Global Business & Development Law Journal

Volume 1 | Issue 2 Article 9

1-1-1988

An Analysis of Foreign Investment in the People's Republic of China in the Aftermath of the Sino-U.S. Tax Agreement

Michael Brent Nelson
University of the Pacific, McGeorge School of Law

Comment

An Analysis of Foreign Investment in the People's Republic of China in the Aftermath of the Sino-U.S. Tax Agreement†

INTRODUCTION

Within the last few years there have been several articles focusing on the People's Republic of China (PRC). Generally, these articles discuss such topics as: perceived change in Chinese political ideology;[1] the evaluation of a new legal system in the PRC;[2] the consequential change in business structures, such as joint ventures;[3] and Chinese laws

† The author wishes to express his appreciation to Professor Paul C. Yuan, McGeorge School of Law, Sacramento, California, for his insightful ideas, unique perspectives, and continued inspiration.

1. *See generally,* Comment, *United States Tax Treaty Policy Toward Developing Countries: The China Example,* 35 UCLA L. REV. 369 (1987); Alford, *The Inscrutable Occidental? Implication of Roberto Unger's Uses and Abuses of the Chinese Past,* 64 TEX. L. REV. 915 (1986).

2. *See generally,* Utter, *Dispute Resolution in China,* 62 WASH. L. REV. 383 (1987). Kim, *The Modern Chinese Legal System,* 61 TUL. L. REV. 1413 (1987); Alford, *Of Arsenic and Old Laws: Looking Anew at Criminal Justice in Late Imperial China,* 72 CALIF. L. REV. 1180 (1984); MacNeil, *Contract in China: Law, Practice, and Dispute Resolution,* 38 STAN. L. REV. 303 (1986).

3. *See generally,* Note, *General Principles of Law in International Commercial Arbitration,* 101 HARV. L. REV. 1816 (1988); Comment, *The Bait Won't Bite: The American Bilateral Investment Treaty Program,* 33 AM. U.L. REV. 931 (1984); Chwang & Thurston, *Technology Takes Command: The Policy of the People's Republic of China with Respect to Technology Transfer and Protection of Intellectual Property,* 21 INT'L LAW. 129 (1987).

promulgated to protect the foreign transfer of intangible assets, such as patents and trademarks.[4]

There have also been writings on the recently enacted Sino-U.S. tax treaty.[5] These writings have fallen short of providing clear guidance for the foreign investor seeking to invest in the PRC. It is therefore the intent of the author to provide a unique and comprehensive writing to aid the foreign investor in acquiring the tools to avoid the trappings of the tax treaty and to utilize the tax laws of the PRC and the United States to their benefit. The first part of this article investigates the rationales which motivated the two countries to create their first mutual tax treaty, effective from January 1, 1987. The purposes and goals of the treaty must be weighed to ascertain whether these objectives were actually achieved or whether the provisions of the final agreement represent compromise positions. The second part of the article discusses the various strategies and alternatives available to the foreign investor. Substantial evaluation is given to the structuring and operation of investment vehicles with special emphasis on international tax planning for the mitigation of tax burdens faced by both the investing entity and the entity's owners.

I. The Sino-U.S. Tax Agreement

A. *Background*

The PRC professes a willingness to cooperate and negotiate with the industrialized western world's nations on economic matters. This will-

---

4. *See generally*, Note, *A Trade-Based Response to Intellectual Property Piracy: A Comprehensive Plan to Aid the Motion Picture Industry*, 76 Geo. L.J. 417 (1987); Comment, *The Patent Law of the People's Republic of China in Perspective*, 33 UCLA L. Rev. 331 (1985); Oddi, *The International Patent System and Third World Development: Reality or Myth*, 1987 Duke L.J. 831; Fikentischer, *Third World Trade Partnership: Supranational Authority vs. National Extraterritorial Antitrust—A Plea for "Harmonized" Regionalism*, 82 Mich. L. Rev. 1489 (1984); Trimble, *Foreign Policy Frustrated—Dames & Moore, Claims Court Jurisdiction and A New Raid on the Treasury*, 84 Colum. L. Rev. 317 (1984); Nimmer & Krauthaus, *Classification of Computer Software for Legal Protection: International Perspective*, 21 Int'l Law. 733 (1987).

5. Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion, April 30, 1984, United States-China, ____ U.S.T.____, T.I.A.S. No.____ reprinted in 17 Diamond & Diamond International Tax Treaties of All Nations, Series B 412 (1985) [hereinafter Sino-U.S. Agreement or Agreement]. For writings, *See generally*, Colloquy, *The Place of Foreign Treaties in the Courts of the United States: A Reply to Louis Henkin*, 101 Harv. L. Rev. 511 (1987); Wilson, *The Legal Structures Concerning Technology Transfers and Joint Ventures with the People's Republic of China*, 3 Int'l Tax & Bus. Law. 1 (1985); McGarry, *Pathfinder for Doing Business Abroad*, 22 Int'l Law. 483 (1988); Rovine, *Report on Bilateral Investment Treaties*, 21 Int'l Law. 274 (1987); Faber, *U.S. Activities of Foreigners and Tax Treaties*, 40 Tax Law. 1215 (1987); Blessing, *The Branch Tax*, 40 Tax Law. 587 (1987).

ingness stems in part from a desire to increase its reserves in the free world's capital, to advance in modern technology, and to develop innovative management techniques.[6] In 1977, the PRC began an unprecedented attempt to build a new economic order out of the mass confusion resulting from the reign of the "Gang of Four."[7]

This economic reconstruction was part of the Cultural Revolution which followed the death of Mao Zedong in September of 1976, bringing an end to the era of the Gang of Four.[8] At that time, Premier Hua Guofeng determined that the achievement of the "Four Modernizations"[9] in agriculture, industry, national defense, and science and technology was "essential to strengthen the socialist movement."[10] The Four Modernizations are a fundamental part of the government's "Open Door" policy.[11]

Currently, the PRC is actively involved in attracting foreign investment capital to make up for the insufficiency of domestic capital and to facilitate the introduction of modern technology and management.[12] China anticipates using this capital and technology to induce rapid modernization leading to commercial growth on an international level. This desire was translated into law when, after two years of negotiations, President Ronald Reagan and Premier Zhao Ziyang signed the first income tax agreement (Sino-U.S. Agreement or Agreement) be-

6. LAMPTON, IMPLEMENTING CHINA'S S & T MODERNIZATION PROGRAM 366 (1987) (*citing* Seligman, *Nike's Running Start*, 9 CHINA BUS. REV. 42 (Jan.-Feb. 1982) [hereinafter LAMPTON].

7. *Business Operations in the People's Republic of China*, Tax Mgmt. (BNA) No. 443-2nd, at A-4 (1988):

> A period of economic progress with the resumption of central planning and capital development under the fourth five-year plan from 1971-75 was followed by the death of Mao Zedong in 1976 and the fall of the so-called "Gang of Four," lead by Mao's widow, Jiang Ching. Responsibility for the political, social, and economic disruptions of the Cultural Revolution is placed with the Gang of Four, to which is attributed the erroneous policy of regarding the pursuit of material growth as a betrayal of the revolutionary ideals upon which the PRC was founded.

Id.

8. *Id.*

9. Zhou, *Report on the Work of the Government*, 18 BEIJING REV. 21, 23 (Jan. 24, 1975).

10. Kuo-Feng, *Unite and Strive to Build a Modern, Powerful Socialist Country! - Report of the Work of the Government*, 21 BEIJING REV. 7, 33 (Mar. 10, 1978).

11. LAMPTON, *supra* note 6. *See also* Yubin, *The Present Situation and Development Trend of Chinese Legislation Concerning Foreign Economic Affairs*, 4 CHINA L. REP. 119 (1987); Hsia & Haun, *The Re-emergence of the Procuratorial System in the People's Republic of China* 1 n.1 (1978).

12. Dashkevich, *PRC: Foreign Economic Relations*, 1 FAR E. AFF. 23, 32 (1983). *See also* *Annual Report of the International Monetary Fund*, EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 158 (1987). *See generally* Jaslow, *Practical Considerations in Drafting a Joint Venture Agreement with China*, 31 AM. J. COMP. L. 209 (1983).

tween the United States and the PRC.[13] The Sino-U.S. Agreement is revolutionary in that it is the first comprehensive income tax treaty between the United States and the PRC.[14]

B. *Principal Purposes of the Income Tax Treaty*

The principal purposes of any income tax treaty are to reduce double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance of the income taxes imposed by the taxing authority of either country.[15] Several countries are parties to such treaties and the law has developed to the point where model treaties provide the basic structure and content of income tax agreements between nations. Following the general model of tax treaties, the Sino-U.S. Agreement is part of a program of close economic cooperation between the U.S. and the PRC aimed at eliminating possible trade barriers caused by overlapping tax jurisdictions of the two countries. In general, each country agrees to limit, in specified situations, the right to tax income derived within its jurisdiction by residents of the other country.[16]

Non-resident United States citizens[17] are not covered by the Agreement.[18] The 1981 Proposed Model Income Tax Treaty (U.S. Model

---

13. The proposed income tax treaty and a modifying protocol were signed on April 30, 1984. Sino-U.S. Agreement, *supra* note 5; Proposed Protocol with Respect to Taxes on Income, *reprinted in* 3 Tax Treaties (P-H) ¶ 72,134, ¶ 72,137 (1988). The proposed protocol was subsequently amplified by an exchange of letters signed that same day. The diplomatic process of exchanging letters results in the embodiment of the letters within the proposed protocol. This exchange of letters gives effect to the protocol. Thus, the two documents are subsequently known as "the protocol." In a final exchange of notes, the PRC notified the U.S. State Department on October 22, 1986, of its approval of the Sino-U.S. Agreement. Protocol Concerning the Interpretation of Paragraph 7 of the Protocol with Respect to Taxes on Income, *reprinted in* 17 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, SERIES B 442. (Signed at Beijing on April 30, 1984) [hereinafter Second Protocol]. The treaty was given the power of law on November 21, 1986 and became effective January 1, 1987.

14. *Message from the President of the United States to the Senate of the United States*, 3 Tax Treaties (P-H) ¶ 72,134 (1988). A prior agreement between the two countries governing only the taxation of shipping and aircraft income was signed on March 5, 1982 and is currently in force. *Id.* The Agreement does not alter the tax rules for shipping and aircraft income as contained in that earlier document. *Id.*

15. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435.

16. *Id.* art. 4, at 415. Article 4 states:

> For the purpose of this Agreement, the term resident of a Contracting State means any person who, under the laws of that Contracting State, is liable to tax herein by reason of his domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature.

Id.

17. 26 U.S.C. § 7701(a)(30) (Supp. IV 1987).

18. Sino-U.S. Agreement, *supra* note 5.

Treaty) does not cover such U.S. citizens.[19] The United States has rarely succeeded in negotiating coverage for non-resident U.S. citizens.[20] Where the country of source retains the right to tax income derived by residents of the other country, the Agreement provides for the relief of potential double taxation by the country of residence by allowing a foreign tax credit.[21]

The Agreement provides that neither country will tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base.[22] The Agreement provides that dividends, interest, royalties, and certain other income derived by a resident of either country from sources within the other country may be taxed by both countries.[23] However, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis.[24] The treaty, which China hopes will

---

19. In 1981 the U.S. Treasury Department developed a model treaty to be used as a guide in future tax treaty negotiations. The model, commonly referred to as the "Model of June 16, 1981, Convention Between The United States of America and . . . . For The Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital," *reprinted in* Taxation of Transnational Transactions (CCH) §§ 212-13, (1987-88) [hereinafter U.S. Model Treaty].

20. 3 Tax Treaties (P-H) ¶ 72,134, at 72,137 (1988).

21. Sino-U.S. Agreement, *supra* note 5, art. 22, para. 2, at 436.

22. *Id.* art. 7, at 419-20. Article 7 states:

> The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other Contracting State but only so much of them as is attributable to that permanent establishment.

Id.

23. *Id.* art. 9, at 422-23. Article 9 states: "Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State." *Id.*

Article 10 states: "Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State." *Id.* at 424.

Article 11 states: "Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State." *Id.* at 426.

Article 12 states: "Gains derived by a resident of a Contracting State from the alienation of real property referred to in Art. 6 and situated in the other Contracting State may be taxed in that other Contracting State." *Id.* at 428.

24. *Id.* art. 9, para. 2, at 423. Article 9, para. 2 states:

> However, such dividends may also be taxed in the Contracting State of which the company paying the dividend is a resident, and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 10 percent of the gross amount of the dividends. *Id.*

Article 10, para. 2 states:

> However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that Contracting State, but if the recipient is the beneficial

attract foreign investment, sets a maximum withholding rate of ten percent, replacing the customary twenty percent Chinese[25] and thirty percent United States income tax withholding rates.[26]

C. *Comparisons With Model and Other Existing U.S. Tax Treaties*

The Sino-U.S. Agreement aligns itself with some provisions of the U.S. Model Treaty and the Model Income Tax Treaty of the Organization for Economic Cooperation and Development (OECD Model Treaty).[27] However, there exist numerous important departures from these conventional models. The following discussion illustrates these alignments and departures.

1. *Residency and Dual Residents*

Where, under the local law of both countries, a company is deemed a resident of both countries, the competent authorities of the United States and the PRC are to determine a single residence of the company. The Agreement does not provide criteria by which to determine residency for these purposes.[28] Regrettably, if the competent authorities are unable to determine a single residence, the company will not be considered a resident of either the PRC or the U.S. and will be ineligible for any treaty benefits.[29]

When a company is a U.S. resident under U.S. law and (under a separate tax agreement between a third country and the PRC) a resident of a third country with management located in the third country, the company is not to be treated as a U.S. resident and is ineligible for

---

> owner of the interest, the tax so charged shall not exceed 10 percent of the gross amount of the interest. *Id.* at 424.

Article 11, para. 2 states:

> However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 10 percent of the gross amount of the royalties. *Id.* at 426.

25. *Individual Income Tax Law of the People's Republic of China*, China Laws Foreign Bus. Tax'n, (CCH) ¶ 30-500(4), art. 3 (Sept. 10, 1980) [hereinafter *Individual Tax Law of PRC*].

26. 26 U.S.C.S. §§ 871(a)(1) (Law. Co-op. 1988).

27. All 24 OECD member countries have approved the model treaty. Most of these member, including the United States, have recorded reservations as to the substantive provisions that are considered unacceptable. The OECD first approved a model income tax treaty in 1963, then revised the model income tax convention in 1977. Both the proposed treaty and convention were accompanied by lengthy commentaries. (Copy of the OECD Model Treaty on file at *The Transnational Lawyer*).

