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Tax Aspects of Doing Business in the People's Republic of China—A Comparative Summary for U.S. Investors

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TAX ASPECTS OF DOING BUSINESS IN THE PEOPLE'S REPUBLIC OF CHINA — A COMPARATIVE SUMMARY FOR U.S. INVESTORS

*James W. Harrison**

I. INTRODUCTION 382
II. OVERVIEW OF TAXES COMMON TO ALL FORMS OF BUSINESS ENTITIES 383
III. CHINESE/FOREIGN EQUITY JOINT VENTURES 385
A. *Tax Rates* 385
B. *Accounting Requirements* 385
C. *Tax Relief* 386
D. *Tax Collection* 387
IV. WHOLLY-OWNED FOREIGN ENTERPRISES 387
A. *Taxable Entities* 388
B. *Entities Without Establishments* 390
1. Tax Rates 390
2. Tax Relief 391
3. Tax Collection 391
C. *Entities With Establishments* 391
1. Tax Rates 391
2. Accounting Requirements 392
3. Tax Relief 393
4. Tax Collections 393
V. COOPERATIVE JOINT VENTURES 394
VI. TAX EFFECTS OF THE U.S.-CHINA TAX TREATY . . . 394
VII. THE UNIFIED FOREIGN INVESTMENT TAX LAW . . . 396
A. *Tax Rates* 397
B. *Accounting Requirements* 397
C. *Tax Relief* 397
D. *Tax Collections* 398
VIII. CONCLUSION 398

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I. INTRODUCTION

Following the Soviet Union's 1961 economic and political withdrawal, the People's Republic of China (PRC) struggled through its Cultural Revolution with a series of failed attempts at economic revitalization. It was not until the passing of a short-lived political upheaval,[1] that the central government developed a series of plans designed to modernize industry, agriculture, technology and defense.

The program's first stage undertook a restructuring and revitalization of the national economy. To this end, the PRC central government implemented its 1978 "open-door" economic policy, stimulating outside trade and supporting the importation of foreign technology and investment capital. Since then, the Chinese government has successfully maintained political sovereignty while concurrently promoting increased foreign trade and investment.

At present, foreign investors who wish to do business in the People's Republic of China (PRC) must submit to an approval process governed by both the Chinese State Council and China's various regional governments. The procedure typically involves a thorough review of articles, agreements, contracts, and other documents by China's foreign economic relations and trade departments. Because this process is time consuming and uncertain, investors are advised to have considered their choice of business entity prior to beginning negotiations. Although this choice will not generally turn on tax consequences, it is nevertheless important to consider governing tax laws.

The PRC currently recognizes three principal methods of foreign investment, these are:

1. Equity Joint Ventures — approved July 1, 1979;[2]
2. Wholly Owned Foreign Enterprises — approved April 12, 1986;[3]

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1. Acting as China's political leadership during the early 1970s, the "Gang of Four" (Mao's widow, Jiang Qing, and three colleagues) virtually halted foreign investment in their pursuit of a pure socialist state free of a desire for material goods.

2. The Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment, adopted by the Third Session of the Fifth National People's Congress, Sept. 10, 1980, and promulgated by an Order of Ye Jianying, Chairman of the Standing Committee of the National People's Congress, Sept. 10, 1980 [hereinafter 1980 Joint Ventures Tax Law]. For discussion of these laws, see CHINA INTERNATIONAL ECONOMIC CONSULTANTS, INC., THE CHINA INVESTMENT GUIDE (1986).

3. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises, adopted at the Fourth Session of the Fifth National People's Congress, Dec. 13, 1981, and promulgated by an order of Ye Jianying, Chairman of the Standing Committee, Dec. 13, 1981 [hereinafter 1981 Foreign Enterprises Tax Law].

3. Cooperative Joint Ventures — approved April 13, 1988.[4]

Following a brief overview of taxes common to all three forms of business enterprise, this article will discuss and compare the unique tax aspects of conducting business in each of the forms. This includes an entity-specific review of tax rates, an explanation of certain applicable tax accounting regulations, and a discussion of available tax reliefs and exemptions. To the extent the recently signed United States — China Income Tax Treaty impacts upon the Chinese tax structure, specific provisions will be discussed. The article will conclude with an analysis of the relevant tax rules in the context of their sought-after goals, and with a discussion of the extent to which the Chinese taxing systems may be altered by specific negotiation and by the recently enacted Unified Foreign Enterprise Tax Law.

Discussions of the potential application of the PRC Individual Income Tax, the taxation of investments in Special Economic Zones and Economic Development Zones, and the special tax promulgations addressing importation of advanced technology are beyond the scope of this paper. However, all investors giving serious consideration to doing business in the PRC should review and become familiar with these topics.

II. Overview of Taxes Common to All Forms of Business Entities

During the last decade, the Standing Committee[5] developed and implemented a bifurcated taxation subsystem within the Chinese Code of Law.[6] With regard to foreign business entities operating within the PRC, investors are subject to the following four forms of taxation:

1. *The Consolidated Industrial and Commercial Tax* (CICT) — Adopted on September 11, 1958,[7] this multistage tax is the equivalent to what is commonly referred to as a value added tax (VAT). The CICT imposes liability whenever goods or services change hands throughout a course of production. Although tax rates vary with re-

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4. At the date of this writing, no tax legislation specific to PRC, Sino-Foreign Cooperative Joint Ventures had been passed.

