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## Taxation of Foreign Business and Investment in the People's Republic Of China

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# Taxation of Foreign Business and Investment in the People's Republic of China

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## I. INTRODUCTION

Up until the last six or seven years, very little attention has been paid in the West to the tax system of the People's Republic of China ("PRC" or "China"). This is understandable since, in the immediate post-liberation years, many countries in the Western Hemisphere tried hard to pretend that the PRC did not exist at all. Following its break with the Soviet Union in 1960, China adhered firmly to a policy of self-reliance. China's opening to the West, in economic terms, did not really begin until approximately 1978.<sup>1</sup> Given the type of economic system which had evolved in China before that date, it was also assumed, although not entirely accurately, there could be little scope for a tax system of any type.

In fact, despite the great expansion of state ownership or direction of industry and commerce, especially following the Cultural Revolution in 1966, taxes continued to play an important role in China's economy. As a percentage of total budget revenue, taxation had fallen from 75% to about one-half that level during the 1950s; thereafter it remained more or less constant.<sup>2</sup> Tax revenues were provided almost entirely by indirect taxation, with some three-quarters of the total coming from the Consolidated Industrial and Commercial Tax,<sup>3</sup> a form of turnover tax on goods

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<sup>1</sup> The birth of the new policy is frequently attributed to the famous "four modernizations" speech of premier Zhou En-Lai, given before the Fourth National Party Congress in January 1975.

<sup>2</sup> See Reynolds, *Doing Business with the People's Republic of China: Tax Considerations*, 14 INT'L. LAW. 49, 51-52 (1980). As this Article will describe, the tax system has assumed a far greater importance since 1980 and taxation now produces approximately 90% of the government's revenue. See Renmin Ribao (Hai Wai Ban), July 13, 1986.

<sup>3</sup> Consolidated Industrial and Commercial Tax Law, promulgated Sept. 13, 1958 [hereinafter CICT].

and services. China introduced an income tax levied upon business profits in 1950,<sup>4</sup> but this source of revenue never assumed any great importance. State-owned enterprises simply accounted to the state for all of their profits<sup>5</sup> and most other enterprises, notably communes and collectives, benefitted from special rates and exemptions. In addition, a number of other taxes existed, one of which — the salt tax — had provided a stable source of revenue for most of the preceding 2,000 years. To the extent that these various taxes are still in force and may have an impact upon foreign investors, they will be discussed briefly.

#### A. Consolidated Industrial and Commercial Tax

The Consolidated Industrial and Commercial Tax ("CICT")<sup>6</sup> can best be described as a turnover tax, similar in nature to a tax which existed in Germany and several other European countries until it was replaced by the value-added tax ("VAT"). The CICT is (at least potentially) a multistage tax, but, unlike the VAT, no credit is given for tax paid at a previous stage under the CICT.

The tax originated in four separate taxes introduced in 1950, but its present form dates from a consolidation which took place in 1958.<sup>7</sup> Owing to its hybrid nature, the CICT combines the features of a number of taxes — a manufacturer's tax, a wholesale tax, a retail tax, a tax on services, and an excise tax. Altogether, the CICT applies to over 100 categories of goods or transactions and prescribes some forty-two different rates, ranging from 69% on top-quality cigarettes to 1.5% on certain basic necessities. Retail sales are taxed generally at 3% and the provision of services at rates between 3% and 7%.

It is this tax on services which is of primary interest and concern to foreign businesses. Although there was some initial uncertainty as to whether the CICT applied at all to foreign enterprises operating in China,<sup>8</sup> it is now well established that the tax does apply.<sup>9</sup> There is, of

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<sup>4</sup> Industrial and Commercial Income Tax Law, promulgated Jan. 31, 1950 [hereinafter ICIT].

<sup>5</sup> This was the case until recently. A new scheme was introduced in 1984, imposing a tax (of up to 55%) on the profits of state enterprises. See Jehle, *Taxation in the People's Republic of China: A Brief Introduction*, in 1985 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 405, 417.

<sup>6</sup> For detailed studies of this tax, see Reynolds, *supra* note 2; Jehle, *supra* note 5; Gelatt & Pomp, *Tax Aspects of Doing Business with the People's Republic of China*, 22 COLUM. J. TRANSNAT'L. L. 421 (1984).

<sup>7</sup> In 1973, a further reform of the CICT took place, but the provisions then introduced do not apply to foreign enterprises operating in China.

<sup>8</sup> See Simon, *Taxation of Joint Ventures in the People's Republic of China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions*, 15 VAND. J. TRANSNAT'L. L. 513, 515-17 (1982).

<sup>9</sup> This is confirmed by the Interim Provisions for Collection of Industrial and Commercial Con-

course, nothing surprising about this; any enterprise operating in another country would expect to be subject to the local taxes on its sales and on its imports. However, a tax on services supplied is less familiar, especially when it appears to take the form of a tax on gross income. Thus, for example, when a Hong Kong company entered into a contractual joint venture with a Shanghai research institute to repair and resell computer equipment, the company was liable for the CICT (at 3%) on the repair fees charged as well as for tax under the Foreign Enterprise Income Tax Law<sup>10</sup> on net profits.<sup>11</sup>

## B. Industrial and Commercial Income Tax

The Industrial and Commercial Income Tax ("ICIT")<sup>12</sup> is something of a mystery tax. It was even suggested at one time that the ICIT had been abolished; this may now indeed be the case. There has been considerable dispute as to whether the ICIT applies to foreign enterprises or joint ventures operating in China. The better view seems to be that it does not apply. Article 1 of the law states that it is applicable to "[a]ll industrial and commercial enterprises operated for profits within the borders of the country, including public, private, joint public/private and cooperative enterprises, *except for those governed by other regulations . . .*"<sup>13</sup> Since foreign enterprises and joint ventures with foreign participation are governed by other regulations while operating in China, such enterprises would not seem to be subject to the ICIT.<sup>14</sup>

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solidated Tax and Business Income Tax from China-based Foreign Companies, issued by the Ministry of Finance on May 14, 1985, reprinted in *BUS. CHINA*, May 30, 1985, at 77. For the answers given by Chinese legal experts, see also *Chinese Legal Experts' Answers to Questions on China's Foreign Tax Legislation (I)*, *CHINA ECON. NEWS*, Sept. 30, 1985, at 1-2. It is also confirmed in a number of rulings given by the Tax Bureau of the Ministry of Finance; see, e.g., (82) *Cai Shui Wai Zi*, No. 199; (83) *Cai Shui Wai Zi*, No. 88; (83) *Cai Shui Wai Zi*, No. 155. The recent Provisions of the State Council for the Encouragement of Foreign Investment, promulgated on Oct. 11, 1986, exempt from the CICT most exported products, other than oil and minerals, of enterprises with foreign capital. The text of the provisions is reproduced in *Provisions of the State Council Encouraging Foreign Investment*, *BEIJING REV.*, Oct. 27, 1986, at 26.

<sup>10</sup> See *infra* notes 48-71 and accompanying text.

<sup>11</sup> Tax Bureau of the Ministry of Finance, (82) *Cai Shui Wai Zi*, No. 199.

<sup>12</sup> For detailed studies, see Reynolds, *supra* note 2; Simon, *supra* note 8; Pomp, Gelatt & Surrey, *The Evolving Tax System of the People's Republic of China*, 16 *TEX. INT'L L.J.* 11 (1981). As to more recent developments, see *infra* note 60.

<sup>13</sup> ICIT, art. 1 (emphasis added).

<sup>14</sup> On those occasions when it has been confirmed that the CICT does apply, it is perhaps significant that no mention has been made of the ICIT. See also Lussenburg, *Joint Venture Investment in the People's Republic of China: A Continuing Challenge*, 63 *CANADIAN BAR REV.* 545, 578 (1985).

### C. Other Taxes

As mentioned above, a variety of other taxes has been in existence in China for some time. Of these, the agriculture tax plays a relatively important role domestically<sup>15</sup> and presumably would apply to foreign enterprises engaged in agriculture; otherwise it is of little significance to the foreign investor. Among the other taxes are some which one would expect to encounter — customs duties, both on imports and on exports, and the motor vehicle tax — and others which are less familiar — the salt tax and the slaughter tax. Property taxes include the urban real estate tax<sup>16</sup> and the more recently introduced city maintenance and construction tax.<sup>17</sup>

### D. Modern Legislation

From the point of view of foreigners wishing to do business in and to invest in China, the government radically altered the tax scene by the adoption of two laws in 1980, another law in 1981, and a series of accompanying regulations. The real impetus for the tax reforms was the adoption of the Joint Venture Law<sup>18</sup> in 1979. The law permits, for the first time since Liberation, the investment of foreign capital in new enterprises. Rather than remodel the existing ICIT, the government introduced a new tax — the Joint Venture Income Tax (“JVIT”) — the following year.<sup>19</sup> Simultaneously, a new Individual Income Tax (“IIT”) was also introduced.<sup>20</sup> Although the IIT applies to resident and nonresident individuals, its main impact will undoubtedly be felt by foreigners working in China or by those receiving various types of income from Chinese sources. The present picture was completed in 1981 with the

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<sup>15</sup> See Jehle, *supra* note 5, at 412. The tax is imposed on the yield of an average harvest for the land in question. At least until recently, it has normally been paid in kind.

