The Evolving Tax System of the People’s Republic of China

Richard Pomp  
*University of Connecticut School of Law*

Timothy A. Gelatt

Stanley Surrey

Follow this and additional works at: https://opencommons.uconn.edu/law_papers

Part of the Taxation-Transnational Commons, and the Tax Law Commons

**Recommended Citation**

https://opencommons.uconn.edu/law_papers/556
The Evolving Tax System of the People's Republic of China*

RICHARD D. POMPT†, TIMOTHY A. GELATT‡‡, AND STANLEY S. SURREY†††.

SUMMARY

INTRODUCTION

I. THE CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX
   A. Taxpayers and Taxable Activities
   B. Taxable Items and Rates
   C. Constructive Sales
   D. Payment and Collection Procedures
   E. Violations and Penalties
   F. Reform of the Consolidated Industrial and Commercial Tax
   G. Implications for Foreign Business

II. THE INDUSTRIAL AND COMMERCIAL INCOME TAX
   A. Taxpayers and Taxable Activities
   B. Tax Base
   C. Tax Rates
   D. Payment and Collection Procedures
   E. Violations and Penalties
   F. Reform of the Industrial and Commercial Income Tax
   G. Implications for Foreign Business

III. THE INDIVIDUAL INCOME TAX
   A. Taxpayers
   B. Tax Base
   C. Tax Rates
   D. Payment and Collection Procedures


† S.B. University of Michigan, 1967; J.D. Harvard Law School, 1972; Professor of Law, University of Connecticut School of Law; Visiting Professor of Law, University of Texas School of Law.


††† B.S. CCNY 1929; LL.B. Columbia University Law School, 1932; Jeremiah Smith Professor of Law, Harvard Law School.
E. Violations and Penalties

IV. THE JOINT VENTURE INCOME TAX
A. Taxpayers
B. Tax Base
C. Tax Rates and Reductions
D. Payment and Collection Procedures
E. Violations and Penalties

V. TAXATION IN THE SPECIAL ECONOMIC ZONES

VI. FOREIGN TAX CREDIT AND TAX TREATY CONSIDERATIONS
A. The Creditability of the Chinese Income Taxes Against United States Tax
1. The Joint Venture Income Tax
2. The Individual Income Tax
   a. Residents of China
   b. Nonresidents
B. The Chinese Foreign Tax Credit
C. Tax Treaties

CONCLUSION

INTRODUCTION

On September 10, 1980, the People's Republic of China took another major step in the reshaping of its economic policies by adopting an income tax on joint ventures and on individuals. These laws had been the subject of considerable speculation since the passage of the Chinese Joint Venture Law in July 1979, which established the procedures and ground rules by which foreigners may invest in China. The Joint Venture Law


The Joint Venture Law allows the parties to agree on the duration of the joint venture. Joint Venture Law, supra, art. 12. A joint venture corporation that is limited in duration raises an issue about its characterization for United States tax purposes. Such a corporation
clearly anticipated a joint venture income tax\(^4\) and an individual income tax\(^5\) as well as other new laws. Many foreign businesses have waited eagerly for these changes in China's institutional and legal framework before proceeding with their investment decisions.\(^6\) Although not all of the framework anticipated by the Joint Venture Law is yet in place, the passage of the two new income tax laws and the subsequent promulgation of implementing regulations should help remove at least one obstacle to foreign investment.

The speculation and interest that preceded the adoption of these new tax laws tended to obscure the existence of China's domestic tax system.\(^7\) The presence of such a system may come as a surprise, since the observation has often been made that China has no taxation. This misconception is understandable since, until recently, taxation was one of the many aspects of China's economic system shrouded in so much mystery as to raise doubts about its very existence. The reality, however, is that China has long had a complex domestic tax structure, including an income tax on certain types of entities. Moreover, at least one of those domestic taxes — the consolidated industrial and commercial tax — may have significant consequences for foreign investors.

may be characterized as a partnership and taxed accordingly. \textit{See D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS} 239-44 (1978).

4. Article 7 of the Joint Venture Law, \textit{supra} note 3, provides that the profit of a joint venture shall be distributed after the payment of a joint venture income tax.

5. Article 11 of the Joint Venture Law, \textit{supra} note 3, provides that wages, salaries or other legitimate income earned by a foreign worker or staff member of a joint venture may be remitted abroad after the payment of a personal income tax.

6. The Wall Street Journal reported that China's "much publicized drive to attract foreign investments has bogged down . . . China's joint venture law stipulates that investors will have to abide by tax laws, foreign-exchange regulations and other Chinese laws and regulations. The trouble is, none of these exists." According to the Wall Street Journal, the Chinese want foreigners to invest in projects first, before any specific legislation is adopted. The Chinese will then use the experience gained from these early projects in order to decide what specific legislation is needed. An inevitable deadlock has arisen because foreign businessmen do not want to be part of such an experiment. Some Japanese businessmen were reported as telling the Chinese that "if you don't have definite laws, it will be mad to invest in your country." Wall St. J., Feb. 29, 1980, at 8, col. 2.

With the enactment of the recent joint venture income tax and the individual income tax, at least eleven taxes now exist in China: the real estate tax, the agricultural tax, the vehicle license tax, the slaughter tax, the list contains all the major taxes of which the authors are aware. The list corresponds to those government levies which are traditionally classified in the West as taxes. Other commentators might well expand the list to reflect transactions and activities that are unique to a noncapitalist economy. Eckstein, for example, refers to the compulsory sale of certain agricultural products to the Chinese government at fixed prices as involving a “quasi-tax.” A. ECKSTEIN, CHINA’S ECONOMIC REVOLUTION 119 (1977). Determining the amount of this quasi-tax is difficult, however, because the differential between the market price and the fixed price at which a product is sold to the government probably overstates the tax element. “Since the ‘free market’ is small and all of the repressed, excess demand tends to be concentrated in this narrow market, prices in it were almost certainly above the levels at which they would have been if there had been no fixed purchase arrangements.” Id. See also P. JONAS, TAXATION OF MULTINATIONALS IN COMMUNIST COUNTRIES 5-10 (1978). China, however, does not view these compulsory sales as a form of taxation. See Ting, supra note 7, at 347.

Enterprises owned by the state pose another definitional problem. Because state enterprises generally turn all of their profits over to the state, which later determines their need for reinvestment funds, one might characterize such enterprises as being subject to a special income tax imposed at a 100% rate. China, however, does not view state enterprises in this manner. Profits from state enterprises are not classified in China as taxes. In fact, such enterprises are generally exempt from income taxation. See text accompanying notes 122, infra. See also notes 100, 154-59 infra and accompanying text for new taxes that are under consideration.

The real estate tax is levied only in the cities and is a source of local revenue. The rate of the tax varies from one city to another. Land is taxed to the owner at approximately 1.2% of the value of the land. Land appears to be valued on a historical basis. With few exceptions, all land is owned by the state, and thus the tax serves to transfer revenue from the state to the cities.

Buildings and structures are taxed differently, depending on whether they are rented or owner occupied. In the case of a building or structure that is rented, the tax is paid by the owner at a rate equal to 18% of rental value. Most rental property is owned by either the state or a state enterprise. Owner occupied buildings are subject to a tax of approximately 1.8% of the fair market value of the building. Although individuals, state enterprises, cooperatives and collectives are free to buy and sell buildings and structures, no active market seems to exist, and it is unclear how fair market value is determined. Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979). For a description of the real estate tax from 1950 to 1959, see G. ECKLUND, supra note 7, at 33. See also A. CHEKHUTOV, supra note 7, at 63, 135.

Presumably, the assessed value of a site for purposes of the real estate tax will have little bearing on the determination of its value for purposes of the Joint Venture Law. Article 5 of the Joint Venture Law provides that the investment contributed by a Chinese participant may include the right to the use of a site provided for the joint venture. If the use of a site is not part of the Chinese participant’s investment, then the joint venture will pay the Chinese government for the use of the site. Joint Venture Law, supra note 3, art. 5. Valuation of a site for purposes of article 5 is unlikely to be governed by the site’s assessed value under the real estate tax.

The basic format of the agricultural tax was established in 1958 when it was approved by the Standing Committee of the National People’s Congress. By 1958, most rural families were members of farm cooperatives. In late 1958, these cooperatives were merged into large communes, and in 1959, the production brigade, a subdivision of the commune, was designated as the taxing unit under the agricultural tax. The only individuals who were subject to the agricultural tax as individuals were those few persons who remained
outside the cooperatives and those cooperative members who still owned land privately. G. Ecklund, supra note 7, at 16.

The rate of the tax is set at 15.5% of the normal, average 1958 harvest output, which is defined as the crop harvested from a certain category of land under natural conditions by the usual methods of labor, organization and plantings. Since average harvests have increased since 1958, the effective rate of tax is currently between 4% and 6%. By basing its specific rate on 1958 outputs, the tax is intended to provide an incentive to increase production. The specific rate can be reduced if a drought or a flood occurs. Recent reports indicate that the rate varies among provinces to take climatic conditions into account. FBIS. supra note 1, Dec. 10, 1980, at S2. The tax is collected in kind by the local government and sold to certain state agencies; the sales proceeds are then transmitted to the national government.

During the Chinese Civil War, ending in 1949, agricultural taxes were collected according to roughly estimated quotas. In areas that the new government acquired after 1949, progressive agricultural taxes were imposed on gross income derived from the land. In areas where the government had completed its policy of land redistribution, e.g., North China and Manchuria, proportional rates rather than progressive rates were levied. G. Ecklund, supra note 7, at 11-12.

Between 1950 and 1958, the agricultural tax was levied on the “set yield” of the land. The set yield was determined by committees composed of persons designated by local government units. These committees computed the set yield by taking into account the type of soil, the extent of irrigation and the use of fertilizers. Once determined, the set yield could remain the same for several years. In 1957, the national set yield was reported to be 69% of actual production. In certain individual cases, however, the set yield was reported to be greater than actual output. Id. at 12.

The actual operation of the pre-1958 agricultural tax was quite complex. In general, the agricultural tax was designed to encourage production of certain crops, e.g., cotton, tobacco and hemp, to increase production and cultivation generally, to redistribute land from landlords to peasants and to achieve a more equitable distribution of income among persons farming their own land. For a more complete discussion, see id. at 12-16; Chao Kuo-Chun, supra note 7, at 188-93; A. Chekhutov, supra note 7, at 80-95, 147-67; and A. Donnithorne, supra note 7, at 337-64.

The pre-1958 tax on set yield also was intended to provide farmers with an incentive to develop their land and increase production without becoming subject to higher taxes. As an incentive to increase the amount of land under cultivation, newly plowed acreage was exempt from the tax for a period of from three to five years. See G. Ecklund, supra note 7, at 12-13. Tax reductions were also provided under the pre-1958 agricultural tax in case of crop losses caused by natural disasters. A local committee determined the extent of loss, and the tax due was reduced accordingly.

11. The vehicle license tax applies to all vehicles, but some cities exempt nonmotorized vehicles such as carts and bicycles. Beijing, for example, exempts bicycles owned by Chinese. The tax is paid once a year to the local government, with proceeds earmarked for road construction. The tax does not appear to be levied in the rural areas. The amount of the tax varies. In the case of motorized vehicles, which generally are not owned by individuals, the tax is based on tonnage. For other vehicles, the tax is a fixed amount. Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979).

12. The slaughter tax is levied at the time of slaughter at a fixed amount per animal. The amount of tax, which is different for each animal, is based on the animal’s fair market value. The tax is paid to the local government by the owner of the animal. An exemption is provided for the slaughter of animals during specific holidays. For a description of the slaughter tax from 1950 to 1959, see G. Ecklund, supra note 7, at 32. See also A. Chekhutov, supra note 7, at 61, 135.
salt tax, the foreign shipping tax, customs duties, the consolidated industrial and commercial tax, the industrial and commercial income tax, the joint venture income tax and the individual income tax. Of these eleven, the consolidated industrial and commercial tax and the various income taxes are of the most interest to foreigners and therefore form the heart of this Article.

Section I of this Article examines the consolidated industrial and commercial tax and Section II analyzes the industrial and commercial income tax. China is presently reviewing the structure of both of these taxes and changes have recently been made on an experimental basis. If these changes are successful, subsequent revisions can be expected. The individual income tax and the joint venture income tax are detailed in Sections III and IV. The tax regime applicable in China's new special economic or "free trade" zones is outlined in Section V. Section VI discusses the creditability of the individual and joint venture income taxes for purposes of the United States foreign tax credit, explores the refinements needed in order for the Chinese to implement their own foreign tax credit and concludes with a brief note on tax treaties.

I. THE CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX

The Consolidated Industrial and Commercial Tax Act (CICTA) was adopted in 1958. Prior to 1958, industry and commerce were subject to

---

13. The amount of the salt tax, which is levied on a tonnage basis, varies from region to region. The tax ranges from under 100 yuan per ton to 160 yuan per ton and is paid by the producer. (As of March 26, 1981, one yuan equaled U.S. $0.62. Wall St. J., Mar. 27, 1981, at 44, col. 5.) For a description of the salt tax during 1950 to 1959, see G. ECKLUND, supra note 7, at 23. Historically, the salt tax has been one of the easiest of all Chinese taxes to administer and has provided a stable source of revenue. Id. at 24. See also A. DONNITHORNE, supra note 7, at 380; T. MIYASHITA, THE CURRENCY AND FINANCIAL SYSTEM OF MAINLAND CHINA 39-40 (1966).

14. The foreign shipping tax is in lieu of the industrial and commercial income tax and the consolidated industrial and commercial tax. The tax is levied on the revenue from freight originating in China and on the income from freight and passengers loaded in China. The rate of tax is 3%, but local governments can levy a supplemental tax of .03%, bringing the total rate to 3.03%. This rate is quite high by worldwide standards and is often reduced as part of a bilateral agreement. Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979).

15. For a description of customs duties in the 1950s, see G. ECKLUND, supra note 7, at 29-31. Customs duties were used in the past for bargaining purposes during foreign trade negotiations. A. DONNITHORNE, supra note 7, at 380. Recent indications are that exemptions may be provided for raw materials, supplementary materials, parts and equipment imported for the purpose of processing or assembly or for use by a joint venture; and for machinery, equipment and construction materials imported as part of the investment by a foreign participant in a joint venture. In some cases, the exemption may apply only if the imported items are not easily available within China. New China News Agency, China Strengthens Customs Work (Press Release Apr. 15, 1980).

16. Consolidated Industrial and Commercial Tax Act of the People's Republic of China (Draft), passed in principle by the 101st Meeting of the Standing Committee of the National
four separate taxes — a merchandise circulation tax or turnover tax, a goods or commodity tax that applied to items not subject to the turnover

People's Congress, Sept. 11, 1958, promulgated for trial implementation by the State Council, Sept. 13, 1958 (on file with the authors) [hereinafter cited as CICTA]. A final version of this Act has never been issued. See note 23 infra.