5. Authorized in 1955 by the National People's Congress to promulgate individual laws for the PRC.

6. Taft, *Tax Aspects of Investing in China*, 198 New York L.J. 1 (1987).

7. The Decree of the State Council of the People's Republic of China Concerning the Promulgation and Trial Implementation of the Consolidated Industrial and Commercial Tax Regulations, was adopted in principle at the 101st meeting of the Standing Committee of the National People's Congress, Sept. 11, 1958 [hereinafter Industrial and Commercial Tax Regulations]. This Decree consolidated four separate taxes introduced in 1950.

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spect to the type of activity,[8] all foreign businesses and investors operating within the PRC are subject to the tax.[9]

2. *Customs Duties* — The PRC has elected to impose customs duties on both imports and exports.

3. *Vehicle and Vessel Licensing Tax* — Determined annually by region, this tax must be paid by all foreigners[10] on a quarterly basis.[11] The tax is determined by the type of vehicle or vessel, and by its weight. In addition to the license tax, the PRC also taxes the transportation incomes of vessels of foreign nationality.[12]

4. *The Urban Real Estate Tax*, *the Real Estate Tax*, and *the Land Use Tax* — *The Urban Real Estate Tax*, promulgated August 8, 1951, is levied in designated municipal areas,[13] taxing land and buildings at 1% to 1.5% of appraised value. The broader Real Estate Tax, adopted on September 15, 1986, taxes property within townships, cities and industrial areas at approximately 1.2% of residual value.[14] And, the Land Use Tax, enacted on September 27, 1988, taxes square meters of land at rates ranging from 2 jiao and 10 yuan[15] depending on the location and use[16] of the land.[17] Beyond these common taxes, foreign investors face the additional, entity-specific taxes which follow.

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8. Tax rates vary from 1-1/2% to 69%. For a list of the tax rates applicable to different activities, see the Consolidated Industrial and Commercial Tax Regulations of the People's Republic of China, adopted at the 101st meeting of the Standing Committee of the National People's Congress, Sept. 11, 1958 and promulgated on Sept. 13, 1958.

9. *See* Industrial and Commercial Tax Regulations, *supra* note 7, art. 2.

10. *See* Provisional Regulations Governing License Dues for the Use of Vehicles and Ships, art. 1, promulgated by the Administrative Council of the Central People's Government, Sept. 13, 1951.

11. *Id.* art. 5.

12. Notice of the Ministry of Finance of the People's Republic of China Concerning the Taxation of Transportation Revenue of Foreign Vessels, issued by the Ministry of Finance of the People's Republic of China, Feb. 26, 1982, and implemented Apr. 1, 1982.

13. The Provisional Regulations Governing the Urban Real Estate Tax was promulgated by the Administration Council on Aug. 8, 1951. In the letter No. (53) Cai-Shui-Wu 4, of the Ministry of Finance, Jan. 12, 1955, it is stipulated: From the year 1955, cities where the Tax is to be levied shall be designated by the People's Council of the province (autonomous region) concerned. *Id.* art. 1.

14. The Provisional Regulations of the People's Republic of China on Real Estate Tax, art. 4, issued by the State Council of China, Sept. 15, 1986. Residual value equals original value less 10-30%. *Id.* art. 3.

15. 1 jiao equals 1/10 Renminbi yuan.

16. 2-4 jiao in county towns, industrial and mining towns and 5 jiao-10 yuan in large cities.

17. The Provisional Regulations of the People's Republic of China Governing Land Use Tax in Cities and Towns, art. 4, promulgated by the State Council, Sept. 27, 1988 [hereinafter 1988 Regulations on Land Use Tax].

III. Chinese/Foreign Equity Joint Ventures

"Equity joint venture" generally refers to a joint venture with foreign capital participation incorporated as a Chinese legal person.[18] It is treated as a separate legal entity, and its profits are taxed prior to shareholder distribution. In most cases the Unified Tax has replaced the Joint Venture Income Tax. However, the latter can, in many cases, have continuing importance, and for this reason, is discussed.

A. *Tax Rates*

Equity joint venture income is taxed by the Central Government at a flat rate of 30% under the Joint Venture Income Tax (JVIT).[19] In addition, local governments charge a 10% surtax on the central government's tax assessment.[20] Foreign parties repatriating profit shares are subject to a 10% levy on amounts remitted.[21] Although not specifically set forth in either the JVIT or JVIT Regulations, it appears foreign shareholders are not liable for either the Individual Income Tax[22] or the Foreign Enterprise Income Tax.

B. *Accounting Requirements*

The preceding paragraph underscores the general tax liabilities equity joint venturers will face. However, before proceeding to tax reliefs and exemptions, it is important to discuss the Chinese calculation of "taxable income."

