxed at a flat 20% rate on the gross amount of any dividends, interest, rent, royalties and other income from sources within China.<sup>93</sup> Neither the law nor its implementing rules contained a concept that characterized income as "effectively connected" with an "establishment."<sup>94</sup> Therefore, at least on paper, the 1981 law is consistent with a "force of attraction" regime: as long as an "establishment" exists, all Chinese-source income would be subject to net-basis taxation. It is unclear whether the law was interpreted and enforced in this way, although the answer is likely to be no.<sup>95</sup>

Under the Foreign Invested Enterprise and Foreign Enterprise Income Tax Law of 1991, the consequences of having an "establishment" in China were reformulated. Income effectively connected with the "establishment" would still be taxed on a net-income basis, but Chinese-source income not effectively connected with an "establishment" was only

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90. Within the Chinese legal system, material statutory terms and provisions are often left to be defined and elaborated by the State Council instead of by the national legislature, and the State Council is often the de facto ultimate decisionmaker in tax lawmaking. Thus, the discussion here treats implementation regulations issued by the State Council as quasi-statutory.

91. Foreign Enterprise Income Tax Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 13, 1981, effective Jan. 1, 1982), *translated in ASIANLII* (last visited Feb. 14, 2010) [hereinafter 1981 FEITL], *replaced by* Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises (promulgated by the Standing Comm. Nat'l People's Cong., April 9, 1991, effective July 1, 1991), *translated in ASIANLII* (last visited Feb. 14, 2010) [hereinafter 1991 FEITL].

92. 1981 FEITL, *supra* note 91, arts. 1-3.

93. *Id.* art. 11.

94. *See* Rules for the Implementation of the Income Tax Law for Foreign Enterprises (promulgated by the Ministry of Finance, Feb. 21, 1982), *translated in ASIANLII* (last visited Feb. 14, 2010) [hereinafter 1982 FEITL IR].

95. Foreign taxpayers still face fragmented tax administration in China: presence or activities in a particular locality could trigger tax return filing and other compliance obligations enforced by the tax authorities in that particular locality, without regard to the taxpayer's other activities elsewhere. Therefore, a local tax bureau may not regard itself as having the authority to tax a foreign company, which has an "establishment" within its jurisdiction, on other income received elsewhere.

subject to withholding tax on the gross amount.<sup>96</sup> Moreover, the definition of “establishment” itself was further developed. For example, according to the 1981 FEITL, a “business agent” could constitute an establishment,<sup>97</sup> but no definition was provided for the term. By contrast, the regulations implementing the 1991 FEITL explicitly defined business agent, albeit narrowly focusing on trade-related agency activities.<sup>98</sup> (As discussed below, this narrow definition of a business agent allowed for a significant 2003 ruling in favor of foreign taxpayers in the VC fund context.) Similarly, the non-agency, physical presence type of “establishment” was redefined to include a larger variety of physical business presences.<sup>99</sup>

The 2007 EIT Law and its implementing regulations (which together constitute what I call the “new EIT regime”) introduced what are perhaps the most significant changes to the definition of “establishment” to date. First, with respect to the agency type of establishment, the new law would find such an “establishment” where “a nonresident enterprise entrusts an agent to engage in production or trade, including signing contracts or storing and delivering commodities on behalf of the [principal] on a regular basis.”<sup>100</sup> This is a broader definition of “business agents” than under previous law, most fundamentally because it is tied to the agent’s actions in production or trade (*shengchan jingying*), which potentially could be interpreted to cover many activities<sup>101</sup>. In similar fashion, the new law no longer defines the physical presence type of “establishment” merely by enumerating examples. Instead, it provides a catch-all category, “other

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96. 1991 FEITL, *supra* note 91, art. 19. Although the statutory language states only that Chinese-source income effectively connected with an “establishment” would be subject to net-income taxation, subsequent regulations defined Chinese-source income as including any income, even if arising outside China, that is effectively connected with a Chinese establishment. See Detailed Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (promulgated by the State Council, June 30, 1991, effective July 1, 1991) art. 6., translated in LAWINFOCHINA (last visited Feb. 14, 2010) [hereinafter 1991 FEITL IR]. This is based on an erroneous understanding of the function of source rules, and has been corrected by the EIT Law and the EIT Law IR.

97. 1982 FEITL IR, *supra* note 94, art. 2(1).

98. A business agent was defined as a person “engaged in business as an agent for the principal and (1) regularly representing the principal in sourcing and purchasing, as well as in signing purchase contracts and buying goods on the principal’s behalf; (2) entering into an agency agreement or contract with the principal, regularly storing products or goods owned by the principal and delivering these products or goods to other parties on the principal’s behalf; or (3) being awarded the authority to regularly represent the principal in signing sales contracts and in accepting purchase orders.” 1991 FEITL IR, *supra* note 96, art. 4.

99. *Id.* art. 3.

100. EIT Law IR, *supra* note 12, art. 5.

101. *See id.*

establishments engaged in production or trade."<sup>102</sup> The category of physical establishments is thus also open-ended, and the main criterion for determining its scope is whether there is engagement in "production or trade."<sup>103</sup>

How, then, is the term "production or trade" to be understood? The answer is that although the term has been employed in the definition of "establishment" from the beginning,<sup>104</sup> it has never been defined in statutes, administrative regulations, or agency rulings.

The closest that the law has come to defining the term is the following. Regulations under both the 1981 FEITL and the 1991 FEITL distinguished between two types of income: "income from production or trade" and "other income." Whereas "income from production or trade" was defined, circularly, by enumeration of various industries and trades and then a catch-all category of "other income from production or trade,"<sup>105</sup> "other income" was defined as "dividend, interest, income from rental or transfer of property, royalties and income from transfer of patents and intellectual property rights, as well as income not derived from the carrying on of a trade."<sup>106</sup> It would appear logical to infer from the distinction between these two types of income that the mere holding or disposition of stock, debt, tangible property, and intellectual property, which does not generate "income from production or trade" but only "other income," would not constitute "production or trade." This inference will be particularly tempting for those familiar with the practice in the U.S. (and similar practices in OECD countries) of distinguishing between mere investments and the carrying on of a "trade or business."<sup>107</sup>

However, the validity of this inference in the Chinese context is doubtful, not because of any contrary interpretation of the term "production or trade" but for an opposite and striking reason: no known official pronouncement has ever relied on the distinction between "income from production or trade" and "other income." Indeed, perhaps precisely because of a perceived lack of relevance of the distinction, it has been eliminated in the new EIT Law and the regulations that have been issued so far. This is, of course, rather ironic, since the new EIT regime has given the government greater latitude in interpreting the meaning of both the physical

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102. *Id.*

103. *Id.*

104. 1982 FEITL IR, *supra* note 94, art. 2.

105. *Id.*

106. *Id.* art. 4; 1991 FEITL IR, *supra* note 96, art. 2.

107. *See, e.g.,* Higgins v. Comm'r, 312 U.S. 212 (1941); Chang Hsiao Liang v. Comm'r, 23 T.C. 1040 (1955); *see also* Ross, *supra* note 13, at 295, for a discussion of OECD practice.

presence and agency types of establishment,<sup>108</sup> and the only articulated criterion for such interpretation is whether there is engagement in “production or trade.”

Against this background of interpretive vacuum, two administrative announcements stand out in that they have directly delineated the scope of “establishment.” I will examine these now, and consider to what extent they shed light on “production or trade.”