17. Because the business tax was levied on both gross and net receipts, see note 21 infra, some commentators view industry and commerce as having been subject to five, rather than four, separate taxes prior to 1958. See, e.g., G. ECKLUND, supra note 7, at 27.

18. The Communist government that came to power in 1949 was not immediately in a position to restructure the economy along socialist principles. Its goals were to replace private enterprises gradually with state owned or cooperative enterprises, encourage industrialization at the expense of personal consumption, penalize activities considered to be nonessential and increase agricultural productivity. The tax system, used as a tool in achieving these goals, was designed to favor heavy industry, to encourage state enterprises and to redistribute land and income. Consumer goods, particularly those classified as luxuries and semiluxuries, were generally taxed at much higher rates than industrial goods. Discriminatory taxes were levied on private industry and commerce, and price controls made it difficult for private businessmen to shift these taxes to consumers. By 1958, state owned and cooperative enterprises accounted for more than 95% of the economic activity in the country. The rapid socialization of the country allowed the tax system to be modified in 1958, and most of its anticapitalist features were eliminated. G. ECKLUND, supra note 7, at 1-2, 72-73. See A. ECKSTEIN, supra note 8, at 32-58; note 23 infra.

19. The merchandise circulation tax, or turnover tax, was introduced in 1953 and appears to have been modeled after a similar tax in the Soviet Union. Twenty-two categories of goods were subject to the tax and exempt from all other taxes. See A. CHEKHUTOV, supra note 7, at 127. Ecklund reports that the rates of tax ranged from 7% to 66%, and that they were applied to the state price of the taxable good. G. ECKLUND, supra note 7, at 25. Chekhutov states that the tax was computed either as a percentage of the price of the good or as a fixed amount per unit of the good. A. CHEKHUTOV, supra note 7, at 128. He does not indicate the rates of tax or the tax per unit of good. The purchaser paid the tax in the cases of imports, agricultural products and purchases made by wholesale commercial organizations. Producers paid the tax on sales to nonwholesalers. A producer also paid the tax if the goods were used by it in further production. See id. at 127-28, 137.

The turnover tax replaced a number of overlapping taxes, including the stamp tax, the business tax and a special tax on cotton yarn. CHAO Kuo-CHUN, supra note 7, at 185. The net effect of this substitution was to reduce the tax burden on persons dealing in the taxable goods. The government, however, did not wish to encourage privately owned businesses by extending this tax reduction to them. Consequently, the 22 categories of goods subject to the turnover tax and thus exempt from other taxes, were primarily goods under the control of state enterprises. A. CHEKHUTOV, supra note 7, at 127. These goods included pig iron, cement, nonferrous metals, rolled steel, coke, tobacco products, alcohol, flour, matches and cotton thread. In 1954, the government subjected a number of new commodities to the turnover tax. These new items were primarily goods produced in the private sector, and according to Chekhutov, their taxation was an attempt to reduce the profits accruing to capitalists. Id. at 137. Chekhutov’s explanation of the 1954 change needs further elaboration, since on its face it appears to contradict his explanation for the selection of the original 22 taxable categories.

Comparing the turnover tax with the taxes it replaced, Chekhutov asserts that the turnover tax had a number of advantages. First, tax revenue was collected faster and more regularly. Second, the administrative burden of complying with tax obligations was reduced for the state enterprises. Third, the government found it easier to control prices and to achieve greater uniformity of prices among regions of the country. Fourth, a more geographically uniform incidence of taxation of consumers was achieved. Fifth, state enterprises improved their accounting and bookkeeping methods, and the government therefore was able to increase its control over these enterprises. See id. at 128.
20. The goods tax, or commodity tax, was introduced in 1950. Producers or wholesale buyers paid the tax, and the rates ranged from 3% to 120% of the wholesale price of the good. See G. Ecklund, supra note 7, at 21-23. In 1953, the number of items subject to the tax decreased from 358 to 173, but this reduction may have resulted partially from a consolidation of the classes of taxable goods. Id. at 24. Chekhutov reports that the government increased the tax rates for a majority of the items in 1953. Industrial goods generally were taxed at lower rates than consumption goods. Within the latter class, necessities generally were taxed at lower rates than luxury goods. A. Chekhutov, supra note 7, at 129.

21. The government introduced the business tax in 1950. Before 1951, the business tax applied to either gross receipts or net receipts, but sometime after 1951, the tax applied to both gross receipts and net receipts. See G. Ecklund, supra note 7, at 20-21. The tax was levied on industrial enterprises that produced goods not subject to the turnover or the commodity tax. The tax also was levied on commercial enterprises that sold goods not subject to the turnover tax. See A. Chekhutov, supra note 7, at 133. State enterprises were exempt from the tax on net receipts, but were taxed on gross receipts. Exemptions were provided for state monopolies, poor artisans and certain cooperatives. See G. Ecklund, supra note 7, at 20-21.

The rates of tax on gross receipts varied from 1.5% to 3% for gross receipts from the sale of goods and from 1.5% to 15% for gross receipts from the sale of services. Within these ranges, the lower rates applied to those goods and services which were considered important for economic development. See id.

Before 1953, an enterprise that sold more than one product paid tax on gross receipts at the rate applicable to the product subject to the lowest rate. Starting in 1953, however, such an enterprise computed its gross receipts tax at the rate applicable to each item sold. See A. Chekhutov, supra note 7, at 131. Changes also were made in 1953 in the taxation of enterprises that produced taxable goods and used them in further production. The gross receipts tax applied to the movement of semifinished goods between branches and departments of the same enterprise. In 1954, state enterprises were exempted from this rule. The government also increased the number of goods subject to the gross receipts tax. Both changes were an attempt to encourage state controlled enterprises. See id. at 137.

The rates applied to net receipts ranged from 5% to 30%. No minimum level of net receipts was exempt from taxation. Until 1957, a reduction in tax was available for those activities which the government wished to encourage. See G. Ecklund, supra note 7, at 20-21.

22. The government revised the stamp tax in 1950, reducing the list of documents subject to the tax from 36 to 25. See A. Chekhutov, supra note 7, at 59. All documents used in commercial transactions and in transfers of property were subject to the stamp tax. See G. Ecklund, supra note 7, at 23. Documents involved in the transfer of land pursuant to agrarian reform, passenger tickets and baggage receipts, marriage certificates and labor agreements were exempt. The tax was levied either as a percentage (.01%, .03% or 0.3%) of the amount indicated on the document or as a fixed amount (.02, .05 or 0.1 yuan). A. Chekhutov, supra note 7, at 59. Revenue from the stamp tax went to local governments. Chao Kuo-Chun, supra note 7, at 185. Reports from China in later years suggest that the stamp tax may not have been eliminated entirely in 1958. A. Donnithorne, supra note 7, at 381.

23. The government had recognized the need to simplify the taxation of businesses for several years. The previous system involved too many taxes and too many rates. The multiple taxation of certain products was also criticized. For example, a manufacturer might pay the commodity tax on the sale of its products, the business tax on receipts generated by those sales and the stamp tax on the documents of sale. Intermediate goods manufactured by a
and a schedule of more than forty different rates, applicable to more than 100 categories of items. Thirty-five regulations have been issued under the Act. The consolidated tax can be described generally as a broad-based turnover tax or as a combination of cascading sales and excise taxes. Unlike the sales taxes that are used in the United States, which generally apply only at the retail level, the consolidated tax can be imposed at each stage of production when goods or services are transferred from entity to entity. The tax also is levied at the retail level when the goods or services are sold to the ultimate consumer. Unlike a value-added tax, no credit is firm for inclusion in its final product were also taxable. G. Ecklund, supra note 7, at 26-27. By the latter half of the 1950s, the existing tax system had achieved its goals of encouraging the growth of state enterprises and of discouraging the capitalist sector of the economy. Simplification of the tax structure was therefore possible. Chao Kuo-Chun, supra note 7, at 186.

The 1958 consolidation was preceded by considerable experimentation. A unified industrial and commercial tax had been adopted earlier for petty traders. In the spring and summer of 1958, the government implemented the consolidated tax for limited groups of commodities in certain areas of the country, though in other areas the tax applied to all taxable goods. In September 1958, the consolidated tax was promulgated for general application, but only as a draft. See note 16 supra; A. Donnithorne, supra note 7, at 374.

In 1973, a new Industrial and Commercial Tax Act (Draft) was evidently implemented on a trial basis. The 1973 Act, which neither the authors nor apparently any other foreigner has seen, is reported as having incorporated into the consolidated tax rates, where appropriate, the vehicle license tax, the slaughter tax and the real estate tax. Guojia Shuishou Jiaocai Bianxie Zup (The National Taxation Teaching Materials Editorial Group), Guojia Shuishou (The National Taxation) 26 (1979) [hereinafter cited as National Taxation]. National Taxation is a textbook on China's current tax system, prepared by officials of the Ministry of Finance and of other economic and financial agencies. Another source states that it was the salt tax and not the real estate tax that was incorporated into the consolidated tax rates. Liu Zhicheng, Lun Gaige Woguo Gongshe Shuishou Zhidu (A Discussion of Reform of Our Country's Industrial and Commercial Tax System), [1980] Jingji Guanli (Econ. Management) (No. 9) 23, 24. The taxes incorporated into the consolidated tax rates have continued to be imposed on foreigners and other individuals. National Taxation, supra, at 26. The 1973 Act left the basic structure of the CICTA intact. The authors could not determine whether the 1973 Act was ever issued in a final form, but further and significant revisions of the consolidated tax can be expected. See text accompanying notes 96-101 infra.

24. The government designed the rate structure of the consolidated industrial and commercial tax to generate the same revenues as the four taxes that it replaced. G. Ecklund, supra note 7, at 27. The rates of the new consolidated tax did not diverge much from the rates previously imposed on the same taxable goods and services. Some rates are lower under the consolidated tax to help enterprises that were operating at a loss or to encourage the production of certain goods, such as fertilizers. Other rates are higher because the profits of certain enterprises were considered to be too high. A. Donnithorne, supra note 7, at 373.

25. Detailed Rules and Regulations for the Implementation of the Consolidated Industrial and Commercial Tax Act of the People's Republic of China (Draft), promulgated for trial implementation by the Ministry of Finance, Sept. 13, 1958 (on file with the authors) [hereinafter cited as CICTA Regulations].

26. The consolidated tax is unlikely to qualify as an income tax or as a tax in lieu of an income tax and will not, therefore, be creditable against United States income tax. See I.R.C. §§ 901, 903; Temp. Treas. Reg. §§ 4.901-2, 4.903-1 (1980); E. Owens, The Foreign Tax Credit 26-83 (1961). See also text accompanying notes 398-431 infra.
provided for any tax previously paid on the purchase of goods or services.  

Because the tax is paid whether an enterprise is profitable or not, the Chinese view it as providing an incentive for a firm to generate enough revenue so that some profit remains after payment of the tax. In 1979, the consolidated tax accounted for over three-fourths of China's total tax revenue.

A. Taxpayers and Taxable Activities

The consolidated industrial and commercial tax reaches all state enterprises, cooperatives, collectives and individually run businesses engaged in the production of industrial products, the purchase of agricultural products, the importation of foreign goods, commercial retailing, communications and transport or the rendering of services. Wholesalers are not subject to the tax unless they are engaged in the purchase of agricultural products or in the importation of foreign goods. The regulations make it clear that the tax is paid only with respect to business conducted within China.

The tax is generally imposed on the amount of proceeds received from the sale of goods and services. Taxpayers engaged in the purchase of agricultural products or taxpayers engaged in the importation of foreign goods, however, pay the tax on the amount of their purchases. Presumably, the seller is not also subject to the consolidated tax on the proceeds from such transactions.

Exemptions exist for revenues received by state banks in the form of interest, remittance, handling and other miscellaneous charges received in a banking business; by insurance enterprises in the form of insurance premiums, handling charges, proceeds from the sale of remnant materials and other monies generated by the provision of insurance (including business reinsured abroad); by agricultural machinery centers from cultivating land for agricultural production units, from the rental of agricultural machinery

---


28. Conversations of Pomp with Officials of the Ministry of Finance, in Beijing (July 1979). Referring to the tax increase on state enterprises producing rolled metal products, pig iron, steel and machines which resulted in 1958 when the consolidated industrial and commercial tax became law, Ecklund reports that the government wanted to reduce the profits of such enterprises in order to provide an incentive to better management and efficiency. G. Ecklund, supra note 7, at 28.


30. See note 125 infra.

31. CICTA, supra note 16, art. 2.

32. CICTA Regulations, supra note 25, art. 2.

33. CICTA, supra note 16, arts. 5, 6.
for agricultural production and from the performance of other labor; by hospitals, commune hospitals, health care clinics and veterinary hospitals for providing medical care; and by scientific research units for providing services and selling experimental products and samples.  

In addition to these exempt categories, the CICTA provides that, if tax incentives are deemed necessary, an exemption or a tax reduction may be available for revenue received by public canteens or other public enterprises managed by agricultural production cooperatives or by urban street organizations; commissions received on the purchase and sale of industrial and agricultural products by the supply and sales divisions of agricultural production cooperatives if such sales took place at the request and on behalf of state enterprises; and revenue derived from the sale of products made by industrial and agricultural enterprises that are operated by schools under work-study programs, including any proceeds received for performing processing work and any proceeds derived from performing other labor. The full extent to which these tax exemptions or tax reductions have been granted in practice is unclear, but there is some indication that tax reductions have been granted to infant or ailing domestic enterprises and have been used to encourage certain types of economic activity.

34. Id. art. 10; CICTA Regulations, supra note 25, art. 25.

35. CICTA, supra note 16, arts. 11, 12.

36. Taxpayers seeking an exemption or a reduction in tax initially apply to the local tax bureau. The provinces and cities also have some authority to grant an exemption or a reduction. Id. art. 12. The extent of the authority of the local tax bureau, the cities or the provinces to grant these exemptions or reductions remains unclear. Two 1977 directives increased the power of the central State Council and the Ministry of Finance in matters of taxation. Caizheng Bu (Ministry of Finance), Guanyu Shuishou Guanli Tizhi de Qingshi Bao-gao (Report Requesting Instructions Regarding the System of Tax Administration) Nov. 1977; Caizheng Bu (Ministry of Finance), Shuishou Guanli Tizhi de Guiding (Provisions on the System of Tax Administration), approved by the State Council, Nov. 1977, both cited in NATIONAL TAXATION, supra note 23, at 30-31. These directives allow officials of the provinces, municipalities and autonomous regions to decide in some cases, with the prior approval from the Ministry of Finance, on appropriate reductions and exemptions for certain types of industries within their areas. Id. As China stresses the principle of "flexibility in adapting to local conditions," perhaps more responsibility will be delegated to local authorities. A recent provincial report, however, denounced certain localities for formulating their own tax rules "to reduce and remit taxes at will." FBIS, supra note 1, Jan. 2, 1981, at O4. Central coordination of the taxation system is being stressed now to avoid such irregularities. Renmin Ribao (People's Daily), Jan. 31, 1981, at 1.