<sup>16</sup> This is levied on the value of the property, at an annual rate of 1.2%, or on its rental income, at 1.8%.

<sup>17</sup> See 19 TAX NEWS SERVICE, Mar. 15, 1985, at 39 (International Bureau of Fiscal Documentation).

<sup>18</sup> Law on Joint Ventures Using Chinese and Foreign Investments, adopted July 1, 1979.

<sup>19</sup> Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment, adopted Sept. 10, 1980 [hereinafter JVIT]. This is supplemented by the Detailed Rules and Regulations promulgated on Dec. 14, 1980 [hereinafter JVIT Regs.].

<sup>20</sup> Individual Income Tax Law, adopted Sept. 10, 1980 [hereinafter IIT], with Detailed Rules and Regulations promulgated on Dec. 14, 1980 [hereinafter IIT Regs.]. As of Jan 1, 1987, Chinese citizens resident in the PRC are subject to a separate Individual Income Regulatory Tax. For Chinese citizens the taxable threshold is lower and tax rates rise to 60%. Interim Regulations Concerning the Individual Income Regulatory Tax [“IIRT”], adopted by the State Council on Sept. 25, 1986. The text is published in Renmin Ribao, Dec. 13, 1986.

introduction of the Foreign Enterprise Income Tax ("FEIT").<sup>21</sup> The rest of this Article will be concerned primarily with these three taxes.

## II. THE CHOICE OF BUSINESS MEDIUM

The initial matter faced by an individual or enterprise contemplating investment or business in China (as in any other foreign country) is the choice of the most appropriate investment or business medium. Tax considerations may influence this choice, but other factors are generally more important. After all, the investment must be profitable before tax becomes a factor at all. Moreover, the investment must be lawful.

Before going forward with an investment, there is the inevitable question: Is the individual or enterprise proposing to do business *with* China or *in* China? If the answer is the latter alternative, another question must be asked. Will the individual or enterprise require setting up some form of "establishment" in China, for example a branch plant or office, a sales or distribution agency, repair or servicing operations, or training facilities?

An important factor to take into account in answering these questions is the strong preference the Chinese government shows for cooperative ventures. In view of China's history, it is not surprising that there is a deep suspicion of foreign investment as it might lead to foreign control. Consequently, in most cases the main preoccupation will be finding a suitable local "partner" and obtaining the necessary permissions.<sup>22</sup>

It is not always necessary to have a Chinese coventurer. A foreign enterprise which sells its products or services in China may, with the necessary permissions, establish a representative office, send maintenance crews, technical advisers or instructors to China, or otherwise carry on business activities sufficient at least to be regarded as having an establishment. Apart from such activities, wholly foreign-owned enterprises operating independently in China are relatively rare.<sup>23</sup> In the past, such operations apparently were carried out by branch establishments. Under

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<sup>21</sup> Income Tax Law Concerning Foreign Enterprises, adopted Dec. 13, 1981, with Detailed Rules and Regulations promulgated on Feb. 21, 1982 [hereinafter FEIT].

<sup>22</sup> For consideration of these issues, see Lussenberg, *supra* note 14; Fenwick, *Equity Joint Ventures in the People's Republic of China: An Assessment of the First Five Years*, 40 BUS. LAW. 839 (1985); Nishitateno, *China's Special Economic Zones: Experimental Units For Economic Reform*, 32 INT'L & COMP. L.Q. 175 (1983); and *Chinese Legal Experts' Answers to Further Questions on Foreign Investment in China*, CHINA ECON. NEWS, Jan. 14, 1985, at 1.

<sup>23</sup> By the end of March 1986, wholly foreign-owned enterprises operating in China numbered 120. There were 1,881 equity joint ventures and 3,408 contractual joint ventures by September 1985. *Questions on Foreign-Owned Companies Law Answered*, P.R.C. NAT'L AFFAIRS, Apr. 24, 1986, at K19; Renmin Ribao (Hai Wai Ban), Jan. 14, 1986.

a recent law, however, the creation of wholly foreign-owned corporations in China is permitted.<sup>24</sup> Before the enactment of this law the choice of business medium rested between a branch operation (normally with local participation) — commonly referred to as a contractual joint venture — and the creation of a separate corporation (jointly with one or more Chinese coventurers) — called an equity joint venture.<sup>25</sup>

### III. EQUITY JOINT VENTURES

A joint venture with foreign participation incorporated under the Joint Venture Law, therefore a Chinese “citizen” and resident for tax purposes, is subject to tax on its income under the JVIT law and is also liable to pay the CICT. The corporation is taxed as a single entity on its total profits. In other words, the share of profits of the Chinese partner (which might be a state enterprise) is also subject to the JVIT. The profits of any branches<sup>26</sup> are included in the joint venture’s income. This sum presumably includes income of any branch situated in another country, as a Chinese corporation is taxable on its world income.<sup>27</sup>

#### A. Taxable Income

The JVIT is imposed on taxable income derived from production, business, and other sources. “Production and business” are defined as “industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, tourism, food and drink service and other trades.”<sup>28</sup> Income from “other sources” includes “dividends, bonuses, interest, income from lease or transfer of property, patent right, ownership of trademark, proprietary technology and copyright.”<sup>29</sup> Income would seem to include at least some types of capital gain, but no distinction is made between capital gains and other types of income.<sup>30</sup>

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<sup>24</sup> Law on Enterprises Operated Exclusively with Foreign Capital, adopted on Apr. 12, 1986. The text of the law is published in a Xinhua agency release of that date. See also *Provisions of the State Council of the People’s Republic of China for the Encouragement of Foreign Investment*, China Daily, Beijing, Apr. 23, 1986, at 2. The State Council Provisions of Oct. 11, 1986, *supra* note 9, expressly encourage establishment of wholly foreign-owned enterprises.

<sup>25</sup> The joint venture law stipulates that, in general, the proportion contributed by the foreign party shall not be less than 25% of the registered capital. In practice, the allocation of shares varies widely, the lowest foreign participation being about 15% and the highest about 85%.

<sup>26</sup> The Chinese term translated as “branch” could, perhaps, also include a subsidiary. See Pomp, Gelatt & Surrey, *supra* note 12, at 52.

<sup>27</sup> A credit is allowed for foreign tax paid. JVIT, art. 16.

<sup>28</sup> JVIT Regs., art. 2.

<sup>29</sup> *Id.*

<sup>30</sup> The JVIT refers only to “net income.” *Id.* art. 2. The Regulations require revenue and ex-



Taxable income is defined as “net income in a tax year after deduction of costs, expenses and losses in that year.”<sup>31</sup> More detailed formulas are set out in the regulations<sup>32</sup> and provide methods of computation of income from industrial, commercial, and service operations, and from “other lines of operations.” Profits must be computed, and accounts drawn up, in accordance with the relevant accounting regulations.<sup>33</sup> An auditor’s report prepared by a public accountant registered in the PRC must be submitted with the tax return. For the most part, the relevant accounting principles will cause little surprise to Western business executives. With respect to stock valuation, for example, a variety of methods — first-in-first-out (“FIFO”), shifting average, and weighted average — are permitted, although permission of the local authorities must be obtained in order to change accounting methods.

China’s position regarding accounting of income is comparable, in principle, to that in most Western countries. Profits are computed in accordance with normal accounting principles, except insofar as these principles are expressly modified by tax legislation. Thus, proper business expenses are deductible unless the law provides otherwise. A number of exceptions are made in Article 9 of the regulations. These are discussed below.<sup>34</sup>

1. Capital Expenditures. The regulations specifically disallow the deduction of capital expenditure for the purchase or construction of machines, equipment, buildings, and other fixed assets. However, depreciation or amortization is permitted on an annual straight-line basis over prescribed periods of the useful life of the assets in question. Thus, houses and buildings are normally depreciated over a period of twenty years, machinery, equipment, and other facilities used in production are depreciated over a period of ten years, and electrical equipment and motor vehicles are depreciated over a period of five years.<sup>35</sup> Intangible assets, including know-how, patent rights, and trademarks are normally amortized over a period of ten years (unless they have a specific lifespan). Finally, the initial costs of establishing a joint venture may be amortized

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penditure to be accounted “on accrual basis.” *Id.* art. 23. This is expanded upon in art. 15 of the Accounting Regulations for Joint Ventures using Chinese and Foreign Investment, promulgated on Mar. 4, 1985 [hereinafter Accounting Regulations]. The tax treaties entered into by China specifically allow for the taxation of certain capital gains; e.g., art. 12 of the Agreement between China and the United States for the Purpose of Avoidance of Double Taxation, signed on Apr. 30, 1984 entered into force Nov. 21, 1986. Tax Treaties (CCH) ¶ 1406 [hereinafter China-United States Agreement].