### B. *Administrative Announcements*

In 1996, the State Administration of Taxation (SAT) issued a circular regarding rental income received by foreign enterprises.<sup>109</sup> It states that if a foreign enterprise owns and rents out a house, building or other real property in China, but has not set up an “establishment or site” to carry out routine management of the property, it is subject to income tax on the rental income it receives on a gross income basis at the withholding tax rate.<sup>110</sup> If the foreign enterprise entrusts an agent to manage the real property in question (and if, where a relevant income tax treaty applies, the agent is not an independent agent), then the foreign enterprise should be treated as having an “establishment” in China and subject to tax on a net income basis.<sup>111</sup>

The background of this circular is unclear, but its aim was probably to ensure some type of income tax collection on real estate rent received by foreigners, without particular emphasis on differential treatment between income derived from an “establishment” and income in the absence of an establishment. For example, in its instructions on the implementation of the circular, the Beijing State Tax Bureau explicitly stated that, for rental income treated as effectively connected with an “establishment” under the SAT circular, a deemed profit of 30% should be used in computing tax liability.<sup>112</sup> Had the 33% enterprise income tax rate been applied, the resulting 9.9% tax burden would be close to the 10% withholding tax rate on income not effectively connected with an establishment.<sup>113</sup> Tax bureaus

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108. *See supra* notes 100–103 and accompanying text.

109. *Guo shui fa* [1996] 212 [Notice Regarding Taxing Rental Income of Foreign Enterprises from Real Property within China] (promulgated by the State Admin. of Taxation, Nov. 20, 1996) [hereinafter *Guo shui fa* [1996] 212].

110. *Id.*

111. *Id.*

112. *Jing guo shui* [1997] 27 [Notice Regarding the Taxation of Rental Income of Foreign Enterprises by Renting Out Buildings in China] (promulgated by the Beijing State Tax Bureau, Jan. 27, 1997).

113. *See Guo fa* [2000] 37 [Notice Regarding Reduced Taxation of Interest and Other

in Shanghai allowed a similar approach and also provided for a deemed profit of 30%.<sup>114</sup> This suggests that the distinction made in the SAT circular was merely theoretical and did not have the intention of either encouraging foreign investment in real estate or securing greater revenue for the government.<sup>115</sup>

Nonetheless, the text of the circular suggests, at least in the real estate context, the distinction between merely holding an asset and operating or using that asset.<sup>116</sup> This resonates with a well-established body of U.S. law, going back to at least the 1940s, providing that mere real estate holding without servicing and maintaining the property does not give rise to a U.S. trade or business.<sup>117</sup> Conversely, under U.S. law, if a nonresident engages an agent to actively manage real property in the U.S., then the nonresident generally would be treated as engaging in a U.S. trade or business.<sup>118</sup> The 1996 SAT circular seems to have provided an extremely condensed version of this doctrine, and it is consistent with the earlier tax regulations characterizing rental income as other than "income from production or trade."<sup>119</sup>

A second administrative announcement on the scope of "establishment" came in 2003<sup>120</sup> and was associated with a well-known government effort to promote venture capital investments in China.<sup>121</sup> At the start of 2003, several government ministries jointly issued regulations

Income from China Derived by Foreign Enterprises] (promulgated by the State Council, Nov. 18, 2000).

114. *Hu shui wai* [1997] 90 [Notice Regarding the Taxation of Rental Income of Foreign Enterprises by Renting Out Buildings in China] (promulgated by the Shanghai State and Local Tax Bureaus, July 11, 1997) [hereinafter *Hu shui wai* [1997] 90].

115. By contrast, in most of the early U.S. cases in which taxpayers and the government disputed whether real estate investment in the U.S. constituted a U.S. trade or business, important differences in tax liability existed (e.g., taxpayers sought to claim large deductions). See, e.g., *Lewenhaupt v. Comm'r*, 20 T.C. 151, 162 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955).

116. *Guo shui fa* [1996] 212, *supra* note 109.

117. See, e.g., *Neill v. Comm'r*, 46 B.T.A. 197 (1942); *De Amodio v. Comm'r*, 34 T.C. 894 (1960).

118. *De Amodio*, 34 T.C. at 904–905 (citing *Lewenhaupt v. Comm'r*, 20 T.C. 151 (1953)).

119. See *Hu shui wai* [1997] 90, *supra* note 114 (Shanghai tax authorities held further that "routine management" of real property involved the capacity to sign rental agreements, collect rent, to improve, repair and decorate the property, and "other substantive management activities," but the mere hiring of persons to clean, guard, or perform daily maintenance of the property is not sufficient).

120. *Guo shui fa* [2003] 61 [Notice Regarding the Payment of Enterprise Income Tax by Foreign Invested Venture Capital Companies] (promulgated by the State Admin. of Taxation, June 4, 2003) [hereinafter *Guo shui fa* [2003] 61].

121. See *supra* Section I.B.



on the formation of foreign-invested venture capital investment enterprises (FIVCIEs); a few months later, the SAT issued clarifications as to how such enterprises would be taxed.<sup>122</sup> According to the SAT pronouncement (the 2003 VC Tax Rules),<sup>123</sup> if a FIVCIE takes a “legal person” form (*i.e.*, its investors have limited liability), then it is taxed as a Chinese corporation.<sup>124</sup> If, on the other hand, it takes the “non-legal person” form (*i.e.*, some investors bear unlimited liability), then the enterprise and its investors have a choice of computing their tax liabilities either at the enterprise or the investor level, but are not taxed at both levels.<sup>125</sup>

How, though, should the foreign investors be taxed if they determine their tax liabilities separately? Should they be treated as having an “establishment” and taxed on a net-income basis, or should they be subject only to gross-income taxation? The 2003 VC Tax Rules provide that, generally, investors in non-legal person FIVCIE should be treated as having establishments within China and be taxed accordingly.<sup>126</sup> However, if the FIVCIE does not have its own management office, and does not directly manage and advise its investments, but instead contracts with a separate management entity to conduct all of its daily affairs and manage its investments, then investors would not be treated as having an “establishment” in China by virtue of investing in the FIVCIE.<sup>127</sup>

While the circular contains no explicit argument for the conclusion, the underlying reasoning appears to be the following. As previously discussed, in general, a foreigner’s “establishment or site” in China can take the form either of a physical presence (*e.g.*, a business office) or a business agent. Under Chinese commercial law, the investors in a non-legal person VC fund own the assets and rights of the business and are principals of its agents.<sup>128</sup> Therefore, any business office or agent of the fund itself would be deemed, for non-tax purposes, to be the office or agent of the fund’s investors. In the scenario described in the 2003 VC Tax Rules in which foreign investors are treated as not having an establishment, tax authorities

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122. *Guo shui fa* [2003] 61, *supra* note 120.

123. *Id.*

124. *Id.*

125. *See also* 1991 FEITL IR, *supra* note 96, art. 7 (stating that participants in a “non-legal person” cooperative joint venture may elect to pay EIT separately, in lieu of the joint venture itself).

126. *Guo shui fa* [2003] 61, *supra* note 120.

127. *Id.*

128. Implementation Rules on Chinese-Foreign Contractual Joint Ventures, arts. 50 and 52 (promulgated by the Ministry of Foreign Trade and Econ. Coop., Aug. 7, 1995, effective Aug. 7, 1995), *available at* [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/RegulationsonForeignInvestment/t20060620\\_51088.jsp](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/RegulationsonForeignInvestment/t20060620_51088.jsp) (in translation) (last visited Feb. 14, 2010).

seem to have assumed that the fund does not have its own business office in China. (Whether the office of the external manager should be attributed to the fund was not considered.)<sup>129</sup> In addition, even if the external manager is an agent of the fund and its investors, there is no agency establishment. This is because under the tax law then in effect, only business agents engaged in the trading of goods were deemed to give rise to “establishments” for tax purposes.<sup>130</sup>

Unlike the 1996 SAT circular on foreign ownership of real estate, the 2003 VC Tax Rules had a genuinely positive effect, in that they enabled foreign investors to operate VC funds in China without the fear of being subject to net-income basis taxation.<sup>131</sup> Virtually all FIVCIEs formed until recently (before the revised Partnership Enterprise Law took effect) used the management company structure endorsed by the 2003 VC Tax Rules. However, as the foregoing analysis shows, the SAT’s position is technically based not on characterizing VC investing as a type of investment activity, and thus as different from “production or trade.” Instead, it is based on a narrow definition of “business agents”—a situation that the new EIT regime has already changed. Under that new regime, the questions can now be raised: Why isn’t the external manager a business agent of the fund and its investors? If it is, why don’t the foreign investors have a business agent “establishment” through the manager?