37. In 1962, a reduction or exemption was granted for indigenous chemical fertilizers, insecticides and farm tools made by communes and production teams. In 1963, a tax reduction for unspecified new industrial consumer goods was reported. A. DONNITHORNE, supra note 7, at 373. See Wei Min, supra note 7, at 23.

38. The new Chinese Environmental Protection Law allows a reduction of or an exemption from taxes, presumably including the consolidated tax, for enterprises using waste gas and other recycled resources as their main raw materials. Zhonghua Renmin Gongheguo Huanjing Baohu Fa (Shixing) (Law of the People's Republic of China on Environmental Protection (for Trial Implementation)), art. 31, adopted in principle by the Eleventh Session of the Standing Committee of the Fifth National People's Congress, Sept. 13, 1979. See also
B. Taxable Items and Rates

The CICTA delineates the items subject to the tax, the applicable tax rates and the method of computing the tax base. In general, the sales price is the stated tax base. Special rules are provided for imported goods. In the case of imported industrial goods, the tax is computed on the basis of the sum of the cost-insurance-freight (C.I.F.) price of the good, the customs duties and the tax itself. In the case of imported agricultural products, the tax is computed only on the basis of the C.I.F. price.

Over 100 categories of taxable industrial and agricultural products are listed, some of which are divided further into subcategories. The rates applicable to the enumerated items range from 3% (for raw cotton cloth) to 66% (for Grade A cigarettes). More than forty different rates exist within

notes 64, 113, 116 infra and text accompanying notes 57, 68 infra. A recent set of regulations grants exemptions of up to three years from both the consolidated tax and the industrial and commercial income tax to collective enterprises that hire unemployed youth. Caizheng Bu Guanyu Dui Anzhi Daiye Zhiqing de Chengzhen Ji Ji Qiye Jin yi bu Jianmian Shui de Tongzhi (Notice of the Ministry of Finance on the Further Reduction of Taxation of Collective Enterprises in Cities and Towns Providing Employment for Unemployed Educated Youth), Apr. 25, 1980, ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO (PEOPLE'S REPUBLIC OF CHINA STATE COUNCIL GAZETTE), Oct. 8, 1980, at 310. Tax exemptions have also been granted to several categories of enterprises in the economically crippled Tibetan Autonomous Region, Ta Kung Pao, June 23, 1980, at 3, and in the Ningxia Hui (Moslem) Autonomous Region, Maruyama, CHINA'S SYSTEM OF ECONOMIC MANAGEMENT AND ITS IMPACT ON JOINT Ventures, JETRO CHINA NEWSLETTER, June 1980, at 3, 12.

The State Council has recently promulgated new regulations effective April 1, 1981, regarding incentives and adjustments to the CICTA as well as to the ICITA (discussed in full in Section II infra) on enterprises run by rural communes and brigades. The regulations provide automatic tax exemptions for such enterprises that produce certain products used in connection with agricultural production. Exemptions are also provided for such enterprises operating in disaster areas which provide for their own needs by their productive efforts.

A case by case review procedure, controlled by the provincial level governments, has been established for granting tax exemptions in other situations. A five year tax exemption from both the consolidated and the industrial and commercial income tax has been provided, with some exceptions, for "educated youth" who set up cooperative businesses in the countryside or urban suburbs. FBIS, supra note 1, Feb. 17, 1981, at L14. See also note 122 infra and accompanying text.

39. CICTA, supra note 16, Schedule of Taxable Items and Tax Rates.
40. Id. arts. 4-5, 7-8; CICTA Regulations, supra note 25, art. 10.
41. CICTA, supra note 16, art. 6; CICTA Regulations, supra note 25, art. 11.
42. CICTA Regulations, supra note 25, art. 11.
43. These categories of products include cigarettes, wines, sugar, tea, cotton yarn, machine-made linen, silk, leather, thermos bottles, bicycles, bamboo, gas, coke, ores and machinery. CICTA, supra note 16, Schedule of Taxable Items and Tax Rates. NATIONAL TAXATION, supra note 23, at 57-65, has a similar schedule of taxable items. The rates listed, however, differ in some cases from the rates listed in the CICTA. These differences apparently reflect changes made by the 1973 Act and perhaps other changes made thereafter. See note 23 supra. The rates used in this article are those listed in NATIONAL TAXATION, supra note 23, at 57-65.
44. For example, sugar is divided into machine-made sugar, native sugar, saccharin and maltose; cigarettes are divided into five grades. NATIONAL TAXATION, supra note 23, at 57-65.
this range.\textsuperscript{45} A 5\% catchall rate applies to any industrial product that is not listed specifically in the categories of taxable items;\textsuperscript{46} no similar catch-all rate applies to unlisted agricultural products. Agricultural products that are not listed specifically are not subject to the tax at the time of purchase or at the time of importation. Such products are taxable only when they are sold at retail.\textsuperscript{47}

Taxable items under the categories of communications and transportation, services and commercial retailing\textsuperscript{48} are subject to tax rates ranging from 3\% to 15\%.\textsuperscript{49} The communications and transportation category is subject to a 3\% rate and includes mail and telecommunications and the transportation of cargo by modes other than rail. Cargo transport by railway is subject to a 15\% rate.\textsuperscript{50} The items listed in the services category are more extensive than those listed under communications and transportation. Restaurant, hotel, rental and similar services are taxed at 5\%.\textsuperscript{51} Industrial processing services are also taxed at 5\%.\textsuperscript{52} Repair, photography, hairdressing and laundry services are taxed at 3\%.\textsuperscript{53} A 3\% tax rate applies to commercial retailing but no specific items are listed under this category.\textsuperscript{54} No catchall rate is provided for items not specifically listed. The authors have been told that local governments may levy a 1\% surtax on all of the consolidated tax rates.

Special rules govern the taxation of the proceeds from the sale of processed products. The proceeds from such sales are divided into three categories. First, if an industrial enterprise purchases a product in a taxable transaction, for example timber or wool, and processes it into furniture or yarn that is then sold, the sales receipts are taxable at the rate applicable to the new product. Second, if an industrial enterprise purchases a good in a taxable transaction and processes it into a product that would otherwise be taxed at the same rate as the purchased goods, a 5\% rate is applied to the proceeds from the sale of the processed product.\textsuperscript{55} For example, if an industrial enterprise purchases uncoated copper wire in a taxable transaction and processes it into coated copper wire that is then sold, the sales receipts are taxable at the 5\% rate. The same is true if raw sugar is processed into crystallized sugar that is then sold.\textsuperscript{56} Third, if the processing is very modest or simple in nature, for example the starching or polish-

\textsuperscript{45} For example, the applicable rate is 5\% for motor vehicles and ships, 5\% for machinery and electric power, 8\% for nonmetallic minerals, 15\% for cement, 40\% for wrist watches, 40\% for cosmetics and 60\% for white or yellow wine. \textit{Id.}
\textsuperscript{46} CICTA, \textit{supra} note 16, Schedule of Taxable Items and Tax Rates.
\textsuperscript{47} CICTA Regulations, \textit{supra} note 25, art. 3(2).
\textsuperscript{48} NATIONAL TAXATION, \textit{supra} note 23, at 57-65.
\textsuperscript{49} \textit{Id.} at 63-65.
\textsuperscript{50} \textit{Id.} at 63.
\textsuperscript{51} \textit{Id.} at 64.
\textsuperscript{52} \textit{Id.} at 63. It is unclear whether there are any types of processing which would not be considered industrial, and would therefore fall outside the scope of this provision.
\textsuperscript{53} \textit{Id.} at 64.
\textsuperscript{54} \textit{Id.} at 63.
\textsuperscript{55} CICTA Regulations, \textit{supra} note 25, art. 7.
\textsuperscript{56} \textit{Id.}
ing of cotton cloth, or if only a “simple alteration or rearrangement of a product” occurs, the industrial enterprise can apply for a total exemption from the consolidated tax on its sale of the processed product.\textsuperscript{57}

In general, the consolidated tax rates are set low on those goods and services which the state is seeking to encourage—industrial goods tend to be taxed at lower rates than consumer goods. Within the class of consumer goods, necessities tend to be taxed at lower rates than luxuries. Another guideline in the setting of rates is the average pretax profit of enterprises producing a given product: high profit items tend to be taxed at higher rates than are low profit items.\textsuperscript{58} The state does, however, take into account the rate of the consolidated tax in setting the price of various controlled domestic goods and services,\textsuperscript{59} although in the past the prices and rates may not have been changed very often.\textsuperscript{60}

### C. Constructive Sales

The consolidated tax, like any turnover tax, provides an advantage for a firm that is vertically integrated. Under a turnover tax, the aggregate tax borne by a good is a function of the number of times it passes from entity to entity in the chain of production and distribution. A good produced by an integrated enterprise changes hands fewer times during its production and distribution than an identical good produced by nonintegrated firms. Consequently, the aggregate tax borne by a good produced by an integrated enterprise is less than that borne by an identical good produced by nonintegrated enterprises.

In order to reduce the tax advantage of integrated firms, the CICTA taxes certain items produced by an enterprise and used by the same enterprise in further production.\textsuperscript{61} Although the CICTA lists only wine, cotton yarn and leather,\textsuperscript{62} this rule apparently applies also to furs, woolen yarn, cane or beet sugar, liquid corn sugar and perhaps other products as well.\textsuperscript{63} The same rule governs products manufactured by an industrial enterprise and used by it in capital construction rather than in further production.\textsuperscript{64}

\textsuperscript{57} Id.; \textit{National Taxation}, \textit{supra} note 23, at 41.
\textsuperscript{58} Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979).
\textsuperscript{59} Id.
\textsuperscript{60} Donnithorne, writing in 1966, remarked that little information is available about changes in the rates of tax since 1958. A. DONNITHORNE, \textit{supra} note 7, at 373. The authors have been unable to determine the extent to which any rate changes that may have occurred since 1958 are reflected in the rates used in the text. \textit{See} notes 23, 43 \textit{supra}.
\textsuperscript{61} CICTA, \textit{supra} note 16, art. 4; CICTA Regulations, \textit{supra} note 25, art. 6.
\textsuperscript{62} CICTA, \textit{supra} note 16, Schedule of Taxable Items and Tax Rates.
\textsuperscript{63} Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979).
\textsuperscript{64} CICTA Regulations, \textit{supra} note 25, art. 6. The authors have seen an internal regulation of 1972 that exempts from this constructive sale treatment “by-products” used by construction and geological prospecting enterprises. \textit{Guanyu Jijian Fuchanpin Nashui Wenti de Guiding} (Regulations [of the Ministry of Finance] on Questions of Paying Tax on By-
The rule is implemented by imputing to the enterprise a constructive sale of the good used in capital construction or in further production. The constructive sales proceeds are equal in amount to the proceeds received by the enterprise on its sale of identical products to outside parties. If no identical products are sold by the enterprise, the tax is determined in consultation with the tax administration.

A somewhat similar approach is adopted in the case of an industrial enterprise that retails its own products. Such an enterprise is subject to the consolidated tax on its retail sales and is also subject to tax “at the industrial stage.” Although the law is vague, the tax at the industrial stage is presumably paid on the amount that would have been received if the product had actually been sold to a retailer. In other words, a constructive sale is imputed to the enterprise. Parity is thus maintained between an industrial enterprise that markets its own products through a sales division and an industrial enterprise that sells its own products to a retailer. The law does provide, however, that if an industrial enterprise retailing its own products has “difficulty” paying the consolidated tax at both the industrial stage and the retail stage, it may receive an exemption from paying the tax at the retail stage. Unlike the other rules that impute a constructive sale only in the case of certain products (such as wine, cotton yarn and leather), the rule governing retail sales by industrial enterprises apparently covers all products that are subject to the consolidated tax.

Another situation that gives rise to a constructive sale involves the processing of goods. If an industrial enterprise sends goods to another enterprise for processing, the industrial enterprise is subject to the consolidated tax when the processed goods are returned to it. In effect, the industrial enterprise is treated as if it “imported” the processed good. If a nonindustrial enterprise sends goods to another enterprise for processing, the consolidated tax is paid either by the processor, “on behalf of” the nonindustrial enterprise, or by the nonindustrial enterprise itself. Products of Basic Construction Enterprises), June 1, 1972 (on file with the authors). The stated goal of this exemption was to encourage the recovery of by-products. A 1973 regulation indicates that the Ministry of Finance and provincial-level tax bureaus have the power to exempt certain intraenterprise transactions from the constructive sale rule. See Guanyu Gongye Qye yi Zizhi Chanpin Yong yu Jiben Jianshe Deng Zengshui Wenti de Guiding (Regulations of the Ministry of Finance on the Use in Basic Construction of their Own Products by Industrial Enterprises and Other Taxation Questions), Dec. 25, 1973 (on file with the authors).

65. CICTA Regulations, supra note 25, art. 6.
66. Id. The authors are unable to ascertain the approach used by the tax administration in establishing the tax in this situation.
67. Id. art. 12.
68. Id.
69. CICTA, supra note 16, art. 9.
70. See text accompanying note 33 supra.
71. CICTA, supra note 16, art. 9.
basic construction enterprise, or other type of noncommercial, nonindustrial enterprise, sends goods for processing, the tax is paid "on behalf of" such enterprise by the processor.\footnote{72}

In the case of an industrial enterprise, the tax is based on the ex-factory price of the processed product.\footnote{73} In the other cases, the tax is either based on the ex-factory price of the processed product, or is based on a price agreed upon between the taxpaying enterprise and the tax authorities.\footnote{74} It is unclear whether the consolidated tax is assessed again at the retail level when the finished product is sold, as would be expected from the general pattern of the CICTA.\footnote{75}

The rationale behind these rules regarding processing is far from obvious. Foreigners involved in the processing of goods in China will have to define the scope and the application of these rules to their particular situations through discussions with Chinese officials.