<sup>31</sup> JVIT, art. 2.

<sup>32</sup> JVIT Regs., art. 8.

<sup>33</sup> Accounting Regulations, art. 9.

<sup>34</sup> JVIT Regs., art. 9.

<sup>35</sup> In special cases, shorter periods may be permitted by the Ministry of Finance.

at a maximum rate of 20% each year.<sup>36</sup>

2. Interest on "Equity Capital." The restriction on interest on equity capital has caused some confusion.<sup>37</sup> The restriction seems to prohibit the deduction of interest on original loan capital and, perhaps, on loans from shareholders. Once operations have commenced, interest on subsequent borrowing should be deductible. However, if funds are borrowed to acquire fixed assets, it may be that the interest is not deductible and that the interest charges may be included in the cost of the assets for the purpose of calculating depreciation.

3. Income Tax and Local Surtax Payments. The reference here to "income tax" is somewhat confusing since, as discussed above, it does not appear that a joint venture to which the JVIT law applies is liable to pay the ICIT or any other income tax. Consequently, it may be presumed that income tax withheld by the joint venture (e.g., on salaries and dividends) is not deductible.

4. Penalties. The regulations prohibit the deduction of penalties for illegal activities, overdue tax, and losses from confiscated property.

5. Losses Covered by Insurance.

6. Donations and Contributions. No deduction is permitted except in the case of donations for public welfare and relief purposes. There is some doubt as to whether this permits the deduction of amounts which are required to be set aside as reserves or contributed to welfare or bonus funds.<sup>38</sup>

7. Entertainment Expenses. Entertainment expenses are only deductible to the extent that they are relevant to production and operation and are subject to a ceiling of 1% of total operational income.

8. Losses. Losses may be carried forward for up to five years.<sup>39</sup>

## B. Tax Rates

The taxable income of a joint venture is taxed at a flat rate of 30%. In addition, a local surcharge of 10% of the basic tax is levied on this amount, bringing the total tax rate to 33%. The local authorities in the province or region where the joint venture is located may reduce or waive this tax. It appears that the local surcharge may be levied only once; consequently, if the joint venture conducts operations in more than one region, the region where the head office is situated has the exclusive right

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<sup>36</sup> JVIT Regs., arts. 10-17.

<sup>37</sup> See Pomp, Gelatt & Surrey, *supra* note 12, at 55-56; Simon, *supra* note 8, at 540.

<sup>38</sup> See Rasmussen & Theroux, *China's New Tax Laws for Joint Ventures and Individuals*, CHINA BUS. REV., Nov.-Dec. 1980, at 36; Gelatt & Pomp, *supra* note 6, at 454-55.

<sup>39</sup> JVIT, art. 7.

to tax.<sup>40</sup>

In addition to the flat rate of tax on profits, a further tax of 10% is levied on profits remitted by the foreign investor outside China. Presumably what is intended to be covered here are dividends paid to the foreign shareholders. The use of the word "profits" would seem to exclude interest paid to a foreign shareholder or a return of capital, unless either payment could be regarded as a disguised distribution of profits. The additional tax appears to have the effect of a withholding tax. Consequently, the 10% tax applies, rather than the 20% tax imposed by both the IIT and the FEIT, on investment income paid to nonresidents.<sup>41</sup> This may be less important if a tax treaty applies, as the rate on dividends is normally reduced to 10% in any event.<sup>42</sup>

This withholding tax must be considered in conjunction with a provision which permits a refund of tax paid with respect to profits reinvested in China. Article 6 of the JVIT law provides that a participant in a joint venture which reinvests its share of profit in China for a period of not less than five years may, upon approval of the tax authorities, obtain a refund of 40% of the income tax paid on the reinvested amount.<sup>43</sup> In other words, the participant or shareholder must reinvest in order to recover a proportion of the underlying tax paid by the corporation on the distributed profits. To qualify as a reinvestment, the participant (foreign or Chinese) must invest the profits in the same joint venture, in some other joint venture, or establish a new joint venture in China.<sup>44</sup> If the refunded tax is remitted abroad, this amount is not treated as a repatriation of profits and no withholding tax is levied.<sup>45</sup> A participant who withdraws invested funds within five years must pay back the amount of tax refunded; presumably, if those funds are remitted out of China, the additional 10% withholding tax will also apply.

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<sup>40</sup> Rasmussen & Theroux, *supra* note 38, at 37.

<sup>41</sup> See *infra* notes 72-80. It would seem that the foreign shareholder is not liable to pay the FEIT or IIT. The Individual Income Tax Regulations, art. 5(2), expressly exempt dividends paid by equity joint ventures.

<sup>42</sup> China-United States Agreement, *supra* note 30, art. 9. This is also the rate prescribed in China's treaties with Belgium, Canada, France, the Federal Republic of Germany, Japan, and the United Kingdom, though higher rates apply to portfolio dividends in the case of Canada (15%) and Japan (20%).

<sup>43</sup> The refund does not include the local tax surcharge. Consequently, it should be approximately 17% of the amount reinvested. The State Council Provisions of Oct. 11, 1986, *supra* note 9, provide for a full refund for profits reinvested to establish or expand export enterprises or technologically-advanced enterprises.

<sup>44</sup> Ministry of Finance Notice of Sept. 16, 1981, (81) Cai Shui Wai Zi, No. 82.

<sup>45</sup> Ministry of Finance Notice of June 8, 1981, (81) Cai Shui Wai Zi, No. 188.

### C. Exemptions and Reliefs

The refund is but one of a number of special reliefs and exemptions which provide a variety of incentives to foreign investment generally and to certain activities in particular. The tax rates which apply to joint ventures exploiting petroleum, natural gas, and other resources are determined separately and, as already mentioned, the local surcharge may be reduced or waived. Moreover, a number of Special Economic Zones ("SEZs") have been set up in China and, for joint ventures established within these zones, the tax rate is normally reduced to 15%, or 10% in the case of export enterprises, with no local surcharge.

Two other important incentives are provided. First, newly-established joint ventures scheduled to operate for ten years or more may be exempted from the JVIT in the first two profit-making years and allowed a 50% reduction in the following three years.<sup>46</sup> Second, certain low-profit operations (notably farming, forestry, and ventures located in remote or economically-underdeveloped areas) may, with approval, be allowed a reduction of up to 30% for an additional ten years.<sup>47</sup>

## IV. BRANCHES AND ESTABLISHMENTS

Foreign enterprises carrying on business in China, other than as participants in equity joint ventures, are subject to the Foreign Enterprise Income Tax ("FEIT").<sup>48</sup> Whereas an equity joint venture is treated as a separate entity (whose profits are taxed before distribution to the foreign and local participants), a contractual joint venture has no separate status for tax purposes. The foreign participant is taxed on its share of the profits under the FEIT law and the Chinese participant is taxed on its share under the relevant domestic law. The other major difference is that the JVIT is essentially a flat-rate tax whereas the FEIT is levied at progressive rates if the foreign enterprise has an establishment in China. A foreign enterprise which does not have an establishment in China is subject to a flat-rate tax of 20% — which is essentially a withholding tax — on certain types of passive investment income from Chinese sources.

Article 1 of the FEIT law provides that income tax shall be charged

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<sup>46</sup> Originally the "tax holiday" was for one year only, with a 50% reduction in the following two years. JVIT, art. 5. This was increased by an amendment adopted on Sept. 2, 1983. The relief is subject to approval of the tax authorities. The State Council Provisions of Oct. 11, 1986, *supra* note 9, provide for further extended tax holidays, at the reduced rate, in the case of export enterprises and technologically-advanced enterprises.

<sup>47</sup> JVIT, art. 5.