Taken together, the 1996 real estate circular and the 2003 VC Tax Rules demonstrate that the government has yet to confront the distinct tax issues raised by the developments in business forms described in Section I. These issues include basic items such as recognition of what is at stake in distinguishing net-income and gross-income taxation, as well as specialized items such as understanding the proper treatment of partnership and partnership-like forms. And most centrally, both rulings arose in the context of FPI, where a crucial issue is whether investment activities should be included in the scope of “production or trade” and therefore of “establishment.”<sup>132</sup> The 2003 VC Tax Rules skirted that crucial issue, whereas the earlier ruling only apparently addressed it (without embracing its full consequences).

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129. I.R.C. § 864(c)(5) (2009) (attributing the fixed place of business of a non-independent agent to a foreign person).

130. See *supra* note 98.

131. *Guo shui fa* [2003] 61, *supra* note 120.

132. See *supra* notes 105–107 and accompanying text.

C. *New Uncertainties*

Several recent developments in Chinese tax administration highlight both the urgent need for the immediate clarification of the scope of “establishment” and how, in the absence of sustained policy focus on the matter, parties can take widely divergent and inconsistent approaches to taxing foreign investment.<sup>133</sup> To begin, the 2003 VC Tax Rules<sup>134</sup> appear to have been made obsolete—ironic in light of the already paltry amount of guidance available regarding fund formation.<sup>135</sup> This is presumably due to the fact that the legal basis of those rules—the Implementation Regulations for the Foreign Invested Enterprise and Foreign Enterprise Income Tax Law of 1991—was replaced by the EIT Law on January 1, 2008.<sup>136</sup> Strictly speaking, therefore, there is no longer any valid legal guidance regarding the tax treatment of foreign invested venture capital investment enterprises.<sup>137</sup> However, because other central government ministries have issued several circulars in favor of the operation of FIVCIEs,<sup>138</sup> market participants appear to assume that it is not the government’s intention to adopt radically new and unfavorable tax rules for FIVCIEs, and new funds of this type continue to be formed.<sup>139</sup> While the 2003 VC Tax Rules can no longer be shown to local tax authorities as binding on the treatment of FIVCIEs, they are still presented as a reasonable way of taxing such entities in the absence of further guidance.<sup>140</sup>

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133. I am grateful to Lawrence Sussman and Min Huang at the Beijing office of O’Melveny & Myers for discussion of the developments reported in this Section.

134. See *Guo shui fa* [2003] 61, *supra* note 120.

135. There has been no formal announcement of revocation of the circular. Instead, it is shown as “void in whole” on the website of the State Administration of Taxation. State Admin. of Taxation, <http://202.108.90.178/guoshui/action/GetArticleView1.do?id=3716&flag=1> (last visited Feb. 14, 2010).

136. See 1991 FEITL IR, *supra* note 96, art. 7 (stating that non-legal person cooperative joint ventures may be exempt from entity level taxation). There is no similar provision under the EIT Law or EIT Law Implementation Regulations.

137. Some have gone so far as to suggest that such enterprises are no longer exempt from entity-level taxation. See Kevin Wang, *Foreign Investors in RMB Funds May Face Double Taxation*, 49 TAX NOTES INT’L 742, 742–43 (2008). As discussed in the ensuing text, the market has discounted the suggestion of such a radical change in policy.

138. See *supra* note 71 for deregulatory actions taken by the Ministry of Commerce; see also *Huizongfu* [2008] 125 [Replies to Questions Regarding the Application of Foreign Exchange for Domestic Equity Investments by Foreign Invested Venture Capital Investment Enterprises] (promulgated by the State Admin. of Foreign Exchange, Nov. 14, 2008) (facilitating foreign exchange conversion for FIVCIE investment activities).

139. Telephone Interview with Lawrence Sussman, Managing Partner, O’Melveny & Myers LLP, in Beijing, China (Nov. 23, 2009).

140. *Id.*

Needless to say, this state of affairs presents a significant legal risk to investors in FIVCIEs, if only because there is no legal impediment to the government reversing the treatment in the 2003 VC Tax Rules. But just as importantly, as discussed above,<sup>141</sup> the underlying reasoning in that regulation is in tension with the expansion of the scope of “business agent” type of “establishment” under the EIT Law Implementation Regulations. Thus, even if the 2003 VC Tax Rules had not been made obsolete, there would have been a question of how it could be reconciled with the new EIT regime. Another source of concern is that foreign invested partnerships are widely regarded as a competing business form for the formation of RMB funds that will be available soon,<sup>142</sup> whereas the 2003 VC Tax Rules, by their terms, do not apply to partnerships.<sup>143</sup> The adoption of new tax rules for foreign invested partnerships could trigger new scrutiny of the rationale underlying the 2003 VC Tax Rules. In that scenario, taxpayers and their advisors may be called upon to freshly defend, for example, why holding an equity interest in a partnership or a partnership-like entity in China (which has assets and activities in China) should not constitute an “establishment” in China. As we will see in Section III below, such a defense involves complex policy considerations and is not easy to carry out.

Aggravating this legal uncertainty in the fund formation area is the manner in which Chinese tax authorities have approached other related areas of foreign investment seemingly without awareness of the importance of the “establishment” concept, promulgating rules that imply contradictory positions. Two regulations that have recently attracted practitioners’ attention illustrate this point. The first is a circular issued by the SAT (State Administration of Taxation) at the beginning of 2009 that initiated the practice of withholding income tax paid to QFIIs (qualified foreign institutional investors) by companies with stock or bonds listed on the Chinese securities markets.<sup>144</sup> This regulation (Circular 47) brought an end to the previous status quo whereby QFIIs were not subject to any withholding tax at all (even though there appeared to be no legal basis for such an exemption).<sup>145</sup> A potential silver lining in Circular 47, however, is

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141. See *supra* notes 130–31 and accompanying text.

142. See *supra* notes 48–57 and accompanying text.

143. The 2003 VC Tax Rules apply only to entities formed under the Provisions Concerning the Administration of Foreign-Funded Venture Investment Enterprises. See *Guo shui fa* [2003] 61, *supra* note 120; Provisions Concerning the Administration of Foreign-Funded Venture Investment Enterprises, *supra* note 47.

144. *Guo shui han* [2009] 47 [Notice Regarding the Withholding of Enterprise Income Tax with Respect to Dividends and Interest Paid to QFII by Chinese Resident Enterprises] (promulgated by the State Admin. of Taxation, Jan. 23, 2009) [hereinafter *Guo shui han* [2009] 47].

145. See *supra* notes 73–75 and accompanying text; see also Jinji Wei, *A View on*

that it could be read as resolving an issue regarding “establishment” for QFIIs. As discussed in Section II.A, under the EIT Law Implementation Regulations, a foreign entity may be deemed to have an “establishment” in China by operating through a business agent, even one that is independent in nature.<sup>146</sup> Under this regulatory language, the QFIIs—foreign mutual funds, insurance companies, and other asset management companies—may all theoretically be deemed to have establishments in China via their onshore custodians and trading agents. Although this issue may be mitigated for QFIIs that are eligible for treaty benefits (as treaties generally provide that the conduct of business through independent agents does not give rise to permanent establishments),<sup>147</sup> not all QFIIs (or all customers that have accounts with QFIIs) are formed in treaty jurisdictions. Therefore, the question whether such foreign investors could be deemed to have “establishment” in China may remain unanswered.