D. Payment and Collection Procedures

The consolidated tax is paid on the basis of a taxable period that is determined by the tax administration for each taxpayer.\footnote{76} The regulations specify that the taxable period may be one day, three days, ten days, fifteen days or one month.\footnote{77} Payment is due within five days following the end of monthly taxable periods and within three days following the end of all other taxable periods.\footnote{78} The rapid collection of the tax provides the state

\footnote{72. CICTA Regulations, \textit{supra} note 25, art. 16.}
\footnote{73. CICTA, \textit{supra} note 16, arts. 4, 9.}
\footnote{74. CICTA Regulations, \textit{supra} note 25, arts. 15, 16. The system described in the text was first introduced for a limited range of goods—primarily cigarettes and foodstuffs—in a set of trial regulations in June 1958. \textit{Caizheng Bu Guyanyu Shixing Gaige Gongshang Shuizhi de Guiding} (Regulations of the Ministry of Finance on Trial Reforms of the Industrial and Commercial Taxation System), promulgated June 20, 1958, art. 6 (on file with the authors). These regulations did not contain a provision for any consultation between the taxpayer and the tax administration regarding price. The rules described in the text were implemented a few months later when the CICTA was promulgated.}
\footnote{75. If the retail sale of the processed product were subject to the consolidated tax, the rules set forth in the text accompanying notes 55-57 \textit{supra} would presumably apply.}
\footnote{76. CICTA, \textit{supra} note 16, art. 14; CICTA Regulations, \textit{supra} note 25, art. 19.}
\footnote{77. CICTA Regulations, \textit{supra} note 25, art. 19. For example, in the city of Dalian, which is heavily industrialized, the period is one day for major enterprises and 10 days for smaller enterprises.}
\footnote{78. \textit{Id.} art. 20. Special measures may be adopted to collect the tax from certain types of smaller enterprises. CICTA, \textit{supra} note 16, art. 17. The authors have no information about these measures. In unspecified "special circumstances," the tax may be collected each time that sales proceeds are received by a taxpayer. \textit{National Taxation,} \textit{supra} note 23, at 49.}

A taxpayer may apply for a credit or a refund of any tax paid on the sale of goods that are subsequently returned, apparently by accounting for returned goods at the end of the tax-
with a current source of revenue, especially from state enterprises that otherwise would turn over any profits only on a quarterly basis.

The regulations also contain a set of rules based on the type of enterprise for determining when tax liability arises. For an industrial enterprise that uses bank settlement procedures, liability arises on the day that sales proceeds are transferred to the account of the enterprise.\textsuperscript{79} If bank settlement procedures are not used, the tax administration determines the appropriate time in accordance with the accounting system and operating conditions of the enterprise.\textsuperscript{80} For taxpayers engaged in the purchase of agricultural products, the regulations state only that liability for the tax arises on the day payment for the products is made.\textsuperscript{81} For enterprises that import goods, liability arises on the day that the goods are brought into China or on the day that an application for importation is made.\textsuperscript{82} Neither the CICTA nor the regulations specify who determines which of the two dates is applicable. For a taxpayer engaged in commercial retailing, liability for the tax arises on the day that proceeds from the sale are received.\textsuperscript{83} No examples or definitions explain "the day that proceeds are received." Because most, if not all, commercial retailing takes place on a cash basis, however, the determination of the day of receipt presumably creates few problems. For a taxpayer engaged in communications and transportation or in the rendering of services, the regulations state only that the liability for the tax arises on the day that the revenue is received.\textsuperscript{84}

The tax is paid to the local branch of the People's Bank of China or directly to the tax administration in areas with no local bank branches.\textsuperscript{85} An enterprise that is unable to compute the amount of tax due may pay an amount based on the tax paid in the previous taxable period, or it may pay an estimated amount until the exact amount owed is determined.\textsuperscript{86}

Taxpayers that have well-developed accounting systems prepare their own returns, calculate their liability and send their forms and payment to the local branch of the People's Bank of China. Taxpayers that have inadequate accounting systems must submit their calculations to the local tax bureau for review before sending their forms and payment to the People's Bank.\textsuperscript{87}

A comprehensive system of tax inspection safeguards the collection of the consolidated tax. In addition to encouraging taxpayers to carry out

\textsuperscript{79} CICTA Regulations, supra note 25, art. 4(1).
\textsuperscript{80} Id.
\textsuperscript{81} Id. art. 4(2).
\textsuperscript{82} Id. art. 4(3).
\textsuperscript{83} Id. art. 4(4).
\textsuperscript{84} Id. art. 4(5).
\textsuperscript{85} Id. art. 22.
\textsuperscript{86} Id. art. 23.
\textsuperscript{87} NATIONAL TAXATION, supra note 23, at 48.
self-inspection on a regular basis, the tax administration sends investigators to audit key enterprises. These investigators have access to all of the books and records of a taxpayer. The enterprise's current figures are compared with its past figures and are also compared with those of similar enterprises. Investigators are trained to detect signs of evasion such as the nonreporting of sales, the reporting of sales of items in high tax brackets as sales of items in low tax brackets, the reporting of taxable sales as exempt sales and the nonreporting of constructive sales.88

E. Violations and Penalties

The tax administration deals with all violations of the CICTA except the most serious, which must be handled by the courts.89 The general Chinese legal principles of "persuasion-education" before punishment and of leniency for those demonstrating a good attitude are also applicable to tax offenders.90

The tax administration may impose a late payment penalty of 0.1% per day on the amount of tax in arrears.91 In the case of tax evasion, it may impose a penalty of up to five times the amount of tax evaded.92 The tax administration may commend or materially reward persons who report acts of tax evasion.93 A taxpayer who disagrees with the decision of the tax administration may, after paying the amount of tax due, appeal either to the local government or to the next higher level within the tax administration.94 Such appeals, however, are rare.95

88. Id., at 188-200.
89. CICTA Regulations, supra note 25, art. 32. China's new criminal code provides for up to three years of imprisonment for those "directly responsible" for "grave" violations of tax laws and regulations. Zonghua Renmin Gongheguo Xingfa (Criminal Code of the People's Republic of China), passed by the Second Session of the Fifth National People's Congress, July 1, 1979, art. 121. Foreigners are subject to this code. Id. art. 3. See notes 92, 258, 264 infra.
90. NATIONAL TAXATION, supra note 23, at 49. See also notes 258, 264 infra.
91. CICTA, supra note 16, art. 31.
92. Id. art. 16. During the 1950s, the tax authorities often levied harsh fines against private businesses for alleged tax evasion. See A. ECKSTEIN, supra note 8, at 76. The Chinese press has recently reported a number of major cases of tax evasion. In one case, the head of a factory was arrested for evading 116,000 yuan of tax over a two year period. Renmin Ribao (People's Daily), Oct. 16, 1980, at 3. A recent radio broadcast in northern Jilin province reported that some taxpayers were taking advantage of the various tax "suspensions" being offered, see notes 36, 38 supra, to "[invent] all sorts of pretexts" for not paying tax. Those who "refuse to mend their ways in spite of repeated education," the commentary warned, "must be seriously dealt with according to law." FBIS, supra note 1, Dec. 3, 1980, at S5. One tax evader received a five year prison sentence for attacking the tax official who was attempting to collect the delinquent taxes. Renmin Ribao (People's Daily), July 28, 1980, at 3.
93. CICTA Regulations, supra note 25, art. 30.
94. Id. art. 33.
95. Conversations of Pomp with Officials of the Ministry of Finance, in Dalian (July 1979).
F. Reform of the Consolidated Industrial and Commercial Tax

Some indications exist that the Chinese are considering major changes in the consolidated tax. In recent reports in influential Chinese economic publications, taxation officials have concluded that the basic structure of the consolidated tax must be revised. These experts realize that the cascading or pyramiding feature of the tax can produce a substantial burden on certain types of foreign investment as well as on domestic activity. They also are aware that investors are especially concerned about the burden of the consolidated tax because most countries will not grant a foreign tax credit for turnover taxes such as the consolidated tax. In addition, the Chinese are worried that the pyramiding feature of the tax, which provides a tax advantage for integrated firms, is discouraging small, specialized enterprises.

Proposals for reform of the consolidated tax—including a shift to a value-added tax, under which a credit is provided for prior taxes paid in order to eliminate cascading—are under active consideration. Indeed, steps toward implementing a value-added tax have already been taken. A recent report notes that in Shanghai, a city always in the forefront of economic changes, "industrial and commercial [consolidated] taxes are now calculated on the basis of total income from sales of products sold less the cost of materials. . . . A factory is no longer required to pay taxes for parts purchased from other units because taxes have already been paid for such parts by the manufacturing factories."

At the same time, the tax

---

97. See note 26 supra; notes 398-431 infra and accompanying text.
98. The rules on constructive sales, see text accompanying notes 61-75 supra, are only a limited response to this problem.
99. One of the reasons that many European countries replaced their turnover taxes with value-added taxes was to eliminate the cascading problem. See note 27 supra.
100. In addition to favoring the adoption of a value-added tax, one commentator advocates a "special products tax" and a business tax. Wang Chengyao, Give Full Play to the Role of Taxation as an Economic Lever, Renmin Ribao (People's Daily), Nov. 7, 1980, at 5, translated in FBIS, supra note 1, Nov. 26, 1980, at L14. He also favors a restoration of the stamp tax, supra note 22, "in line with the current extensive use of contracts." FBIS, supra note 1, Nov. 26, 1980, at L14. Guo, Wang & Han, supra note 96, at 20, also advocate a special products tax, described as a tax on the sale of certain luxury items such as cigarettes and cosmetics that the state prices at a higher level than their real value.
rates are being increased. These experiments with a value-added tax are likely to be expanded in the coming months.

G. Implications for Foreign Business

The consolidated tax is paid with respect to business conducted within China.\(^\text{102}\) The CICTA does not distinguish between foreign and domestically owned businesses. Foreigners and foreign entities, therefore, are apparently subject to the consolidated tax on business conducted within China. Businesses operating in China that are owned by overseas Chinese and several branches of foreign banks in Shanghai have been said to be subject to the consolidated tax.\(^\text{103}\)

Nothing in the Joint Venture Law would appear to exempt joint ventures from the consolidated tax. The Joint Venture Law does not refer explicitly to the consolidated tax. The only references to taxation involve an income tax,\(^\text{104}\) and the only exemptions referred to in the law concern an income tax. Moreover, the Joint Venture Law states that “[a]ll the activities of a joint venture shall be governed by the laws, decrees, and pertinent rules and regulations of the People's Republic of China,”\(^\text{105}\) language that suggests that the activities of a joint venture can be subject to the consolidated tax.\(^\text{106}\) In addition, the new Joint Venture Income Tax Law (JVITL) apparently assumes that a joint venture is subject to the consolidated tax. The regulations to the JVITL provide that, in computing its taxable income, a joint venture may deduct any “taxes on sales,”\(^\text{107}\) a reference to the consolidated tax.

---

102. CICTA Regulations, \textit{supra} note 25, art. 2. No rules are provided to determine what constitutes “business conducted within China.”
104. \textit{See} notes 4-5 \textit{supra}.
105. Joint Venture Law, \textit{supra} note 3, art. 2.
106. This interpretation is supported by a clause in the recently approved joint venture agreement among China Construction Machinery Corporation, Schindler Holding AG and Jardine Schindler (Far East) Holdings, S.A. The agreement contains a list of taxes to which the joint venture “may” be subject and includes a “sales tax.” Loong, \textit{Schindler's Ups and Downs}, \textit{Far E. Econ. Rev.}, July 11, 1980, at 67, 69. This reference is evidently to the consolidated tax, which the Chinese sometimes describe as a sales tax. The reference represents a significant change from an earlier, unapproved version of the joint venture agreement, which had specified that the joint venture would have to pay only the taxes outlined in the agreement. These taxes did not include the consolidated tax or any other name therefor. Agreement on the Establishment of a Joint Venture Elevator Company in the People's Republic of China, para. 8.5, \textit{translated in E. Asian Executive Rep.}, May 15, 1980, at 20. One of the first joint venture agreements approved by China provides for the payment of an “income tax . . . and other taxes in accordance with the provisions of the Tax Laws of the People's Republic of China.” Joint Venture Contract for the Construction and Operation of the Great Wall Hotel of Beijing, ch. II, \textit{translated in E. Asian Executive Rep.}, Aug. 15, 1980, at 22. Presumably, this clause encompasses the imposition of the consolidated tax. At one time, the Chinese had indicated that joint ventures might be exempt from the consolidated tax. \textit{See Asian Bus.}, Mar. 1980, at 28 (comment of the former vice director of the Foreign Investment Control Commission); \textit{Ta Kung Pao}, Mar. 20, 1980, at 19 (comment of a leading economist).
The nature and manner, however, in which the consolidated tax will actually be applied to particular types of foreign transactions and investment remains uncertain because of the previous paucity of foreign economic activity in China and the tax administration’s historically nonassertive attitude toward the collection of taxes. The tax probably will not be levied on foreign firms that only export to China, because the Chinese importer pays the tax in that situation. It is also questionable whether a foreign firm that only exports to China satisfies the jurisdictional requirement of conducting business within China. A recent report indicates that the Chinese were intending to apply the tax to exports from China by joint ventures. This approach would not only be inconsistent with that of other countries, most of which exempt exports from their excise or sales taxes, but also would be outside the existing scope of the CICTA. More consistent with international practice are recent regulations that indicate that foreign companies and their personnel in China are expected to pay the consolidated tax and import duties on office equipment, personal effects and motor vehicles that they import into China.

In other situations, questions remain unanswered concerning the application of the tax to compensation trade agreements and to joint ventures. For example, will technology be treated as a product so that its importation by a joint venture will be subject to tax? Will foreign equipment contributed under a compensation trade agreement be considered as the importation of a taxable good or, as the Chinese sometimes view it, as a loan of the equipment? Will goods brought into China for processing be treated as having been imported and how will the constructive sale rules for processed goods be applied? The Chinese seem to have not yet

---

109. CICTA Regulations, supra note 25, art. 2.
111. See text accompanying note 31 supra.
114. See Cohen & Stevens, supra note 108. See also text accompanying note 41 supra.
115. For a discussion of these rules, see text accompanying notes 69-75 supra.
reached a position on these and similar questions. Foreign investors are attempting to clarify in their contracts and agreements with the Chinese the extent to which the consolidated tax will apply.\textsuperscript{116}

II. \textbf{THE INDUSTRIAL AND COMMERCIAL INCOME TAX}

The Industrial and Commercial Income Tax Act (ICITA)\textsuperscript{117} was adopted in 1950. Except for changes in the rate schedule,\textsuperscript{118} the ICITA has remained essentially unchanged since its adoption. The ICITA consists of twenty-nine broadly phrased articles and a schedule of income tax brackets and rates. A set of regulations, which the authors have not seen, are reported to exist.

\textit{A. Taxpayers and Taxable Activities}

All industrial and commercial profit making enterprises within the boundaries of the People's Republic of China, whether state owned, privately owned, part state owned and part privately owned or cooperative, are subject in principle to the income tax.\textsuperscript{119} The ICITA classifies industrial and commercial enterprises, according to the manner in which they do business, as either permanent industrial and commercial enterprises, temporary commercial enterprises or street peddlers.\textsuperscript{120} The Ministry of Finance may prescribe separate measures for taxing temporary commercial enterprises and street peddlers.\textsuperscript{121} The ICITA provides exemptions

\\textsuperscript{116} The Chinese are aware that United States investors are concerned about the burden of the consolidated tax because it is unlikely to qualify as a creditable income tax for purposes of the United States foreign tax credit. See note 26 supra; text accompanying notes 398-431 infra. The Chinese might be expected to be more flexible in negotiating an agreement concerning the application of the consolidated tax than they would be if they were negotiating an agreement concerning the application of a creditable income tax. The authors understand that the Chinese may be willing to grant a hardship exemption if the consolidated tax would severely affect a joint venture's profitability. A Japanese-Chinese taxi service venture in Canton has reportedly received special treatment under the consolidated tax. This venture is not organized as a limited liability company, but appears to be structured as a partnership. Asian Wall St. J. Weekly, Sept. 1, 1980, at 3, col. 4.