<sup>48</sup> Income Tax Law concerning Foreign Enterprises, adopted Dec. 13, 1981. See also Han, *People's Republic of China's Foreign Enterprises Income Tax Laws and Regulations*, 6 HASTINGS INT'L & COMP. L. REV. 689 (1983).

on the income derived from production, business, and other sources by any foreign enterprise operating in the People's Republic of China. "Foreign enterprises" are defined as "foreign companies, enterprises and other economic organizations which have establishments in the People's Republic of China engaged in independent business operations or cooperative production or joint business operations with Chinese enterprises."<sup>49</sup>

#### A. Enterprises

The word "enterprise" is defined to include foreign companies and other "economic organizations." Consequently, a foreign partnership, limited partnership, trust, and various hybrid organizations are included. Less clear is the position of a foreign individual who carries on business activities in China, and, as such, might also be liable to tax under the IIT law. The latter legislation, which sets out a number of categories of income, has no category for "business income," although it does apply to "remuneration for personal services."<sup>50</sup> What then would be the position of a self-employed business consultant or a touring concert musician who earns income in China? It would seem that a single individual may be regarded as an "enterprise" or, more accurately, that the business carried on by that individual may be so regarded and its profits taxed under the FEIT law.<sup>51</sup> It would still be necessary, however, to draw a distinction between "business income," subject to the FEIT, and "remuneration for personal services," subject to the IIT.<sup>52</sup>

#### B. Establishments

Another vital question is to determine whether the foreign enterprise has an establishment in China. According to the regulations, "establishments" are "organizations, places or business agents established in the Chinese territory by foreign enterprises and engaged in production and business operations."<sup>53</sup> These establishments "mainly include management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building, installation, assembly and exploration are operated."<sup>54</sup>

The definition is, on its face, fairly broad. Nonetheless, it seems that

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<sup>49</sup> FEIT, art. 1.

<sup>50</sup> The correct categorization is important because taxable income is computed differently under the two laws and FEIT is charged at progressive rates, rising as high as 50%, whereas IIT is charged at a flat rate of 20% on income from personal services.

<sup>51</sup> Ministry of Finance Notice of Aug. 2, 1982, (82) Cai Shui Wai Zi, No. 99.

<sup>52</sup> This is considered further, *infra* notes 113-22, in connection with the IIT.

<sup>53</sup> JVIT Regs., art. 2.

<sup>54</sup> *Id.*

Chinese authorities interpret the term quite narrowly. In practice the word seems to correspond to the notion of "permanent establishment" used in tax treaties and may even be less extensive than the definition commonly given in the treaties negotiated so far by China. It is clear that foreign enterprises involved in construction projects or in oil or mineral exploration are regarded as having an establishment in China for purposes of the FEIT. In contrast, foreign firms which have set up exhibitions at trade fairs and subsequently sell their products generally seem to be treated as not having an establishment and are not subject to the FEIT.<sup>55</sup> Similarly, foreign enterprises involved in "compensation trade" — in which products are sold to Chinese concerns in return for Chinese products which the foreign enterprise will market in other countries — are normally not considered to be operating in China through an establishment.

The most difficult cases appear to involve situations in which the foreign enterprise has an agent or representative office in China. Two significant questions must be asked concerning the status of agents. First, does the agent act for a single principal rather than for a number of firms? Second, does the agent have authority to enter into contracts binding upon the principal? If the answer to both questions is "Yes," then it seems clear that the principal is regarded as having an establishment in China and is subject to the FEIT.<sup>56</sup> Less clear is the position where the agent may have authority to bind two or more principals, especially if these happen to be affiliated concerns. It would normally be in the interests of the Chinese tax authorities to assert that the agent itself was an independent enterprise carrying on business in China through an establishment. In that way, the earnings from both principals would be aggregated and subject to progressive rates of tax.

The position regarding representative offices has been clarified by the recent adoption of special rules.<sup>57</sup> These rules adopt a view similar to that taken by most other countries. In effect, if the activities of the office are restricted simply to marketing, promotional, and liaison work on behalf of its home office, and if the office receives no payment as such for

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<sup>55</sup> For the ruling given by the Ministry of Finance, see (82) Cai Shui Wai Zi, No. 95; cf. (83) Cai Shui Wai Zi, No. 80 (where a Singapore company was considered to be carrying on a business in China and to have an establishment there because it organized exhibitions in China and maintained storage facilities in Shanghai).

<sup>56</sup> See Han, *supra* note 48, at 691-94. See also China-United States Agreement, *supra* note 30, art. 5.

<sup>57</sup> Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Business Income Tax from China-based Foreign Companies, issued on May 14, 1985, reprinted in BUS. CHINA, May 30, 1985, at 77 [hereinafter Interim Provisions].

that work, the foreign enterprise is not considered to have an establishment in China. To the extent that the office provides a wider degree of services or receives commissions, rebates, or fees or payments by scheduled installments or in accordance with the volume of the commissioned services, the income of the office is taxable.<sup>58</sup>

### C. Taxable Income

Foreign enterprises with establishments in China are taxed on their income "derived from production, business and other sources" which, in turn, is defined as the "net income in a tax year."<sup>59</sup> The regulations set out detailed rules for the computation of income<sup>60</sup> which are essentially similar to those applying to joint ventures. Among the differences in computation, it should be noted that reasonable interest and reasonable administrative expenses are expressly stated to be deductible,<sup>61</sup> but that royalties paid to the head office are not a deductible expense.<sup>62</sup>

As is the case with any other branch operation, determining precisely how much income should be attributed to a branch or establishment in China is not a simple matter. For example, a foreign company might sell a product or license the use of a process to a Chinese enterprise for a particular price. Typically, such activity would not involve any liability to income tax in China. However, the agreement might include a provision that the vendor provide servicing and maintenance facilities, training programs for local operators, assistance with installation, and other services. The result may be the setting up of an establishment in China and, consequently, liability for tax on the income earned by that establishment.<sup>63</sup>

If a foreign enterprise cannot provide accurate evidence of costs and expenses and cannot correctly compute its taxable income, the local tax

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<sup>58</sup> It is also liable to pay the CICT, as the Interim Provisions make clear, normally at the rate of 5% of the commissions or fees received. Interim Provisions, art. IV.

<sup>59</sup> The tax year is defined as the calendar year (under the Gregorian Calendar), but approval may be given to use a different 12-month fiscal period. FEIT Regs., art. 8.

<sup>60</sup> FEIT Regs., arts. 9-23. These regulations may, of course, be modified by a relevant tax treaty. Computation of profits of a permanent establishment is dealt with in China-United States Agreement, *supra* note 30, art. 7. This also restricts deduction of royalties or of interest paid to the head office.

<sup>61</sup> FEIT Regs., arts. 11-12.

<sup>62</sup> FEIT Regs., art. 10.

<sup>63</sup> Under the treaties negotiated so far, it would seem that this will not constitute a permanent establishment unless these activities continue for at least 6 months; *e.g.*, China-United States Agreement, *supra* note 30, art. 5. Where payment takes the form of royalties or rent, the practice seems to be to treat any additional fees (*e.g.*, for servicing or technical training) as part of the royalty of rental income. Provisional Regulations concerning Reduction and Exemption of Income Tax on Proprietary Technology Usage Fees, dated Dec. 13, 1982.

authorities may make an estimate of the enterprise's profits based on its net sales or gross business income.<sup>64</sup> In practice, it seems that foreign enterprises may elect to be taxed on this basis. In the case of representative offices, the special interim provisions expressly provide that, where satisfactory documentation is not available, taxable income will be deemed to be 15% of "business proceeds."<sup>65</sup>

#### D. Tax Rates

The FEIT is assessed at progressive rates, ranging from 20% on the first 250,000 yuan<sup>66</sup> of annual taxable income to 40% on the income in excess of one million yuan.<sup>67</sup> A local income tax of an additional 10% is levied on the same income.<sup>68</sup> Unlike the local tax on equity joint ventures, this local tax is imposed on income (i.e., the local tax is not a percentage of the tax payable to the central government). Thus, the effective rates of tax on foreign establishments vary from 30% to 50%. Except in the case of small operations, an equity joint venture will pay a lower rate of tax on its profits. It must be remembered, however, that there will be a further 10% tax charged on profits remitted out of China by the equity joint venture. As in the case of equity joint ventures, the tax rate on foreign enterprises established in the SEZs is commonly reduced to 15% or, in some cases, 10%.

#### E. Exemptions and Reliefs

In addition to the reduction of taxes in SEZs and the possible reduction of or exemption from local taxes, the FEIT law contains a "tax holiday" provision of more general effect.<sup>69</sup> Foreign enterprises scheduled to operate for a period of ten years or more in farming, forestry, animal husbandry, coal mining, or other low-profit operations may, with the approval of the tax authorities, be exempted from income tax in the first profit-making year and allowed a 50% reduction in the second and third years. A further reduction, from 15% to 30% may be allowed for an additional period of up to ten years. Special extensions are given for export enterprises and technologically-advanced enterprises.

Important reliefs and exemptions are also provided in the case of

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<sup>64</sup> FEIT Regs., art. 24.

<sup>65</sup> Interim Provisions, *supra* note 57, art. IV. This appears to be acceptable under China-United States Agreement, *supra* note 30, art. 7(4).