28. *Id.*

29. *Id.* art. 4, para. 3, at 415.

the benefits of the Agreement.[30] The U.S. Model Treaty contains different rules for dual resident corporations. Under the U.S. Model Treaty,[31] a corporation residing in both the United States and its treaty partner pursuant to local law, is automatically considered a resident of the country in which it was first legally created. The corporation is then entitled to the same treaty benefits that other corporate residents receive in that country.

The Agreement's dual corporate resident rules technically permit the determination of a single corporate residence, which is inconsistent with the general U.S. tax policy[32] to refrain from restricting the U.S. taxation of American corporations by treaty. According to the Agreement, the two countries are free to decide whether a company incorporated in the United States, and either a resident of the United States under American law or resident of the PRC under Chinese law, is treated as a PRC resident for tax purposes.[33] The United States would then be obliged to extend tax reductions to the entity involved. However, while the U.S. must agree to treat an American company as a resident of another country under other existing treaties, the U.S. probably will not agree to do so under the Sino-U.S. Agreement in the future.[34] The dual corporate resident rules of the Agreement actually may result in the denial of treaty benefits to a company residing in both China and the United States under local law. This somber possibility may tend to encourage a company to establish a single residence in either country in order to assure treaty coverage.

The Agreement's dual corporate resident rules do not appear in any other existing U.S. income tax treaty, since the rules may complicate the planning of U.S. multinational entities. A U.S. corporation operating in the PRC might inadvertently lose its benefits under the Agreement if it opens a branch in a third country, thus becoming a resident under a separate treaty between that third country and the PRC.[35] Consequently, these rules may encourage a U.S. corporation, managed in and a resident of another PRC treaty partner, to establish a single residence in the United States, where the benefits available to U.S. corporate residents under the Sino-U.S. Agreement are more advantageous.

30. Sino-U.S. Agreement, *supra* note 5, art. 4, para. 4, at 415-16.
31. U.S. Model Treaty, *supra* note 19, art. 4, at 213-14.
32. *See generally* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).
33. Sino-U.S. Agreement, *supra* note 5, art. 4, at 415-16.
34. *See generally* U.S. Model Treaty, *supra* note 19.
35. Sino-U.S. Agreement, *supra* note 5, art. 4, para. 4, at 415-16.

2. *Permanent Establishment*

The definition of "permanent establishment" under the Agreement[36] is broader than definitions found in either the U.S. Model Treaty[37] or any other existing U.S. treaty, and may create some uncertainties as to the exact effect of the Agreement.[38] The Agreement defines a permanent establishment to include a drilling rig or ship used for the exploration or exploitation of natural resources in excess of three months.[39] This treatment contrasts with the Agreement's six month permanent establishment rule for construction activities.[40] The three month provision also contrasts with the position expressed in a 1984 Senate Committee on Foreign Relations report on the income tax treaty with Canada.[41] In the report, the Committee observed that the offshore activities of contract drillers, as a general matter, are closely analogous to construction activities.[42]

The Agreement raises the issue of whether or not the unequal treatment of drilling rigs and construction activities is appropriate. Arguably, the United States should not make concessions of this kind, especially in light of the Senate Committee's express comments in its Canadian treaty report. Alternately, the unequal treatment is appropriate when viewed in the context of a comprehensive agreement that

---

36. *Id.* art. 5, at 214.

37. U.S. Model Treaty, *supra* note 19, art. 5, at 416.

38. Sino-U.S. Agreement, *supra* note 5, art. 5, paras. 1,2, at 416. Article 5 states:

> 1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
>
> 2. The term "permanent establishment" includes especially:
> a) a place of management;
> b) a branch;
> c) an office;
> d) a factory;
> e) a workshop; and
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Id.

39. *Id.* para. 3(b), at 416.

40. *Id.* para. 3(c), at 416-17.

41. *See generally* SENATE COMM. ON FOREIGN RELATIONS, EXEC. DOC. T, 96th Cong. 2nd Sess. (1908). The report accompanies the 1980 United States-Canada Income Tax Treaty, (*reprinted in* 10 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, SERIES B 165 (1981)), and the 1983 and 1984 Protocols, 17 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, SERIES B 311 (1985).

42. The Committee indicated its strong belief that the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities. Senate Comm. on Foreign Relations, Exec. Rept. No. 22, 98th cong., 2nd Sess. at S. Rpt. 99-313 p. 880 (1986).

benefits a broad range of U.S. taxpayers and the United States.

The Agreement departs significantly from the U.S. Model Treaty[43] in other areas as well. An independent agent of an enterprise may constitute a permanent establishment of that enterprise under the Agreement, where the agent's activities are almost wholly on behalf of that enterprise, and the transactions between the agent and the enterprise are shown not to have been made pursuant to arm's length bargaining.[44] The U.S. Model Treaty does not contain this rule.[45] In addition, the performance of certain supervisory or consulting services can by themselves create a permanent establishment despite the fact that the enterprise has no fixed place of business in the PRC.[46] The practical effect of these rules is that the PRC will receive larger tax revenues from U.S. mineral exploration activities, construction activities, and consulting services than it would have under the U.S. Model Treaty rules.

D. *Treaty Concessions*

Along with providing relatively broad source base taxation, the Agreement contains some additional types of developing country concessions. The Agreement prohibits the United States from imposing its personal holding company tax[47] or accumulated earnings tax[48] on Chinese companies that are wholly owned by either the Chinese Government or individual residents of China.[49] The notes exchanged when the treaty was signed allow the United States to amend the Agreement to provide a U.S. tax sparing credit if at any time in the future the United States should agree to such a credit provision in a treaty with another country.[50] Currently it is a firm policy of the United States

43. U.S. Model Treaty, *supra* note 19, art. 5, at 214.
44. Sino-U.S. Agreement, *supra* note 5, art. 5, para. 5, at 417-18.
45. U.S. Model Treaty, *supra* note 19, art. 5, para. 5, at 214-15.
46. Sino-U.S. Agreement, *supra* note 5, art. 5, para. 3, at 416-17.
47. 26 U.S.C.S. §§ 541 (Law. Co-op. 1988).
48. 26 U.S.C. § 531 (1982).
49. Second Protocol, *supra* note 13, para. 3, at 442-43.
50. The correspondence between Premier Zhao Ziyang and President Reagan was as follows:

Bejing, April 30, 1984

Excellency:

I have the honor to refer to the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income which was signed today [hereinafter referred to as "the Agreement"] and to confirm, on behalf of the Government of the United States of America, the following understanding reached between the two Governments:

that a foreign tax credit will be allowed as a creditable tax against existing U.S. tax liabilities only on foreign income taxes *actually paid* by the party claiming relief under U.S. tax law.[51] Another concession to source basis taxation in the Agreement is the allowance of maximum rates of source country tax on direct dividends.[52] This maximum rate conforms with those provided in some other treaties with developing countries, but are higher than those provided in the U.S. Model Treaty.[53]

The basic issue is whether these developing country concessions represent appropriate U.S. treaty policy and, if so, whether China is an appropriate recipient of these concessions. The concessions do acknowledge China's status as a capital importing and developing country. Tax concessions arguably are necessary to obtain treaties with developing countries. Treaties with developing countries can be advantageous to the United States because they provide a basic framework for the taxation and tax relief of U.S. investors abroad.[54] Uncertainty regarding the Chinese taxation of foreign persons was a significant cause for concern among U.S. investors prior to the Agreement. There is a risk, however, that the inclusion of these concessions in the Agreement could result in additional pressure on the United States to

---

> Both sides agree that a tax sparing credit shall not be provided in Article 22 of this Agreement at this time. However, the Agreement shall be promptly amended to incorporate a tax sparing credit provision if the United States here after amends its laws concerning the provisions of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.
>
> His Excellency
> Zhao Ziyang
> Premier of the
> People's Republic of China
>
> I have the honor to request Your Excellency to confirm the foregoing understanding on behalf of Your Excellency's Government.
>
> I avail myself of this opportunity to assure Your Excellency of my highest consideration.
>
> Ronald W. Reagan
> President of the
> United States of America

17 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, SERIES B 442.

51. 26 U.S.C. § 901(j)(1)(A) (Supp. IV 1987). *See also* Treas. Reg. § 1.901-2(a)(1) (1954).

52. Sino-U.S. Agreement, *supra* note 5, art. 9, para. 2, at 423. Article 9 states:

> However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the law of that Contracting State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 10 percent of the gross amount of the dividends.

Id.

53. U.S. Model Treaty, *supra* note 19, art. 10, paras. 2(a) and (b), at 217.

54. SALACUSE, HOST COUNTRY REGULATION OF JOINT VENTURES AND FOREIGN INVESTMENT 103-04 (1985) [hereinafter SALACUSE].

include them in future treaties negotiated with other developing countries.

E. *Agreement Provisions*

1. *Competent Authorities*

The Agreement contains a provision under which taxpayers of the contracting state may present their case to the competent authority in the country of residency if the taxpayer believes that the action of either state's tax authorities is not in accordance with the Agreement.[55] If the taxpayer's claim is valid and is considered to have merit, then the competent authority in the taxpayer's country of residence must attempt to reach an agreement with the other country to avoid double taxation.[56] Unfortunately, there is no assurance that both country's competent authorities will agree upon any particular treaty position taken by one of them.

The Agreement provides that the competent authorities shall exchange information necessary to carry out the provisions of the Agreement and for the prevention of fraud or fiscal evasion.[57] The Agreement also contains a variety of restrictions as to the treatment and the type of information that can be exchanged. Any information exchanged is secret information and can be disclosed only to persons or authorities responsible for assessing and collecting the taxes to which the treaty applies.[58] The Agreement contains limitations on the obligations of the countries to supply information.[59] A country is not required to: carry out administrative practices of either country, supply information which

---

55. Sino-U.S. Agreement, *supra* note 23, art. 8, para. 1, at 437.
56. *Id.* art. 24, para. 2, at 438-39.
57. *Id.* art. 25, para. 1, at 439-40. Article 25 states:

> The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Contracting States concerning taxes covered by this Agreement insofar as the taxation thereunder is not contrary to this Agreement, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Art. 1. Any information received by a Contracting State shall be treated as secret and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement of prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

Id.

58. *Id.*
59. *Id.* para. 2, at 440.

is not obtainable under the laws or in the normal course of the tax administration of either country, disclose any industrial or professional secret or process, or release information in contravention of public policy.[60]

2. *Treaty Shopping*

The Agreement limits the amount of a source country's withholding tax on interest paid to residents of the other country.[61] This limitation is common in a number of a U.S. income tax treaties, such as the United States-Canada Treaty.[62] Although this tax reduction is intended to benefit only residents of China and the United States, residents of other countries may attempt to use the treaty to obtain treaty benefits. This is known as "treaty shopping."[63]

To illustrate, assume an investor is from a country without a tax treaty with the United States. The investor may attempt to limit source country taxation of interest to the same extent provided in the Sino-U.S. Agreement.[64] The third country investor may try tax avoidance by establishing a subsidiary, trust, or other investing entity in some treaty country (for this illustration, in China) which makes a loan to the U.S. person and claims the Agreement's tax reduction for the interest received.[65]

By repealing the U.S. gross withholding tax on interest paid to foreigners on certain portfolio indebtedness,[66] the Tax Reform Act of

---

60. *Id.*

61. Sino-U.S. Agreement, *supra* note 5, art. 11, at 426.

62. Second Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and by The Protocol Signed at Ottawa on June 14, 1983, *reprinted in* 17 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, series B 311 (1985) [hereinafter Canadian Second Protocol].

63. Treaty shopping is performed by resident of a country that is currently without an existing treaty with another country. The effect of this non-treaty status is an increase of withholding tax to the resident of first country. To obtain favorable treaty benefits of another country with an existing treaty, the resident of first country establishes an operation in that treaty country to obtain favorable withholding rates. Taxation of Transnational Transactions 1987-1988 (CCH) 235 (1987).

64. Sino-U.S. Agreement, *supra* note 5, art. 10, para. 6, at 425-26.

65. *Id.* at 424.

66. 26 U.S.C.S. § 871(h) (Law. Co-op. 1988). This section provides:

> Repeal of Tax on Interest of Nonresident Alien Individuals Received from Certain Portfolio Debt Investments -
> (1) In General
> In the case of any portfolio interest received by a nonresident individual from sources within the United States, no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

Id.

1986[67] limited treaty shopping incentives dramatically.[68] Yet, opportunities for treaty shopping remain since the United States still imposes tax on interest paid to foreigners.[69] The anti-shopping provision[70] of the Agreement is much less detailed than the anti-shopping provision of the current U.S. Model Treaty[71] and the provisions found in most of the recent U.S. treaties, such as the United States-Canada Treaty.[72] The provision is also considerably less strict than the anti-shopping measure in the current U.S. Model Treaty.[73] While the U.S. Model Treaty provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses,[74] the U.S. Model Treaty[75] provides a standard against which to compare the Agreement's anti-shopping provision. A stronger anti-shopping provision in the Sino-U.S. Agreement may be necessary to forestall potential treaty shopping abuses.

Under the Agreement, the competent authorities of the two countries may deny treaty benefits through consultation.[76] One can argue that, under this language, if the Chinese competent authority failed to cooperate, the United States would be unable to prevent third country

67. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1810(d)(1)(A), 100 Stat. 2825 (codified as 26 U.S.C. § 1 et. seq.).

68. 26 U.S.C.S. § 871(h)(1) (Law. Co-op. 1988). Prior to § 871(h), foreign investors had a flat 30% U.S. tax withheld from U.S. portfolio income. Treaties had the effect of reducing the amount of tax withheld below the flat 30% rate. §871(h) now eliminates witholding to citizens of both United States treaty and non-treaty countries.

69. 26 U.S.C.S. § 871(h)(3) (Law. Co-op. 1988). The United States taxes the interest paid to parties related to the payor, interest on debts incurred prior to July 19, 1984, and certain interest paid to banks.

70. Sino-U.S. Agreement, *supra* note 5, art. 8, at 421.

71. U.S. Model Treaty, *supra* note 19, art. 16, para. 1, at 220. This article states:

> 1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless
> (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting Sate; and
> (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

Id.

72. Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983, and the Protocol Signed at Washington on March 28, 1984. 17 Canadian Second Protocol, *supra* note 62, at 311.