Although "taxable income" is defined in a way similar to its United States' usage, differences between the two tax accounting systems do exist. For example, the JVIT Regulations[23] specifically disallow immediate expensing of local surtax payments, charitable contributions (for other than public welfare and relief purposes), and business enter-

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18. Easson & Jinyan, *Taxation of Foreign Business and Investment in the People's Republic of China*, 7 NW. J. OF INT'L L. & BUS. 666, 672 (1986).

19. *See* 1980 Joint Ventures Tax Law, *supra* note 2, art. 3. Certain resource exploiting concerns taxed based on separate negotiations.

20. *Id.*

21. *Id.* art. 4.

22. *See* Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China, art. 6, adopted by the State Council, Dec. 10, 1980, and promulgated by the Ministry of Finance, Dec. 14, 1980 (exemption for dividend payments to joint venture investors).

23. The Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment, approved by the State Council, Dec. 10, 1980, and promulgated by the Ministry of Finance, Dec. 14, 1980 [hereinafter 1980 Rules for Joint Ventures Tax Law].

tainment expenses exceeding 1% of operating income.[24] Interest payments attributable to fixed asset financings, whether in the form of shareholder loans or original third party extensions, are also non-deductible.[25]

The JVIT Regulations mandate straight-line depreciation of assets[26] assessed at original value less 10%[27] with depreciation terms fixed at 20, 10 and 5-year terms, assuming adequate venture life.[28] In valuing inventory, venturers may choose a first-in first-out (FIFO), shifting average or weighted average method.[29] The law does not discuss last-in first-out (LIFO) valuation. Losses sustained by equity joint ventures may be carried forward over a five-year period, but the drafters wrote no provisions for loss carryback.[30]

C. *Tax Relief*

The Chinese government has implemented a great variety of tax relief and exemption plans in an attempt to attract certain types of investment. Subject to PRC Ministry of Finance approval, most of these incentives are aimed towards planned industrial and geographic development.

For those ventures conceived as operating for periods exceeding ten years, the government provides a graduated tax holiday. The venture will be exempt from tax during its first profit-making year, with the following two years receiving a 50% tax reduction.[31] However, United States investors should be aware that the United States government consistently refuses to acknowledge foreign tax holidays in granting foreign income tax credits. Article 5 of the JVIT Regulations indicates that "the first profit-making year" allows for consideration of prior-year loss carryforwards, but does not state that loss carryforwards may be considered in calculations of profitability for years two through five.

In addition to the foregoing graduation, the government permits an additional 15% to 30% tax reduction (for the ten-year period follow-

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24. *Id.* art. 9.
25. *See* 1980 Rules for Joint Ventures Tax Law, *supra* note 23; *see also* Easson & Jinyan, *supra* note 18, at 674.
26. *See* 1980 Rules for Joint Ventures Tax Law, *supra* note 23, art. 12.
27. *See id.* art. 11.
28. *See id.* art. 13. In the case where venture life is less than scheduled asset life, depreciation of fixed assets may be accelerated upon approval of the Ministry of Finance of the PRC. *Id.*
29. *See id.* art. 18.
30. *See* 1980 Joint Ventures Tax Law, *supra* note 2, art. 7.
31. *See id.* art. 5.

ing the initial five-year profit-making period) for those companies engaged in low profit-making ventures or in ventures located in underdeveloped areas.[32] The law does not, however, state that only profit-making years are considered in this additional ten-year period. There is likewise no express provision governing loss carryforwards in these later year calculations of profitability.

Anxious to stimulate reinvestment, the authorities have provided for a 40% refund for taxes paid on profits reinvested in China over a consecutive five-year period.[33] Although there is no detail regarding the required amounts of investment, the JVIT Regulations do specify that funds must either return to the subject joint venture or go towards other Chinese-foreign joint ventures.

For ventures involving port and wharf construction, rates are reduced to 15% with long-term projects (15 years) receiving a tax free holiday during the first five years, and a 50% reduction during the following five years.[34]

Unique to the Chinese joint venture tax system is its willingness to grant incentives beyond those noted. Not only does Ministry of Finance literature make this point,[35] but the tax laws incorporate it in many provisions. This is true for both the PRC central government and the governments of the various regions and municipalities. Investors should remain cognizant of this flexibility throughout the course of investment negotiations.

D. *Tax Collection*

The JVIT is assessed annually and paid quarterly within 15 days of each quarter's end. Final settlements (refunds and deficiency payments) are made within three months of the end of the tax year.[36]

IV. Wholly-Owned Foreign Enterprises

One year after promulgation of JVIT legislation, the People's Congress approved tax legislation covering another foreign investment vehicle, the wholly-owned foreign enterprise. "Wholly-owned foreign enterprises" are foreign business organizations which operate exclusively with foreign equity capital in accordance with a body of specific

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32. *Id.* Farming and forestry are cited.
33. *See id* art. 6.
34. R. Jianxin, Legal Aspects of Foreign Investment in the People's Republic of China (1988).
35. *Id.*
36. *See* 1980 Joint Ventures Tax Law, *supra* note 2, art. 8.