<sup>66</sup> 1 yuan = US\$0.26 (approximately).

<sup>67</sup> FEIT, art. 3.

<sup>68</sup> The local tax may be reduced or waived by the local authorities in cases of small-scale production or low profit. FEIT, art. 4.

<sup>69</sup> FEIT, art. 5.



certain types of interest and rental income. Entirely exempted from income tax is interest on loans to the Chinese government or to China's state banks and interest on certain loans to China's National Offshore Oil Corporation. Under a provisional regulation, interest on loans made by foreign enterprises between 1983 and 1985 was scheduled to be taxed at the reduced rate of 10%.<sup>70</sup> This reduction also applied to income from leasing equipment to Chinese concerns. The government subsequently decided to extend these concessions until the end of 1990.<sup>71</sup>

## V. PASSIVE INVESTMENT INCOME

The FEIT Law also imposes what is in effect a withholding tax at a flat rate of 20%<sup>72</sup> on the income obtained in China from dividends, interest, rentals, royalties, and other sources by foreign companies, enterprises, and other economic organizations having no establishments there.<sup>73</sup> The exemptions and reductions for certain types of interest income and income from equipment leasing, discussed in the preceding section, also apply to nonestablishment income. Indeed, the exemption for loans to the government and the state banks ostensibly applies only to enterprises without an establishment in China.<sup>74</sup> In practice, however, it seems that a lender will not be refused the exemption simply because the lender also has a branch or office in China.

The treatment of an enterprise which has an establishment in China and which also receives passive investment income is somewhat uncertain. For example, the foreign enterprise might grant a license to a Chinese enterprise to use certain patents or processes in return for which the foreign enterprise receives rental or royalty payments. These payments would normally be regarded as passive investment income. However, in connection with this principal agreement, the foreign enterprise might also operate an establishment in China, providing information, technical assistance, training, or repair and servicing facilities. The income earned by the establishment is clearly subject to the FEIT at progressive rates. But what of the royalty income? Is it subject only to the flat rate withholding tax of 20% or is it treated as part of the establishment income which is aggregated with the other income and taxed at a rate which could be as high as 50%?

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<sup>70</sup> Provisional Regulations concerning the Reduction and Exemption of Income Tax relating to Interest earned by Foreign-Businesses from China, issued Jan. 7, 1983.

<sup>71</sup> Ministry of Finance Notice, Jan. 6, 1986, (86) Cai Shui Wai Zi, No. 1.

<sup>72</sup> Treaty provisions commonly reduce these rates; e.g., to 10% in the China-United States Agreement, *supra* note 30, arts. 9-11.

<sup>73</sup> FEIT, art. 11.

<sup>74</sup> *Id.*

A literal interpretation of the FEIT law and of the regulations would support the latter conclusion. Once the foreign enterprise has an establishment in China, the enterprise is apparently taxed on its income from production, business, and other sources.<sup>75</sup> In computing the foreign enterprise's income, net "nonbusiness income" is included.<sup>76</sup> This literal interpretation would support the force of attraction doctrine according to which all Chinese-source income of an enterprise having an establishment in China is attributed to that establishment.<sup>77</sup> However, since the term "enterprise" is not clearly defined, some doubt remains. For example, a foreign parent company may receive patent royalties while a separate foreign subsidiary provides services through a branch in China; the royalties are paid directly to the parent and the fees for services to the branch. Is there one foreign enterprise or two and does the force of attraction doctrine apply?<sup>78</sup>

We have already considered the question of whether a single individual may constitute an enterprise for the purposes of the FEIT. In many respects, "enterprise" appears to be synonymous with "business," and an individual carrying on business in China through an establishment is apparently taxed under the FEIT law. But what of a foreign individual who receives dividends, interest, royalties, or other passive income and who has no establishment in China? At first, it would not seem to be important whether the individual was taxed as an "enterprise" under the FEIT law<sup>79</sup> or as a nonresident individual under the IIT law (as would normally be the case). In either situation, a withholding tax of 20% (or a lower treaty rate) would apply. However, some of the reliefs and exemptions referred to above apply only to the FEIT, no mention being made of the IIT law.<sup>80</sup> Consequently, a passive investor in China (for example, someone lending money to a foreign enterprise operating there) would be advised to invest through the medium of a personal corporation rather than individually.

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<sup>75</sup> FEIT, art. 1.

<sup>76</sup> FEIT Regs., art. 9.

<sup>77</sup> In practice, however, it seems that the Chinese authorities treat the different types of income separately. See Han, *supra* note 48, at 697-98. The tax treaties commonly employ the "attributed to the permanent establishment" formula; e.g., China-United States Agreement, *supra* note 30, art. 7.

<sup>78</sup> It is submitted that the doctrine should *not* apply. The parent should be subject to flat rate withholding tax on the royalty and the subsidiary should be taxed on the income of its branch.

<sup>79</sup> FEIT, art. 11.

<sup>80</sup> For example, no mention is made of certain types of leasing income and income from investment in the SEZs. Interest on loans to state banks is exempt under both FEIT and IIT laws.

## VI. INDIVIDUAL INCOME TAX

China had no individual income tax of general application before 1980.<sup>81</sup> Before that time, individuals could have been subject to income tax under the ICIT, introduced in 1950, which applied to business profits. Farmers or peasants working on their own account were also liable to pay the agricultural tax. As for investment income, this had largely ceased to exist. For a period following the end of the civil war in 1949, "former capitalists" (if they had not actively opposed the new regime or fled to Taiwan) continued to receive dividends from the property or enterprises they had owned. In time, these payments were converted into interest payments from the state banks. Following the Cultural Revolution in 1966, the number of "private" incomes, whether from business or property, decreased dramatically. Consequently, it was felt that there was no need for a personal income tax.

This picture changed considerably with the introduction of economic reforms in the late 1970s. The ICIT<sup>82</sup> and agricultural tax assumed new importance as many new privately-owned businesses (especially in the retail and service sectors) were established and the government encouraged farmers to increase private production. Certain categories of individual income, however, escaped tax entirely. These categories included the income of artists, writers, inventors, some doctors with private practices, and, of course, the salaries and other income of foreigners working in China.<sup>83</sup> In reality, foreigners were the main target of the IIT introduced in 1980. It was estimated at the time that, out of a population of approximately one billion, only about twenty Chinese citizens (mostly artists whose works were sold abroad) were likely to be affected by the tax.<sup>84</sup> While no statistics appear to have been published, it is reasonable to assume that several thousand Chinese are now affected by the tax. Nonetheless, the IIT remains a tax principally affecting foreigners.

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<sup>81</sup> The government included an income tax on wages and salaries in the 1950 Tax Regulations but it was never put into force. See 1 ZHONG GUO DUI WAI SHUI WU SHOU CE 116 (1983).

<sup>82</sup> The ICIT has now effectively been replaced by the Collective Enterprise Income Tax Regulations (promulgated by the State Council on Apr. 11, 1985) and the Interim Regulations on Income Tax concerning Urban and Rural Individually-Operated Industrial and Commercial Businesses (promulgated by the State Council on Jan. 7, 1986).

<sup>83</sup> See *Individual Income Tax in China*, CHINA ECON. NEWS, May 4, 1981 (interview with Liu Zhicheng, Director of the Taxation Bureau).

<sup>84</sup> N.Y. Times, Sept. 3, 1980, at 1, col. 5. It is reasonable to assume that, by 1986, several thousand Chinese citizens were paying the tax. Beginning in 1987, all citizens will pay the new IIRT, therefore, the IIT applies only for foreigners. See *supra* note 20.

### A. Residence

As is the case in most countries, residence is an important factor in determining liability to personal income tax. Longtime residents of China are, at least in theory, subject to tax on their world income; non-residents are taxed only with respect to Chinese-source income. However, "residence" is not defined by the current law, and the Chinese concept of residence appears to be somewhat different than that found in most Western tax systems.<sup>85</sup>

The basic rules defining residency in the IIT law are quite complex.<sup>86</sup> It is clearly possible to be "resident" in China for less than one year, however the law does not precisely define what activity constitutes residence. The regulations do provide some guidance.<sup>87</sup> Articles 3<sup>88</sup> and 5<sup>89</sup> of the regulations are also important to arriving at a definition. The latter provision suggests that one may be "resident" in China even for a period of less than ninety days. If a tax treaty applies, however, it is probable that such a person would not be treated as resident in China.<sup>90</sup>

There appear to be five possible situations which are explained below.

#### 1. The taxpayer has resided in China for more than five years. In

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<sup>85</sup> For a thorough study, see Gelatt & Pomp, *supra* note 6, at 427-29; see also Byres & Shum, *Individual Income Tax in the People's Republic of China*, 13 TAX PLAN. INT'L REV. 15 (1986).