73. U.S. Model Treaty, *supra* note 19, art. 16, at 220.

74. Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

75. U.S. Model Treaty, *supra* note 19, art. 16, para. 1, at 220.

76. Sino-U.S. Agreement, *supra* note 5, art. 23, para. 1, at 437.

residents from obtaining treaty reductions in U.S. tax through the use of an investing entity set up in China.[77] Thus, the U.S. Treasury Department has ruled that the Agreement's benefits could be denied under the anti-treaty shopping rules without prior consultations by the competent authorities.[78] Further, the Agreement imposes sanctions against treaty shopping if a company formed in a third country becomes a resident of one of the countries for the principal purpose of enjoying the Agreement's benefits.[79] The U.S. Model Treaty imposes sanctions if the principal purpose of the company's conduct is to obtain treaty benefits, regardless of whether the company was formed in a third country, in one of the treaty countries, or with the original purpose of becoming a resident of one of the treaty countries.[80]

The U.S. Model Treaty applies an additional "safe harbor"[81] test to determine whether treaty benefits actually will be denied.[82] Specifically, benefits will not be denied a business organization if seventy-five percent or more of the organization's ownership is held by individuals residing in the country of which the business is a resident, and its income is not used to substantially meet liabilities to non-U.S. citizens residing in third countries.[83] The Agreement does not apply this "safe harbor" test; in fact, it applies no standard for denying treaty benefits other than the rule that they may be denied if a company becomes a resident for the principal purpose of obtaining such treaty benefits.[84]

The "safe harbor" test of the U.S. Model Treaty has the advantage of providing both business organizations and countries with the relative certainty as to who will be denied treaty benefits.[85] However, the "safe harbor" test limits the flexibility of countries to attack treaty shopping abuses. Thus, the omission of the test from the anti-treaty shopping provisions of the Agreement is a benefit to the countries' taxing authorities.

3. *Treaty Shopping in Hong Kong*

Confrontation between treaty shoppers and taxing authorities is made more likely by China's impending resumption of sovereignty over Hong

77. *Id.* art. 4, para. 4, at 415-16.
78. *Id.* art. 4, para. 3, at 415.
79. *Id.* art. 4, para. 4, at 415-16.
80. U.S. Model Treaty, *supra* note 19, art. 16, para. 1, at 220.
81. *Id.*
82. *Id.* at para. 1(b). "For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State." *Id.*
83. *Id.* at para. 1(a) and (b).
84. Sino-U.S. Agreement, *supra* note 5, art. 4, para. 4, at 415-16.
85. U.S. Model Treaty, *supra* note 19, art. 16, para. 3, at 221.

Kong.[86] China has concluded an agreement with the United Kingdom governing the 1997 resumption of sovereign control. Based on the different definitions of "China" contained in the respective agreements, the Agreement apparently will not apply to Hong Kong.[87] The exclusion of Hong Kong from Agreement coverage is important because treaty shopping possibilities in Hong Kong, in contrast with China, may be significant. As an international financial center seeking foreign investment, Hong Kong imposes low income taxes.[88] Generally, profits earned overseas are not included in taxable profits.[89] Dividends[90] paid by Hong Kong companies, and income derived from trusts paid on Hong Kong bank deposits, are exempt from Hong Kong tax in most cases.[91] Hong Kong currently has no exchange controls or other rules that restrict the movement of capital or the repatriation of profits;[92] further, Hong Kong places few restrictions on foreign ownership.[93] Because firms are likely to consider establishing themselves in Hong Kong to obtain these benefits, the treaty partners should clarify the status of enterprises

---

86. DELOITTE, HASKINS & SELLS, 2 INT'L TAX BUS. 4 (Hong Kong) (March 1985) [hereinafter DELOITTE, HASKINS & SELLS].

87. Sino-U.S. Agreement, *supra* note 5, art. 2, para. 1(a), at 412.

88. DELOITTE, HASKINS & SELLS, *supra* note 86, at 17. "Profits tax rates are assessed at a flat rate of 17 percent on all businesses except limited companies. Limited companies are taxed at 18.5 percent." *Id.*

89. *Id.* Hong Kong has no tax treaties with any countries, including the United States because: Hong Kong is not empowered to negotiate tax treaties, only income that either arises in or is derived from Hong Kong is taxed, and the tax rate causes Hong Kong to be a tax haven. *Id.*

90. *Id.* Dividends paid from profits that have already been subject to Hong Kong tax are not taxable in the hands of shareholders, whether foreign or domestic. Dividends paid by foreign companies are not taxable because they do not arise in, and are not derived from, Hong Kong. *Id.*

91. *Id.* If a company is a financial institution, its entire interest income may be taxable even if the loan funds were made available outside of Hong Kong. A financial institution is any of the following:

> A bank
>
> A deposit-taking company
>
> A company associated with a bank or deposit-taking company, which company would have had to register as a deposit-taking company except for the fact that it borrows only from a bank licensed in Hong Kong or from a registered deposit-taking company. For the purpose of defining a financial institution, a company associated with a bank or deposit-taking company is one over which the bank or deposit-taking company has control, or vice versa, or where the same person controls the bank or deposit-taking company and the associated company.
>
> The interest income of a financial institution may escape taxation if it can be shown that, in addition to having an offshore source, the interest did not arise through or from the carrying on of business in Hong Kong.

DELOITTE, HASKINS & SELLS, *supra* note 86, at 27-28.

92. *Id.* at 27.

93. *Id.* Foreign companies carrying on business in Hong Kong are subject to profits tax and are treated in the same way as domestic companies. *Id.*

established in Hong Kong to forestall these enterprises from engaging in activities which are later penalized.

4. *Real Property*

The Agreement differs from the U.S. Model Treaty by prohibiting investors in real property from electing taxation on a net basis.[94] Current U.S. law allows foreign persons to make such an election.[95] Real property ownership interests in the PRC, however, are extremely different from those of the United States. Under the Constitution of the People's Republic of China, land ownership is held by the Government.[96] Therefore, this treaty provision, as it applies to China's real property, may be severely limited.

5. *Capital Gains*

The Agreement allows source country taxation of most capital gains, including gains on the disposition of real property.[97] The Agreement's rules preserve the U.S. tax under the Foreign Investment in Real Property Tax Act of 1980.[98] The U.S. Model Treaty generally permits the source country to tax real property gains and the gains from the alienation of personal property,[99] but prohibits other source base taxation of capital gains.[100]

---

94. Sino-U.S. Agreement, *supra* note 5, art. 12, para. 1, at 428.
95. 26 U.S.C.S. § 1445(c)(2) (Law. Co-op. 1988).
96. Articles 9 and 10 of the Constitution of the People's Republic of China state:

> Article 9. Mineral resources, waters, forests, mountains, grassland, unreclaimed land, beaches and other natural resources are owned by the state, that is, by the whole people, with the exception of the forests, mountains, grassland, unreclaimed land and beaches that are owned by collectives in accordance with the law.

Article 10. Land in the cities is owned by the state.

> Land in the rural and suburban areas is owned by collectives except for those portions which belong to the state in accordance with the law; house sites and private plots of cropland and hilly land are also owned by collectives.
>
> The state may in the public interest take over land for its use in accordance with the law.
>
> All organizations and individuals who use land must make rational use of the land.

CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA, 5TH NAT'L PEOPLE'S CONG. 5TH SESS. arts. 9 & 10 (December 4, 1982) [hereinafter CONST. OF CHINA] *reprinted in China Laws for Foreign Business*, Constitution (CCH-Australia Ltd.) at ¶ 4-500, ¶ 4-500(9)-(10)(1982).

97. Sino-U.S. Agreement, *supra* note 5, art. 12, at 428.
98. *Id.*
99. U.S. Model Treaty, *supra* note 19, art. 13, at 219.
100. *Id.*

6. *Business Profits*

Under the Agreement, only business profits generated by permanent establishment can be taxed by the host country.[101] The Agreement does not contain a definition of "business profits," although certain categories of business profits are defined in a number of its articles.[102] This general omission may leave local law to define that term.[103] The U.S. Model Treaty definition of business profits includes income from rental of tangible personal property, and the rental or licensing of films or tapes.[104] The absence of such a provision in the Agreement means that a person who earns such rental or licensing income could be subject to tax in the source country on a gross income basis rather than on a net income basis, unless they maintain a permanent establishment in the source country.[105] The tax burden is significantly increased when the taxpayer cannot reduce the tax base through deductions and expenses.

The Agreement also allows a country to determine profits attributable to a permanent establishment on a "deemed basis"[106] pursuant to the country's internal law. The determination must parallel the determination applicable to other entities in that permanent establishment's industry and respect the principles contained in the business profits article of the Agreement.[107] The U.S. Model Treaty does not contain this attribution method of calculating profits on a deemed basis.[108]

---

101. Sino-U.S. Agreement, *supra* note 5, art. 12, at 428-29.

102. *Id.*, arts. 6-9, at 419-24; arts. 12-13, at 428-30; arts. 21-23, at 435-38.

103. Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, 5th Nat'l Cong., 3rd Sess. (1980) (amended 6th Nat'l Cong., 2nd Sess., art. 5 (1983)), [hereinafter Tax Law of China] *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 33-500, ¶ 33-500(5) (May 4, 1986); Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, art. 9, (approved 10 December 1980 by the State Council and promulgated 14 December 1980 by the Ministry of Finance) *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 33-510, ¶ 33-510(10) (Aug. 7, 1986) [hereinafter Rules for Joint Ventures].

104. U.S. Model Treaty, *supra* note 19, art. 7, para. 7, at 216 states:

> For the purposes of the Convention, the term "business profits" means income derived from any trade or business, including the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting.

Id.

105. Sino-U.S. Agreement, *supra* note 5, art. 7, para. 4, at 421.

106. *Id.*

107. *Id.* art. 7, at 419.

108. U.S. Model Treaty, *supra* note 19, art. 7, para. 3, at 216.

China's practice is to deem[109] as taxable profits an amount equal to ten percent of the Chinese source gross receipts of U.S. subcontractors from offshore oil operations.[110] China also declares as taxable income the profits from the outgoing traffic received by operators of ships and aircraft in international traffic.[111] In both cases, a 5.05 percent tax is imposed on the deemed profits.[112] Under the agreement currently in force between the United States and China governing the taxation of shipping and aircraft income, income earned by a U.S. enterprise from operation of ships or aircraft in international traffic is exempt from Chinese tax.[113]

7. *Gross Dividends*

Taxation of gross dividends by the source country is limited to ten percent[114] in contrast to the five percent limit for direct dividends[115] and fifteen percent limit for portfolio dividends[116] found in the U.S. Model Treaty. The U.S. Model Treaty allows one country to tax dividends paid by a resident company of the other country. The tax is owed when profits of its permanent establishment in the first country constitute five percent or more of the company's worldwide income.[117] In contrast, the Agreement allows one country to tax dividends paid by a residing company in the other country only when the dividends are paid to a resident of the taxing country or effectively connected

---

109. INTERIM PROVISIONS OF THE MINISTRY OF FINANCE CONCERNING THE LEVY OF THE CONSOLIDATED INDUSTRIAL AND COMMERCIAL INCOME TAX AND THE ENTERPRISE INCOME TAX ON FOREIGN BUSINESSES THAT CONTRACT FOR PROJECTS AND OPERATIONS AND PROVIDE LABOR SERVICES, (Finance - Taxation Document No. 102 (86) 21 April 1986) Issued on July 5, 1983, *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 33-515, ¶ 33-515(3) (July 8, 1986).

110. FOREIGN ENTERPRISE INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA, 5TH NAT'L CONG., 4TH SESS., art. 4, (1981), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 32-500, ¶ 32-500(4) (June 18, 1987) [hereinafter FOREIGN ENTERPRISE INCOME TAX].

111. Mutual Exemption from Taxation of Transportation Income of Shipping and Air Transport Enterprises, March 5, 1982, United States-People's Republic of China, ____ U.S.T.. , T.I.A.S. No.____ Senate Treaty Doc. No. 97-24 (art. II, para. 1(a)) *reprinted in* 13 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS Series B 493 (1983) [hereinafter SHIPPING AND AIR TRANSPORT TREATY].

112. THE REGULATIONS OF THE CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX OF THE PEOPLE'S REPUBLIC OF CHINA (DRAFT), (Adopted in principle 11 September 1958 at the 101st Meeting of the Standing Committee of the National People's Congress), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-500, ¶ 31-500(2).

113. Shipping and Air Transport Treaty, *supra* note 111, at 99.

114. Sino-U.S. Agreement, *supra* note 5, art. 9, para. 2, at 423.

115. U.S. Model Treaty, *supra* note 19, art. 10, para. 2(a), at 217.

116. *Id.* at para. 2(b).

117. *Id.* at art. 10.

with a permanent establishment with respect to holdings or other corporate rights to which the dividends are paid, or a fixed base situated in that other country.[118] This variation from the U.S. Model Treaty has the effect of prohibiting the United States from imposing its "second tier"[119] withholding tax on dividends paid by any Chinese company that will earn significant business profits within the United States.[120] The Agreement, unlike the U.S. Model Treaty, also expressly prohibits a country from taxing the undistributed profits of a company that is a resident in the other country.[121]

8. *Repeal of Portfolio Withholding*

The 1984 U.S. Tax Act repealed the U.S. gross withholding tax on interest related to portfolio indebtedness held by foreign persons.[122] In most cases, this permits Chinese residents to receive U.S. source interest on portfolio indebtedness free of U.S. tax.[123] However, U.S. residents may be subject to Chinese tax, limited to ten percent by the Agreement, on Chinese source interest on similar indebtedness, subject to certain exemptions.[124] The Agreement generally limits the tax at source on gross royalties, including movie royalties, to ten percent.[125] The protocol to the Agreement further reduces the maximum rate to seven percent.[126] Although the U.S. Model Treaty exempts royalties from the source country tax,[127] this limited tax on royalties is consistent with provisions found in other Chinese tax treaties.[128] The Agreement's limitations on source country withholding tax on dividends, interest, and royalties paid to residents of the other country apply by their terms only if the

---

118. Sino-U.S. Agreement, *supra* note 5, art. 9, at 422-24.
119. 26 U.S.C.S. § 884(e)(3) (Law. Co-op. 1988).
120. 26 U.S.C.S. § 884(e)(3)(A) and (B) (Law. Co-op. 1988).
121. Sino-U.S. Agreement, *supra* note 5, art. 9, para. 5, at 423-24.
122. Temp. Treas. Reg. § 35a.9999-5 (1987).
123. 26 U.S.C.S. § 871(h)(1) (Law. Co-op. 1988).
124. Sino-U.S. Agreement, *supra* note 5, art. 10, para. 2, at 424.
125. *Id.*, art. 11, paras. 1-2, at 426.
126. Second Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, *as amended by* The Protocol Signed at Ottawa on June 14, 1983.
127. U.S. Model Treaty, *supra* note 19, at 219. Article 12, paragraph 1 of the U.S. Model Treaty states: "[r]oyalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State." *Id.*
128. Agreement between the Government of the Kingdom of Norway and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, Art. 12, 21 DIAMOND & DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, Series B 185, 193-94 (1988); The Income Tax (Singapore - People's Republic of China Avoidance of Double Taxation Agreement) Order 1986, art. 12, *id.* at 251, 264-65.

recipient of the income is also its beneficial owner.[129] Under the U.S. Model Treaty, by contrast, these limitations on source country withholding tax generally apply so long as the beneficial owner of the income resides in the non-source country.[130] In that case, initial receipt of the income by an intermediary which is not the beneficial owner will be irrelevant.