Chinese regulatory law.[37] If the entity did not rise to the level of being a Chinese legal person, it paid tax in accord with China's 1981 Income Tax Law Concerning Foreign Enterprises (ITFE). While this law has largely been replaced by the Unified Tax Law, in many cases it remains of importance, and will be discussed. The ITFE, when originally enacted, covered all forms of non-joint venture, foreign enterprise, both wholly-and partially-owned. Now, with the recent advent of cooperative joint ventures (treated infra), partially-owned foreign enterprises have been classified as either contractual or joint venture; the former being subject to the Unified Tax of 1981's foreign enterprise law (along with wholly-owned foreign enterprises).

A. *Taxable Entities*

Before addressing tax consequences facing foreign enterprises, it is necessary to understand the meaning of the term "foreign enterprise" (in order to distinguish those forms of foreign business activity not subject to the ITFE, such as certain agency representations and promotional efforts).

The ITFE states that "foreign enterprise" refers to — "foreign companies, enterprises and other economic organizations that have *establishments* within the territory of the People's Republic of China engaged in independent business operations or in co-operative or production co-operative business operations with Chinese enterprises."[38]

The ITFE's Regulations expand on this definition by stating that "establishment" refers to —

> organizations, places, or business agents established in the Chinese territory by foreign enterprises and engaged in production and business operations.
>
> The organizations and places mentioned in the preceding paragraph mainly include management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building, installations, assembly and exploration are operated.[39]

37. The Law of People's Republic of China on Enterprises Operated Exclusively with Foreign Capital, art. 2, adopted during the Fourth Session of the Sixth National Peoples Congress, Apr. 12, 1986.

38. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 1.

39. The Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises, art. 2, approved by the State Council, Feb. 17, 1982, and promulgated by the Ministry of Finance, Feb. 21, 1982 [hereinafter 1982 Rules on Foreign Enterpises Tax].

Despite this definitional consideration in the Regulations, investors still have shown signs of uncertainty. Accordingly, the Director of the Ministry of Finance helped clarify the matter in publishing material relating to the "enterprise-establishment" question.[40] In his discussion of the ITFE, Hu Zhixin points to three business forms subject to the tax —

1. Business enterprises which have set up a business premise in China and have, in fact, operated independently in China;
2. Foreign cooperative ventures engaged in production with, or in business operations with, Chinese companies; and
3. Foreign businesses without establishments, but receiving passive incomes from Chinese sources.

Although little more than the foregoing has been stated on the "enterprise" issue, the *amount of control* possessed by individuals actually doing business in China is frequently raised as a possible indicia of business taxability.

With regard to the narrower issue of agency, the Ministry of Finance has issued Regulations specific to resident *representative offices*.[41] Again, from a reading of the text, it appears the greater the degree to which principals and representatives can negotiate and conclude contracts, the more likely there will be a finding of tax liability.[42]

Note, however, that ITFE Regulations also tax representative offices which receive certain types of proceeds —

> (1) Commissions, rebates and handling fees collected by resident representative offices for engaging in liaison, negotiation, or introduction for the conclusion of transactions within Chinese territory through agency business entrusted to and accepted by their head offices by other enterprises outside Chinese territory.
>
> (2) Compensation paid by clients in scheduled installments of fixed amounts or in accordance with the volume of business involved in the matter commissioned for services conducted by resident representative offices for such clients (including clients of their head offices) within the territory

40. *See* R. JIANXIN, *supra* note 34, at 16.

41. The Provisional Regulations of the Ministry of Finance of the People's Republic of China on the Levy of the Consolidated Industrial and Commercial Tax and the Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises, approved by the State Council, Apr. 11, 1985, and promulgated by the Ministry of Finance, May 14, 1985 [hereinafter 1985 Regulations on Industrial and Commercial Tax and Enterprise Tax].

42. Han, *The People's Republic of China's Foreign Enterprises Income Tax Law & Regulations*, 6 HASTINGS INT'L & COMP. L. REV. 689, 693 n.13 (1983).

of China, and such as taking the responsibility of understanding the market situation, business liaison, collection of business information and provision of consultation services.

(3) Commissions, rebates and handling fees collected by resident representative offices for engaging in agency business for other enterprises, or for engaging in liaison, negotiation or middleman introduction services for economic and trade transactions between other enterprises within Chinese territory.[43]

The Regulations specifically exempt —

> Resident representative offices engaging in such activities as understanding the market situation, providing business information and other business liaison, consultation and services on behalf of their head offices and receiving no business proceeds or service proceeds therefrom . . .; [and]
>
> Resident representative offices, which accept entrustment by enterprises within Chinese territory to engage in agency businesses outside the territory of China with its activities conducted mainly outside of the Chinese territory. . . ."[44]

Regardless of the foregoing, it should always be borne in mind that whether or not an establishment is subject to the ITFE, it must still pay the CICT and relative import duties on its office equipment.[45]

B. *Entities Without Establishments*

1. Tax Rates

If the foreign business operation *does not have* (pursuant to the foregoing) *an establishment* in the PRC, a flat 20% withholding tax is levied on income derived from dividends, interest, royalties and other passive forms of China sourced income.[46]

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43. *See* 1985 Regulations on Industrial and Commercial Tax and Enterprise Tax, *supra* note 41, art. 1.