<sup>86</sup> According to IIT Regs., art. 1:

An individual income tax shall be levied in accordance with the provisions of this Law on the income gained within or outside China by any individual residing for one year or more in the People's Republic of China.

For individuals not residing in the People's Republic of China or individuals residing in China less than one year, individual income tax shall be levied only on that income gained within China.

<sup>87</sup> Art. 2 of the IIT Regs. states:

Any individual residing for one year or more in the People's Republic of China mentioned in Article 1 of the Tax Law refers to any individual who resides in China for a full 365 days of a tax year. No subtractions shall be made therein of the number of days of temporary absence from Chinese territory within the tax year.

A tax year starts from January 1 and ends on December 31 in the Gregorian Calendar.

<sup>88</sup> According to IIT Regs., art. 3:

Individuals who reside in the People's Republic of China for one year or more but not exceeding five years shall pay tax only on that part of their income received outside China which is remitted to China; individuals whose residence in China exceeds five years shall pay tax on all their income received outside China from the sixth year of residence.

<sup>89</sup> Art. 5 of the IIT Regs. states in part: "[F]or individuals whose continuous residence in China does not exceed 90 days. . .remuneration by employers outside China may be exempted from taxation."

<sup>90</sup> The treaties entered into by China contain the usual "dual residence" rules. In the China-United States Agreement, *supra* note 30, art. 4, such questions are to be resolved by the competent authorities. This is also the case with the Japanese treaty. The treaties with Belgium, Canada, France, Germany, and the United Kingdom adopt the usual "tie-breaker" rules. It should be noted that the United States Treaty refers only to residence — citizenship is not taken into account. In addition, the treaties contain "183-day rules" with respect to employment and professional income.

this instance the individual is taxed on income from all sources regardless of whether it is remitted to China. Presumably this taxable income includes foreign business income. (As discussed below, the IIT is not levied on income from business as such.) It should be noted that foreign-source income is not aggregated with Chinese-source income; it is *net* income (computed in accordance with the Chinese rules) which is taxed and a *credit* for foreign taxes may be claimed.<sup>91</sup> In practice, however, foreigners working in China for non-Chinese enterprises, even if resident for more than five years, are not taxed on foreign-source income so long as they do not intend to become a permanent resident.<sup>92</sup>

2. The taxpayer has resided in China for more than one year but not more than five years. For individuals in this category, foreign-source income is taxed only if it is remitted to China. As with persons qualifying under the first category, this foreign-source income is not aggregated with other income; only net income is taxed. A foreign-tax credit may be claimed and the income may be exempted entirely.

3. The taxpayer has resided in China for less than one year but for at least ninety days. The law is not entirely clear how to treat the income of individuals in this category although the problem would normally be resolved by treaty. Essentially, such a person is treated in the same way as a nonresident and is taxed only on income "gained within China."<sup>93</sup> By implication, salary paid by a foreign employer for services performed in China is taxable regardless of whether it is remitted to China.<sup>94</sup> The tax treaties generally exempt such income if the recipient has spent no more than 183 days in China during the year and the remuneration is paid by a nonresident employer and is not borne by a permanent establishment or fixed base in China.<sup>95</sup>

4. The taxpayer has resided in China for ninety days or less. As in the case of persons qualifying under the third category, only Chinese-source income is taxable; however, remuneration paid by a foreign employer is exempt from taxation.<sup>96</sup>

5. The taxpayer has not resided in China. In this instance, only

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<sup>91</sup> IIT Regs., art. 16.

<sup>92</sup> Ministry of Finance Notice, Mar. 7, 1983, (83) Cai Shui Zi, No. 62.

<sup>93</sup> IIT, art. 1.

<sup>94</sup> IIT Regs., art. 5.

<sup>95</sup> *E.g.*, China-United States Agreement, *supra* note 30, art. 14. In the case of self-employed persons providing professional or other services, income earned in China is taxable there only if that person has a "fixed base" in China or is present there for 183 days or more in the year. *Id.* art. 13.

<sup>96</sup> This provision is translated variously as "remuneration paid by employers outside China" and "remuneration obtained from employers outside China." It is clear, from the first paragraph of art. 5 of the Regulations, that it is not the place of payment which matters, but the location of the employer.

Chinese-source income is taxed.<sup>97</sup> Tax is effectively restricted to income such as royalties, interest, dividends, and rent. For individuals in this category, tax is imposed on *gross* income.<sup>98</sup>

It may still be necessary to define "residence" in each particular case. The practice of the tax authorities is to base the determination of residence principally upon the taxpayer's residence status and upon the type of visa held.<sup>99</sup> A foreigner holding a residence permit is normally considered to be resident in China for as long as the permit is valid. Typically, a residence permit is issued only to individuals working in China on a full-time basis or on an extended assignment. A permit is normally valid for six months and may be renewed or extended. The permit holder is treated as resident in China and temporary absences for business trips, vacations, or other reasons are ignored. Consequently, a person could be physically present in China for less than ninety-one days in a tax year but still be taxed on remuneration for services performed in China paid by a foreign employer (unless relieved by a treaty provision).

Foreigners who visit China temporarily will be issued with a visa and will not obtain a residence permit. Two types of visa are available, single-entry and multiple-entry. The holder of a single-entry visa is liable for income tax based upon the actual number of days of continuous presence in China. A foreigner could make two or three separate visits of eighty days each during the year under separate single-entry visas and still claim the benefit of the ninety-day rule. This exception would apply if the visits are separated by absences from China of thirty days or more; where the absences are shorter and the visitor has a succession of short-term visas, the periods may be aggregated. In contrast, if the visitor holds a multiple-entry visa, the individual will be treated as residing in China for the entire period between the date of first entry until the last date of exit under that visa, regardless of any absences from China during that time.

A foreigner deciding between the two types of visas should weigh the greater convenience of a multiple-entry visa against the increased likelihood of liability for income tax on salary earned by services performed in China.<sup>100</sup> Recently, however, the rules relating to holders of multiple-entry visas have been relaxed. If the holder of such a visa makes a number of visits to China while the visa is valid and the visits are

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<sup>97</sup> IIT, art. 1.

<sup>98</sup> IIT Regs., art. 11.

<sup>99</sup> Ministry of Finance Notice, June 2, 1981, (81) Cai Shui Zi, No. 185. Local authorities may interpret the rules in a way more favorable to the taxpayer.

<sup>100</sup> Only if the visa is for more than 90 days is the visitor required to register with the tax authorities.

interrupted by a series of absences, the person will still be able to claim the benefit of the ninety-day rule if the total period spent in China does not exceed ninety days and is not longer than one-third of the valid period of the visa.<sup>101</sup>

The operation of the 365-day rule is also a matter of uncertainty. A literal interpretation of Article 2 of the regulations suggests that an individual could be present in China from January 2 of one year until December 30 of the following year without becoming a resident subject to tax liability on foreign-source income. Chinese tax officials have apparently not accepted this view and consider that the period may span two years.<sup>102</sup> The issue is no longer important for most foreigners (i.e., those working for non-Chinese employers) as the current practice is not to tax foreign-source income regardless of whether it is remitted to China.<sup>103</sup>

## B. Income and Tax Rates

While the IIT law is, at first glance, extremely simple — having only fifteen short articles<sup>104</sup> — the law has a number of striking features. First, the IIT is a schedular tax. Not only are different categories of income computed separately, they are taxed separately according to different rules and are not aggregated to determine total income or the total amount of tax payable. Second, with the exception of employment income taxed at progressive rates of 5% to 45%, all income is taxed at a flat rate of 20%. Third, although reference is made to the “tax year,”<sup>105</sup> the relevant period for most purposes is the month. Fourth, while certain basic exemptions do exist, no recognition is given to the personal circumstances of the taxpayer based upon marital status, number of dependants, or other factors. Fifth, the IIT does not apply to business income<sup>106</sup> other than what might be termed “professional income.” The categories of income subject to tax under the IIT are: 1) wages and salaries; 2) remuneration for personal services; 3) royalties; 4) interest, dividends, and bonuses; 5) income from the lease of property; and 6) other kinds of income specified as taxable by the Ministry of Finance.<sup>107</sup>

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<sup>101</sup> Ministry of Finance Notice, Feb. 18, 1986, (86) Cai Shui Wai Zi, No. 34.

<sup>102</sup> See Gelatt & Pomp, *supra* note 6, at 430.

<sup>103</sup> See *supra* note 92.

<sup>104</sup> The detailed Regulations have an additional 27 articles.

<sup>105</sup> *E.g.*, IIT Regs., art. 2.

<sup>106</sup> As previously mentioned, business income is subject to the FEIT in the case of foreign businesses and to a variety of taxes in the case of domestic businesses.