Circular 47, by providing for the imposition of withholding tax on QFIIs, could be read as conclusively addressing this issue: since all QFIIs, regardless of whether they can claim the benefits of tax treaties,<sup>148</sup> are treated as subject to the withholding tax and not net-income basis tax, it could be inferred that no QFII is deemed to have an “establishment” in China through actions by independent agents alone.<sup>149</sup> This reading of Circular 47, however, is contradicted by another regulation the SAT issued during the same week. In this latter, widely discussed regulation (Decree 19),<sup>150</sup> the SAT requires all nonresident enterprises that provide labor services<sup>151</sup> in China to (1) register for tax purposes shortly after entering

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*Qualified Foreign Institutional Investors in China*, 56 TAX NOTES INT’L 275, 277 (2009). The regulation remains silent, however, on whether and how capital gain realized by QFIIs is to be taxed, thus leaving a large vacuum in this area.

146. See EIT Law IR, *supra* note 12.

147. See, e.g., United Nations Model Double Taxation Convention between Developed and Developing Countries (2001) art. 14.

148. *Guo shui han* [2009] 47, *supra* note 144.

149. Under EIT Law IR, income is effectively connected with an “establishment” if the “establishment” “possesses, manages, or controls properties through which income is earned.” EIT Law IR, *supra* note 12, art. 8. Since the securities owned by QFIIs are held (possessed) by onshore custodians, it is unlikely that such custodians are deemed to be establishments but the interest and dividend income is not deemed to be “effectively connected.”

150. See State Administration of Taxation Decree [2009] 19 [Provisional Administrative Measures on the Tax Administration of Contract Projects and Service Provisions for Nonresidents] (promulgated by the State Admin. of Taxation, Jan. 20, 2009, effective Mar. 1, 2009) [hereinafter State Administration of Taxation Decree [2009] 19]; Vivian Jiang & Koko Tang, *China Issues Guidance on Tax Treatment of Nonresidents on Contract Projects*, 2009 WORLDWIDE TAX DAILY, Feb. 24, 2009, at 34–35.

151. All labor services are included in the scope of the regulation. See State Administration of Taxation Decree [2009] 19, *supra* note 150, art. 3. The same regulation

into contracts for the provision of such services,<sup>152</sup> and (2) file income tax returns on both quarterly and annual bases.<sup>153</sup> Although nonresident enterprises may claim on their returns that their activities do not constitute permanent establishments under relevant treaties and therefore do not generate taxable income in China, there appears to be no exemption for the return filing requirement.<sup>154</sup>

The only circumstance under which the EIT Law requires nonresidents to file income tax returns in China is when such nonresidents have establishments in China.<sup>155</sup> The implicit position of Decree 19, therefore, seems to be that *any* provision of labor service in China—however transient and regardless of whether a fixed place of business is involved, no matter whether it is pursued through dependent or independent agents, and no matter whether it is pursued in the course of “production or trade”—would give rise to an “establishment” in China. This implicit position is contradictory to the implied position in Circular 47. Moreover, if it can be correctly attributed to the government, it will also amount to a fundamental and untenable expansion in the interpretation of “establishment.” This expansion is untenable because it implies that *any* physical presence in China in connection with service provision would constitute sufficient business nexus for a foreign entity to be taxed on a net-income basis in China (absent treaty protection). Already, at least some nonresident enterprises are resisting compliance with Decree 19.<sup>156</sup>

As surprising as it may seem that the SAT would adopt measures that are at once careless and contradictory, it is equally surprising how few tax practitioners in China have voiced criticism of Decree 19 for lacking legal authority.<sup>157</sup> This silence makes it (painfully) obvious that the domestic law concept of “establishment” has been neglected by Chinese tax administrators and tax practitioners alike, and that there is a widespread failure to recognize that the concept should have some substance of its own, independent of the treaty concept of establishment.

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also covered contract projects that nonresident enterprises have entered into (e.g., construction, installation, assembly, decoration and exploitation).

152. *Id.* arts. 5–6.

153. *Id.* arts. 12–13.

154. *Id.* art. 13.

155. EIT Law, *supra* note 2, art. 51.

156. Interview with Lawrence Sussman, *supra* note 139.

157. For existing commentary on Decree 19, see Jiang & Tang, *supra* note 150, at 34; Peng Tao & Sang Kim, *A Brief Examination of Recent Chinese Tax Rules on Nonresident Enterprises*, TAXES, Dec. 2009, at 39–52.

### III. POLICY ISSUES AND THE INTERPRETATION OF “ESTABLISHMENT”

#### A. *General Tax Policy Toward Inbound Portfolio Investment*

In this Section, I turn to the policy considerations that should guide Chinese lawmakers and tax authorities in responding to the issues highlighted in the last Section. The logic of the examination is as follows. In connection with a range of transactions either actively carried out today or anticipated for the near future, and including, among others, QFII activities on Chinese securities markets,<sup>158</sup> passive investments in domestic investment funds and in real estate, it is reasonable to assume that foreign investors would prefer not to be treated as having establishments in China.<sup>159</sup> There is a range of tax rules that could deliver this result. Viewing the question through the lens of U.S. tax law, for instance, one could suggest, for a start, a doctrine that treats largely passive investments as different in nature from business activities, or, in Chinese terminology, from “production or trade.”<sup>160</sup> But further, since the perceived benefit of inbound portfolio investment is not so much that it supplies additional capital to China, as it is that it would introduce sophisticated investors whose presence would contribute to capital market development, the performance of certain investment-related activities, such as due diligence and negotiation, trading, and exercise of investor rights, should be anticipated. Such activities should not trigger adverse tax consequences. One could address the concerns that would arise here for, for example, QFIIs, by excluding some types of securities trading from “production or trade,” analogous to the safe harbor for trading in stocks and securities of Code Section 864(b)(2)(A).<sup>161</sup> Investments in onshore funds may also benefit from such exclusion, depending on the nature of the funds’ activities.

How should one evaluate proposals like this? Clearly, the question is whether introducing such U.S.-style rules is consistent with China’s current policy objectives with respect to foreign investment. Even some

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158. See *supra* notes 67–69 and accompanying text.

159. This is mainly because the lower rates associated with the withholding tax (10% or less) generally more than compensate for the lack of deductions when income is taxed on a gross basis. See *supra* note 12 and accompanying text.

160. This could be thought of along the lines of U.S. judicial decisions that date back at least to *Higgins*. *Higgins v. Comm’r*, 312 U.S. 212 (1941). Such a doctrine would have to cope with variations in factual circumstances that could challenge one’s intuition about what is passive. The analog would be the judicial elaboration of the “considerable, continuous and regular” standard for “U.S. trade or business.” See Sicular & Sobol, *supra* note 13, at 735–43.

161. I.R.C. § 864(b)(2)(A) (2009).

preliminary reflection is sufficient to cast doubt on any easy assumption that it *must* be good for China to encourage foreign investment through tax rules. Instead, I will argue that the appropriate design of tax rules depends on understanding not only the wider economic context, but also the role tax policy plays relative to other regulatory policy. In particular, one should distinguish two conceptions of the role that tax policy might play. On the first conception, tax policy goals regarding foreign investment are set by general economic policy goals, and one may simply consider whether tax rules would in themselves advance such general goals. On the second conception, tax policy is a subordinate instrument to other regulatory policy, and it is only after considering the effects of other regulatory policy that one can choose objectives for tax policy. I will argue below that it is the second conception that more realistically characterizes the function of Chinese tax policy toward foreign investment. Interestingly, it is also on this second conception that arguments for rules favorable to foreign investors can be more cogently advanced.

#### 1. Assuming Similar Functions for Tax and Regulatory Policies

One potential model is to introduce U.S.-style rules to Chinese inbound taxation. To consider whether this would be appropriate, it is useful briefly to recall the historical origin of some of the current U.S. rules. Some fundamental components of current U.S. inbound tax system are the result of economic policy decisions that informed both tax and non-tax regulatory policies.<sup>162</sup> The most important example of this is perhaps the Foreign Investors Tax Act (FITTA) of 1966.<sup>163</sup> In the early 1960s, the U.S. faced a substantial balance-of-payment problem.<sup>164</sup> Despite a current account surplus from exports and significant current earnings on foreign investment, large outflows of U.S. investment capital were depleting the U.S. gold reserve and threatening the stability of the dollar.<sup>165</sup> The Kennedy and Johnson administrations offered comprehensive tax and non-tax policy responses to this situation, both by discouraging, or reducing the need for, certain types of outbound investment,<sup>166</sup> and by encouraging investment into the U.S.<sup>167</sup> These responses called for not only steps by the

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162. See Ross, *supra* note 13, at 288–90.