44. *See id.* art. 2; *see also* Supplementary Regulations on Questions Concerning the Levy of the Consolidated Industrial and Commercial Tax and the Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises, issued by the Foreign Tax Office, Beijing Municipal Tax Bureau, Oct. 14, 1985, 85 Shi Shui Wai Fen Zi No. 144.

45. O. NEE, COMMERCIAL, BUSINESS AND TRADE LAWS — PEOPLE'S REPUBLIC OF CHINA 5-11 (Oceana Publications, Inc. 1987) (Part 1 — Laws and Regulations Affecting the Conduct of Business by Foreign Enterprises).

46. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 11.

2. Tax Relief

Interest income received from the Chinese government or from China State Banks[47] is exempt from tax if the underlying loan is either from an "international financial organization"[48] or is made at a "preferential" rate. Interest receipts from foreign bank deposits in China State Banks are taxed, but exemptions may be granted if the home country of the foreign lender bank permits a reciprocal exemption.[49]

3. Tax Collection

Given the difficulties inherent in collecting taxes from foreign based business entities, the passive form income tax is withheld at the source. Within this framework, the payor becomes the taxpayer. This *de jure* taxpayer is required by law to remit retainages to the tax authorities within five days of collection.[50]

C. *Entities With Establishments*

1. Tax Rates

Unlike the equity joint venture, annual incomes of foreign owned enterprises *with establishments* are taxed at progressive rates, ranging from 20% on 250,000 yuan to 40% on income in excess of 1,000,000 yuan.[51] As with equity joint ventures, a 10% local tax is imposed; however, in the case of foreign enterprises, the local tax is levied on taxable income rather than on national income taxes due.[52] It appears the National People's Congress intended this larger local tax base as a means of securing a minimum level of local revenues given the progressive nature of the national tax. The ITFE *does not* levy a tax on repatriated profits.[53]

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47. *See* 1982 Rules on Foreign Enterprises Tax, *supra* note 39, art. 30. "China State Banks" mentioned in Article 11 of the Tax Law shall include the People's Bank of China, the Bank of China, the Agricultural Bank of China, the People's Construction Bank of China, the Investment Bank of China, and any international trust and investment corporation which has been authorized by the State Council to engage in foreign exchange deposit, loan and credit business operations externally.

48. *See id.* art. 29. The "International Financial Organizations" *mentioned in Article 11 of the Tax Law* shall mean the International Monetary Fund, the World Bank, the International Development Association, the International Fund for Agricultural Development and other financial organizations of the United Nations. The "preferential interest rate" mentioned therein shall mean an interest rate which is at least 10% lower than the general interest rate in the international financial market.

49. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 11.

50. *Id.*

51. One dollar equals approximately 3.72 yuan (Wall St. J., Mar. 20, 1989).

52. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 3.

53. At the date of this writing, neither the Income Tax Law for Foreign Enterprises nor the supporting Regulations indicate a witholding tax on repatriated earnings.

2. Accounting Requirements

The foreign enterprise accounting regulations do not vary greatly from those governing the computation of equity joint venture income. Differences do include, however, a *graduated* percentage based on tying entertainment expense deductions to net revenues,[54] a capitalization requirement for royalties paid to a head office, and a general ban on the expensing of items "not related to production or operation."[55] Although this latter provision seems quite broad, the ITFE Regulations expressly permit the deduction of properly connected and documented administrative expenses paid to a head office. Administrative expense sharing agreements (between a foreign business operation and its head office) must be agreed to in a written contract and available for inspection and approval by local tax authorities before deduction is allowed.[56] Reasonable interest expensing is also permitted upon loan document inspection and verification by local authorities that the loans are "normal loans."[57]

The ITFE Regulations emphasize the necessity for accurate transfer payment records[58] and reserve the local tax authorities' right to examine and approve allocation practices.[59] If the records are deemed inadequate, governing authorities have also reserved the right to assess the ITFE by determining the concern's profit rate on the basis of its net sales volume (or gross revenues) in the light of industry norms.[60]

If a foreign investor merely sells or licenses to a foreign enterprise, that investor should take steps to insure additional services are not included; otherwise, governing authorities may deem the entity an "establishment" and accordingly tax not only the investor's passive royalty income but the investor's share of income earned by the "establishment" as well. Even if the foreign investor does not perform additional services for its licensee, the investor may still face increased tax liability if the investor operates a second, connected, "establishment" within China (in addition to its licensee). If additional services for a licensee are performed by an entity operated as a branch, the exposure to increased taxes will increase as taxing authorities may attempt to reach incomes earned outside China.[61] In such a case, the

54. *See* 1982 Rules on Foreign Enterprises Tax, *supra* note 39, art. 13.
55. *See id.* art. 10(10).
56. *See id.* art. 11.
57. *See id.* art. 12.
58. *See id.* art. 11.
59. *Id.*
60. *See id.* art. 24.
61. *See* Easson & Jinyan, *supra* note 18, at 679.