\textsuperscript{118} See notes 132-38 infra and accompanying text.

\textsuperscript{119} ICITA, supra note 117, art. 1. Joint state and private enterprises, which existed at least on paper through the mid-1960s, did not in fact pay the income tax after 1958 but turned all of their profits over to the state in a manner similar to state enterprises. National Taxation, supra note 23, at 67. See A. Donnithorne, supra note 7, at 378; text accompanying note 123 infra; note 197 infra.

\textsuperscript{120} ICITA, supra note 117, art. 2.

\textsuperscript{121} Id. art. 4. See note 125 infra.
from income taxation for state enterprises, poor craftsmen and other entities approved by the Ministry of Finance.\footnote{122}{Id. art. 8. In 1979, tax exemptions were granted to a number of types of enterprises, including those which employ family members of military martyrs or poor persons in urban areas, and factories and workshops run by middle and primary schools. \textit{National Taxation}, \textit{supra} note 23, at 73. See note 38 \textit{supra}.}

State enterprises have been exempt from taxation, presumably because all of the profits of these enterprises have been paid to the state in any event.\footnote{123}{See note 8 \textit{supra}. A few state enterprises are so small as to be outside the state budget. These enterprises have not paid their profits over to the state but instead have been subject to the income tax. Other state enterprises are now being treated in the same manner on an experimental basis. See notes 148-53 \textit{infra} and accompanying text.}\footnote{124}{See text accompanying notes 146-59 \textit{infra}.} The profits of a state enterprise are calculated, however, by following the principles and rules contained in the \textit{ICITA}. As discussed below,\footnote{125}{Under the \textit{ICITA}, the taxpayer is considered to be the business and not the individual or individuals running the business. Individuals running service businesses are not taxable on the profits of the business under the new Individual Income Tax; such profits are not within any of the categories of taxable income. See text accompanying notes 192-201 \textit{infra}. Salaries paid to the individuals running the business are subject to the IIITL. Service businesses will continue to be taxed under the \textit{ICITA}. Presumably, the profits of such businesses cannot be distributed to the individuals running the business, but can only be distributed by way of salaries. The amount of such salaries is limited by the state.} the treatment of state enterprises is being reformed on an experimental basis. The primary enterprises that have actually been taxed under the \textit{ICITA} are the collectives and cooperatives, which are not owned by the state and thus are not exempt as state enterprises, and individually run businesses, which were common before 1966 and are now reemerging.\footnote{126}{In 1966, all licenses allowing individuals to operate private businesses were withdrawn, although some persons continue to operate such businesses clandestinely. \textit{Wall St. J.}, Aug. 15, 1979, at 20, col. 3. Licenses allowing individuals to operate private businesses are again being issued. Individual craftspeople, tailors, transport and repair services, barbers, small restaurants run by individuals and similar enterprises are being actively encouraged in order to supplement the state and collective economies. Beijing had 2,834 private businesses in 1980, up from 394 in 1979. FBIS, \textit{supra} note 1, Feb. 25, 1981, at R1. Altogether, there are now some 500,000 individually run or family run businesses. In 1979, there were only 250,000. \textit{Id.} at L13. Before the Cultural Revolution in 1966, there were reportedly as many as 2,000,000. Graham, \textit{Self-Employed Tailor Makes Economic History in China}, \textit{Asian Wall St. J.}, Aug. 22, 1980, at 3, col. 4. A service business that operates without a license is taxed as a temporary business, see text accompanying note 120 \textit{supra}. The rate of taxation of such a business will be increased if its “income is large.” \textit{Renmin Ribao} (People’s Daily), Jan. 31, 1981, at 1. Commune members who sell their excess agricultural products on the free market will be taxed “according to regulations of the State Council.” \textit{Id.}. The gross receipts of individually run businesses is reportedly less than 1% of that of the state enterprises and collectives. \textit{Ta Kung Pao}, June 19, 1980, at 3. Special tax treatment has been provided to encourage the development of these small scale individual enterprises. See notes 135-38 \textit{infra} and accompanying text.}

\textbf{B. Tax Base}

The definition of "income" contained in the \textit{ICITA} is vague, merely

\begin{itemize}
\item \footnote{122}{Id. art. 8. In 1979, tax exemptions were granted to a number of types of enterprises, including those which employ family members of military martyrs or poor persons in urban areas, and factories and workshops run by middle and primary schools. \textit{National Taxation}, \textit{supra} note 23, at 73. See note 38 \textit{supra}.}
\item \footnote{123}{See note 8 \textit{supra}. A few state enterprises are so small as to be outside the state budget. These enterprises have not paid their profits over to the state but instead have been subject to the income tax. Other state enterprises are now being treated in the same manner on an experimental basis. See notes 148-53 \textit{infra} and accompanying text.}
\item \footnote{124}{See text accompanying notes 146-59 \textit{infra}.}
\item \footnote{125}{Under the \textit{ICITA}, the taxpayer is considered to be the business and not the individual or individuals running the business. Individuals running service businesses are not taxable on the profits of the business under the new Individual Income Tax; such profits are not within any of the categories of taxable income. See text accompanying notes 192-201 \textit{infra}. Salaries paid to the individuals running the business are subject to the IIITL. Service businesses will continue to be taxed under the \textit{ICITA}. Presumably, the profits of such businesses cannot be distributed to the individuals running the business, but can only be distributed by way of salaries. The amount of such salaries is limited by the state.}
\item \footnote{126}{In 1966, all licenses allowing individuals to operate private businesses were withdrawn, although some persons continue to operate such businesses clandestinely. \textit{Wall St. J.}, Aug. 15, 1979, at 20, col. 3. Licenses allowing individuals to operate private businesses are again being issued. Individual craftspeople, tailors, transport and repair services, barbers, small restaurants run by individuals and similar enterprises are being actively encouraged in order to supplement the state and collective economies. Beijing had 2,834 private businesses in 1980, up from 394 in 1979. FBIS, \textit{supra} note 1, Feb. 25, 1981, at R1. Altogether, there are now some 500,000 individually run or family run businesses. In 1979, there were only 250,000. \textit{Id.} at L13. Before the Cultural Revolution in 1966, there were reportedly as many as 2,000,000. Graham, \textit{Self-Employed Tailor Makes Economic History in China}, \textit{Asian Wall St. J.}, Aug. 22, 1980, at 3, col. 4. A service business that operates without a license is taxed as a temporary business, see text accompanying note 120 \textit{supra}. The rate of taxation of such a business will be increased if its “income is large.” \textit{Renmin Ribao} (People’s Daily), Jan. 31, 1981, at 1. Commune members who sell their excess agricultural products on the free market will be taxed “according to regulations of the State Council.” \textit{Id.}. The gross receipts of individually run businesses is reportedly less than 1% of that of the state enterprises and collectives. \textit{Ta Kung Pao}, June 19, 1980, at 3. Special tax treatment has been provided to encourage the development of these small scale individual enterprises. See notes 135-38 \textit{infra} and accompanying text.}
\end{itemize}
defining it as the amount of gross income for each business year\textsuperscript{126} or for the actual period during which business is done, less costs, expenses and losses.\textsuperscript{127} From conversations with tax officials and the examination of tax returns, the authors have obtained the following additional information. First, the ICITA contains no concept of capital gains. A gain or a loss on the sale or exchange of what would commonly be considered a capital asset is treated as ordinary income or as an ordinary loss. Second, the government determines the rate of depreciation applicable to various categories of assets. These categories are broad (such as "buildings" or "machines"), and few in number. The government determines the useful life of depreciable assets and publishes a set of depreciation rates based on straight-line depreciation.\textsuperscript{128} Third, small cooperatives apparently use a first-in, first-out (FIFO) approach to inventory accounting. Large cooperatives use instead a method described as a "weighted average price." The last-in, first-out (LIFO) approach is not used. Fourth, with respect to other deductions, all costs of production, including the consolidated tax, administrative expenses and all other necessary expenses, are deductible.

\section*{C. Tax Rates}

In the initial ICITA rate schedule of 1950, income of all taxpayers was subject to a set of progressive rates ranging from 5.75\% (levied on annual income of less than 300 yuan) to 34.5\% (levied on annual income of 10,000 yuan or more). There were twenty-one tax brackets varying in width from 100 yuan to 2500 yuan.\textsuperscript{129} These rates included surtaxes designated for the localities.\textsuperscript{130} A surtax ranging from 10\% to 100\% was also imposed, which

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{126} The business year is a calendar year. ICITA, \textit{supra} note 117, art. 21.
\item \textsuperscript{127} \textit{Id.} art. 18.
\item \textsuperscript{128} Maruyama states that the average rate of depreciation is around 3.6\% to 4\% and that useful lives average 25 to 30 years. In establishing an asset's useful life, "only the physical durability and usability of a piece of equipment is considered. Little recognition is given to decline in value due to style-obsolescence, surface wear, or other subjective factors." He reports that China has recently raised its depreciation rate by 0.5\%. Maruyama, \textit{supra} note 38, at 14.
\item \textsuperscript{129} ICITA, \textit{supra} note 117, Schedule of Income Tax Brackets and Rates. The rates were applied to the total amount of income and not just to the amount of income in the bracket. For example, annual income of less than 300 yuan was taxed at 5.75\%. If a taxpayer's income was more than 300 yuan but less than 400 yuan, the rate was 6.9\%. This rate applied to the taxpayer's entire income and not just to the amount which exceeded 300 yuan. This approach was later changed so that each rate would apply only to income within the particular bracket. \textit{See} note 134 \textit{infra}. From 1950 to 1957, a 10\% to 40\% reduction in the income tax was available for certain essential businesses.
\item \textsuperscript{130} Zhengwu Yuan Caizheng Jingji Weiyuanhui (Finance and Economic Committee of the Government Administration Council), \textit{Guanyu Shuizhi Rogan Xiuzheng Ji Shixing Rigi de Tonggao} (Announcement Concerning Some Tax System Revisions and Implementation Periods), Dec. 31, 1952, \textit{cited in} ICITA, \textit{supra} note 117, art. 9, para. 2 n.3.
\end{itemize}
\end{footnotesize}
apparently varied from region to region and from enterprise to enterprise.\footnote{131}

In 1963, while keeping the basic structure of the ICITA intact, the State Council modified the rate structure.\footnote{132} Separate progressive rate schedules were established for individual peddlers and service businesses, for industrial collectives and for commercial collectives. Individual peddlers and service businesses were subject to a fourteen bracket rate schedule, ranging from 7\% to 62\%. After taking into account surtaxes, the highest rate could reach 86.8\%.\footnote{133} Industrial collectives were subject to an eight bracket rate schedule ranging from 7\% to 55\%. Commercial collectives were subject to nine rates ranging from 7\% to 60\%.\footnote{134}

As part of China's policy of encouraging service businesses,\footnote{135} the Ministry of Finance recently modified these rates.\footnote{136} The fourteen bracket rate schedule that was applicable to peddlers and service businesses has been replaced with the eight bracket rate schedule applicable to industrial collectives. The nine bracket rate schedule that was applicable to commercial collectives has also been replaced with the eight bracket schedule. Further reductions for peddlers, service businesses and commercial collectives may be given "provided their difficulties have been verified by the provincial [level] authorities."\footnote{137} These changes in rates have been made "pending the adoption of a new income tax law."\footnote{138}

\footnote{131} Some observers have been given the impression that a uniform surtax of 60\% was in effect in 1979. See Cohen & Stevens, supra note 108.

In 1958, the government introduced a special surtax, different from the one referred to in the text, but also ranging from 10\% to 100\%. This special surtax applied to "capitalist industrial and commercial enterprises. . . . Those enterprises which receive especially large profits may be subject to a higher surtax." Rules for Improving the System of Taxation Administration, adopted by the 75th Plenary Session of the State Council, Apr. 11, 1958, approved by the 17th meeting of the Standing Committee of the National People's Congress, June 5, 1958, cited in ICITA, supra note 117, art. 9, para. 2 n.3.

Donnithorne reports that "better-off" individual handicraftsmen and peddlers were subject to a surtax ranging from 10\% to 50\% or more in exceptional cases. A. DONNITHORNE, supra note 7, at 379.

\footnote{132} Guanyu Diaozheng Gongshang Suode Shui Fudan he Gaijin Zhengshou Banfa de Shixing Guiding (Provisional Regulations on Adjusting Industrial and Commercial Tax Burdens and Improving Tax Collection Methods), promulgated by the State Council, Apr. 1963, cited in NATIONAL TAXATION, supra note 23, at 69. The authors have not seen these regulations.

\footnote{133} NATIONAL TAXATION, supra note 23, at 69.

\footnote{134} Id. at 71. The progressive rates applicable to the industrial and commercial collectives apply only to income within each bracket and do not apply to a collective's entire income. NATIONAL TAXATION, supra note 23, at 69-71. See note 129 supra.

\footnote{135} See note 125 supra.


\footnote{137} Id. at L26.

\footnote{138} Id. at L25. The new personal income tax and the new joint venture income tax had
D. Payment and Collection Procedures

The taxable period for the ICITA is the calendar year.\textsuperscript{139} Payments of estimated income tax are made quarterly, and final returns are due no later than March of the following year.\textsuperscript{140}

E. Violations and Penalties

The ICITA provides for a penalty payment of .5\% per day on the amount of tax in arrears.\textsuperscript{141} The Minister of Finance may, if necessary, increase or reduce the penalty.\textsuperscript{142} In the case of tax evasion, a penalty of up to ten times the tax evaded may be imposed.\textsuperscript{143} Serious cases of tax evasion may be referred to the courts.\textsuperscript{144} The ICITA imposes a duty on all persons to report cases of tax evasion, with the incentive that informers are entitled to a reward of 20-30\% of the penalty imposed.\textsuperscript{145}

F. Reform of the Industrial and Commercial Income Tax

Indications exist that major reforms of the industrial and commercial income tax will play an important role in the general economic “readjustment” upon which China is embarking. The thrust of this readjustment is that within the context of a centrally planned economy, China will allow enterprises to exercise increased initiative and to enjoy more autonomy in setting their own policies and practices.\textsuperscript{146} State enterprises are being encouraged to compete with other state enterprises and with the collectives, and are being required to seek interest bearing bank loans for their construction projects instead of receiving allocations of funds from the

---

\textsuperscript{139} See ICITA, supra note 117, art. 21.