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.* With respect to outbound investments, for instance, tax policy responses included the enactment of controlled foreign corporation legislation and the interest equalization tax.

167. The imperative of improving the U.S. gold reserve was indeed so clear that even short-term deposits by foreigners in the United States, which “would not reduce the U.S.



Treasury and Congress to change tax rules, but also various actions by other government agencies as well as “the U.S. financial community” and U.S.-based international corporations.<sup>168</sup> The tax policy proposals that resulted in FITA, which abolished the force-of-attraction regime and enacted the trading safe harbors of Section 864(b), were accompanied by many other policy proposals aimed at inducing foreigners to purchase U.S. securities.<sup>169</sup>

Suppose that we conceive the design of Chinese inbound tax rules in general, and the interpretation of “establishment” in particular, as aimed at affecting foreign investments in a similar comprehensive fashion.<sup>170</sup> In that case, one would have to note immediately that China’s current international investment position is diametrically the opposite of the U.S.’ in the early 1960s,<sup>171</sup> and there is currently considerable official reservation about inbound investments. In the last few years, China has run a strong current account surplus and drawn large amounts of FDI, with the result that it now has accumulated the biggest foreign reserve in the world.<sup>172</sup> In addition to trade and FDI-related inflows, very sizeable amounts of other capital inflow are also present, although it has been difficult to identify the precise magnitude.<sup>173</sup> This additional inflow of capital is viewed by many observers to be the result of China’s fixed exchange rate policy and the expectation that renminbi will appreciate.<sup>174</sup> Although disagreement exists as to the extent to which the rapid capital inflows comprise “hot money”—in no small measure because there is disagreement about what is “hot money”<sup>175</sup>—the economic consequences of the inflow are evident: China’s

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payments deficit as customarily defined,” were to be encouraged, as they would “reduce the volume of liquid dollar assets that foreign central banks might use to buy gold.” *Report to the President of the United States From the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad*, 13 (1964) available at [http://www.sechistorical.org/collection/papers/1960/1964\\_0427\\_TaskForceForeign.pdf](http://www.sechistorical.org/collection/papers/1960/1964_0427_TaskForceForeign.pdf) (last visited Feb. 14, 2010).

168. See generally *id.* Other government agencies involved included the Securities and Exchange Commission, the Federal Reserve, and the Department of State.

169. *Id.* at 13.

170. This would not be completely appropriate. See *infra* notes 191–94 and accompanying text.

171. See *supra* notes 184–89 and accompanying text.

172. Andrew Batson, *China's Reserves Expand*, WALL ST. J., Jan. 16, 2010, at A-10.

173. See Prasad & Wei, *supra* note 59, at 8–12; Calla Wiemer, *The Currency: A Tisket, a Tasket, a Band Not a Basket*, 9.2 CHINA ECONOMIC QUARTERLY, at 42–46 (2005). The difficulty with identifying other inflows has to do with the uncertain amount of reserve increases attributable to appreciation in official asset holdings.

174. See Prasad & Wei, *supra* note 59, at 10, 12.

175. The term “hot money” typically refers to speculative flows of capital—particularly flows into countries with weak financial markets and institutions—that could potentially switch directions within a short time. See Prasad & Wei, *supra* note 59, at 10.

foreign reserve is more and more likely to exceed the amount of optimal reserves, and the indirect addition to the domestic monetary base may contribute to inflationary pressure.<sup>176</sup> Moreover, it has been suggested that absent a currency revaluation, and as long as the domestic savings rate continues to exceed the rate of investment, the accumulation of reserves will continue.<sup>177</sup> An analogy has indeed been drawn between this situation and a particular era in U.S. economic history: not the 1960s with large capital outflow and balance of payment problem under the Bretton Woods system, but the gilded age of the 1920s.<sup>178</sup>

Economists disagree as to whether China should try to change this state of affairs by revaluing the renminbi.<sup>179</sup> In any case, the Chinese government has taken a series of ad hoc measures to mitigate the risk of high domestic liquidity and the non-optimality of high reserves. For example, it has loosened capital controls for outbound investments by Chinese individuals<sup>180</sup> and encouraged Chinese state-owned enterprises to invest abroad.<sup>181</sup> It has also relaxed requirements for repatriation of profits of foreign operations.<sup>182</sup> With respect to inbound investments, foreign exchange control has been tightened,<sup>183</sup> and a cautious approach has been

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176. See Michael Pettis & Logan Wright, *Hot Money Poses Risks to China's Stability*, FINANCIAL TIMES, July 13, 2008, at 9.

177. See generally Calla Wiemer, *Don't Bet on the Yuan*, FAR EASTERN ECONOMIC REVIEW, September 2008, at 23 [hereinafter *Don't Bet on the Yuan*].

178. Michael Pettis, *Money Matters: It's the Banking System, Not External Debt, That's Scary*, SOUTH CHINA MORNING POST, July 26, 2008, at 12.

179. China has already allowed the renminbi to float with respect to the dollar within a certain expanded range, but some argue that this is insufficient to deter speculative inflow. See Andrew Peale, *China Fights Speculative Hordes*, WALL ST. J. ONLINE, Jan. 12, 2010, available at <http://online.wsj.com/article/SB10001424052748704586504574653890470562198.html> (last visited Feb. 14, 2010). For a contrary view, see generally *Don't Bet on the Yuan*, supra note 177.

180. For a helpful overview of China's foreign currency regime and the capital control measures to sustain a fixed exchange rate and large foreign reserves, see Thomas Hall, *Controlling for Risk: An Analysis of China's System of Foreign Exchange and Exchange Rate Management*, 17 COLUM. J. ASIAN L. 433, 464 (2004).

181. For a review of recent policies encouraging outbound investment, see Daniel H. Rosen & Thilo Hanemann, *China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*, PETERSON INST. FOR INT'L ECON. (June 2009), available at <http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=1245> (last visited Feb. 14, 2010).

182. *Hui fa* [2009] 30 [State Administration of Foreign Exchange, Regulations on Foreign Exchange Administration of the Overseas Direct Investment of Domestic Institutions] (promulgated by the State Admin. of Foreign Exchange, Sept. 13, 2009) art.4 (stating that foreign exchange earned can be kept overseas).

183. See *Hui zong fa* [2008] 142 [Notice Regarding Operational Issues in Enhancing the Management of Payment Settlement in Foreign Exchange by Foreign Invested Enterprises]

taken particularly with respect to real estate investments.<sup>184</sup> These developments are best viewed as instinctive reactions by the relevant agencies and not as carefully considered new policies. Nonetheless, they represent the complete opposite of U.S. policy toward cross border investments in the 1960s, and, as long as the government continues to resist appreciation of the renminbi or other fundamental economic undertakings, they are likely to persist.

In light of this background, it would appear that any change in the tax system providing new inducements to foreign investment in China is unlikely because it would not fit the current, broader official attitude toward foreign investment. In particular, following the American model in delineating the boundary between net-income and gross-income taxation would seem to produce inconsistencies between tax policy and other policies. This could be said with respect both to the measure of excluding activities of trading securities from net-income taxation in the style of Code Section 864(b)(2), and the *Higgins*-style, more conservative and more longstanding measure of excluding passive investment holding from net-income taxation under case law.<sup>185</sup> Instead, it seems more consistent for China to maintain the status quo, even if that means keeping the interpretation of “establishment” in its muddled state.

However, the foregoing reasoning is based on a conception of tax policy as designed to target inbound investment in general, *pari passu* with non-tax regulatory policy. In reality, regulatory policy toward foreign investment has traditionally been dominant in China, whereas tax policy occupied a secondary role. Put differently, the range of transactions that tax rules are allowed to affect is antecedently shaped by regulatory policy. And insofar as tax policy and regulatory policy play different roles, they may also take on different characters.