royalty income paid to the foreign investor may be taxed at general ITFE rates rather than at more favorable passive income tax rates. And lastly, if the investor's head office is located within China, the operation's entire worldwide income is open to Chinese taxation.[62]

3. Tax Relief

As with equity joint ventures, the Chinese government provides exemptions for foreign enterprises planning to operate for ten or more years. While the JVIT does not restrict the subject venture's activities,[63] the ITFE limits the availability of the exemptions to those enterprises engaged in farming, forestry, animal husbandry or other "low profit"[64] fields.[65] The percentage amounts of the reductions are parallel to those in the JVIT: no tax liability in the first profit-making year and 50% liability in the second and third years. The JVIT and ITFE are, however, very similar in regard to their choices of occupations and operating areas which may gain a further 15% to 30% tax reduction in years following the first three.[66]

Additionally, although the law on enterprises operated exclusively with foreign capital and a Director within the Ministry of Finance has stated that the 40% tax refund is also available for foreign enterprises reinvesting profits "in China" for at least five years,[67] no provision like this is written into the ITFE or ITFE Regulations.

4. Tax Collections

China levies its income tax on foreign enterprises in the same way as it does on equity joint ventures, with one exception. As noted above, final settlements on equity joint venture tax liabilities are to be made within three months of the end of the tax year. In the case of foreign enterprises, this time limit is extended to five months after the end of the tax year.[68]

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62. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 1.

63. *See* 1980 Joint Ventures Tax Law, *supra* note 2, art. 5.

64. "Low profit" refers to foreign enterprises whose annual incomes are under 1,000,000 yuan. *See* 1982 Rules on Foreign Enterprises Tax, *supra* note 39, art. 6.

65. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 5. Note that the Foreign Enterprises Tax specifies "farming, forestry, and animal husbandry or other trades" as a prerequisite for the exemption (unlike the Joint Ventures Tax, art. 5, which mandates no particular trade for the exemption to apply).

66. That is, both the Joint Ventures Tax and the Foreign Enterprises Tax suggest certain low profit-making industries which will qualify for the further 15-30% tax reduction.

67. *See* R. JIANXIN, *supra* note 34, at 17.

68. *See* 1981 Foreign Enterprises Tax Law, *supra* note 3, art. 7.

V. Cooperative Joint Ventures

In order to extend and promote foreign economic cooperation and technology exchange, the National People's Congress recently enacted its first cooperative joint venture law.[69] In doing so, the PRC has recognized that joint ventures may be treated as either independent legal entities or as purely contractual arrangements between two parties with differing nationalities.[70]

Although a specific set of tax laws and regulations have not, as of the date of this writing, been passed, the general law establishing contractual joint ventures does state, "A contractual joint venture shall in accordance with State provisions on tax, pay taxes and may enjoy the preferential treatment of tax reduction or exemption."[71] This means that the venture may be taxed as either an equity joint venture or as a foreign enterprise,[72] depending on whether it assumes the status of an independent legal entity.[73] Like equity joint ventures and wholly-owned enterprises, cooperative joint ventures are liable for common business taxes previously discussed.

VI. Tax Effects of the U.S.-China Tax Treaty

On April 30, 1984, United States President Ronald Reagan and Chinese Premier Zhao Ziyang signed an income tax agreement (the Agreement) designed to prevent both double taxation and tax evasion.[74]

The Agreement, applicable to the JVIT, the ITFE and Unified Tax,[75] discussed infra, requires a cooperative effort to provide tax credits for

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69. The Law of the People's Republic of China on Chinese Foreign Contractual Joint Ventures, adopted by the 1st Session of the 7th National People's Congress and promulgated Apr. 13, 1988 [hereinafter 1988 Contractual Joint Ventures Law].

70. 3 China Law & Practice, Jan. 16, 1989, at 29.

71. *See* 1988 Contractual Joint Ventures Law, *supra* note 69, art. 21.

72. As noted, a Chinese/Foreign equity joint venture pays taxes according to the Joint Venture Tax. Two different income tax laws are applied to the two parties to a Chinese-foreign contractual joint venture, the Chinese party pays income tax according to the regulations of the Chinese government, while the foreign party pays income tax according to the Foreign Enterprises Tax.

73. It is more typical, however, for the cooperative joint venture to be taxed as a foreign enterprise. 2 China Law & Practice, May 2, 1988, at 50.

74. 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, ratified Oct. 22, 1986, and entered into force Nov. 21, 1986, with provisions effective Jan. 1, 1987 [hereinafter U.S.-China Tax Treaty]. Text *reprinted in* 23 Int'l Legal Materials 677 (1988).