The Agreement's language is similar to that of the OECD Model Treaty. For example, read literally, the Agreement's language permits interest received from sources in one country by a nominee for the interest's beneficial owner to be taxed fully by the source country, even though the beneficial owner resides in the other treaty country.[131] The commentaries on the OECD Model Treaty indicate that this language[132] should not be interpreted to deny the source country's reduced withholding tax rates on dividends, interest, or royalty payments received by a nominee or other agent of the beneficial owner when the beneficial owner is a resident of the non-source country.[133]

F. *China's Tax Law*

The Agreement's impact on Chinese taxes extends to individual income tax and the income taxation of joint ventures between Chinese and foreign partners.[134] These taxes are relatively new, adopted in 1980 or later. Almost all Chinese tax revenue comes from foreigners doing business in China, although only the income tax concerning foreign enterprises and the local income tax apply by their terms to foreign enterprises alone.[135] Although Chinese individuals, like foreign indivi-

---

129. Sino-U.S. Agreement, *supra* note 5, art. 9, para. 2, at 423; art. 10, para. 2, at 424; art. 11, para. 2, at 426.

130. U.S. Model Treaty, *supra* note 19, art. 10, para. 4, at 217.

131. Sino-U.S. Agreement, *supra* note 5, art. 10, at 424.

132. The United States Department of Treasury's District Director stated that it was the intent of the contracting countries that the language of the Sino-U.S. Tax Treaty be interpreted in accordance with the OECD commentaries. 3 Tax Treaties (P-H) ¶ 72,100 (1988).

133. OECD Model Treaty, *supra* note 27, at Ch. III, art. 10, para. 5.

134. The Sino-U.S. Agreement, at article 2, paragraph 1 states that "[t]he taxes to which this Agreement applies are

a) in the People's Republic of China:
(i) the individual income tax;
(ii) the income tax concerning joint ventures with Chinese and foreign investment;
(iii) the income tax concerning foreign enterprises;
(iv) the local income tax . . . ."

Sino-U.S. Agreement, *supra* note 5, at 412.

135. The Foreign Enterprise Income Tax Law of the People's Republic of China, 5th Nat'l People's Cong., 4th Sess., (13 December 1981) *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 32-500, ¶ 32-500(4).

duals, are subject to the individual income tax,[136] few Chinese presently earn enough to incur any tax liability. Only the tax imposed by the joint venture law appears to apply evenly to both Chinese and foreign investment.[137]

1. *Operation of Representative Offices*

In 1985, the Ministry of Finance promulgated two regulations which significantly impacted representative offices of foreign enterprises operating in China: the Interim Provisions for Collection of Consolidated Industrial and Commercial Tax and the Enterprise Income Tax for China-based Companies (CICT)[138] and the Provisional Regulations for the Collection of Consolidated Industrial and Commercial Tax and the Foreign Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises (FEIT).[139]

Prior to these regulations, the representative offices of foreign enterprises enjoyed a tax free status. It is now advisable for representative offices[140] to act as agents or consultants rendering services to their principals in return for commissions, rebates, and the like,[141] even

136. *Individual Tax Law of PRC, supra* note 25, at ¶ 30-500, ¶ 30-500(1).

137. The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, 5th Nat'l People's Cong., 3rd Sess., (as amended 2 September 1983 by the 6th Nat'l People's Cong., 2nd Sess.), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 33-500, ¶ 33-500(1) (April 5, 1986) [hereinafter Income Tax Law of Joint Ventures].

138. The Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China (Draft), adopted in principle 11 September 1958 at the 101st Meeting of the Standing Committee of the National People's Congress, *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-500 [hereinafter Consolidated Industrial and Commercial Tax].

139. Issued 15 May 1985 by the Ministry of Finance. These 1985 promulgations were amended October 1986 to provide for a reduction in the deemed profit rate of tax on permanent representative offices from fifteen to ten percent. The reduced rate went into effect retroactively on October 1, 1986. Provisional Regulations for Collection of Consolidated Industrial and Commercial Tax and Enterprise Income Tax from Resident Representative Office of Foreign Enterprises (Issued 15 May 1985 by the Ministry of Finance), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-600.

140. Seligman, *Opening Your Resident Office*, China Bus. Rev. 53 (July-Aug. 1981).

141. Interim Provision of the Ministry of Finance of the People's Republic of China Concerning the Levy of Consolidated Industrial and Commercial Tax and Business Income Tax from China-based Foreign Companies (Promulgated 14 May 1985 by the Ministry of Finance) [hereinafter Interim Industrial & Commercial Tax], *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-600, ¶ 31-600(2) (July 8, 1986); Provisional Regulations for Collection of Consolidated Industrial and Commercial Tax and Enterprise Income Tax From Resident Representative Officers of Foreign Enterprises, (Issued 15 May 1985 by the Ministry of Finance effective January 1, 1985), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-600, ¶ 31-600(2) (April 15, 1987).

though this income is subject to both CICT[142] and FEIT.[143] If, in the course of acting as agent or consultant, part of the service is provided by the representative office in the PRC and part by the head office overseas, the PRC tax authorities allow up to fifty percent[144] of the income in question to be allocated overseas, so that only one-half of the income is taxable in China.

When the representative office acts as an agent or consultant and receives commissions, rebates, or service fees, FEIT is levied on China source income based either on net income or a deemed profit basis.[145] When reporting on the net income basis, the representative office must keep accurate books and records in China.[146] Further, the accounts are subject to audit by a local PRC certified public accounting firm.[147] Where no detailed accounting records are kept in the PRC, FEIT will be levied on a deemed profit basis and ten percent of the allocated China source income will be deemed as taxable profit.[148] CICT is assessed on the gross income of the representative office at the rate of 5.05 percent.[149]

---

142. *Id.* at ¶ 31-600(4).
143. *Id.*
144. *Id.*
145. DETAILED RULES AND REGULATIONS FOR THE IMPLEMENTATION OF THE FOREIGN ENTERPRISE INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA (approved 17 February 1982 by the State Council and Promulgated 21 February 1982 by the Ministry of Finance), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 32-510, ¶ 32-510(2) [hereinafter RULES FOR FOREIGN ENTERPRISE].
146. China uses the following net income formula:

DEEMED GROSS INCOME:

Total Operating Expenses of the Representative Office.
1 - [10% (deemed profit rate) + 5.05% (CICT rate)]
CICT = 5.05% x Deemed Gross Income
FEIT + 10% (Deemed Profit Rate) x Deemed Gross Income x applicable FEIT rate.

This formula can be illustrated as follows:

A representative office provides services in China to several affiliated companies at cost and the cost of operating the representative office is Rmb 850,000 per annum.

	RMB	RMB
Deemed Gross Income = 850,000 x (10% + 5.05%) =	1,000,000	
CICT (5.05% x 1,000,000) =		50,500
Deemed Profit - 10% x 1,000,000 =	100,000	
FEIT (100,000. x 30%) =		30,000
Total CICT and FEIT payable		80,500
[Effective Tax Rate 80,500/850,000 = 9.47%]		

147. RULES FOR FOREIGN ENTERPRISE, *supra* note 145, at ¶ 32-510(36).
148. FOREIGN ENTERPRISE INCOME TAX, *supra* note 110, at ¶ 32-500(4).
149. CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX, *supra* note 138, at ¶ 31-500.

The deemed profit basis is calculated as follows:
Company A. is a commissioned agent which has a representative office in China. The

Frequently, the representative office is not involved in any agency activities and receives none of the types of income mentioned above. The representative office may have been established to provide services to only its affiliated companies within its own group. Under the regulations,[150] if the representative office performs merely preparatory and liaison services on behalf of its immediate head office, it can be *exempted* from PRC tax.[151] However, it is most unusual that a representative office would only render services to a holding company and to no other entity within the group. The representative office usually represents an entire group and assists each of the companies in doing business with the PRC. For this reason, most representative offices do not qualify for tax-exempt status and are taxed on the net income basis. The term "immediate head office" was defined as the legal entity that directly owns the representative office in the PRC.[152] A representative office that renders services to a group of companies or to third parties, even if it does not receive any income or cost reimbursements, engages in taxable activities.[153]

II. The Impact of the Sino-U.S. Agreement on Foreign Investment in the PRC

A. *Investment Methods Utilized by the Foreign Investor*

The PRC utilizes different methods of attracting foreign investment in order to acquire foreign technology, equipment, and know-how.[154]

Company A. is a commissioned agent which has a representative office in China. The representative office does not keep a full set of books in China to enable it to use the net income basis.

	RMB	RMB
Total Commission =	2,000,000.	
Commission income allocated to the Representative Office (50% x 2,000,000.) =	1,000,000.	
CICT (5.05% x 1,000,000.) =		50,500.
FEIT:		
Deemed Profit: [(1,000,000. x 10%) x 30%] =		30,000.
Total CICT and FEIT Payable		80,500.

[Effective Tax Rate 80,500./1,000,000. = 8.05%]

150. Interim Industrial & Commercial Tax, *supra* note 141, at ¶ 31-600(1).

151. *Id.* at ¶ 31-600(1)-(2).

152. Provisional Regulations for Collection of Consolidated Industrial and Commercial Tax and Enterprise Income Tax from Resident Representative Offices of Foreign Enterprises (issued 15 May 1985 by the Ministry of Finance), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-600, ¶ 31-600(1) (April 15, 1987).

153. Interim Industrial & Commercial Tax, *supra* note 141, at ¶ 31-600(3).

154. Measures of the Ministry of Finance for the Implementation of the Preferential

These methods include, but are not limited to, barter trade,[155] compensation trade,[156] processing arrangements,[157] and joint ventures.[158] China's economic policy[159] during the current period of development calls for short-to-medium projects which require only a small initial investment and have good potential for yielding a quick return. All trade,[160] compensation trade,[161] joint ventures, and other cooperative arrangements will likely receive approval[162] if they are: (1) export-oriented projects, (2) self-financing, and (3) do not draw on China's limited foreign exchange reserves.[163]

The internal trading currency within the PRC is a form of blocked currency.[164] There is no established market outside the PRC for exchange of the Chinese yuan into a currency that is freely exchanged in other countries.[165] The PRC therefore favors[166] investment methods that will prevent depletion of its internal reserves and promote growth of non-blocked currency from other countries.[167] In particular, the types

---

TAX TREATMENT PROVISIONS OF THE STATE COUNCIL REGULATIONS CONCERNING ENCOURAGEMENT OF FOREIGN INVESTMENT, Issued 31 January 1987 by the Ministry of Finance, *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 32-650 (June 18, 1987) [hereinafter MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT].

155. *Business Operations in the People's Republic of China*, Tax Mgmt. (BNA) No. 443-2nd, at A-14 (1988).

156. *Id.*

157. *Id.*

158. *Id.*

159. FOREIGN ENTERPRISE INCOME TAX, *supra* note 110, at ¶ 32-500(4).

160. *Business Operations in the People's Republic of China*, *supra* note 155.

161. *Id.*

162. MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT, *supra* note 154, at ¶ 32-650(3).

163. Annual Report of the International Monetary Fund, Exchange Arrangements and Exchange Restrictions 155 (1987):

> Proceeds of certain exports (joint-venture companies and 100 percent foreign-owned companies) may be retained in a foreign exchange account with the Bank of China or an authorized bank. All other foreign exchange earnings from exports must be repatriated and surrendered to the Bank of China, unless specific exception is granted by the State Administration of Exchange Control, and may not be used directly to offset import payments. Part of the proceeds of exports (including foreign exchange earned in compensation trade) may be held as foreign exchange retention quotas in the State Administration of Exchange Control or its sub-bureaus by localities and enterprises in accordance with state regulations.

Id.

164. *Id.* Since January 1, 1986 China has followed an exchange arrangement whereby the exchange rate for the renminbi is based on developments in the balance of payments and in costs and exchange rates of China's major competitors. The exchange rates for the U.S. dollar and 19 other currencies are published on a daily basis by the State Administration of Exchange Control. *Id.*

165. *Penal Provisions for Violation of Exchange Control Regulations*, China Daily (Beijing) (April 5, 1985) at 2.

166. Rich, *Joint Ventures in China: The Legal Challenge*, 15 INT'L LAW. 187 (1981).

167. *Annual Report of the International Monetary Fund*, EXCHANGE AGREEMENTS AND

of transactions most favored by the Chinese are:[168] wholly owned foreign enterprises,[169] because control of the physical facilities and flow of currency will ultimately pass to the PRC; equity joint ventures,[170] because the PRC has an actual equitable interest in the venture, may share in the profits, and, depending on the individual agreement, will retain the enterprise at the end of the enterprise's life; and barter[171] and counter-trade[172] agreements, because they allow the PRC to develop international markets for its domestic goods and generate an influx of outside currency.

The PRC prefers international transactions that are structured in a manner to cause an inflow of outside currency while maintaining the minimum outflow of traded currency.[173] Therefore, when an international transaction requires a sale to the PRC, it is common for the PRC to pay with Chinese domestic goods. These barter[174] and counter-trade[175] practices may create a sizeable dilemma for foreign investors financing their part of a transaction with the false expectation of rapid repayment of the outstanding loan with profits from the PRC transaction. Frequently, profits from a transaction with the PRC are in the form of Chinese domestic goods. Thus, the investor may incur interest on the loans and large storage fees.[176]

The foreign investor preferably should confirm the method and manner of payment from the Chinese party in the early part of the negotiations to help mitigate the element of surprise in the future. If a foreign investor finalizes negotiations with an acceptance of domestic Chinese goods as partial or full payment of the sale's transaction with the PRC, there are methods available to recognize cash or cash

---

EXCHANGE RESTRICTIONS 154 (1987):

> The People's Bank of China (PBC) exercises central bank functions and control over foreign exchange; and the State Administration of Exchange Control (SAEC), as a government institution under the leadership of the People's Bank of China, is responsible for implementing the exchange regulations and controlling all foreign exchange transactions in accordance with state policy.

Id.

168. MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT, *supra* note 154, at ¶ 32-650(2).
169. *See* Wassermann, *China's Expanding Trade*, 19 J. WORLD TRADE L. 542, 543 (1985).
170. *Id.*
171. K. Hobér, *Countertrade: Negotiating the Terms*, 6 INT'L FIN. L. REV. 28, 30 (March 1987) [hereinafter Hobér].
172. *Id.* at 28-30.
173. SALACUSE, *supra* note 54, at 106.
174. Hobér, *supra* note 171, at 28-33.
175. *Id.* at 28-30.
176. "China's outdated machinery and low quality control standards may produce goods that do not meet Western consumer demands." Klenner & Wiesegart, *Joint Ventures in P.R. China*, INTERECONOMICS at 87 n. 3 (Mar.-April, 1980).

equivalents. One alternative is for the foreign investor to sell the contractual right to receive the domestic goods. The foreign investor can also accept payment from a third party in goods that have a more favorable demand in the market place. The advantage of these alternatives is to vary the timing for the recognition of income for tax purposes.[177]

1. *The Establishment of a Wholly Owned Foreign Enterprise*

The Chinese wholly owned foreign enterprise (WOFE),[178] and a U.S. corporation[179] are similar in several respects, but two major differences exist. First, a WOFE has a limited life (twenty years in a high technology industry), whereas a U.S. corporation has an unlimited life.[180] Second, in a separation, merger or other major structural change, a WOFE must seek government agency approval from the Administration of Industry and Commerce. In contrast, a U.S. corporation need only seek permission to conduct an activity in specialized circumstances, such as from the Securities and Exchange Commission when contemplating a proposed merger.

WOFEs are also subject to Ministry of Finance regulations. In reference to WOFEs, the FEIT states:

> Income tax shall be levied in accordance with this law on the income derived from production; business; and other sources of any foreign enterprise operating in the People's Republic of China.[181]

WOFEs are presently subject to the CICT. The Chinese authorities have indicated that the WOFE will be subject to the applicable new income tax laws as they are promulgated,[182] although none specifically address WOFE operations at present.[183] Under U.S. tax laws, a WOFE

177. 26 U.S.C.S. § 1001(a) (Law. Co-op. 1988).
178. FOREIGN ENTERPRISE INCOME TAX, *supra* note 144, at ¶ 32-500(1).
179. Rev. Rul. 88-8, 1988-4 I.R.B. 18.
180. Asian Wall St. J. Weekly, Jan. 14, 1985 at 17, col. 1.
181. FOREIGN ENTERPRISE INCOME TAX, *supra* note 110, at ¶ 32-500(1).
182. *Id.* at ¶ 32-500(17).
183. WOFEs currently within the Special Economic Zones are being taxed in accordance with the Foreign Enterprise Income Tax Law. It is anticipated that the future laws will be based upon this law. WOFEs will be able to enjoy the same tax incentives that are currently being offered to other foreign investors in China.

Article 4 of the REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA ON SPECIAL ECONOMIC ZONES IN GUANGDONG PROVINCE states:

> In the special zones investors are offered a wide scope of operation, favorable conditions for such operation are created, and stable business sites are guaranteed. All items of industry, agriculture, livestock breeding, fish breeding and poultry farming, tourism, housing and construction, research and manufacturing involving high technologies and

that is incorporated outside the United States is not subject to U.S. taxation until the earnings and profits are finally repatriated to the U.S. parent or shareholder in the form of a dividend. However, the Internal Revenue Service has issued a Revenue Ruling[184] which restricts the application of recognizing taxable income from the repatriation of earnings and profits from PRC corporate dividends. This Revenue Ruling uses the U.S. Treasury's Regulation factors[185] to determine if a corporation will be recognized by the U.S. tax authorities. Therefore, a corporation recognized under Chinese tax law may be viewed by the U.S. tax authorities as a branch[186] subject to branch profits tax[187] on the income earned by the Chinese corporation in each year of operation. Thus, there is no deferral of U.S. tax by the common method of imposing tax on the dividend when paid.[188] The U.S. tax would be due immediately on a branch's profits from the China operation, even though not actually paid.[189]

Relief is granted in the Agreement[190] to WOFEs by allowing a foreign tax credit to offset double taxation on the WOFE's income by both contracting states. The United States foreign tax credit provision[191] mitigates the harshness of this double taxation.[192] The usual effect of

---

> techniques that have positive significance in international economic cooperation and technical exchanges, as well as other trades of common interest to investors and the Chinese side, can be established with foreign investment or in joint venture with Chinese investment.

REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA ON SPECIAL ECONOMIC ZONES IN GUANGDONG PROVINCE, 5TH NAT'L PEOPLE'S CONG., 15TH SESS. (August 4, 1980), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 70-800 [hereinafter REGULATIONS ON SPECIAL ZONES IN GUANGDONG PROVINCE].

184. Rev. Rul. 88-8, 1988-4, at I.R.B. 18.

185. Treas. Reg. § 301.7701-2(a)(1) sets forth the basic characteristics of corporations:
"(1) Associates; and
(2) An objective to carry on business and divide the gains therefrom; and
(3) Continuity of life; and
(4) Centralization of management; and
(5) Limited liability; and
(6) Free transferability of interests." *Id.*

186. THE RESEARCH INSTITUTE OF AMERICA, INC., THE RIA COMPLETE ANALYSIS OF THE '86 TAX REFORM ACT, § 1748 (1986) [hereinafter RIA ANALYSIS].

187. 26 U.S.C.S. § 884(a) (Law. Co-op. 1988).

188. 26 U.S.C.S. § 884(b) (Law. Co-op. 1988).

189. RIA ANALYSIS, *supra* note 186, at § 1749.

190. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-36.

191. 26 U.S.C.S. § 904 (Law. Co-op. 1988).

192. Illustration:
A U.S. Domestic Corporation *D* owns all of the stock of a French Corporation *F*, which in turn owns all of one class of stock in a Wholly Owned Foreign Corporation in China *C*. Assume all of the corporations use the calendar year as the taxable year.

utilizing the foreign tax credit is to reduce the U.S. tax burden. This

---

U.S. Corporation—	*D Corp.*
	100 % ownership
French Corporation—	*F Corp.*
	100 % ownership
Wholly Owned Foreign Corporation—	*C Corp.*

China Corporation:

Net Profits Before Imposition of China Tax	\$300,000.
Less: China Taxes Imposed	(120,000.)
Accumulated Profits in Excess of China Tax	180,000.
Less: Dividends paid to the French Corporation	(90,000.)
Net Accumulated Profits (undistributed)	\$90,000.

CALCULATION:

Foreign Income Tax of *C Corporation* Deemed paid by *F Corporation*:

FORMULA:

$$\left(\frac{\text{Dividends paid by } C \text{ to } F}{\text{Accumulated Profits in Excess of China Tax Paid}} \right) \times \left(\begin{matrix} \text{China Income Tax} \\ \text{Paid by } C \text{ Corp.} \end{matrix} \right) = \begin{matrix} \text{Deemed} \\ \text{Paid} \end{matrix}$$

\$90,000./\$180,000. x \$120,000. = \$60,000. (Deemed Foreign Tax Paid by *F*)

French Corporation:

Net Profits Before Imposition of French Tax	\$200,000.
Add: Dividends From China Corporation	90,000.
Total	290,000.
Less: French Taxes Imposed	(40,000.)
Accumulated Profits in Excess of French Tax	250,000.
Less: Dividends Paid by *F Corp.* to *D Corp.*	(125,000.)
Net Accumulated Profits (undistributed)	\$125,000.

CALCULATION:

Foreign Income Taxes Paid, and Deemed Paid, by *F Corp.* on or with respect to its accumulated profits for the current taxable year:

FORMULA:

$$\left(\begin{matrix} \text{Foreign taxes of } C \text{ Corp.} \\ \text{Deemed Paid by } F \text{ Corp.} \end{matrix} \right) + \left(\begin{matrix} \text{Foreign Income Taxes} \\ \text{Paid by } F \text{ Corp. on} \\ \text{Accumulated Profits.} \end{matrix} \right)$$

\$60,000. + \$40,000. = \$100,000.

United States Domestic Corporation:

Dividends Received from *F Corp.*	\$125,000.
Gross-Up of Dividends Received	50,000.
Total Income	\$175,000.

marks a significant incentive for doing business with foreign countries that have tax treaties with the U.S. Caution should be taken to ascertain whether the U.S. will recognize the foreign countries' tax as qualifying as a creditable foreign tax.

2. *Foreign Investment Utilizing Joint Ventures*

a. *Establishment of Equity Joint Ventures in China*

In structuring a joint venture project with Chinese and foreign partners, a limited liability company[193] is formed to carry out the investment activities.[194] Since there is an absence of corporation law in

---

CALCULATION:

FOREIGN TAXES ALLOWABLE AS A CREDIT AGAINST U.S. TAX LIABILITY OF THE U.S. DOMESTIC CORPORATION;

FORMULA:

$$\left(\frac{\text{Foreign Dividend Received by } D \text{ Corp. from } F \text{ Corp.}}{\text{Accumulated Profits of } F \text{ Corp. in Excess of French Taxes}} \right) \times \left(\text{Foreign Income Taxes of } F \text{ Corp. Deemed paid by Domestic Corporation} \right)$$

\$125,000./\$250,000. x \$100,000. = \$50,000.

APPLICATION OF THE FOREIGN TAX CREDIT:

U.S. Corporation's World-Wide Income:

U.S. Source Income from U.S. Operations	\$225,000.
Foreign Source Income from Dividends	125,000.
Foreign Source Income from Gross-Up	50,000.
Total World-Wide Taxable Income	\$400,000.

Gross U.S. Tax Liability Before Application of Foreign Tax Credits:

(\$400,000. x U.S. Corporate Tax Rate of 34%)=	\$136,000.
Less: Foreign Tax Credit	(50,000.)
Net U.S. Tax Liability After Application of Foreign Tax Credits:	\$86,000.

193. THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON JOINT VENTURES USING CHINESE AND FOREIGN INVESTMENT, 5TH NAT'L PEOPLE'S CONG., 2ND SESS., (July 8, 1979), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 30-510(1) & (4).

194. Lorinczi & Dorian, *U.S.-Hungarian Joint Ventures: Prospects and Problems*, 10 LAW & POL'Y INT'L BUS. 1205, 1216 (1978).

> Generally, a joint venture will contain elements atypical to those found in other types of financial arrangements. This includes: (1) ownership by both parties; (2) a common board of directors; (3) joint utilization of financial resources; (4) a specific objective; (5) officers who are directly employed by the joint venture; (6) and a legal relationship among the partners governed by the host country's company law, rather than by contractual arrangements.

Id.

China, the framework of the joint venture company must be drafted in the articles of association and by-laws of the new entity. The legal existence of the joint venture company is established when a business license is issued to it by the Registration and Administration Office of the region in which the joint venture is to operate.[195]

Capital contributions to a joint venture can be made in the form of cash,[196] capital goods, industrial property rights, or other assets. These contributions are specified in the joint venture agreement, the articles of association, and the by-laws. The most common contributions made by the Chinese partner are project site land use, factory facilities, labor, raw materials and a limited amount of cash.[197]

The joint venture law does not impose a time limit on the life of the joint venture *per se*. The contracted duration of a joint venture can be extended upon expiration through the mutual agreement of the Chinese and foreign partners if approval is also obtained from MOFERT.[198]

b. *Taxation of Equity Joint Ventures*

The PRC's initial law on joint ventures was the Joint Venture Using Chinese and Foreign Investment Law, adopted on July 1, 1979 at the Second Session of the Fifth National People's Congress and effective on July 8, 1979. The subsequent Joint Venture Income Tax Law of October 1980 recognizes that foreign technology and capital must be imported to fulfill China's modernization program. In this Socialist-Communist economy, as in a capitalist economy, the income tax is used to implement national policy. Thus, through the Joint Venture Income Tax Law,[199] the PRC is encouraging foreign investment in remote and economically underdeveloped outlying areas.[200]

---

195. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(11).

196. Joint ventures may also open foreign exchange accounts and use them to make payments abroad. With the permission of the Bank of China, foreign banks may hold convertible renminbi accounts in connection with commercial or noncommercial transactions.

> The Bank of China may check any use of renminbi in such accounts. Foreign banks in Special Economic Zones may lend in foreign exchange and accept foreign currency deposits from joint venture companies.

Annual Report of the International Monetary Fund, Exchange Arrangements and Exchange Restrictions, 155 (1987).

197. *Id.* at 157.

198. Ministry of Foreign Economic Relations and Trade. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(11).

199. THE INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA CONCERNING JOINT VENTURES WITH CHINESE AND FOREIGN INVESTMENT, *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 33-500(5).

200. REGULATIONS ON SPECIAL ZONES IN GUANGDONG PROVINCE, *supra* note 183, at ¶ 70-800(5). *See also* DELOITTE, HASKINS & SELLS, *supra* note 86, app. G, at 62.

The extent of general income taxation is based upon the place of residence[201] and the income source base of the joint venture.[202] World-wide income of a resident joint venture and its branches, both within and outside the PRC, is taxable.[203] To lessen the burden of double taxation on income from outside China, a foreign tax credit is allowed for income taxes paid to other countries by joint ventures and their branches.[204] The available tax credit is the lesser of the foreign tax actually paid and the PRC tax payable on the foreign source income. If, however, a double tax agreement is in effect between the PRC and the foreign country, the foreign tax credit will be calculated according to that agreement.[205]

Illustration:

Assume a joint venture operating in China with 50% ownership[206] by a U.S. entity;

JOINT VENTURE:

Gross Income from Operations[207]	$225,000.
Less: Operating Expenses[208]	(25,000.)
Less: General Administrative and Overhead Expenses[209]	(15,000.)
Less: Depreciation under China Tax Laws[210]	(5,000.)
Taxable Income[211]	$180,000.

China Tax Liability on Taxable Income at 40%[212] = $72,000.

201. REGULATIONS ON SPECIAL ZONES IN GUANGDONG PROVINCE, *supra* note 183, at ¶ 70-800(5).
202. *Id.* at ¶ 33-500(11).
203. *Id.* at ¶ 33-500(1). "Income tax on the income derived from production, business and other sources by branches within or outside the territory of China of such joint ventures shall be paid by their head office." *Id.*
204. *Id.* at ¶ 33-500(16).
205. REGULATIONS ON SPECIAL ZONES IN GUANGDONG PROVINCE, *supra* note 183. "Where agreements on avoidance of double taxation have been concluded between the Government of the People's Republic of China and the government of another country, income tax credits shall be handled in accordance with the provisions of the related agreements." *Id.* at ¶ 70-800.
206. There must be at least 25% Chinese ownership to receive approval as a qualifying joint venture. *Id.* at ¶ 33-500(4).
207. *Id.* at ¶ 33-500(2).
208. *Id.*
209. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(2).
210. *Id.*
211. *Id.* at ¶ 33-500(3).
212. *Id.*

RECALCULATION OF JOINT VENTURE TAXABLE INCOME FOR U.S. TAX:

Gross Income from Operations[213]	$225,000.
Less: Operating Expense[214]	(25,000.)
Less: General, Administrative and Overhead[215]	(15,000.)
Less: Depreciation under U.S. Tax Laws[216]	(15,000.)
Total Foreign Source Income	$170,000.
Add: U.S. Source Income from other Operations[217]	$115,000.
Total Worldwide Taxable Income	$285,000.