## 2. Assuming That Tax and Regulatory Policies Have Different Functions

The most important feature of Chinese economic policy toward foreign investment is, of course, capital control.<sup>186</sup> The country’s capital

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(promulgated by the State Admin. of Foreign Exchange, Aug. 29, 2008).

184. *Jian zhu fang* [2006] 171 [Opinions on Regulation of Approval and Administration of Foreign Investment in the Real Estate Market] (promulgated by the Ministry of Commerce, Aug. 14, 2006).

185. While excluding trading activities from net-income taxation is not a prevalent international practice, excluding passive income is common at least among OECD countries. See Ross, *supra* note 13, at 332.

186. See generally Prasad & Wei, *supra* note 59.

account is only partially open, and only a selected group of foreign investments are allowed into China.<sup>187</sup> As mentioned earlier, FPI (both the debt and equity varieties) and foreign loans into China have been and still are relatively restricted, with FDI tending to dominate capital inflows.<sup>188</sup> Even FDI is restricted to limited sectors.<sup>189</sup> Moreover, once inside China, financing options for FDI projects are relatively limited, again partially as a result of the policy of capital control and the foreign exchange regulations that implement it.<sup>190</sup>

In striking contrast with this picture of severe restrictions, traditional tax policy toward FDI—which, starting in 2008, is being gradually phased out by the new EIT regime—had been extremely favorable.<sup>191</sup> Approved FDI projects received generous tax incentives and tax holidays,<sup>192</sup> resulting in much lighter tax burdens than those borne by domestically-owned enterprises.<sup>193</sup> But it would be a mistake to think that these inducements constituted the tax policy embodiment of a general favorable economic policy toward foreign investment, forgetting the careful selection that foreign investments have to go through. The tax incentives and holidays were available only to FDI of particular types,<sup>194</sup> and should be thought of as a targeted subsidy, extended to projects that are pre-selected by non-tax agencies. Put differently, instead of controlling the nature and form of foreign investment, tax policy tried to (positively) affect the quantity of such investments.

To answer these questions, some further methodological issues must be clarified. First, if favorable tax rules were to provide an incentive for increased foreign investment, it must be the case that foreign investors are in a position to respond to this incentive. For example, a key aspect in the current regulation of foreign investment in Chinese securities markets (*i.e.*, the QFII regime) is a quota on the overall volume of such investments.<sup>195</sup> If the demand for Chinese securities on the part of foreign

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187. *Id.*

188. *Id.*

189. *Id.*

190. In addition to the economic policy of capital control, regulatory barriers such as lengthy approval processes also raise the cost of foreign investment, leading commentators to conclude that “in terms of the overall legal regime, it is not obvious that China makes for a particularly attractive FDI destination.” See Prasad & Wei, *supra* note 59, at 18-20.

191. See Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 FLA. TAX REV. 669, 671-74 (2007).

192. *See id.* at 678-79.

193. *See id.* at 677, 690-91.

194. *See supra* notes 186-90 and accompanying text.

195. In December, 2007, the overall quota for initial QFII investment was raised from \$10 billion to \$30 billion. *See, inter alia*, Hou Lei, *China to Expand QFII Quota*, CHINA DAILY, available at [http://www.chinadaily.com.cn/china/2008-03/07/content\\_6518464.htm](http://www.chinadaily.com.cn/china/2008-03/07/content_6518464.htm)

investors is higher than this quota, the quota sets an effective ceiling on the volume of investment; more favorable tax treatments would not induce a larger volume, and would instead simply offer existing investors a windfall. This would not be effective tax policy. In contrast, if a favorable tax treatment is targeted as a threshold issue—foreign investors would invest only if a certain treatment is available and would not invest otherwise—then the justification for the treatment is stronger. To put it another way, it must be specified at what point on the demand curve are tax rules intended to affect investor behavior.

Second, it is important to specify what it means to treat foreign investments favorably. For example, under China's prior FDI tax regime, favorable treatment of FDI meant more than that the effective corporate tax rate was lower than in many other countries.<sup>196</sup> Instead, resident enterprises are divided into two groups: those that had significant foreign-ownership (FIEs, with 25% or more foreign-ownership), and those that had greater than 75% domestic ownership.<sup>197</sup> FIEs enjoyed better tax treatment from lower tax rates, greater use of deductions, and other measures.<sup>198</sup> This discriminatory treatment—"supra-national" treatment for foreign investment<sup>199</sup>—led to serious distortions, including, most importantly, efforts by domestic capital to disguise itself as foreign capital investing in China.<sup>200</sup> Any proposal for new favorable treatments of foreign investments that creates significant risks of this type of distortion, it seems, should be avoided.

These considerations suggest that any novel tax treatment of foreign investment needs to be of a type that is neutral between domestic

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(last visited Feb. 14, 2010); Jiang Yuxia, *China Triples QFII Quota Ahead of Key Meetings with U.S. Officials*, CHINA VIEW, Dec. 10, 2007, available at [http://news.xinhuanet.com/english/2007-12/10/content\\_7226220.htm](http://news.xinhuanet.com/english/2007-12/10/content_7226220.htm) (last visited Feb. 14, 2010).

196. Li, *supra* note 191, at 696.

197. See 1991 FEITL, *supra* note 91, art.2 (defining FIEs as including equity joint ventures, cooperative joint ventures, and wholly foreign owned enterprises).

198. Li, *supra* note 191, at 690–91.

199. For a brief discussion on the international investment law concept of national treatment in China, see Jian Zhou, *National Treatment in Foreign Investment Law: A Comparative Study from a Chinese Perspective*, 10 TOURO INT'L L. REV. 39, 47–48 (2000).

200. See Renqing Jin, Minister of Finance, *The Necessity and Juncture of Release of the Legislation of Enterprise Income Taxation*, Address to the National People's Congress before the deliberation of the adoption of the EIT Law, (Mar. 8, 2007), available at [http://news.xinhuanet.com/video/2007-03/08/content\\_5816843.htm](http://news.xinhuanet.com/video/2007-03/08/content_5816843.htm) (last visited Feb. 14, 2010). The privileged treatment of FDI contributed to the phenomenon of "roundtripping": domestic capital being moved offshore and reinvested into China. See also Qinghua Xu & A.W. Granwell, *Round-Tripping: The Chinese Approach to Business Restructuring*, 15 TAX MGMT. TRANSFER PRICING REPORT No. 8, 320, 320–25 (2006).

and foreign investors.<sup>201</sup> It should also focus on threshold issues facing foreign investors—removing obstacles that would otherwise prevent foreign investment—instead of offering windfalls. Interestingly, these simple guidelines are in fact quite useful in resolving some vexing issues confronting Chinese tax authorities and taxpayers today, for example, how to interpret “establishment” in the context of investments in Chinese partnerships and partnership-like entities. I now turn to that question as an illustration of how the principle of equal treatment of foreign- and domestically-owned investments must be applied in actual rule design.

*B. Interpretation of “Establishment” for Investment in Partnerships*

1. Symmetry Between Foreign- and Domestically-Invested Partnerships

Many countries and subnational jurisdictions have had to consider the following question: Does holding a general or limited partnership interest in a partnership conducting business in jurisdiction X cause a foreign partner to have a business nexus to X, such that the foreign partner is subject to net-income taxation of by X on the partner’s share of income derived from the activities of the partnership in X?