75. Treaty application applies to related local taxes as well. *See generally* Foster & Horsley, *Business Operations in the People's Republic of China*, in Tax Mgmt. (BNA) 443 (2d ed. 1988).

income taxes paid in a contracting state,[76] and mandates an information exchange for the prevention of fraud or evasion of income taxes in either country.[77] In keeping with United States policy, the Agreement does not contain a tax sparing credit provision, but does, however, commit to enacting such a provision should the United States include one in any other treaty currently in force.[78]

Among the less generic provisions, the Agreement limits the taxes imposed on passive forms of income to 10% of gross amounts.[79] In addition, royalties paid for the rental of industrial, commercial or scientific equipment are only taxed on 70% of their gross amount.[80] As with the ITFE, this reduced tax on passive income is inapplicable to receipts from investments with "permanent establishments." Under the treaty, "permanent establishment" means "a fixed place of business through which the business of an enterprise is wholly or partly carried on . . . ."[81] To the extent China's other tax laws permit taxing deemed

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76. *See* U.S.-China Tax Treaty, *supra* note 74, art. 22.

77. *See id.* art. 25.

78. See the "Letter of Submittal" from George P. Schultz, Secretary of State, to the President of the United States, Ronald W. Reagan, July 24, 1984.

79. *See* U.S.-China Tax Treaty, *supra* note 74, art. 10.

80. "Protocol 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." Text *reprinted in* 23 INT'L LEGAL MATERIALS 701 (1988).

81. *See* U.S-China Tax Treaty, *supra* note 74, art. 5.

> 1. [T]he 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.
>
> 3. The term "permanent establishment" also includes:
>
> (a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;
>
> (b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and
>
> (c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.

profits of a permanent establishment, China may do so, but only so far as the law addresses a "specific industry."[82] And, as might be expected, the Agreement disallows the deduction of royalties and interest paid to a head office.[83]

Capital gains derived from sales of real property located in China, and capital gains derived from the sale of capital stock representing interests in Chinese real property, are taxable. This provision extends to general, non-real property related, capital stock sales, if such a sale represents a 25% participation in a Chinese company.[84]

In an attempt to prevent treaty shopping, contracting parties have reserved the right to deny treaty benefits to any party who is a resident of both contracting states.[85]

VII. THE UNIFIED FOREIGN INVESTMENT TAX LAW

The Income Tax Law of the PRC concerning enterprises with foreign investment and foreign enterprises is a newly drafted replacement for both the JVIT and the ITFE. The new Unified Tax Law was made effective July 1, 1991.[86] The law applies to equity joint ventures, cooperative joint ventures and wholly-owned foreign enterprises.[87]

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4. Notwithstanding the provisions of paragraphs 1 through 3, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenence of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

(Editor's Note — The foregoing is an incomplete transcription of art. 5. The article also provides for agents, brokers and controlled companies.).

82. *See* U.S.-China Tax Treaty, *supra* note 74, art. 7 § 4.

83. *See id.* art. 7 § 3.

84. *See id.* art. 7 §§ 4-5.

85. *See id.* art. 12 § 3.

86. Adopted by the Fourth Session of the Seventh National People's Congress on April 9, 1991; effective July 1, 1991.

87. *See* The Income Tax Law of the PRC Concerning Enterprises with Foreign Investment and Foreign Enterprises [hereinafter The Unified Tax], art. 2.

A. *Tax Rates*

The rate structure borrows from both the JVIT and the ITFE in that foreign ventures are to be taxed on total income at a flat 30% rate. Local governments will tax total income at 3%,[88] yielding a total income tax rate of 33%. Passive incomes received from foreign enterprises *without establishments* are to be taxed by a flat 20% witholding.[89] However, if a foreign investor establishes a resident head office, profit distributions received by such foreign investors are not subject to tax.[90] Unlike both the JVIT and the ITFE, the Unified Tax proposes an income tax on liquidation gains on the sale of capital assets.[91]

B. *Accounting Requirements*

Like the JVIT or the ITFE, the Unified Tax allows for a five-year carryforward of losses.[92] Although the Unified Tax does not discuss expensing in detail,[93] the law still requires arm's length transfer pricing with an allowance for inspection and adjustment by local authorities.[94]

C. *Tax Relief*

Following the concession set forth by the ITFE, the Unified Tax allows a graduated tax holiday for ten-year ventures operating in specific fields.[95] However, under the Unified Tax, the qualifying entity will pay no taxes in its first profit-making year and none in the following year (no provision indicates whether the benefit may carry if the second year operates at a loss). The income tax is reduced in years three through five by 50%. In order for the enterprise to qualify for the subsequent ten-year 15% to 30% tax reduction, the enterprise must engage in either agriculture, forestry, or animal husbandry, or be located in a poor area yielding low profits.[96] The draft also provides for a possible tax elimination or reduction to 10% for royalty receipts stemming from investments in certain industries.[97]

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88. *Id.* art 5.
89. *Id.* art. 19.
90. *Id.* art. 19(1).
91. *Id.* art. 18.
92. *Id.* art. 11.
93. *Id.* art. 13.
94. *Id.*
95. *Id.* art. 8.
96. *Id.*
97. *Id.* art. 19(4).

As with the JVIT (and possibly the ITFE), a five-year reinvestment of profits will result in a 40% rebate, which was not the case when the Unified Tax Law was initially proposed. Reinvestment may now be made, and ther rebate expected, regardless of whether the enterprise has a head office in the PRC.[98] Accordingly, the an investor should remember that enterprises with their head office inside China are taxed on income sourced both within and outside of China.