\textsuperscript{140} Some persons have been told that final returns are due by March 31, but the law states only that such returns are due no later than March. \textit{Id.} The requirement of a quarterly payment was instituted by a 1956 State Council directive; originally, only one estimated payment was required at the end of the second quarter. Individual service businesses may be required to pay income tax on a monthly basis. \textit{National Taxation}, supra note 23, at 74.

\textsuperscript{141} ICITA, supra note 117, art. 27, as modified by Ministry of Finance (52) Finance Tax Notice No. 594, Aug. 15, 1952.

\textsuperscript{142} ICITA, supra note 117, art. 27.

\textsuperscript{143} \textit{Id.} art. 25. \textit{National Taxation}, supra note 23, at 75, states that the penalty may be up to five times the tax.

\textsuperscript{144} ICITA, supra note 117, art. 25. \textit{See also} text accompanying notes 89-90 supra; notes 258, 264 infra.

\textsuperscript{145} ICITA, supra note 117, art. 26.

\textsuperscript{146} The extent of autonomy and initiative to be granted to enterprises is a subject of debate and experimentation. Recent reports suggest that firm central control is viewed as necessary in issues of pricing and capital construction. \textit{See} \textit{N.Y. Times}, Dec. 10, 1980, \textsection D, at 1, col. 1; \textit{Renmin Ribao} (People's Daily), Dec. 2, 1980, at 1.
They are also expected to bear losses from their operations without receiving an automatic subsidy from the state.

Consistent with this new approach, China is beginning to allow state enterprises to retain part of their profits, instead of turning them all over to the state. In early 1980, the State Council approved a trial set of measures under which state enterprises may retain for their own use a percentage of their profits, varying according to locality and type of enterprise. Subsequently, in accordance with the proposals of key Chinese economic and financial commentators, the Ministry of Finance authorized experiments in various parts of the country under which state industrial enterprises are allowed to keep all of their profits and in return, to pay the income tax to the state. In this manner, China hopes to encourage economic initiative. These experiments have received favorable reports in the Chinese press and they may be reflected in future revisions of the ICITA.

147. This change was approved by the State Council to be effective from the beginning of 1981. Renmin Ribao (People's Daily), Nov. 27, 1980, at 2.
148. See text accompanying note 123 supra.

Reforms are also taking place in the allocation of those profits which are turned over by state enterprises. The provinces are being allowed to keep greater percentages of these revenues than previously. Lecture by Professor Audrey Donnithorne, Australian National University, in Hong Kong (June 26, 1980).

150. See Guo, Wang & Han, supra note 96; Liu Zhicheng, supra note 23; Wang Chengyao, supra note 100.
151. [Finance] Ministry Issues Circular on Tax on State Enterprises, FBIS, supra note 1, Nov. 12, 1980, at L1. This Circular was issued in pursuance of the policy set forth by the State Economic Commission and approved by the State Council. See Report of the State Economic Commission, supra note 101, at 424. Prior to the Ministry's announcement, such experiments had already begun in Guangdong province, Beijing, Sichuan province and Shanghai. Renmin Ribao (People's Daily), Oct. 20, 1980, at 3; id. Oct. 28, 1980, at 2; id. Nov. 17, 1980, at 1; Bowring, Don't Persecute the Pianist, Give Him a Loan, Far E. Econ. Rev., Nov. 21, 1980, at 32. Tax rates seem to vary among and within localities. In Sichuan, for example, rates are reportedly "subject to negotiation," and range from 30% to 50%. Id. at 33. See also Wall St. J., Jan. 9, 1981, at 38, col. 1; note 153 infra. In Shanghai, rates apparently do not exceed 50%. FBIS, supra note 1, Nov. 12, 1980, at L22. Experiments are also being conducted with state commercial enterprises, though these experiments are not authorized by any known directive. In Sichuan, 99 state commercial enterprises are paying progressive tax rates ranging from 65% to 84%. Ta Kung Pao, Sept. 25, 1980, at 6.
152. See note 150 supra. See also Renmin Ribao (People's Daily), Aug. 20, 1980, at 1.
153. The profits of the Shanghai Battery Factory were reported to have doubled from
In addition to the reform of the income tax system, a number of new taxes on enterprises have been proposed. These include a natural resources tax, a fixed assets tax, a land-occupation tax, a construction tax in cities and in towns and an income regulatory tax. Most of these new taxes are being tried on the same state enterprises involved in the income tax experiments described above. Little detailed information is yet available, but if these new taxes are implemented on a wide scale, they hold important implications for foreign businesses.
G. Implications for Foreign Business

The extent to which the ICITA will be applied to foreign businesses remains unclear. Clearly, if the foreign investment takes the form of a Chinese joint venture, it will be subject to the new Joint Venture Income Tax Law. The JVITL, however, does not apply to income accruing to forms of business other than the joint venture. For example, income accruing to the Chinese branch of a foreign corporation or to the wholly owned Chinese subsidiary of a foreign corporation would not be taxed by the JVITL. Unless the JVITL were amended to reach these situations, presumably such income would be taxed by the ICITA. Some support for this view can be found in a recent Chinese treatise on taxation that lists foreign businesses in China as one of the targets of the industrial and commercial income tax. A new set of regulations, however, governing the operations of representative offices in China of foreign businesses simply

“fixed assets” or “utilization surcharge”) is being used in Beijing and Guangdong, see note 151 supra, in Shanghai, see Wen Shi supra note 101, at L21-22, and in Sichuan, see Ta Kung Pao, Sept. 25, 1980, at 6. See also discussion infra. The construction tax is being used in Beijing. Rennin Ribao (People’s Daily), Oct. 28, 1980, at 2.

Recent reports have discussed the experience in Sichuan with some of these new taxes. For example, the fixed assets tax, levied monthly at a rate equal to 2% of the asset’s value, has reportedly achieved considerable success. Gu Zongcheng, supra note 153, at 27. Because the tax increases as the value of the asset increases, one enterprise has complained that the tax discourages improvements in equipment. Sichuan Diyi Mian Fangzhi Yinran Chang ([Report by] Sichuan Number One Cotton Textile Printing and Dying Mill), Zifu Yingkui Shi Qiye Shengchan Fazhan de Juda Tuidongli (Bearing Responsibility for Its Own Profits and Losses Is an Immense Driving Force for the Development of Enterprise’s Production), [1980] Jingji Guanli (ECON. MANAGEMENT) (No. 12) 29, 32. One problem experienced in Sichuan has been the difficulty of separating permissible differences in profitability that are the result of superior management methods from differences that are the result of outside forces. The income regulatory tax is apparently being used to correct for differences that are the result of outside forces. See note 158 supra. See also Report of the State Economic Commission, supra note 101, at 424.

160. A Chinese joint venture is a limited liability company, incorporated in China, having both Chinese and foreign shareholders. Joint Venture Law, supra note 3, art. 1. Before the new joint venture tax was enacted, it was open to question whether joint ventures would be subject to the ICITA. The reference in the ICITA to part state owned, part privately owned industrial enterprises, ICITA, supra note 117, art. 1, was originally directed at a form of ownership common for a period of time after the Chinese revolution of 1949. Although this form of ownership has been phased out, see note 197 infra, the language remains in the ICITA and could be deemed to cover joint ventures. The Chinese, however, have apparently never attempted to tax a joint venture under the ICITA.

161. See text accompanying notes 267-71 infra.

162. Id.

163. See NATIONAL TAXATION, supra note 23, at 68, 88, indicating that foreign businesses would be subject to the 21 bracket rate schedule discussed in note 129 supra and text accompanying notes 129-31, supra. An American lawyer in China was recently told that the profits of a Chinese branch of a United States corporation would be taxable under the ICITA. See also Ta Kung Pao, note 175 infra, indicating that the Chinese branch or subsidiary of a foreign corporation is taxable under the ICITA, but that a new tax law might be drafted to cover these situations.
states that such offices will pay tax according to regulation, without specifying either the ICITA or any other particular tax law. The picture is further complicated because special income tax regimes seem to apply to investment in China’s new special economic or free trade zones.

The revisions of the ICITA and the new taxes under active consideration may offer some insight into the approach that will be adopted regarding the taxation of foreign businesses. It seems reasonable to expect, however, that the ICITA, the JVITL and the tax regimes peculiar to the special economic zones will not develop independently from each other. Consequently, as China gains more experience, some general pattern of taxation of foreign business and investment may be expected to emerge.

III. THE INDIVIDUAL INCOME TAX

Until September 10, 1980, the Chinese were able to claim that, unlike “the capitalist world . . . [and] the Social-imperialist Soviet Union,” China had no individual income tax. The passage of the Individual Income Tax Law (IITL) on September 10, 1980, ended that assertion, although most Chinese will not be affected by the income tax in the short run. Because of the large exemptions provided, only foreigners will initially be subject to income taxation. Over time, however, the tax can be expected to reach an increasing number of Chinese.

The IITL consists of fifteen articles and a schedule of tax rates. Twenty-seven regulations were issued within three months of the passage of the IITL.
A. Taxpayers

The IITL provides different tax treatment for nonresidents and residents. In addition, the treatment of a resident varies depending on the length of his residency. An individual not residing in China or an individual residing in China for less than one year is subject to taxation only on income gained within China.\textsuperscript{172} The regulations provide an exception to this rule for an individual who is a resident\textsuperscript{173} for not more than ninety consecutive days.\textsuperscript{174} Such a person is exempt from taxation on any compensation paid by his employer outside of China for services performed within China.\textsuperscript{175}

A broader assertion of income tax jurisdiction is exercised over an individual who is a resident for one year or more. An individual residing in China for a full 365 days within a taxable year—defined as the calendar year\textsuperscript{176}—is taxable on his income “gained within or outside” of China.\textsuperscript{177} The regulations provide an exception to this rule in the case of an individual who resides in China for one year or more but less than five years.\textsuperscript{178}

\begin{footnotesize}

\textsuperscript{173} IITL, supra note 2, art. 1.

\textsuperscript{174} The use of the term “resident” is confusing since such a person would not appear to be a resident under traditional concepts of residency. See Pomp & Oldman, Tax Measures in Response to the Brain Drain, 20 HARV. INT’L L.J. 1, 28-33 (1979).

\textsuperscript{175} IITL Regulations, supra note 171, art. 5. The term “consecutive” is found in the Chinese text but not in the English translation. By using the term “consecutive,” the Chinese text seems to impose a physical presence standard. United States tax law contains a somewhat similar 90 day physical presence standard for nonresidents. See I.R.C. §§ 861(a)(3)(A), 871-72. Some Americans have been told, however, that temporary absences from China, see note 181 infra and accompanying text, will be ignored for purposes of the 90 day rule. For example, a person entering China with a one-year multiple entry visa who leaves after 88 days but who later returns during the same year may have his entire stay in China aggregated for purposes of the 90 day rule.

\textsuperscript{176} IITL Regulations, supra note 171, art. 2.

\textsuperscript{177} IITL, supra note 2, art. 1; IITL Regulations, supra note 171, art. 2.

\textsuperscript{178} IITL Regulations, supra note 171, art. 3. The English translation, supra note 171,
\end{footnotesize}
While this individual is taxable on his income gained within China, he is taxable on his income gained outside of China only if such income is remitted to China. An individual residing in China for more than five years, however, is taxable on his worldwide income, regardless of whether income gained outside of China is remitted to China. Married individuals are apparently taxed separately on the income gained by each as determined under the preceding rules. There is no provision for the filing of a joint return.

Critical to the determination of an individual's tax liability are the definitions of "remitted," "residence," "gained within" China and "gained without" China. No definition is provided for remitted. Additionally, neither the IITL nor the regulations provide an explicit definition of residence. A regulation does stipulate, however, that in determining whether an individual resides in China for a full 365 days, "no subtractions shall be made of the number of days of temporary absence from Chinese territory within the tax year." This regulation suggests some notion of residence that goes beyond mere physical presence. Presumably, residence is not analogous to the United States concept of domicile, but whether it is similar to United States concepts of residence remains to be determined.

Slightly more guidance is provided by the regulations in determining what income is "gained within China." The following items of income are evidently considered as gained (or sourced) within China: income from work and compensation for services performed within China; dividends and bonuses gained within China; remuneration for staff members sent to work abroad by any Chinese governmental office; royalties for the

which contains numerous inconsistencies and inaccuracies, see notes 174-75 supra; note 233 infra, reads "less than 5 years," but the Chinese text translates as "not exceeding 5 years."

179. IITL Regulations, supra note 171, art. 3. There are no rules provided for determining the character (e.g., wages, dividends, rents) of any income remitted. For example, assume a resident gains outside of China $1000 of dividends, $1000 of rents and $1000 of wages, and remits $500 to China. It is necessary to characterize the $500 because wages are taxed at a different rate from other categories of income, and because the deductions available for computing taxable income are different for each of the categories. See text accompanying notes 211-26 infra.

180. IITL Regulations, supra note 171, art. 3.

181. Id. art. 2. According to Ren Jianxin, temporary absence refers to temporary business or vacation trips out of China. See Ta Kung Pao, supra note 175.

182. See Treas. Reg. § 1.871-2(b) (1960). Some confusion exists over the Chinese definition of "resident" because the term is apparently used in some places in the law to mean physical presence. See notes 173-74 supra and accompanying text. Ren Jianxin has indicated that the standard for residence is, in principle, physical presence. See Ta Kung Pao, supra note 175. The authors suspect, however, that as the Chinese gain more experience they will move away from the strict application of a physical presence standard.

183. IITL Regulations, supra note 171, art. 5. No source rule exists classifying income from the sale of a product manufactured in China but sold abroad.

184. See notes 193-94 infra.

185. See notes 197-98 infra.

186. This rule is apparently an exception to the general approach that income for services is gained within China if the services are performed within China. See text accompanying note 184 supra.
use of property within China;\textsuperscript{187} rent for the lease of property within China;\textsuperscript{188} and interest from within China.\textsuperscript{189} These items of income are considered as gained within China regardless of where the income is actually paid.\textsuperscript{190} In broad outline, these rules are similar to those used by other countries,\textsuperscript{191} but are less detailed and offer little insight into what will be considered as Chinese source income.

\section*{B. Tax Base}

The individual income tax is levied on\textsuperscript{192} wages and salaries,\textsuperscript{193} compensation for personal services,\textsuperscript{194} royalties,\textsuperscript{195} interest,\textsuperscript{196} dividends,\textsuperscript{197} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China;\textsuperscript{8} and interest from within China.

\textsuperscript{187} See note 195 infra.

\textsuperscript{188} See note 199 infra.

\textsuperscript{189} See note 196 infra.

\textsuperscript{190} IITL Regulations, supra note 171, art. 5.