<sup>107</sup> IIT, art. 2.

### 1. *Employment Income*

Income from wages and salaries is unique in that it is taxed at progressive rates. A monthly deduction of 800 yuan is allowed, with the excess taxable at the following rates:

<u>Monthly Income (yuan)</u>	<u>Tax Rate (%)</u>
801 - 1500	5
1501 - 3000	10
3001 - 6000	20
6001 - 9000	30
9001 - 12,000	40
above 12,000	45

The effective rates of tax are relatively low. Most executives are likely to pay less income tax in the People's Republic of China than in Hong Kong, which is known for its low taxes. The basic exemption, equal to approximately US\$200 a month, may not seem high but it is about eight times greater than the average wage in China. Consequently, very few Chinese wage earners were ever affected by the tax.<sup>108</sup>

The legislation provides very little detail regarding the computation of income from wages or salaries. The regulations simply include: "bonuses and year-end extras earned from work in offices, organizations, schools, enterprises, undertakings and other entities."<sup>109</sup> Further, it is generally provided that, if income is paid "in kind or in marketable securities," the value of such income is to be included.<sup>110</sup>

No general principles have yet evolved dealing with fringe benefits, allowances, and similar items. In practice, it seems that cash allowances, especially "foreign service" or "hardship" allowances paid on a per diem basis, are treated as part of taxable income. Reimbursement of actual expenses, in so far as they are company expenses, are not considered to be income. However, the treatment of expenses paid by the employer is less clear. It appears that benefits such as accommodations, local transportation, moving costs, and home leave are not considered part of the employee's income.<sup>111</sup> In contrast, food allowances are specifically taxable as a personal benefit.<sup>112</sup> It should also be noted that there is no provision for the deduction of any expenses from such income, other than the

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<sup>108</sup> They are now subject of the IIRT. The new basic monthly exemption figure is 400 yuan, although this is increased in some regions. *See supra* note 20.

<sup>109</sup> IIT Regs., art. 4(1). Details for calculation of bonuses and other year-end extras are set out in a Ministry of Finance Ruling, dated June 2, 1981, (81) Cai Shui Zi, No. 185.

<sup>110</sup> IIT Regs., art. 7.

<sup>111</sup> *See* Byres & Shum, *supra* note 85, at 16; *see also* Ministry of Finance Notices of Oct. 24, 1980, (80) Cai Shui Wai Zi, No. 189, and of June 2, 1981, (81) Cai Shui Zi, No. 185.

<sup>112</sup> Ministry of Finance Notice of July 7, 1981, (81) Cai Shui Wai Zi, No. 60.



basic 800 yuan per month. Consequently, it is preferable for the employer to pay actual expenses for travel, accommodations, entertainment, and other items, rather than paying the employee an allowance to cover such expenses.

## 2. *Income from Personal Services, Royalties, and Rents*

While only employment income is taxed at progressive rates, other income is divided into two basic categories: 1) types of income from which certain deductions are permitted, and 2) types of income in which tax is levied on the gross amount received or payable. It should be noted that this distinction does not apply if the income is received by an individual who is not resident in China.<sup>113</sup>

For income derived from "remuneration for personal services, royalties or lease of a property," a deduction of 800 yuan is allowed if the amount is less than 4,000 yuan; if the amount exceeds 4,000 yuan, the deduction is restricted to 20% of the amount.<sup>114</sup> Remuneration for "personal services" is defined as income earned "in designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting, free-lance writing, translating, calligraphy and painting, sculpture, films, drama and comic talk, sports, technical services and other personal services."<sup>115</sup> It should be remembered that income "derived from production and business" is taxed under the FEIT law at progressive rates which can rise as high as 50%. Clearly, there may be some types of activity which will be difficult to categorize, for example, "consultation" or "technical services" (subject to the IIT) or "commerce" or "service trades" (subject to the FEIT). The individual will typically prefer to pay the IIT because of the lower tax rates, however the FEIT rules may be more favorable at times as most expenses incurred in earning the income are deductible.

"Royalties" are defined as income "from the provision and transfer of patents, copyright, the right to use technical know-how and other rights."<sup>116</sup> "Income from lease of property" refers to income "from lease of houses, machinery and equipment, motor vehicles and ships, and other kinds of property."<sup>117</sup> With regard to these sources of income, it should be recalled that, if the recipient may be regarded as a foreign enterprise,

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<sup>113</sup> IIT Regs., art. 11.

<sup>114</sup> IIT, art. 5(2).

<sup>115</sup> IIT Regs., art. 4(2). As mentioned, *supra* note 90, the treaties generally exempt income from professional and other services unless the recipient has a fixed base in China or is present there for 183 days or more in the year.

<sup>116</sup> IIT Regs., art. 4(3).

<sup>117</sup> IIT Regs., art. 4(5).

these payments will be subject to the FEIT. Under the FEIT law, progressive rates apply if the taxpayer is established in China and there are various exemptions and reliefs for certain types of rental income and for royalty payments for technology transfer.

The Chinese deduction system is unusual and gives rise to many interesting situations. In some respects the system corresponds with the deduction from employment income and performs the function of a basic personal deduction. In other respects the deduction system is more like a notional cost of earning income. The recipient is taxed on gross professional fees, royalties, or rental income, less only the standard deduction and without regard to actual expenses incurred earning the income.<sup>118</sup> The deduction of 800 yuan, or 20%, applies to each single payment. This system produces some unusual results. For example, if property is leased at an annual rent of 9,600 yuan, then, if the rent is payable monthly (800 yuan per month), there will be no taxable income. If the rent is payable quarterly, there will be a deduction of 800 yuan from each payment of 2,400 yuan; taxable income for the year will be 6,400 yuan. If the rent is payable in one lump sum, there will be a 20% deduction, leaving taxable income of 7,200 yuan.

In order to prevent income splitting, the regulations provide that "single payment" refers to the income earned on one occasion or the income earned for performing one piece of work.<sup>119</sup> Clearly, an artist may receive only one payment for a painting and, presumably, a concert pianist may not receive a separate fee for playing each of Bach's forty-eight preludes and fugues.<sup>120</sup> Nonetheless, it is unclear to what extent a lawyer or accountant may be able to bill separately for completing various stages of, what is essentially, the same piece of work. The regulations also provide that, if income is earned consecutively from the same item, the income received within one month is aggregated.<sup>121</sup> The effect of this earned income deduction appears to be that, while payments such as rent may be made monthly and treated separately, the deduction may not be multiplied by applying it to a weekly or daily rent.

One further provision should be mentioned. While certain payments from the same source may be aggregated in order to prevent multi-

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<sup>118</sup> It is nevertheless eligible for the foreign tax credit in the United States. China-United States Agreement, *supra* note 30, arts. 2 & 22.

<sup>119</sup> IIT Regs., art. 12.

<sup>120</sup> In practice, such artists' income will normally not be taxed. The treaties provide for the exemption of income of artists, athletes, and entertainers if they perform in connection with a cultural exchange program (e.g., China-United States Agreement, *supra* note 30, art. 16). This is almost invariably the case.

<sup>121</sup> IIT Regs., art. 12.

ple deductions, the basic rule is that each category of income is computed and taxed separately.<sup>122</sup> Thus, an individual receiving income from personal services of 1,200 yuan and rental income of 400 yuan may claim deductions of 800 yuan and 400 yuan respectively; the income derived from the two sources cannot be added together in order to claim two deductions of 800 yuan each.

### 3. Other Chinese-Source Income

Interest, dividends, bonuses,<sup>123</sup> and other kinds of income (if specified as taxable by the Ministry of Finance) are taxed at a flat rate of 20% on the full amount received. In other words, no deduction may be made for any cost incurred on such income.<sup>124</sup> This is true regardless of whether the recipient is resident in China.<sup>125</sup>

### 4. Foreign-Source Income

As mentioned previously, the IIT law provides for the taxation of longtime residents of China based upon their world income.<sup>126</sup> Persons resident in China for less than five years pay tax only on foreign income remitted to China.<sup>127</sup> A separate tax return of foreign source income is required on a yearly basis.<sup>128</sup>

Most foreigners living in China work for foreign employers and are not taxed on non-Chinese source income regardless of whether it is remitted to China.<sup>129</sup> However, Chinese citizens and some foreigners will be taxed on foreign source income. Such income is calculated and taxed separately from taxable income earned within China; nevertheless this income must be allocated to the appropriate category and is eligible for the relevant deductions.<sup>130</sup> If foreign source income is taxable, a credit is given for foreign tax paid.

## C. Exemptions and Reliefs

Chinese tax legislation exempts certain categories of income from

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<sup>122</sup> IIT Regs., art. 6.