To alleviate the possible harsh effects of worldwide taxation, the Unified Tax provides a tax credit for enterprises which have established their head office inside China, allowing a deduction against taxes payable, for income taxes paid on income derived from sources outside China.[99] Although the credit is limited to the amount of Chinese income tax on such outside income,[100] the text does not limit their tax credit by class of income.[101] Lastly, the law permits the tax-free receipt of qualifying interest payments similar to those specified under the ITFE.[102]

D. *Tax Collections*

Following the ITFE, the Unified Tax requires prepayment of quarterly tax installments with settlement to occur within five months of the end of each tax year.[103]

VIII. Conclusion

In choosing their business vehicle, U.S. investors should look first to their business objectives — What sort of enterprise do they want to operate? What functions will the entity perform? A clear assessment of business goals will narrow candidate business forms.

If the investor's activities do not rise to the point of requiring a permanent establishment, as defined in the U.S.-China Tax Agreement, and do not lead to the receipt of passive income, the investor's business profits will escape Chinese taxes entirely. If an investor without a permanent establishment receives only passive income from Chinese sources, the Tax Agreement limits withholdings to 10% of amounts paid (not the higher 20% noted in the ITFE).

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98. *Id.* art. 10.
99. *Id.* art 12.
100. *Id.*
101. *Id.*
102. *Id.* art. 19(2) and (3).
103. *Id.* art. 15.

The Unified Tax legislation has eliminated much of the confusion surrounding the equity joint venture — foreign enterprise dicotomy. The Unified Tax implements guarantees more favorable income tax rate of 33% (central tax plus local), and for those industries beginning operations in specified fields, the Law's graduated holiday is extended. Qualifying enterprises, scheduled to operate ten years or more, escape tax for *both* the first profit-making year and the following year. In addition, the enterprise will receive a 50% tax reduction in years three through five (rather than in years two and three, as provided by the JVIT and ITFE). Like the JVIT, and possibly the ITFE, investors receive the 40% reinvestment rebate.

While the Unified Tax Law replaces the JVIT and ITFE, effective July 1, 1991, the JVIT and ITFE remain important to investors. Pursuant to the Law, if an existing enterprise's income tax rate is increased to an amount higher than that existing prior to the Law's implementation, the JVIT or ITFE will continue to apply. For enterprises suffering rate increases under the new Law, where such enterprises operate under an approved period of operation, tax laws in effect prior to the Unified Tax Law's enactment will continue to apply for the period. For enterprises suffering rate increases under the new Law, where such enterprises operate without an approved operating period, matters shall be implemented during a period stipulated by the State Council, "in accordance with the laws and relevant provisions of the State Council in effect prior to the implementation of this law."[104]

Operation as an equity joint venture permits separate operation as a Chinese legal person, and subjects the entity to the Unified Tax (or the JVIT, if it's an existing enterprise which was more favorably taxed under the JVIT). In the aggregate, the equity joint venture pays income taxes of approximately 33% of taxable income under the JVIT. Tax reliefs available under the JVIT are, with slight variation, very similar to those available under the ITFE. This is also true for governing accounting regulations.

U.S. investors operating branches which qualify as permanent establishments also are taxed under the Unified Tax, unless existing prior to July 1, 1991 and more favorably taxed under the ITFE, (unless the U.S. investor is operating as an individual, in which case, the investor is subject to the Individual Income Tax). The tax burden, in this case, is generally heavier than the JVIT for branches earning higher incomes (exceeding 250,000 Yuan). However, investors should

104. *Id.* art. 27.

remember that the ITFE allows tax-free dividend remittance. For planning purposes, the foreign investor would be well advised to operate the branch as an arm of a wholly-owned U.S. subsidiary. Doing so would limit the impact of Chinese taxation on the U.S. subsidiary, thereby protecting its owner(s) from greater taxation. In addition, arm's-length transfer payments allocated (by foreign investors) to the U.S. subsidiary are more likely to remain in place, lowering total taxable income. Although operation of a Chinese branch through a subsidiary based in a third country which acts as a tax haven can, at times, enable branch profits to escape U.S. taxation, structuring in this manner will also shake the branch free of U.S. Tax Agreement protections.

Under the Cooperative Joint Venture Law, enterprises may be taxed under the Unified Tax, the JVIT or the ITFE, depending on whether the enterprise rises to the level of an independent Chinese legal entity. If it does not, and the enterprise is deemed to have a permanent establishment, the enterprise appears subject to the Unified Tax or the ITFE.

As of the date of this writing, the degree to which investors will be able to continue to negotiate special tax packages prior to project commencement is unclear. What is apparent, however, the recent tragedy surrounding Tiananmen Square not withstanding, is the central government's effort to develop a sophisticated taxing system, capable of increasing foreign economic participation without overly compromising Chinese socialized democracy.

Doing business in China can be a very rewarding venture, but it is not for those requiring precise codification of investment law. It is for those who recognize and can capitalize upon China's desire to become an industrialized leader in the twenty-first century.