\textsuperscript{191} In the case of compensation for services, some countries emphasize “place of payment” in determining the source of the income. “Place of payment” is rarely considered a relevant factor, however, in determining the source of other types of income. See also text accompanying notes 438-39 infra.

\textsuperscript{192} IITL, supra note 2, art. 2.

\textsuperscript{193} Wages and salaries include bonuses and “year-end extras” received from work in offices, organizations, schools, enterprises, undertakings and other units. IITL Regulations, supra note 171, art. 4, para. 1. The Chinese term translated as “bonus” (jiangjin) would more meaningfully be translated as “incentive payment,” thereby avoiding confusion with the use of “bonus” discussed in note 198 infra.

\textsuperscript{194} Compensation for personal services includes earnings from personal services in designing, installation, drafting, medical treatment, law practice, accounting, consultation, lecturing, news reporting, radio and television broadcasting, contribution to publications, translations, calligraphy and painting, sculpture, cinema, drama and opera, music, dancing, acrobatics, ballad singing, comedy, sports and technical services. IITL Regulations, supra note 171, art. 4, para. 2. A glossary of IITL terminology published in Renmin Ribao (People’s Daily) specifies that compensation for personal services is limited to one time fees for the above services but does not cover, for instance, the income of lawyers or accountants who are paid on a salary basis. Liang ge Suode Shuifa de Mingci Jieshi (Explanation of Terms in the Two Income Tax Laws), Renmin Ribao (People’s Daily), Sept. 4, 1980, at 4. Presumably, the differentiation is similar to that drawn under United States law between independent contractors and employees. Compensation for personal services does not include income from sole proprietorships or businesses in general. See note 125 supra.

\textsuperscript{195} Royalties include income from the provision and transfer of patent rights, copyrights, proprietary technology and “other rights.” IITL Regulations, supra note 171, art. 4, para. 3.

\textsuperscript{196} Interest includes interest received from deposits, loans and securities. IITL Regulations, supra note 171, art. 4, para. 4. Some types of interest are exempt from taxation. See text accompanying note 204 infra.

In 1950, an interest tax was instituted on interest from bank deposits. Beginning in December 1950, the tax was broadened to include interest from bonds, securities and loans to employees. The tax rate was a flat 5%. Excluded were interest from funds invested in “industrial development,” interest on bank loans, interest receipts of less than 5 yuan and interest received by certain nonprofit organizations. Payors of taxable interest withheld and remitted the tax to the government. Payors were entitled to retain 1% of the withheld tax for their own use. The tax on interest was abolished in 1959, following a reduction in interest rates. NATIONAL TAXATION, supra note 23, at 27; Liu Zhicheng, supra note 23, at 23; G.
A number of new corporations in southern China which were formed to promote foreign investment in their regions are apparently planning to issue interest bearing bonds for purchase by Chinese and foreigners. For instance, the Guangdong Trust and Investment Company will issue 10 year bonds to overseas Chinese at an annual interest rate of 8%. Interest will be exempted from income tax “upon the approval of the Guangdong provincial people’s government.”

A similar system is being used by a Shanghai textile mill, whose shares can be purchased by individuals or groups at the end of the year.

For the first time since the 1950s, the State Council has authorized the issuance of treasury bonds. Purchase of the bonds will apparently be nearly compulsory for certain state enterprises, collectives and governmental units, but voluntary for individuals. Annual interest at 4% will be paid in a lump sum at the end of the ten year life of the bonds and will not be compounded. Zhonghua Renmin Gonghe Guo Guoku Juan Tiaoli (Treasury Bond Regulations of the People’s Republic of China), passed by the State Council, Jan. 16, 1981, arts. 2, 4. For a translation and discussion of these regulations, see FBIS, supra note 1, Mar. 9, 1981, at L34. The IITL would presumably tax such income, since the only exemption for interest applies to that received on savings deposits in China’s state banks and credit cooperatives. See note 204 infra and accompanying text. The Ministry of Finance might choose to exempt such interest income. See IITL, supra note 2, art. 4, para. 9.

197. IITL Regulations, supra note 171, art. 4, para. 4. Some types of dividends are exempt. See text accompanying notes 206-07 infra.

Unlike interest income, which was taxed from 1950 to 1959, see note 196 supra, dividend income is apparently being taxed for the first time, notwithstanding that dividends were a source of income for former Chinese capitalists. In 1955, the government began a large-scale nationalization drive to convert all private enterprises into joint public-private corporations whose stock would be held both by individuals and by the government. Dividends, limited in amount, were paid on the shares held by individuals. See A. Eckstein, supra note 8, at 76. Donnithorne states that in the mid-1960s, approximately 250,000 former capitalists were receiving dividends. These payments were supposed to terminate in 1962 but were extended for three more years, after which time their continuance was to be reconsidered. A. Donnithorne, supra note 7, at 147-48. These payments were discontinued in about 1966 at the start of the Cultural Revolution, when the joint public-private enterprises ceased to exist. See A. Eckstein, supra note 8, at 76.

In contemporary China, a number of sources of dividend income might be possible. An article in China’s official press advocated the formal establishment of a system of dividend paying stock in order to promote economic development. Chang Chun, Jigu Touzi Da Ke Shixing (Investment by the Use of Stocks Is Extremely Workable), Renmin Ribao (People’s Daily), Nov. 2, 1980, at 3, translated as Capitalist China, N.Y. Times, Nov. 9, 1980, § D, at 3. A factory in Harbin has already issued shares to its workers to help solve a cash flow problem. Dividends are to be paid on the shares, which are valued at 100 yuan, and may be purchased by individuals or groups at the end of the year. Ta Kung Pao, July 15, 1980, at 1. A similar system is being used by a Shanghai textile mill, whose shares can be purchased only by workers and carry a fixed dividend of 5.4% per year. Although this rate is the same as that paid by banks on savings accounts, the textile mill will pay an extraordinary dividend at the end of the year if a profit is made. Asian Wall St. J. Weekly, Jan. 5, 1981, at 2, col. 1.

“Investment service companies,” perhaps similar to American mutual funds, are being formed to invest in other enterprises and will issue their own shares. Renmin Ribao (People’s Daily), Oct. 25, 1980, at 2. In addition, different methods of individual equity participation in enterprises are being devised—joint venture enterprises that have individuals as stockholders, collectives in which employees own dividend paying stock and “joint agricultural, industrial, and commercial enterprise companies” run by communes with shares held by commune members. FBIS, supra note 1, Feb. 25, 1981, at L11-13. Some of these dividends will be exempt from taxation. See notes 206-07 infra and accompanying text.
bonuses and rental income. The Ministry of Finance may classify other items of income as taxable. Income paid in kind or in marketable securities is taxable at the asset's fair market value when acquired by the taxpayer.

Exemptions are provided for prizes and awards for scientific, technological or cultural achievements; interest on savings deposits in China's state banks and credit cooperatives; welfare benefits, survivors' pensions and relief payments; insurance indemnities; military severance pay; retirement or severance pay for officials and employees; salaries of diplomatic personnel; income exempted from tax by conventions or agreements to which China is a party; dividends and bonuses derived from joint ventures and from urban and rural cooperatives; and dividends from investment by individuals in "construction [investment] companies" in China, if such dividends are not higher than the interest on savings deposits in state banks or credit cooperatives and if such companies do not pay any bonuses. The Ministry of Finance has the power to exempt other income from taxation.

---

198. "Bonuses" refers to bonuses "from investment," IITL Regulations, supra note 171, art. 4, para. 4, and seems to cover a distribution to investors that is not based on shares of stock, such as a distribution to members of a collective. The Chinese term for bonus, "hongli," is different from that discussed in note 193 supra.

199. Rental income includes income from the rental of houses, warehouses, machinery and equipment, motor vehicles and boats and other kinds of property. IITL Regulations, supra note 171, art. 4, para. 5.

200. Id. art. 4, para. 6. Income from the sale of property is not mentioned in either the IITL or its regulations. Income from the sale of at least one kind of property—agricultural products—is taxable under other provisions. See note 125 supra.

201. IITL Regulations, supra note 171, art. 7.

202. IITL, supra note 2, art. 4.

203. Prizes and awards for scientific, technological or cultural achievements include prizes and awards given to individuals by the Chinese government or by Chinese or foreign scientific, technological or cultural organizations for inventions or creations in the fields of science, technology or culture. IITL Regulations, supra note 171, art. 8. Prizes and awards by foreign governments are not included. This omission may be unintentional since foreign organizations are included and it is not obvious why foreign governments should be excluded.

204. The exemption includes interest on savings deposits in RMB (RMB is the abbreviation for renminbi, the Chinese currency; the yuan is a unit of Chinese currency) and in foreign currency. Also exempted is interest on savings deposits in "other banks entrusted by the State banks." Id. art. 9. The term "entrusted bank" is sometimes used to refer to banks that act as the Bank of China's agents, of which there are now 960. CHINA ECON. NEWS, Jan. 12, 1981, at 9. It is not clear whether the regulations are using "entrusted bank" in this context.

205. These salaries include the salaries of diplomats in foreign embassies, consulates and other persons enjoying the "same treatment" as diplomats. The exemption for salaries earned by "other persons" in foreign embassies and consulates in China is to be kept at the same level as the tax exemption granted by the foreign country for employees of similar status in Chinese embassies and consulates located in that foreign country. IITL Regulations, supra note 171, art. 10.

206. See notes 197-98 supra.

207. IITL Regulations, supra note 171, art. 5, para. 2. See note 197 supra.

208. IITL Regulations, supra note 171, art. 9.

209. IITL, supra note 2, art. 4, para. 9. Amounts paid by a foreign firm to an employee...
In calculating taxable income, certain statutory allowances are provided against specific categories of income. These deductions are automatically allowed, regardless of whether actual expenses are greater than or less than the statutory amount. No other deductions are allowed.\footnote{210}

In the case of wages and salaries, a monthly deduction of 800 yuan is allowed.\footnote{211} In the case of compensation for personal services, royalties or rents from the lease of property, the deduction is related to the amount of income\footnote{212} and is only available to residents of China.\footnote{213} A monthly deduction of 800 yuan is allowed if the amount "in a single payment" is less than 4000 yuan. If "a single payment" is greater than 4000 yuan, the deduction is equal to 20\% of the payment.\footnote{214} The regulations define a single payment as "income gained on one single occasion or income from the performance of one task or matter."\footnote{215} In order to prevent taxpayers from maximizing the benefit of the deduction by receiving such income in two or more payments,\footnote{216} the regulations provide that "succeeding income from the same item that cannot be obviously divided into separate payments . . . is combined and counted" as one payment if it is received within the same month.\footnote{217} If income is gained by two or more persons in working in China as an allowance for living expenses, business expenses or business trips are exempt from taxation. Beijing Tax Bureau, Questions and Answers on the Individual Income Tax 3, Dec. 1980 (on file with the authors) [hereinafter cited as Tax Bureau Release]. It is unclear whether the Chinese will limit the amount of such exemptions, especially with respect to allowances for living expenses.

\footnote{210} An official in the Ministry of Finance was reported to have mentioned the possibility of a personal allowance being introduced. Loong, \textit{China Leaves Some Grey Areas}, \textit{FARECON. REV.}, Sept. 26, 1980, at 108.

An American lawyer was recently told in China that some flexibility might exist in allowing a deduction for expenses in excess of the statutory limits.

\footnote{211} IITL, supra note 2, art. 5, para. 1. The deduction is granted on a monthly basis because income is taxed monthly. \textit{See} text accompanying notes 222-38 infra.

\footnote{212} IITL, supra note 2, art. 5, para. 2.

\footnote{213} IITL Regulations, supra note 171, art. 11.

\footnote{214} IITL, supra note 2, art. 5. Any deductions not used against one category of income cannot be used against any other category of income. \textit{See} text accompanying notes 229-31 infra.

\footnote{215} IITL Regulations, supra note 171, art. 12.

\footnote{216} For example, a taxpayer receiving a single payment within the month of 1600 yuan would be entitled to an 800 yuan deduction, leaving 800 yuan of taxable income (1600 - 800 = 800). If, however, the payment of 1600 yuan were divided into two payments within the same month of 800 yuan each, and if the taxpayer were successful in characterizing each 800 yuan payment as a "single payment," then he would be entitled to claim an 800 yuan deduction against each of the two payments and thereby reduce his taxable income to zero.

\footnote{217} IITL Regulations, supra note 171, art. 12. The Chinese text reads "may be" combined.

Nothing in the regulation seems to anticipate that a taxpayer might divide a single payment into two payments, each received in a different month. For example, the taxpayer in note 216 supra, instead of receiving the 1600 yuan in one month, might divide it into two payments of 800 yuan, each received in a different month. For reasons that are not apparent, the regulation allows the payments to be combined only if they are received within the same month. Wage earners presumably have a similar incentive to arrange their payments in order to maximize the benefits of their monthly 800 yuan deduction.
collaboration, each person is entitled to take the full amount of any allowable deduction.\textsuperscript{218} No deductions are allowed against interest, dividends, bonuses\textsuperscript{219} or "other kinds of income."\textsuperscript{220} The reference to "other kinds of income" presumably would reach income that might be declared taxable in the future by the Ministry of Finance.\textsuperscript{221}

C. Tax Rates

China has adopted two different rate structures—one for income from wages and salaries and one for all other income. Wages and salaries are taxed under a seven bracket progressive rate schedule.\textsuperscript{222} The schedule is based on a taxpayer’s monthly income in excess of the 800 yuan deduction available to all wage and salary earners.\textsuperscript{223} This 800 yuan deduction is built into the rate schedule through a zero bracket for monthly income under 800 yuan.\textsuperscript{224} Monthly income between 801 yuan and 1500 yuan is taxed at 5%; monthly income between 1501 yuan and 3000 yuan is taxed at 10%. After 3000 yuan, the marginal tax rate increases by ten percentage points until it reaches 40% on income between 9001 yuan and 12,000 yuan. Income above 12,000 yuan is taxed at 45%.\textsuperscript{225}

Compensation for personal services, royalties, interest, dividends, bonuses, rents and "all other kinds of income" are taxed at a flat rate of 20%.\textsuperscript{226} A decision to levy a 20% flat tax on these nonwage sources of income may have been the result of two considerations.