Generally, being a foreign shareholder of a corporation formed in X does not create a business nexus with X for the shareholder; nor would being a creditor of the corporation, unless perhaps the credit were extended to a borrower in the business of lending.<sup>202</sup> More modern limited partnership laws provide that limited partners have little or no control over the conduct of a partnership’s business, such that limited partners have no more control than shareholders have over corporations they own, or creditors have over their debtors.<sup>203</sup> It is typical, for instance, that management of the partnership is wholly delegated to one or more general partners.<sup>204</sup> It seems logical, then, that a limited partner interest should no

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201. It may be worth noting that the recommendation of neutrality here is made in order to prevent manipulation, and not on the basis of a general attempt to equalize the tax competitiveness of foreign and domestic investors. The competitive advantage foreign investors enjoy relative to domestic investors depends on not only source country but also resident country taxation. *See generally* Michael Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?*, 82 S. CAL. L. REV. 703 (2009).

202. *See* OECD Model Convention, *supra* note 3, art. 5(7).

203. ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP §§ 12–18, 32 (Aspen Publishers 27th ed. 2009).

204. *Id.*

more result in a business nexus than a shareholder's or creditor's interest.<sup>205</sup>

Many jurisdictions, however, have disregarded this logic about limited partners. For instance, Section 875 of the U.S. tax code provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged."<sup>206</sup> This rule is understood to apply to both general and limited partners.<sup>207</sup> When the predecessor of Section 875 was enacted in 1936,<sup>208</sup> the use of limited partnerships (particularly by foreigners) was not as prevalent as it would become subsequently, and case law from which the Section was extracted largely concerned general partnerships.<sup>209</sup> In the context of general partnerships, the attribution of partnership activities to its partners followed from the view of the partnership as a mere aggregate of its partners and not a separate entity.<sup>210</sup> However, under limited partnership statutes of the various U.S. states, attributing assets and activities of a partnership to the partners would be incorrect for non-tax purposes.<sup>211</sup> From this perspective, the application of Section 875 to limited partnerships seems inappropriate.<sup>212</sup>

One suggestion for a defense of Section 875 may be that the

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205. Some U.S. states take this view and exempt limited partners of partnerships operating in the states from return-filing obligations. *See, e.g.*, Tenn. Code Ann. §§ 67-4-806(a), 67-4-903(a); *see also* Tenn. Dep't of Rev. Ltr. Rul. 97-49 (Dec. 2, 1997), *available at* <http://www.tn.gov/revenue/rulings/fae/97-49fe.pdf> (last visited Feb. 14, 2010).

206. I.R.C. § 875 (2009).

207. *See, e.g.*, *Vitale v. Comm'r*, 72 T.C. 386 (1979) (holding that a nonresident alien individual who is a limited partner in a U.S. partnership engaged in trade or business is deemed to engage in a U.S. trade or business). By contrast, the presence of limited partners demanded significant adjustment of U.S. domestic partnership tax rules, *e.g.*, on rules that determine whether allocations of losses or liabilities to a limited partner have "substantial economic effect". *See also* the "alternate test for economic effect" in Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 2008).

208. The 1936 provision addressed only non-resident alien individuals and not foreign corporations.

209. *See, e.g.*, *Cantrell & Cochrane, Ltd.*, 19 B.T.A. 16, 22-25 (1930) (holding that where an Irish corporation and a U.S. corporation formed a joint venture manufacturing beverages in the U.S., the Irish corporation was engaged in U.S. trade or business because the joint venture was so engaged); *see also* *W.C. Johnston v. Comm'r*, 24 T.C. 920 (1955).

210. *W.C. Johnston*, 24 T.C. at 922-23.

211. *See* *Wroblewski v. Brucher*, 550 F.Supp. 742 (W.D. Okla. 1982); *Evans v. Galardi*, 546 P.2d 313 (Cal. 1976); *BROMBERG & RIBSTEIN*, *supra* note 203, at §§1.03, 11.03 and 14.02.

212. The issue of whether a limited partnership interest creates a business nexus has been contested in another area of U.S. inbound taxation: the determination of whether such an interest constitutes a permanent "establishment" under income tax treaties. *See* *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Robert Unger*, T.C. Memo 1990-15, *aff'd*, *Unger v. Comm'r*, 936 F.2d 1316 (D.C. Cir. 1991).

structure of tax rules should not be made to depend on the vagaries of partnership law over time and across jurisdictions: what a limited partner does and is entitled to do could vary greatly under different partnership laws and specific partnership agreements. But a stronger defense is in fact available. The justification for the broad partnership-to-partner attribution rule of Section 875 probably does not lie in any particular interpretation of partnership law. Instead, it could be seen as necessary to maintain one set of partnership rules for both foreign-invested and domestically-owned partnerships, and, by the same token, equal treatment of domestic and foreign partners. This may be illustrated by reference to U.S. tax law, but the basic point is generally applicable.

Suppose, for instance, that a U.S. partnership is engaged in a trade or business, but that foreign limited partners in the partnership are, contrary to Section 875, not deemed to be so engaged. Assuming that the foreign partners do not otherwise engage in a U.S. trade or business, none of their income derived from the partnership would then be treatable as effectively connected with a U.S. trade or business. This would make it very difficult to implement the flow-through approach that generally characterizes federal income taxation of partnerships and partners. First and foremost, there would be no basis for allocating expenses to the foreign partners, since they would be taxed only on a gross-income basis. Second, it would no longer make sense to allow the character of many types of income (*e.g.*, operating income, Section 1231 gain) to pass through to the partners. However, if the character of any item of income received by a foreign partner were indeterminate, its source and applicable tax rate would also become indeterminate. In other words, treating income of a partnership as received in the course of a trade or business, while treating the same income, when allocated or distributed to foreign partners, as not received in the course of a trade or business, would render flow-through taxation of partnerships incoherent.<sup>213</sup>

It is conceivable, of course, to tax foreign partners on partnership income other than on a flow-through basis. Foreign partners could be subject to tax only on net income derived from a partnership, and a single tax rate could be applied to such income depending on whether the foreign partner is an individual or a corporation. This would be similar to how U.S. partnerships now compute Section 1446 withholding on effectively connected income allocated or distributed to foreign partners.<sup>214</sup>

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213. For an overview of the flow-through approach to partnership taxation adopted by U.S. federal income tax law, see LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS* (West 3d ed. 2006).

214. I.R.C. § 1446 (2009).



Simplifying even further, a single tax rate may be applied to any net income allocated or distributed to foreign partners, regardless of whether they are individuals or corporations. This would basically implement a business profits tax for foreign partners, its chief difference from a corporate income tax being that investors are not taxed on distributions from the business's after-tax profits.

These ways of taxing foreign partners are not only theoretically possible, but are in fact practiced in some jurisdictions (including some U.S. states).<sup>215</sup> The crucial point is that they diverge from the flow-through (or aggregate) approach to partnership taxation that the federal income tax generally follows. If these non-flow-through approaches are followed, partners' individual tax profiles will no longer determine the ultimate tax liability on income derived from a partnership. This could be unfavorable to foreign partners in some circumstances and would likely trigger a charge that the rule violated the non-discrimination article found in most income tax treaties.<sup>216</sup> In other circumstances, computing tax on income derived from a partnership on a self-standing basis could be favorable to foreign partners, but this means that the foreign limited partners could receive better treatment than domestic limited partners who are still subject to flow-through taxation.

In summary, abandoning the partnership-to-partner attribution rule of Section 875 for foreign limited partners would be inconsistent with flow-through taxation of foreign partners, and if flow-through taxation continued to be practiced at all, there would be a discrepancy in the treatment of foreign and domestic partners.<sup>217</sup> Therefore, in any jurisdiction in which a

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215. See *supra* note 205 and accompanying text.

216. See OECD Model Convention, *supra* note 3, art. 24(3) ("The taxation on a permanent 'establishment' which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.").