U.S. Tax Liability on Taxable Income at 34%[218] = $96,900.

CALCULATION OF FOREIGN TAX CREDIT LIMITATION[219]

$$\left[\frac{\text{Total Foreign Source Income}}{\text{Total Worldwide Income}}\right] x \text{ U.S. Tax Liability}$$

$170,000./$285,000. *x* $96,900. = $54,400.

CALCULATION OF FOREIGN TAX CREDIT APPLICATION:

Total U.S. Tax Liability *Before* Foreign Tax Credit	$96,900.
Less: Foreign Tax Credit	(54,400.)
U.S. Income Tax Liability *After* Foreign Tax Credit	$42,500.

The Agreement allows the usage of foreign tax credits to offset the double taxation.[220] A 100 percent relief was not provided for in the calculation of net U.S. income tax liability after foreign tax credit:

Amount of Foreign *Tax Actually Paid*	$72,000.
Amount of Foreign *Tax Utilized* as an Offset	(54,400.)
Amount of Foreign Tax *Not Utilized* as an Offset	$17,600.

213. 26 U.S.C.S. § 862 (Law. Co-op. 1988).
214. 26 U.S.C.S. § 862(b) (Law. Co-op. 1988).
215. 26 U.S.C.S. § 863 (Law. Co-op. 1988).
216. 26 U.S.C.S. § 168(g)(4) (Law. Co-op. 1988).
217. 26 U.S.C.S. § 861(a) (Law. Co-op. 1988).
218. 26 U.S.C.S. § 11(b)(1)(C) (Law. Co-op. 1988).
219. 26 U.S.C.S. § 904(a) (Law. Co-op. 1988).
220. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-37.

The rationale for the ineffectiveness of the Agreement in this situation is twofold:

(1) The China tax rate[221] is greater than the U.S. tax rate;[222] and

(2) The China tax law[223] allows a lesser amount of depreciation expense to reduce taxable income than the U.S. tax law.[224]

This gives a lower numerator in the calculation of Foreign Tax Credit Limitation. The recourse in situation (1) is to carryback and carryforward[225] the non-utilized foreign tax credit. Situation (2) must be addressed to the competent authorities[226] in seeking a reconciliation of the tax accounting policy variances between the two contracting states.[227]

An alternative which the foreign investor may wish to consider is the avoidance of the "permanent establishment" status within the Agreement. Article 5, paragraph 7 of the Agreement states:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

When using the above paragraph from Article 5 with the following illustration, the status of permanent establishment as to the income to be derived can be avoided.

---

221. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(3).
222. 26 U.S.C.S. § 11(b)(1) (Law. Co-op. 1988).
223. RULES FOR JOINT VENTURES, *supra* note 103, at ¶ 33-510.
224. 26 U.S.C.S. § 168(g)(4) (Law. Co-op. 1988).
225. 26 U.S.C.S. § 904(c) & (e) (Law. Co-op. 1988).
226. Sino-U.S. Agreement, *supra* note 5, art. 24, at 438.
227. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

26 U.S.C.S. § 482 (Law. Co-op. 1988).

The facts are:

A U.S. corporation, involved in the manufacturing industry, enters into a joint venture agreement with a Chinese corporation for the purpose of: (1) designing, developing, and manufacturing in China; and (2) delivering the manufactured goods in the U.S. and China.

The U.S. corporation agrees to provide the technical expertise as part of the joint venture. However, in a separate agreement, the U.S. corporation agrees to supply, in a direct method, to the Chinese corporation the components for producing the manufactured goods in China.

Result:

Under the Agreement, the U.S. corporation is held to have a permanent establishment within China. The rationale for this status is the agency relationship created by the joint venture agreement. This situation may yield larger foreign taxes because the sale of manufacturing components may be held as effectively connected[228] with the conduct of the joint venture.

In this situation, the U.S. corporation should form a separate subsidiary to act as a management consulting corporation. The U.S. corporation thus would subcontract the work to the subsidiary in the capacity of a service corporation. The subsidiary's duties would include the hiring of personnel from the U.S. corporation for performing any extended work within China. The subsidiary would be compensated in the form of a fee for performing that particular part of the contract. The result is to have the subsidiary labeled a permanent establishment, and only the subsidiary's management fee would be taxable to China. The U.S. corporation's sales activities would not be held to create a permanent establishment for purposes of invoking Chinese taxation. This analysis assumes that the U.S. corporation's sales activities are not excessive.[229] Additionally, it may be wise to obtain an administrative ruling from China before commencing such an arrangement of management consulting fees.[230]

c. *Formulation of specific tax refunds and exemptions*

Participants in joint ventures who expect to operate in China for ten years or more may apply to the Tax Bureau for exemption from income tax in the first profit-making year, with a full exemption applicable the following year and a fifty percent tax reduction during the three years

228. 26 U.S.C.S. § 864(c) (Law. Co-op. 1988).
229. "Excessive" amounts of sales activities are to be determined on a case by case basis.
230. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(11).

thereafter.[231] The first "profit-making year" is defined under the regulations as the year in which a joint venture recognizes profits after the accumulated operating losses from prior years have been used up.[232] After expiration of the period of reduction of, or exemption from, Enterprise Income Tax as stipulated by the State, any exporting enterprise with an export value for the year amounting to seventy percent or more of the value of the enterprise's product output for that year may pay Enterprise Income Tax at one-half of the prevailing rate.[233]

The foreign partner of a joint venture may apply to receive a tax refund of forty percent of the income tax paid on the foreign partner's share for that portion of the joint venture profit which is subsequently reinvested in China for a period of at least five years.[234] The Regulations provide that reinvestments can be in the original joint venture or in other joint ventures.[235] The refund is made at the time of the reinvestment.[236] If the reinvestment is withdrawn before the end of five years, the tax is re-assessed against the foreign partner through the joint venture vehicle.[237] In exporting enterprises and technologically advanced enterprises, foreign investors are exempt from paying Chinese income taxes on dividends remitted abroad.[238] Foreign investors in Sino-foreign joint equity exporting enterprises and technologically advanced enterprises are exempt from payment of the ten percent withholding tax levied on the amount of their share of profits remitted abroad from 1986 and subsequent years.[239] Withholding tax already paid on the amount of 1986 pre-distributed profits remitted abroad before the date of promulgation of the Regulations, shall be refunded.[240] Foreign participants in joint ventures who remit profit from years before 1986 will still pay withholding tax on the remitted amount in accordance with the original regulations.[241]

---

231. *Id.* at ¶ 33-500(5).
232. " 'The first profit-making year' as mentioned in Article 5 of the Tax Law refers to the year in which a joint venture has begun making profit after the losses, if any, in the initial stage of its operation." RULES FOR JOINT VENTURES, *supra* note 103, at ¶ 33-510(5).
233. MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT, *supra* note 154, at ¶ 32-650(2).
234. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(6).
235. MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT, *supra* note 154, at ¶ 32-650(6).
236. *Id.*
237. *Id.*
238. *Id.*
239. PROVISIONS FOR THE ENCOURAGEMENT OF FOREIGN INVESTMENT, art. 7, promulgated by the State Council and effective on October 11, 1986. (copy on file at *The Transnational Lawyer*).
240. *Id.* art. 10.
241. MEASURES FOR ENCOURAGEMENT OF FOREIGN INVESTMENT, *supra* note 154, at ¶ 32-650(1).

Upon approval by the Ministry of Finance, investments made by low-profit joint venture operations in remote and undeveloped locations, and such as farming and forestry, may qualify for fifteen to thirty percent reductions in tax rates for ten years (although the length is negotiable).[242] Joint venture partners must obtain the joint approval of the Tax Bureau and the Foreign Investment Control Commission to secure those reductions.[243] The particular location characteristics determine the "remote, economically underdeveloped outlying area" status.[244] This determination should be obtained as early as possible in joint venture negotiations.

3. *Barter*

Pure barter[245] is quite possibly the financial world's oldest form of commerce. Barter is generally defined as a transaction that provides for a direct exchange of goods or services on an equal par between two parties without any cash changing hands in the form of boot. Thus, each party must desire exactly what the other party offers and vice-versa.

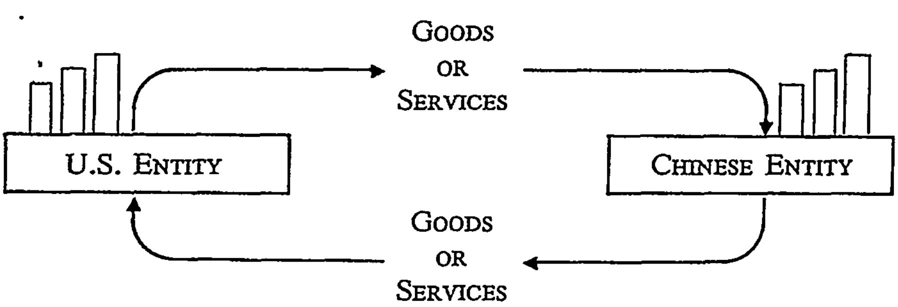

Figure 1.[246]

242. FOREIGN ENTERPRISE INCOME TAX, *supra* note 110, at ¶ 32-500(5).
243. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500(5).
244. Special economic zones have been set up on Shantou, Shenzhen, Xiamen, and Zhuhai. Economic and technological development areas have been established in 14 designated coastal cities. Foreigners, overseas Chinese, and Chinese from the Hong Kong and Macao regions are permitted to invest in and open factories in these zones and areas. Raw materials, equipment, and machinery or parts and components thereof, means of transportation, and other means of production imported by and intended to be used in the production of the enterprises in the zones are exempt from import duties and the consolidated industrial and commercial tax.
Annual Report of the International Monetary Fund, EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 156 (1987).
245. Grabow, *Negotiating and Drafting Contracts in International Barter and Countertrade Transactions*, 9 N.C.J. INT'L L. & COM. REG. 255, 259 (1984).
246. The tax consequences of the above transaction pivot on the actual sourcing of the

Today, such barters in the pure form are rare. Currently, modified versions of barter exist.

4. *Compensation Trade Agreements*

Under a compensation trading arrangement,[247] the foreign trade partner will supply the PRC with equipment, technical services, and necessary raw materials where needed. In exchange, the foreign partner will receive the manufactured product as payment. Factory premises are provided by the Chinese and built to foreign specifications. Further, a stable work-force is guaranteed to produce goods at reasonable prices under the supervision of the foreign firm's representatives. The PRC is paid for its processing costs, which are mostly labor charges expressed as a processing fee.[248] Such a fee usually is substantially discounted and applied against the initial cost of the equipment. China becomes the owner of the equipment at the end of the foreign investors' term and thereafter the full processing fee is charged.

---

income. Sections 861-864 of 26 U.S.C.S. provide the sourcing rules used by the United States. These sourcing rules are extremely complex in their application. They are paramount for the following purposes: (1) nature of the income; (2) character of the income; (3) timing of the realization and recognition of income; (4) limitation calculation on foreign tax credit; and (5) invoking various provisions of the Agreement. *See* 26 U.S.C.S. §§ 861-864 (Law. Co-op 1988).

247. Rajski, *Some Legal Aspects of International Compensation Trade*, 35 INT'L & COMP. L.Q. 133 (1986).

> A compensation or buy back transaction may be described as a long-term arrangement which involves a party that is under an obligation to deliver equipment, licenses or know-how for the construction of an industrial installation, and is committed to rendering appropriate technical services. This party undertakes to buy, over a fixed period, products resulting from those installations, in total or in part payment. Identification of the compensation goods is normally, if not always, well known in advance. Parties, therefore, can determine more precisely the quality and quantity of these goods, and may agree on the time limits for delivery. Prices also can be determined more easily. Since the risks to all parties are readily assessable, the elaborate contracts used in compensation arrangements do not encounter the same problems as the contracts used in the third main form of countertrade, namely counterpurchase.

Id.

248. *See* Alford & Birenbaum, *Ventures in the China Trade: An Analysis of China's Emerging Legal Framework for the Regulation of Foreign Investment*, 3 N.W. J. INT'L L. & BUS. 79 (1981).

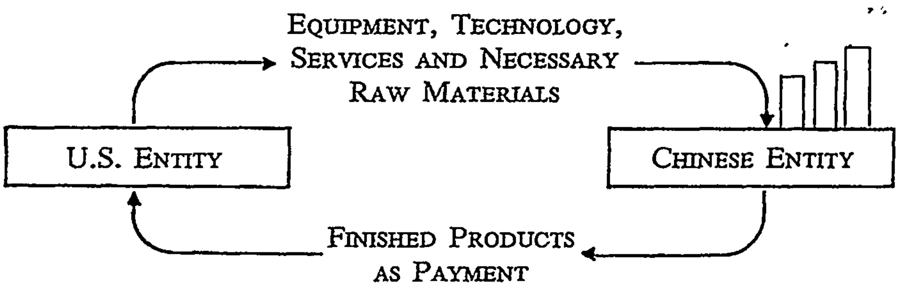

Figure 2.[249]

Large-scale compensation trade involves foreign firms supplying technology, equipment, and the necessary materials to key construction projects undertaken by the state.[250] The foreign firms' contribution is paid in products to be produced in the future by the enterprises currently under construction. Negotiations for large-scale compensation trade agreements are handled by Chinese ministries and State commissions such as the Ministry of Petroleum Industry, the Ministry of Chemical Industry, and the Ministry of Machine-Building.[251]

5. *Counter-Purchase Agreements*

Counter-purchase is the joining of a sales transaction for the export of goods, technology, or services with a tied purchase of products from the buyer's country.[252] Both parties will generally pay cash for the goods or services received. This payment will be in a hard currency, generally in the form of letters of credit.[253]

---

249. *See generally supra* note 246.
250. Article 1 of the Provisional Rules of China's Construction Tax states: "These Rules are formulated to control the scale of fixed asset investment and to readjust the structure of investment, in order to centralize funds and guarantee key State construction." PROVISIONAL RULES OF THE PEOPLE'S REPUBLIC OF CHINA ON CONSTRUCTION TAX (promulgated 25 June 1987 by the State Council), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 31-704, ¶ 31-704(1) (Sept. 21, 1987).
251. FOREIGN ENTERPRISE INCOME TAX, *supra* note 110, at ¶ 32-500(4).
252. Hobér, *supra* note 171, at 28.
253. Mishkin, *Countertrade and Barter: The Basic Legal Structure*, 14 INT'L BUS. LAW. 11 (1986).