<sup>123</sup> This term is defined as "bonuses from investment." IIT Regs., art. 4(4). These payments are not to be confused with bonuses forming part of a salary.

<sup>124</sup> IIT Regs., art. 5(3).

<sup>125</sup> The rate is commonly reduced to 10% by treaty. See China-United States Agreement, *supra* note 30, art. 5.

<sup>126</sup> IIT, art. 1.

<sup>127</sup> IIT Regs., art. 3.

<sup>128</sup> IIT, art. 7.

<sup>129</sup> See *supra* note 92 and accompanying text.

<sup>130</sup> IIT Regs., art. 16.

the IIT, including prizes and awards for scientific, technological, or cultural achievements, interest on deposits in state banks, welfare benefits and certain pensions, or severance pay and salaries of foreign diplomatic and consular officials.<sup>131</sup> Certain other forms of income may be approved as tax free by the Ministry of Finance.<sup>132</sup> In the SEZs, a lower rate schedule for wages and salaries, ranging from 3% to 30% has been operative since 1981; nonetheless, no official regulations appear to have been published to that effect. The SEZs also apply reduced rates of withholding tax on dividends, interest, rental payments, and royalties although the tax regulations sometimes state that these reduced rates apply only to "foreign business people" (for the purposes of the FEIT) and do not mention the IIT.<sup>133</sup>

## VII. SEZs, EDZs, AND OTHER SPECIAL REGIONS

References have been made previously with regard to special exemptions and reliefs applicable in China's SEZs and in certain other special areas. In practice, tax rates and the manner in which the tax laws are applied and interpreted by local tax officials vary considerably from one activity to another and from one region of the country to another. This inconsistent application generally operates to the advantage of the foreign investor who cannot be taxed more heavily than the law provides, but may well be able to take advantage of some form of preferential treatment. For example, investment by a joint venture or foreign enterprise in a remote region such as Inner Mongolia, Tibet, or Xinjiang may attract lower tax rates or longer tax holidays. Moreover, local authorities generally have the power to reduce or waive local taxes.

More systematic rules have been promulgated for the SEZs, Economic Development Zones ("EDZs") and certain other special areas, such as the "industrial development districts" and "old urban zones."<sup>134</sup>

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<sup>131</sup> IIT, art. 4.

<sup>132</sup> Among the special exemptions which have been granted are the salaries of certain "foreign experts" invited to work in China and persons working in connection with foreign aid programs. See Ministry of Finance Notices of Mar. 25, (81) Cai Shui Zi No. 39, Sept. 26, 1981, (81) Cai Shui Zi, No. 78, and Oct. 24, 1980, (80) Cai Shui Zi, No. 189. Living allowances and scholarships of foreign students are also exempt. Ministry of Finance Notice of Oct. 24, 1980, Cai Shui Zi, No. 189. The treaties also generally contain exemptions for visiting teachers, researchers, and students. *E.g.*, China-United States Agreement, *supra* note 30, arts. 19 & 20.

<sup>133</sup> See, *e.g.*, Provisional Tax Regulations for 14 Open Cities, Special Economic Zones and Hainan Island, art. 4, which came into force on Dec. 1, 1984, *reprinted in* CHINA ECON. NEWS, Dec. 3, 1984.

<sup>134</sup> See generally Nishitaten, *supra* note 22; Klitgaard & Rasmussen, *Preferential Treatment for Foreign Investment in the People's Republic of China: Special Economic Zones and Industrial Development Districts*, 7 HASTINGS INT'L & COMP. L. REV. 377 (1984).

The most important of these areas are the four SEZs. Three are in the southern province of Guangdong — Shenzhen, Zhuhai, and Shantou — and the fourth is located in Fujian Province on the coast facing Taiwan — Xiamen. Of the four SEZs, Shenzhen is the most important. It is situated close to Hong Kong and accounts for almost half of all foreign investment in the People's Republic of China.

In many respects the SEZs resemble the export processing zones which have been established in countries such as India and Korea. Special facilities are provided to attract foreign investment including a modern communications infrastructure, simplified procedures for obtaining development permits and visas for staff, relaxed currency controls and import restrictions, and other benefits. Local taxes and property taxes are reduced or waived, the tax rates on joint ventures and foreign enterprises are reduced (generally to 15% but sometimes to 10%), withholding taxes on dividends, interest, and royalties are reduced (to 10%) or waived, tax holiday periods are extended, and tax rates on salaries are reduced.<sup>135</sup>

In addition to the SEZs, a number of other special zones have been established. These include the industrial development districts of Hainan Island (in the extreme south), Minhang (near Shanghai), and the fourteen "open" coastal cities known as EDZs. Foreign enterprises operating in these zones enjoy various tax exemptions which, in some respects, are even more favorable than those granted in the SEZs.<sup>136</sup> Additional exemptions and reliefs are granted, notably for investment involving advanced technology, in what are termed "old urban zones" of the open coastal cities and certain other large cities.<sup>137</sup>

### VIII. TAX TREATIES

Whenever taxation has an international element, domestic rules may be modified by the provisions of a relevant tax treaty. Although the main laws governing the taxation of foreign investment and business have been in existence for such a short time, China has been remarkably quick in instituting a program for the negotiation of tax treaties. Tax treaties are already in force between China and France, the Federal Republic of Germany, Japan, Malaysia, Singapore, the United Kingdom, and the United

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<sup>135</sup> For further detail, see the Provisional Regulations, *supra* note 133; see also *Chinese Legal Experts' Answers to Questions on China's Foreign Tax Legislation*, CHINA ECON. NEWS, Oct. 21, 1985, at 1-2. Additional advantages are provided by the State Council Provisions of Oct. 11, 1986, *supra* note 9.

<sup>136</sup> Gelatt, *Interim Provisions Sharpen EDZ's Competitive Edge*, EAST ASIAN EXEC. REPORTS, Dec. 1984, at 9-10.

<sup>137</sup> These are also governed by the Provisional Regulations, *supra* note 133.

States of America.<sup>138</sup> China has concluded additional treaties with Belgium, Canada, Denmark, Finland, New Zealand, Norway, and Sweden which await ratification. Finally, negotiations are being conducted with Australia, Austria, Czechoslovakia, Italy, Netherlands, Romania, Switzerland, Thailand, and Yugoslavia.<sup>139</sup>

China's tax treaties generally adhere to the OECD Model<sup>140</sup> with additional elements drawn from the United Nations Model.<sup>141</sup> China is particularly eager to negotiate tax sparing provisions which avoid nullifying the tax holidays extended to foreign enterprises. Following its standard practice, the United States has not accepted the inclusion of any such provisions. However, the China-United States treaty is accompanied by an exchange of diplomatic notes stating that, if at some future date the United States should amend its laws to provide a tax sparing credit or should agree to grant such a credit to any other country by treaty, then the same privilege will be extended to China. Several other countries, however, have been willing to adopt tax sparing, either for specific exemptions or reliefs contained in Chinese legislation<sup>142</sup> or by deeming a higher rate of tax to have been withheld regarding dividends, interest, and royalties.<sup>143</sup>

## IX. CONCLUSION

In a remarkably short period of time, China has created a tax system which, as one commentator has remarked, "is very much within the mainstream of international taxation systems."<sup>144</sup> At the same time, China has also established a substantial network of tax treaties. China seeks to retain a reasonable proportion of the profits generated by foreign investment in the form of taxes. For the most part, China's tax system is conducive to such investment and should not produce any unpleasant surprises to foreign enterprises. Nonetheless, additional changes in Chinese tax law will take place in the years to come. To observers in the West, the present system appears to be lacking both detail and precision — much of the law is left to be negotiated with the local tax administra-

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<sup>138</sup> The treaty between China and the United States was executed on Apr. 30, 1984. For an analysis, see Schreyer, *A Guide to the China-U.S. Tax Treaty*, EAST ASIAN EXEC. REPORTS, Aug. 1984. For a study of China's treaties generally, see Jehle, *supra* note 5.

<sup>139</sup> See China Daily, Beijing, Oct. 24, 1986.

<sup>140</sup> OECD Model Double Taxation Convention on Income and Capital (1977).

<sup>141</sup> United Nations Model Double Taxation Convention between Developed and Developing Countries, U.N. Doc. ST/ESA/102 (1980).

<sup>142</sup> Notably JVIT, arts. 5 & 6; JVIT Regs., art. 3; and FEIT, arts. 4 & 5. See the treaties with Canada, Japan, and the United Kingdom.

<sup>143</sup> See the treaties with Belgium, France, Germany, and Japan.

<sup>144</sup> Schreyer, *supra* note 138, at 10.

tion. This situation is not unique to China, however, and the existing laws undoubtedly provide an adequate framework within which foreign investment can continue to take place.