217. I am not aware of such a defense of I.R.C. § 875 having been offered elsewhere, although in one important case, the U.S. Tax Court made an argument that could be interpreted along these lines. In *Unger*, *supra* note 212, the Tax Court defended the *Donroy* doctrine of attributing the permanent "establishment" of a partnership to a foreign limited partner, even while acknowledging that such an attribution would not be justifiable on the basis of partnership law alone. In particular, the court stated:

[T]he tax on a partnership's income and gains is applied at the individual partner level through the use of the aggregate theory . . . [The] characterization of a partnership as being merely an association of individuals, for purposes of determining the actual tax to be imposed on a partnership's . . . profits, is perhaps the most important characteristic of a partnership for Federal income tax purposes . . . Because the actual taxation of a partnership is achieved through the aggregate theory of partnership, we hold the aggregate theory of partnership to also be applicable when determining whether a partner has a "permanent establishment" in the United States . . . regardless of whether the partner is a limited or general partner.

flow-through, aggregate approach to partnership taxation is taken, if inbound transactions are also taxed in such a way that business nexus, however labeled, leads to net-income basis taxation, then partnership-to-partner attribution of business activities of the kind Code Section 875 exemplifies should also be observed.

## 2. Implication for Partnership Funds in China

China's previous partnership tax rules cannot easily be categorized as taking the flow-through approach.<sup>218</sup> Nonetheless, tax rules that would apply to partnerships formed under the newly revised Partnership Enterprise Law are still being designed, and there is very strong interest on the part of both domestic and foreign investors in seeing that flow-through taxation is adopted so that the character of investment income received by a partnership is preserved when distributed to partners.<sup>219</sup> However, if foreign investors are granted flow-through taxation, they would, by the logic of the preceding discussion, have to confront the partnership-to-partner attribution of establishments (or permanent establishments, if a treaty is applicable). As we have seen in Section II.B, the issue of attribution of an "establishment" from an investment fund to the fund's investors also arises in connection with a partnership-like form, the non-legal person CJV.

A recap of the policy considerations in this Section shows clearly the predicament facing foreign investors in Chinese funds. Such investors will be found to have an "establishment" in China if they engage in "production or trade" through a fixed place of business or through agents. Chinese tax law has not excluded acts of purchasing, holding and selling securities and other assets from the definition of "production or trade," let alone acts of trading securities and managing underlying companies. And it is unlikely that such a narrowing of the definitions of "production or trade" would be offered in the near future as a general inducement for the inflow of foreign investments. Insofar as the activities of an investment partnership might constitute "production or trade," such a characterization would also likely be applied to its general and limited partners, resulting in

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Robert Unger, T.C. Memo 1990-15, at 90-58.

218. For example, expenses and losses are not allocated to partners but, rather, offset partnership income directly and, if unused, are carried forward; similarly, the character of partnership income does not generally flow through to partners. See *Prospect of New Partnership Taxation*, *supra* note 88, at 627-29, 630.

219. *Id.* For domestic individual partners, investment income such as dividends, interest and capital gain is taxed at a lower rate than other types of income from partnerships. Domestic corporate partners may also benefit from flow-through treatment because of the inter-corporate dividend exemption, and for other reasons as well.

net-income basis taxation of income derived from the partnership—generally an unacceptable consequence for foreign passive investors.<sup>220</sup>

This analysis also makes clear what a concession to foreign investors in onshore partnership funds might be. What is at stake is a threshold issue: if an interest in a Chinese fund is considered an “establishment” that would subject the owner to net taxation in China, most foreign investors would not acquire such interests. If the government wants to encourage foreign acquisition of partnership interests in Chinese funds, the interpretation of “establishment” will have to be selectively relaxed. One approach is to designate some fund activities (*e.g.*, performing due diligence on, negotiating for the purchase of, purchasing, holding and selling securities) as falling outside the scope of “production or trade.” In addition, for other activities (*e.g.*, providing consulting and other services to portfolio companies) that could not be easily excluded from the scope of “production or trade,” if such activities are performed by other parties (*e.g.*, a separate investment manager) neither at the direction of nor for the benefit of the partnership, then the government could also agree that they do not lead foreign partners in a fund to have establishments in China. This would be a continuation of the approach taken in the 2003 VC Tax Rules, as discussed in Section II.B above.<sup>221</sup> Such targeted relaxations would be more easy to adopt than a more liberal general interpretation of “establishment.” Finally, to the extent that similar rules are adopted for domestic investors in the funds as well (*e.g.*, flow-through taxation, certain income treated as passive investment income and not active operating income), they would also not lead to any meaningful discrepancy between the treatment of resident and non-resident investors.

While this approach appears both practical and justifiable on a number of policy grounds, the analysis it is based on is only preliminary and can no doubt be further refined. What is important to note, however, is that unless a new discourse emerges in China among taxpayers, tax practitioners and administrators as well as policymakers concerning tax policy toward inbound investment and basic legal concepts such as establishment, there can be no expectation that the government will tackle

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220. For a foreign corporate investor (which generally is the relevant case in the Chinese context; *see supra* notes 88–89 and accompanying text), the effect of taxation on a net basis instead of a gross basis is roughly as follows: (1) the applicable tax rate would be 25% instead of 10%, with this rate difference being offset to some extent by the deductibility of certain expenses; and (2) where a treaty applies, a gain on sale that might otherwise have been exempted under the capital gain article in the treaty will become a normal taxable item under the business profits article.

221. It would also be similar to the practice of bifurcating the general partner and investment manager entities in U.S. fund practice. *See* ANDREW W. NEEDHAM & ANITA BETH ADAMS, *Private Equity Funds*, B.N.A. TAX MGMT. PORTFOLIO 735 at A-18 (2005).

the issues we have discussed in any fashion like what we have done here. Generally, this is because tax authorities are guided chiefly by the goal of revenue preservation, and taxpayers by the goal of minimizing tax, and these conflicting goals cannot be resolved without policy and legal norms that show what is reasonable. More specifically, the determination that some activities might constitute production or trade while others do not is exactly something that the government has largely avoided doing so far in the evolution of the concept of establishment, as shown in our previous discussion.<sup>222</sup> Taxpayers' acquiescence in this practice has arguably resulted in a general view that there are *no* norms in this area.<sup>223</sup> But clearly, it cannot be the case such determination is required only in the investment fund area and not in others.

#### CONCLUSION

This Article has aimed to identify and analyze some of the basic concepts, principles, and policy considerations that underlie and unify a number of seemingly disparate and very practical issues in Chinese taxation today, such as the tax treatment of onshore investment funds, foreign investment in real estate, and QFIIs. It does so first by highlighting some fundamental trends that are likely to lead to paradigmatic changes in Chinese inbound taxation. These trends include a gradual but definite shift to a more balanced mix of inbound direct and portfolio investment, as well as a breach in the traditional bias against the deployment of noncorporate business forms. In addition to identifying the directions in which Chinese inbound taxation is likely to evolve, we have approached the legal issues involved by taking seriously the Chinese tax law concept of establishment. This has meant two things. One is to examine systematically the concept's use under existing law. The other is to evaluate this use, and its possible augmentation, not primarily in light of "international norms" or concepts playing similar roles in other countries' tax systems, but in the first place in light of the tax and regulatory policies China may adopt in its own unique circumstances.

We have largely stayed away from the treaty concept of permanent establishment, or that concept's interpretation by Chinese authorities. Although a comparison between the domestic law and the treaty concept is no doubt useful, it is important to recognize, as a fundamental matter, that the domestic law concept may well follow its own logic. It is not

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222. The main exception to this is *Guo shui fa* [1996] 212 and related local government circulars. See *supra* notes 109–19 and accompanying text.

223. See *supra* notes 155–56 and accompanying text.

uncommon for practitioners of international taxation to speak, particularly in connection with jurisdictions not their own, of “permanent establishment” even when they are discussing whether, under the *domestic* tax law of a host country, particular items of income may be subject to net basis taxation, and even when it cannot be assumed that a treaty is applicable. The risk of being subject to net-income taxation and return filing obligations is sometimes referred to as “PE risk.” While this blurring of domestic law concepts with the treaty concept may often serve as convenient shorthand, it may also imply an assumption that there is one international norm for designing two-tiered tax systems for inbound investment and that countries merely differ in the details in implementing this norm. We have not made that assumption here, and our findings have shown that dispensing with such an assumption facilitates the comprehension and analysis of the issues domestic taxing authorities face.