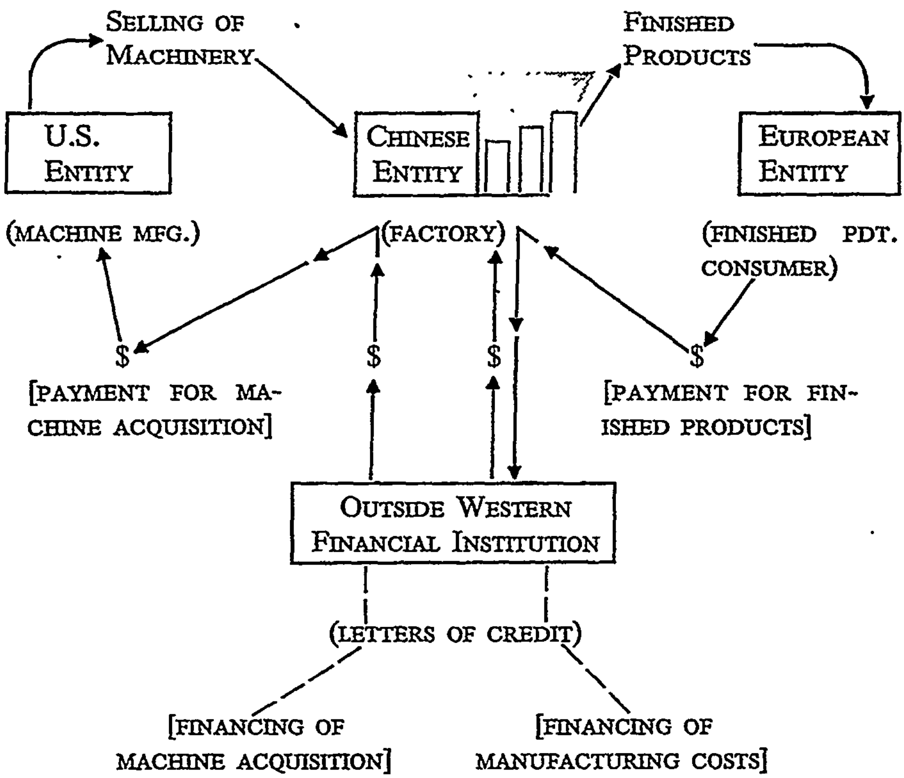

Figure 3.[254]

B. *Taxation of Individuals*

1. *Length of Residence Within China*

PRC tax law[255] subjects foreign nationals to taxation on a basis quite different from the U.S. tax law. China breaks down a foreign national's days present within China for the purpose of characterizing the reach of the tax on total earnings.[256] The PRC taxes all income derived within its borders, except items specifically exempted by statute.[257] This system of taxation applies to both residents and

254. *See generally supra* note 246.
255. Sino-U.S. Agreement, *supra* note 5, art. 2, para. 1, at 412.
256. *Individual Tax Law of PRC, supra* note 25, at ¶ 30-500(1).
257. *Id.*

nonresidents.[258] Individuals paid by enterprises with an establishment in China are taxed from their first day in the PRC.[259] In all other cases, individuals are taxed according to their residence status as follows:

1. residence in China for less than ninety consecutive days during the tax year - wages and salaries received are exempt from taxation;[260]
2. residence in China for ninety consecutive days or more, but for less than the entire tax year - taxed on all China source income during period of residence;[261]
3. residence in China for the entire tax year (but not for the previous five years) - taxed on all China source income during the year plus all non-China source income remitted to China;[262] and
4. residence in China for entire tax year and having been a resident of China for all of each of the previous five years - taxed on worldwide income.[263]

There is a reduction of fifty percent of the amount of income tax assessed by the Chinese government based upon one's wages or salary if one qualifies under the law.[264] Foreigners wishing to visit China must first declare their intended purpose when applying for any visa. If an individual does not intend to stay in China, the PRC does not tax their foreign source income.[265] Individuals with visas for periods longer than ninety days should register with the Tax Bureau within thirty days of entering China.[266]

---

258. *Id.*
259. *Id.*
260. DETAILED RULES AND REGULATIONS FOR THE IMPLEMENTATION OF THE INDIVIDUAL INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA (approved 10 December 1980 by the State Council and promulgated 14 December 1980 by the Ministry of Finance), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 35-520, ¶ 30-520(5) (May 27, 1988).
261. *Id.*
262. *Id.* at ¶ 30-520(2).
263. *Id.* at ¶ 30-520(3).
264. PROVISIONAL REGULATIONS OF THE STATE COUNCIL CONCERNING THE REDUCTION OF INDIVIDUAL INCOME TAX ON WAGES AND SALARIES OF FOREIGN NATIONALS WORKING IN CHINA (promulgated 8 August 1987 by the State Council), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 30-528, ¶ 30-528(2) (Sept. 21, 1987).
265. DETAILED RULES AND REGULATIONS FOR THE IMPLEMENTATION OF THE INDIVIDUAL INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 260.
266. *Individual Tax Law of PRC*, *supra* note 25, at ¶ 30-500(7).

2. *Personal Income*

The Agreement contains several provisions relating to personal income which vary from the U.S. Model Treaty. For instance, the Agreement allows source country taxation of independent professional services income on the basis of presence in the source country for more than 183 days in a calendar year.[267] The U.S. Model Treaty does not allow taxation of such income on the basis of days of presence. Under the U.S. Model Treaty, independent personal services income of a nonresident is taxable only if the nonresident has available a fixed base in the source country.[268] The Agreement also allows director's fees derived by a resident of one country as a member of the board of directors of a company which is a resident of the other country to be taxed in that other country.[269] The U.S. Model Treaty treats directors' fees as personal service income or as a distribution of profits.[270] Thus, the country where the recipient resides generally has primary taxing jurisdiction over personal service income, and the source country tax on distributed profits is limited.

Wages and salaries attributable to services performed in China[271] will be considered Chinese source income regardless of the situs of payments used in determining the period of residence.[272] Absences of less than thirty days will not affect an individual's resident status.[273] Thus, if a person re-enters China under a visa previously utilized, the absence from China will be disregarded for the purpose of calculating the number of days spent in China. If a specific amount of wages or salaries is not allocated to the service performed in China, an allocation will be made based on the number of days present in China.[274]

267. Sino-U.S. Agreement, *supra* note 5, art. 13, at 429-30.
268. U.S. Model Treaty, *supra* note 19, art. 14, at 220.
269. Sino-U.S. Agreement, *supra* note 5, art. 15, at 431.
270. *Id.*
271. "Foreign staff members and employees of foreign joint ventures, as well as those from Hong Kong or Macao regions, may remit their salaries and other income earned in China, after payment of taxes and deduction of their living expenses in China and approval by the relevant local authorities." *Annual Report of the International Monetary Fund*, EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 157 (1987).
272. REGULATIONS ON THE IMPLEMENTATION OF THE INDIVIDUAL INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA (Promulgated 14 December 1980 and effective as of 10 September 1980), *reprinted in China Laws for Foreign Business*, Taxation (CCH-Australia Ltd.) at ¶ 30-520, ¶ 30-520(2) (May 27, 1988).
273. *Individual Tax Law of PRC, supra* note 25, at ¶ 30-500.
274. REGULATIONS ON WAGES AND SALARIES, *supra* note 264, at ¶ 30-528 (Sept. 21, 1987).

3. *The Saving Clause*

The "Saving Clause,"[275] added by the protocol,[276] differs in certain respects from that found in the U.S. Model Treaty.[277] The principal differences are:

1) the U.S. Model Treaty[278] and the Agreement[279] reserve the right to tax their citizens and residents as if the treaty had not come into effect;
2) the U.S. Model Treaty provides for several exceptions to this reservation of taxing rights, while under the Agreement, the United States reserves the right to tax its citizens without exception;[280] and
3) the U.S. Model Treaty[281] contains a provision specifically retaining a country's right to tax former citizens who renounce citizenship to avoid income tax, while the Agreement does not.

Even absent a former citizen provision,[282] the Internal Revenue Service takes the position that the United States retains the right to tax former citizens who are residents of the Agreement partner country.[283]

C. *Creditable Taxes*

In lieu of a special treaty credit rule, the Chinese government apparently sought to make the subject taxes creditable under the internal creditability rules[284] of the United States and certain other Chinese trading partners. In private letter rulings,[285] the Internal Revenue Service has held that, under certain circumstances, three of

---

275. 3 Tax Treaties (P-H) ¶ 72,154 (1988).
276. *Id.*
277. U.S. Model Treaty, *supra* note 19, art. 2, at 212-13.
278. *Id.* art. 24, para. 1, at 223-24.
279. Sino-U.S. Agreement, *supra* note 5.
280. *Id.* art. 24, para. 1, at 438-39.
281. U.S. Model Treaty, *supra* note 19, art. 1, para. 3, at 212.
282. Some treaties, such as that between the United States and Pakistan, have no saving clause but reach the same result by definitions of persons entitled to treaty benefits.
283. 26 U.S.C.S. § 877(a) (Law. Co-op. 1988) provides as follows:

Expatriation to Avoid Tax.

(a).-In General.-Every nonresident alien individual who at any time after March 8, 1965, and within 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section is imposed pursuant to section 871.

Id.

284. 26 U.S.C.S. § 7852(d) (Law. Co-op. 1988).
285. Priv. Ltr. Rul. 81-33-056 (Aug. 26, 1981). *See also* Priv. Ltr. Rul. 58-12-056040A (1958).

the four covered taxes are creditable for U.S. tax purposes. The Service has not ruled on the creditability of the fourth type of income tax concerning joint ventures. These favorable rulings were issued under temporary regulations that have since been finalized in modified form. The taxes previously ruled on, as well as the net income tax imposed under the joint venture income tax law, appear creditable under the final regulations.[286]

1. *Foreign Tax Credit*

If the Chinese tax laws are fully creditable under U.S. internal law, then they would generally reduce on a dollar-for-dollar basis the U.S. tax otherwise due on the foreign income of a U.S. taxpayer.[287] This was the situation before the 1986 Tax Reform Act modified the Foreign Tax Credit Alternative Minimum Tax.[288] The structuring of the Chinese taxes to meet the creditability requirements of the United States and other Chinese trading partners may result in an effective transfer of tax revenue from the U.S. to the Chinese Treasury. The amount of the transfer is limited by a variety of factors, including the relatively low rates of Chinese tax presently applicable and the possibility of excess foreign tax credits from operation in third countries that would shelter Chinese source income from U.S. tax.

The United States could amend its internal creditability rules in a manner that might discourage foreign governments from establishing taxes, collected chiefly from nonresidents, that effectively transfer tax revenue from the U.S. Treasury to the foreign government's treasury. While Congress might be willing to override treaties to achieve this goal, the presence of treaty credit rules in the Agreement[289] may complicate any future Congressional efforts to restrict the indirect transfer of U.S. tax revenues to foreign governments via the foreign tax credit mechanism.

Most existing U.S. income tax treaties, like the Sino-U.S. Agreement, allow the crediting of covered foreign taxes.[290] The U.S. Model Treaty imposes a per treaty and per country limitation on the credit

286. INCOME TAX LAW OF JOINT VENTURES, *supra* note 137, at ¶ 33-500.
287. 26 U.S.C.S. § 904 (Law. Co-op. 1988).
288. 26 U.S.C.S. § 59(a)(1)(B) (Law. Co-op. 1988).
289. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-36.
290. Taxation of Transnational Transactions 1987-1988 (CCH) § 2164 (1987).

for taxes deemed creditable.[291] The Agreement[292] does not specifically impose a per country limitation. In general, a per country limitation may reduce the amount of the credit utilized when the treaty partner's taxes are relatively high. However, as indicated earlier, the covered Chinese taxes may be creditable independent of the Agreement.

The foreign tax credit is limited to the proportion of U.S. tax against which the credit is claimed, based on the taxpayer's income from all sources outside the U.S. which contribute to the taxpayer's entire taxable income for the period.[293] U.S. source income is treated as any amount derived from a U.S. owned corporation that receives at least ten percent of its earnings and profits from U.S. sources.[294]

The sourcing rules of Title 26, Internal Revenue Code Section 904(g) referred to previously will override any past, present or future treaty. This goes against the spirit of the general theory[295] that a treaty or statute takes precedence over a tax code section. When Congress passed the initial Code Section 904(g) with the 1984 Tax Act of Public Law 98-369, Congress intended this section to override any pre-existing treaties, as well as any conflicting treaties in the future, absent an express provision in the treaty to the contrary.

Statutory or regulatory limitations on the creditability of foreign taxes structured to meet U.S. creditability requirements[296] would raise some significant policy concerns. Taxes instituted by capital-importing foreign countries probably are structured with creditability in mind.[297] Thus, it may be unreasonable for the United States to argue that foreign countries cannot structure new taxes to make them creditable. It is important to note that statutory or regulatory limitations might encourage foreign countries to substitute non-creditable taxes, other than net income taxes, for creditable net income taxes. Non-creditable taxes could result in the double taxation of foreign earnings of U.S. taxpayers. An additional problem is that the actual intent of foreign

---

291. U.S. Model Treaty, *supra* note 19, art. 23, at 223.
292. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-36.
293. 26 U.S.C.S. § 904(a) (Law. Co-op. 1988) provides as follows:

> Limitation.- The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

Id.

294. 26 U.S.C.S. § 862 (Law. Co-op. 1988).
295. 26 U.S.C.S. § 7852(d) (Law. Co-op. 1988).
296. 26 U.S.C.S. § 901(a) (Law. Co-op. 1988).
297. 26 U.S.C.S. § 903 (Law. Co-op. 1988).

tax officials in structuring a tax in a particular manner could be very difficult to determine. A foreign country is likely to protest if a newly adopted tax is treated as non-creditable, while a similar tax adopted by another country before the creditability limitations were imposed remains creditable. Application of the creditability limitations to taxes pre-dating those limitations would solve this political problem, but might require the Internal Revenue Service to determine the intent of foreign drafters.

The creditability rules might be amended simply to deny a credit for taxes collected chiefly from foreigners. Thus, an inquiry into the intent of the drafters could be avoided. There are, however, potential problems with this approach. For example, establishing criteria for determining whether a tax is collected "chiefly" from foreigners could prove difficult.

2. *Tax Sparing Credit*

In the notes exchanged in the signing of the proposed treaty and protocol, the United States and China agreed that a tax sparing credit[298] would not be provided for at the present time. However, the countries agreed that the proposed treaty would be promptly amended to incorporate a tax sparing credit provision if, in the future, the United States amended its law concerning the provision of tax sparing credits, or agreed to a tax sparing credit with any other country. This agreement is similar, but goes somewhat beyond, the existing agreements between the United States and certain developing countries regarding the reduction of conflicts between the U.S. tax system and developing countries' foreign investment tax incentives.[299] Although the existing agreements do not refer explicitly to a tax sparing credit, neither do they include a promise by the United States to allow such a credit upon allowing it to any other country, i.e., they do not confer most favored nation status on the U.S. treaty partner in connection with the tax sparing credit. Generally, the existing agreements only commit the United States to resume discussions, when circumstances permit, with a view to incorporating provisions in the treaty. Both agreements will minimize interference and preserve the incentives offered by the other country. Any future amendment of the proposed treaty to provide a tax sparing credit,

298. 3 Tax Treaties (P-H) ¶ 72,136, ¶ 72,216-17 (1988).
299. *Id.*

like any treaty amendment, would be subject to both the full negotiation process and the Senate ratification process as they apply to treaties generally.

D. Discrimination by the Chinese Tax System

The broader issue raised by the Agreement's coverage of Chinese taxes is whether the United States ought to allow U.S. persons in China to be exposed to the imposition of Chinese taxes which are collected chiefly from nonresidents. Three of the four Chinese taxes arguably discriminate against nonresidents, except for the Joint Venture Income Tax. The alternative argument is that these taxes do not discriminate because, under China's present socialist economic system, the Chinese Government owns the means of production and thus "owns" most, if not all, of the earnings of its residents. Under this argument, Chinese taxes do not discriminate against nonresidents. The taxes are simply inapplicable to Chinese residents who do not qualify for these taxes. The Agreement's actual effect with respect to the taxes is to lessen their discriminatory impact by limiting them in some cases. In the absence of the Agreement, China could subject U.S. persons to these taxes without any reductions.

E. Recent U.S. Tax Legislation as to Existing Tax Treaties

The Tax Reform Act of 1984[300] amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income the dividends, interest, and certain other income derived from a foreign corporation in which a significant part of the income arose in the United States.[301] The Agreement[302] provides that the United States needs to credit taxes paid to China only when in accordance with the provisions of domestic U.S. law. Thus, income derived by a resident of one country which may be taxed in the other country is deemed to arise in that other country.[303]

The key issue is whether the Agreement allows this 1984 change of the foreign tax credit limitation rule to operate as Congress intended. If the 1984 change is a provision of U.S. law limiting the foreign tax credit, the Agreement would not prevent operation of

300. Tax Reform Act of 1984, Pub. L. 98-369, § 1201(b), 98 Stat. 494 (1984).
301. 26 U.S.C.S. § 904 (Law. Co-op. 1988).
302. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-37.
303. *Id.*

the change since the treaty credit is to be granted only in accordance with the provisions of the U.S. law.[304] The 1984 Act amended Code Section 904,[305] which itself deals with foreign tax credit limitation, weighs heavily in favor of this view. However, if the 1984 change is to be read as merely a source rule amendment, the Agreement will control. In this case, the Agreement arguably would prevent the operation of the change since the Agreement[306] requires foreign sourcing of certain income that would be treated as U.S. source income under the 1984 Act. This latter argument falls within the double taxation article of the Agreement and would have little meaning unless it obliged the United States to credit taxes on income treated as foreign source income.

At present, the Chinese rules governing foreign investment probably preclude the use of a Chinese corporation to convert U.S. source income to foreign source income. However, Chinese restrictions on foreign investment have been eased considerably over the last several years and could be eased further in the future. The Agreement treats all future payments from a Chinese corporation to a U.S. person as Chinese source income, even if the Chinese corporation derives all its income from the United States. This result defeats the purpose of the 1984 Code amendment. Because the Agreement's[307] source rules apply in determining the credit allowed for foreign taxes paid to countries other than the treaty partner (unlike the corresponding source rules of the U.S. Model Treaty,[308] which expressly prohibit such application), the impact of a future override of the 1984 sourcing amendment will reach beyond the U.S. taxation of income earned through a Chinese company. The U.S. Treasury Department interprets the treaty to not override the 1984 sourcing amendment. The issue for the Joint Subcommittee now is to ensure that the Committee Report language and the U.S. Treasury's technical explanation clarify the retention of the 1984 change to the Code.

1. *Branch Profits Tax*

Income tax treaties can act to modify the effects of U.S. branch profits tax laws. The branch profits tax is not meant to apply in

304. *Id.*
305. 26 U.S.C.S. § 904(b) (Law Co-op. 1988).
306. Sino-U.S. Agreement, *supra* note 5, art. 22, at 435-37.
307. *Id.*
308. U.S. Model Treaty, *supra* note 19, art. 23, at 223.

situations where its application would be inconsistent with existing U.S. income tax treaty obligations. The Senate Finance Committee recognizes[309] that the Department of the Treasury interprets the treaties' nondiscrimination articles to prohibit the application of branch profits tax.[310] The Senate Finance Committee has indicated its intention to respect the U.S. Treasury's interpretation. The branch profits tax is not to be imposed upon income that is not attributable to a permanent establishment, even if effectively connected with a U.S. business, as long as the Agreement bars the regular income tax on such income and there is no treaty shopping.[311]

The 1986 Tax Reform Act limits the effect of income tax treaties on branch profits tax. Under this reform, no income tax treaty shall exempt a foreign operation from the tax nor reduce the amount of the tax unless such foreign operation is a qualified resident of the foreign country with which the U.S. has a tax treaty.[312] The treaty benefits are also available if the relevant treaty permits a withholding tax on dividends as described in Code Section 861(a)(2)(B) and the foreign corporation pays such tax, even if the foreign corporation is not a qualified resident of the treaty country.[313]

2. *Qualified Resident*

The term "qualified resident" means any foreign corporation that is a resident of that foreign country, unless more than fifty percent by value of the foreign corporation's stock is owned[314] by individuals who are not residents of the foreign country and are not U.S. citizens or resident aliens.[315] The 1986 Act disregards treaty obligations in determining if the stock ownership requirement is met.[316]

A treaty shopping situation apparently would arise when more than half the value of the foreign corporation's stock is owned by another foreign corporation which is wholly owned by nonresidents of the treaty country. A foreign corporation is not a qualified resident of a foreign country if fifty percent or more of its income is used

309. S. Rep. (Fin. Comm.) No. 99-313, 99th Cong., 2nd Sess. 404 *reprinted in* 1986 U.S. Code Cong. & Admin. News 4492.
310. U. S. Model Treaty, *supra* note 19, art. 24, para. 5, at 223-24.
311. H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. *reprinted in* 1986 U.S. Code Cong. & Admin. News 4735, 4738.
312. 26 U.S.C.S. § 884(e)(1)(A) (Law. Co-op. 1988).
313. 26 U.S.C.S. § 884(e)(4)(A)(ii) (Law. Co-op. 1988).
314. 26 U.S.C.S. § 883(c)(4) (Law. Co-op. 1988).
315. 26 U.S.C.S. § 884(e)(4)(A)(i) (Law. Co-op. 1988).
316. *See supra* note 311, at pt. II, 649.

(either directly or indirectly) to meet liabilities to persons who are not residents of that foreign country or the U.S.[317] This "base erosion" rule is necessary to prevent nonresidents of a treaty country from gaining treaty benefits.[318] Even if the foreign corporation is not a qualified resident under the base erosion rule, it is still a qualified resident of the treaty country if its stock or the stock of another foreign corporation which wholly owns its stock is primarily and regularly traded on an established securities market in the treaty country.[319] The Internal Revenue Service may treat a foreign corporation as a qualified resident of a treaty country if the Internal Revenue Service is satisfied that the corporation meets the requirements established under the regulations which ensure that nonresidents of a treaty country do not use the treaty improperly.[320]

If a foreign corporation is a resident of a foreign country with which the U.S. has an income tax treaty, the rate of branch profits tax is that set by the treaty. If the treaty does not specify the branch profits tax rate, the treaty rate on dividends paid by a U.S. corporation to a corporation resident in the foreign country which wholly owns such corporation is used.[321] Any other treaty limitations on the branch profits tax will apply.[322] The Sino-U.S. Agreement is silent on the matter of branch profits tax, leaving control of this matter to the Agreement's article on tax treatment of dividends.[323]

The U.S. Congress was concerned that the branch level interest provisions may lead to increased use of the back-to-back loans by non-treaty residents, and to mischaracterization of these interbranch funds by both treaty and non-treaty residents to avoid U.S. tax. Back-to-back loans are to be collapsed by the Internal Revenue Service and the ultimate recipients, if not treaty protected, are to be subject to U.S. tax. The Internal Revenue Service is to scrutinize closely the characterization of interbranch transactions. As the Internal Revenue Service may find it difficult to identify these arrangements, the tax-writing committee of Congress is to monitor collections and compliance with the interest provision to ensure their continued viability and, if necessary, propose legislation to obviate any abuses.[324]

317. 26 U.S.C.S. § 884(e)(4)(A)(ii) (Law. Co-op. 1988).
318. *See supra* note 311.
319. 26 U.S.C.S. § 884(e)(4)(B) (Law. Co-op. 1988).
320. 26 U.S.C.S. § 884(e)(4)(C) (Law. Co-op. 1988).
321. 26 U.S.C.S. 884(e)(2)(A) (Law. Co-op. 1988).
322. 26 U.S.C.S. § 884(e)(2)(B) (Law. Co-op. 1988).
323. Sino-U.S. Agreement, *supra* note 5, art. 9, at 422-24.
324. *See supra* note 309.

F. *Exchange of Information*

The Agreement's exchange of information provision[325] generally parallels that of the U.S. Model Treaty[326] but is somewhat narrower in scope. The U.S. Model Treaty provides for the exchange of information relating to taxes of every kind imposed by the two countries.[327] The Agreement provides for the exchange of information relating only to taxes that are covered in the Agreement.[328] The U.S. Model Treaty requires that, upon an appropriate request for information, the requested country must obtain the information in the same manner and to the same extent as if its tax were at issue.[329] The U.S. Model Treaty also requests that, when specifically requested by the competent authority of one country, the competent authority of the other country should provide the information in the form actually requested.[330] The Agreement does not contain these provisions. In addition, the U.S. Model Treaty provides that each country will collect taxes for the other country to the extent necessary to ensure the benefits of the treaty are not going to persons who are not entitled to them.[331] The Agreement does not contain this collection rule. However, the Agreement,[332] like the U.S. Model Treaty,[333] makes it clear that the appropriate Congressional committees and the General Accounting Office must have access to information exchanged under the treaty where appropriate.[334]

CONCLUSION

Historically, U.S. tax laws were considered to be controlled by the terms of treaties between the U.S. and other contracting states. This meant that the foreign investor could expect to rely on the terms of the treaty for guidance in structuring the investment vehicle and the investment itself. In this historical setting, the Agreement between the U.S. and China establishes a network for the sharing of tax and

325. Sino-U.S. Agreement, *supra* note 5, art. 25, at 439-40.
326. U.S. Model Treaty, *supra* note 19, art. 26, paras. 1-2, at 225.
327. *Id.* art. 26, para. 6, at 226.
328. Sino-U.S. Agreement, *supra* note 5, art. 25, para. 1, at 439-40.
329. U.S. Model Treaty, *supra* note 19, art. 26, para. 1, at 225.
330. *Id.* art. 26, at 225-26.
331. *Id.* para. 3, at 225.
332. Sino-U.S. Agreement, *supra* note 5, art. 25, at 439-40.
333. U.S. Model Treaty, *supra* note 19, art. 26, paras. 1-2, at 225.
334. Sino-U.S. Agreement, *supra* note 5, art. 25, para. 1, at 439-40.

related information between the two countries and provides a type of stability and unification framework for resolving disputes which already exist within U.S. treaty countries.

However, the U.S. 1986 Tax Reform Act[335] was a sweeping tax reform for the American tax system, unsurpassed in its broad reaches since the 1939 tax reform. This 1986 Act has a two-fold effect upon the Agreement. First, there are sections within the 1986 Act which Congress specifically designated as controlling over any treaty agreement.[336] This is clearly a deviation from the accepted manner of interpreting treaty agreements. Secondly, the 1986 Act's breadth is so extreme that it may be years before authoritative interpretation of the new laws will evolve and assist investors in understanding the U.S. Treasury's position on the controlling laws and their enforcement.

Thus, it may be prudent for a foreign investor anticipating a large investment within China to seek advice of the Tax Law Specialists of the Internal Revenue Service in Washington, D.C., in the form of Private Letter Rulings.[337] These rulings are the interpretation of the Internal Revenue Service, limited to the particular facts and parties of the situation being evaluated, and will be generally issued very timely for the foreign investor's consideration. There are, of course, drawbacks to the use of Private Letter Rulings, such as: (1) constant change of facts as to the proposed foreign investment rendering the ruling void; (2) exposure of the situation to the Internal Revenue Service; and (3) the outside legal cost of obtaining such a ruling.

The foreign investor should perpetually be apprised of new legislation issued by the U.S.: (1) U.S. Treasury Regulations; (2) U.S. Treasury Revenue Rulings; (3) U.S. Treasury Revenue Procedures;

---

335. Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085.

336. Tax Reform Act of 1986, Pub. L. 99-514 § 1810(a)(4), 100 Stat. 2823.

337. *IRS National Office Procedures-Rulings, Closing Agreements*, Tax. Mgmt. (BNA) No. 104-6th, at A-3 (1988):

> A private ruling is, briefly, a statement by the IRS of the way it will treat a prospective or completed transaction for federal tax purposes.
>
> The ruling is honored, with narrow exceptions, by Service officials everywhere, but only with respect to the taxpayers to whom the terms of the ruling apply. The Service cannot be relied upon to apply the ruling to others even if they meticulously follow the transaction set out in it, or to apply the ruling to other transactions of the taxpayer to whom the ruling is addressed. The Service does not issue rulings or determination letters upon oral request. Rulings are issued by letter. Oral opinions or advice are not binding on the Service. Usually, it takes the IRS 60 to 90 days to process a request for a ruling [footnote omitted].

Id.

(4) U.S. Treasury Private Letter Rulings; (5) U.S. Tax Court Rulings; and (6) General Counsel Memorandums. Additionally, there may be modifications to the Agreement itself through negotiations between the two governments which will effect, either retroactively or concurrently, the foreigners' investments within China.

Michael Brent Nelson