First, having decided to tax wages and salaries on a monthly basis under a progressive rate schedule, the Chinese could not simply extend these rates to other types of income which might accrue over several months. For example, compensation received in one month for personal services might reflect activities of the taxpayer which extended over several months. No logically compelling reason exists for taxing such compensation at the same rates applicable to wage earners whose monthly compensation is presumably received for services that are rendered within the month. This problem—the selection of a rate appropriate for taxing income accruing over more than one taxable period—must be faced by all

\textsuperscript{218} IITL Regulations, \textit{supra} note 171, art. 13.
\textsuperscript{219} For a definition of bonus, see note 198 \textit{supra}.
\textsuperscript{220} IITL, \textit{supra} note 2, art. 5, para. 3.
\textsuperscript{221} See note 200 \textit{supra} and accompanying text.
\textsuperscript{222} IITL, \textit{supra} note 2, art. 3, para. 1; \textit{id.} Schedule of Individual Income Tax Rates.
\textsuperscript{223} See text accompanying note 211 \textit{supra}.
\textsuperscript{224} From the English text it is unclear whether the 800 yuan zero bracket is in addition to the monthly 800 yuan deduction available to all wage and salary earners. The authors have learned, however, that the 800 yuan zero bracket amount is the statutory embodiment of the 800 yuan deduction that is available to all wage and salary earners. In other words, only the first 800 yuan—not the first 1600 yuan—is exempt from taxation. Since the average wage in China is approximately 50 yuan (and even the Chairman of the Chinese Communist Party reportedly earns no more than 400 yuan), the 800 yuan exemption removes most Chinese wage earners from the tax. See note 170 \textit{supra}.
\textsuperscript{225} IITL, \textit{supra} note 2, art. 3, para. 1; \textit{id.} Schedule of Individual Income Tax Rates.
\textsuperscript{226} IITL, \textit{supra} note 2, art. 3, para. 2.
countries; the problem is compounded in China, however, because wages are taxed on a monthly basis rather than on the basis of a longer period of time, such as a year.

Second, administrative considerations may have pointed in the direction of a flat rate for taxing nonwage income. A flat rate greatly facilitates the collection process because it can be easily implemented through withholding procedures. These procedures are facilitated by the system of statutory deductions which the IITL adopts. For example, a withholding table can be designed to incorporate any statutory deduction allowable against the nonwage income being paid. The amount of tax withheld by the payor would therefore equal the recipient's ultimate tax liability on that income, eliminating the need for a taxpayer to file a return. Other explanations for the selection of a flat tax, however, may suggest themselves as more is learned about the nature of nonwage income in China and the manner in which it is paid.

Taxpayers who receive two or more categories of taxable income compute their tax separately for each category. In other words, for each category, the taxpayer computes the amount of his gross income and then subtracts any allowable deductions. Apparently, this rule is meant to prevent a deduction allowable against income from one category from being used against income from another category, thereby reducing the rate of tax on the latter category of income. For example, suppose a resident were to receive 400 yuan of rental income and 400 yuan of interest income. The taxpayer would be entitled to an 800 yuan deduction against his rental income. If both categories of income were aggregated, the taxpayer would be able to use the excess of the 800 yuan deduction over his 400 yuan rental income to shield the 400 yuan of interest income, notwithstanding that no deduction is allowed against interest income.

Individuals residing in China for one year or more compute the tax on their income gained outside of China separately from the tax on their income "earned" within China. The application of this rule to wage

---

227. For one of the solutions adopted by the United States, income-averaging, see I.R.C. §§ 1301-04.
228. This result cannot be achieved easily under a progressive rate structure if a taxpayer receives income from more than one payor. In order to withhold the proper amount of tax under such circumstances, each payor would have to know the amount of income paid by the others so that the taxpayer's ultimate liability could be calculated. The payors would then have to coordinate the amount of taxes each withheld.
229. IITL Regulations, supra note 171, art. 6.
230. IITL, supra note 2, art. 5, para. 2.
231. Id. art. 5, para. 3.
232. See notes 172-82 supra and accompanying text.
233. The same Chinese term (qude) is variously translated as "earned," "gained" or "derived" in the IITL and the regulations. See IITL, supra note 2, art. 1; IITL Regulations, supra note 171, arts. 3, 5, 11, 12, 16.
234. IITL Regulations, supra note 171, art. 16, para. 1. See text accompanying notes 177-80 supra; note 179 supra.
income received during the same month from both outside and within China needs to be clarified. Will the wage earner receive only one 800 yuan deduction against his wage income, or will he be able to claim one 800 yuan deduction against his foreign wage income and one 800 yuan deduction against his Chinese wage income? Similarly, will both sources of income be aggregated for purposes of applying the progressive rate schedule, or will the taxpayer calculate the tax separately for each source of income, thus obtaining the benefits of the lower rate brackets twice? Will the tax due on the foreign wages be calculated on a monthly basis, even though the tax is paid on an annual basis?

After calculating the Chinese tax under the rules discussed above a taxpayer can claim as a credit against the Chinese tax any income tax paid to a foreign country on income "earned abroad." The Chinese foreign tax credit is discussed below.

D. Payment and Collection Procedures

Since November 4, 1980, any representative of a foreign business or any foreigner living in China has been required to file an Individual Income Tax Registration Form with the newly formed Foreign Tax Collection Office (FTCO) of the Beijing Municipal Tax Bureau. The form asks for the registrant's name, sex, age, nationality, employer, date of arrival and the period of his planned stay. It also requires a listing of all types of income received by the registrant, divided into the same categories as in the IITL, with a space provided for "other income." Separate columns are provided for income gained within and outside of China. Sometime after registration, the FTCO informs a registrant whether he is subject to taxation.

A foreign individual taxable on income gained within China, who is not

---

235. See text accompanying note 211 supra.
236. See text accompanying note 247 infra.
237. IITL Regulations, supra note 171, art. 16, para. 2. The taxpayer must present a receipt indicating that the tax has been paid.
238. See Section VI, B infra.
239. The establishment of this office and the deadline for registration were announced in Chinese in a notice in the Beijing Daily. Bei'ing Ribao (Beijing Daily), Oct. 21, 1980, at 4. Americans in Beijing were informed of the notice by the United States Embassy. Similar offices are apparently being established in other Chinese cities that have a substantial number of foreign residents. Persons holding a visa for a period of less than 90 days do not have to register with the FTCO. Tax Bureau Release, supra note 209.
240. The form indicates that a person must cancel his registration if he "leaves China," but it is unclear whether "leaves China" refers to any departure or only to a departure without intent to return, at least in the near future.
241. Wages and salaries are to be listed on a monthly basis. No particular period is specified for other income, although such income is evidently taxed on a monthly basis. See text accompanying notes 211-31 supra; Tax Bureau Release, supra note 209.
242. Recent returnees from China indicate that as of December 1980, the FTCO was not ready to issue any decisions. Presumably the promulgation of the IITL Regulations, supra note 171, will facilitate the FTCO's duties.
employed by a Chinese organization, must submit a tax declaration form to the FTCO within seven days from the end of each month. Within the seven days, he must also submit the tax payment form issued by the FTCO, along with the tax owed, to any branch of the People's Bank of China. A resident who is taxable on income gained outside of China has thirty days from the end of the year in which to submit a tax return and to pay the tax.

Chinese organizations employing individuals (including foreigners) who are taxable on their wages and salaries act as withholding agents, filing the requisite forms and paying the tax within the seven day period. Withholding agents are entitled to retain a 1% commission of the tax withheld. The extent to which Chinese payors other than employers act as withholding agents is unclear.

In the case of "special circumstances," a taxpayer or withholding agent may apply for an extension of any of the above time periods. An application for an extension must be made to the local tax authorities within the time period in question.

Income is denominated and tax is paid in renminbi (RMB), tax being

243. In addition to name, nationality and related information, the form requires the taxpayer to list each item of income, its amount, the period in which it was received, the amount of any deductions, the tax rate, the amount of tax for each item and the aggregate amount of tax.

244. IITL, supra note 2, art. 7.


246. See text accompanying notes 177-80 supra.

247. See text accompanying notes 177-80 supra.

248. Id. arts. 6, 7; IITL Regulations, supra note 171, arts. 14, 20.

249. IITL Regulations, supra note 171, art. 20. The practice of allowing a withholding agent to keep a 1% commission was used in the collection of the 5% tax on interest, levied during the 1950s. See note 196 supra.

250. Only one provision of the IITL defines who is a withholding agent. "The income earner shall be the party responsible for paying the tax and the paying unit shall be the withholding agent." IITL, supra note 2, art. 6. The same provision states, however, that "[t]axpayers not covered by withholding are required personally to file declarations of their income and pay tax themselves," implying that not every payor is a withholding agent. It is unclear whether Chinese payors of only wages and salaries act as withholding agents or whether Chinese payors of other categories of income also act as withholding agents. Furthermore, although no distinction is drawn between foreign paying units and Chinese paying units, apparently foreign organizations are not withholding agents because foreign individuals employed by foreign organizations are responsible for the payment of their own taxes on wages and salaries. See text accompanying notes 243-45 supra. A question can also be raised whether the use of the term "paying unit" suggests that individuals are not to act as withholding agents.

As the discussion in the text accompanying notes 243-50 supra indicates, not all income will be subject to withholding. A taxpayer receiving income that has not been subject to withholding will presumably follow the procedure outlined in the text accompanying notes 243-47 supra.

251. IITL Regulations, supra note 171, art. 15.
payable in either currency or checks.\textsuperscript{252} Income earned in foreign currency is converted at the exchange rate quoted by the newly established State General Administration of Exchange Control on the day that the taxes are paid.\textsuperscript{253} Individuals subject to taxation must pay any tax owed at least seven days before leaving China.\textsuperscript{254}


\section*{E. Violations and Penalties}

A taxpayer is required to "report according to the facts and provide all relevant information."\textsuperscript{255} An individual who violates this stricture may be fined up to 500 yuan.\textsuperscript{256} Tax evasion or a refusal to pay tax may subject the offender to a penalty of up to five times the unpaid tax.\textsuperscript{257} Cases of "gross violation" are to be handled by the local people's court "according to the law."\textsuperscript{258} Notice must be served in any case in which a penalty is imposed.\textsuperscript{259}

Late payments are subject to a daily fine of 0.5\% of the overdue tax beginning from the first day of arrears.\textsuperscript{260} A fine of up to 500 yuan may be imposed for the late filing of a return.\textsuperscript{261}

A taxpayer who disagrees with the tax authorities must first pay the tax and then apply to "higher-level tax authorities" for relief.\textsuperscript{262} These authorities have to render their decision within three months of receiving the application.\textsuperscript{263} A taxpayer who disagrees with the decision of the higher-level tax authorities can bring the case before the local people's court.\textsuperscript{264}

\begin{thebibliography}{99}
\bibitem{252} Embassy Communication, \textit{supra} note 245. Foreigners paying in cash will presumably use the "foreign currency certificates," denominated in RMB, which banks and hotel cashiers have been issuing in exchange for foreign currency since April 1980.
\bibitem{253} \textit{IITL}, \textit{supra} note 2, art. 8; \textit{IITL Regulations}, \textit{supra} note 171, art. 17.
\bibitem{254} \textit{IITL Regulations}, \textit{supra} note 171, art. 18.
\bibitem{255} \textit{IITL}, \textit{supra} note 2, art. 9.
\bibitem{256} \textit{IITL Regulations}, \textit{supra} note 171, art. 21.
\bibitem{257} \textit{IITL}, \textit{supra} note 2, art. 12.
\bibitem{258} \textit{Id.; see} note 89 \textit{supra}. The Chinese have indicated their firm intention to apply the new criminal code to foreigners. \textit{See} Cohen & Gelatt, \textit{China: The Foreigner and the New Criminal Code}, Asian Wall St. J., Feb. 7, 1980, at 4, col. 3. A number of Hong Kong Chinese have already been sentenced under the code for serious customs violations.
\bibitem{259} \textit{IITL Regulations}, \textit{supra} note 171, art. 23.
\bibitem{260} \textit{IITL}, \textit{supra} note 2, art. 11.
\bibitem{261} \textit{IITL Regulations}, \textit{supra} note 171, art. 22.
\bibitem{262} \textit{IITL}, \textit{supra} note 2, art. 13.
\bibitem{263} \textit{IITL Regulations}, \textit{supra} note 171, art. 24.
\bibitem{264} \textit{IITL}, \textit{supra} note 2, art. 13. In the past it would have been unthinkable for either a Chinese or a foreigner to sue a government agency, such as the tax administration. Recently, however, the Chinese press has indicated that such cases have occurred. In 1980, 75 citizens' suits against government authorities, primarily on housing matters, were heard in the civil chamber of a Tianjin court. The results of these suits were not disclosed. \textit{Renmin Ribao} (People's Daily), Dec. 11, 1980, at 1. In a recent tax case, a factory in Sichuan refused to pay the assessed tax and brought suit against the local tax bureau in the economic chamber of the Chungqing Intermediate Court. The judge, in a typical example of in-court conciliation or "persuasion-education," "criticised the petitioner's mistaken conduct of violation of tax laws and regulations and harm to the state's interests, and pointed out that the tax
IV. THE JOINT VENTURE INCOME TAX

The Joint Venture Income Tax Law\textsuperscript{265} was passed on September 10, 1980. The JVITL consists of eighteen short articles. Three months after the JVITL was adopted, thirty-five regulations were issued.\textsuperscript{266} Although many ambiguities, lacunae and details need to be resolved, the broad structure of the JVITL appears to comport with generally accepted concepts of income taxation.

A. Taxpayers

Under the Joint Venture Law of July 1979, a joint venture with Chinese and foreign investment must take the form of a limited liability company incorporated in China.\textsuperscript{267} This Chinese corporation (the joint venture) is subject to the JVITL on its worldwide income.\textsuperscript{268} Branches of the joint venture, whether within or without China, are also subject to the tax.\textsuperscript{269} Any tax due on a branch’s\textsuperscript{270} income is paid by the head office in China.\textsuperscript{271}

The JVITL applies to all joint ventures for which contracts were approved on or after September 10, 1980.\textsuperscript{272} Joint venture contracts approved before September 10, 1980, that contain tax rates or incentives
different from those in the JVITL\textsuperscript{273} are subject to special transitional rules. These joint ventures are allowed to enjoy the benefits of any tax rates and incentives that were agreed upon for the initial period of the venture.\textsuperscript{274} Subsequent extensions\textsuperscript{275} of these joint ventures, however, will be subject to the JVITL. If a joint venture contract approved prior to September 10, 1980, specifies a tax rate that is higher than the rate contained in the JVITL, the rate may be lowered to the JVITL rate as of January 1, 1981.\textsuperscript{276} Presumably other provisions of the JVITL, such as the rules on calculating taxable income and on payment and collection procedures, will apply immediately to all joint ventures regardless of when they were approved.

B. Tax Base

The joint venture income tax is imposed on a joint venture's worldwide income derived from "production, business, and other sources."\textsuperscript{277} Presumably income from sources outside of China is taxable regardless of whether or not a branch of the venture exists abroad. "Production and business income" includes income from production and business operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, tourism, food and drink, service and other trades.\textsuperscript{278} "Income from other sources" includes dividends,\textsuperscript{279} bonuses,\textsuperscript{280} interest, royalties, rental income "and

---

\textsuperscript{273} The JVITL tax rate is 33\%, including a local surtax. See text accompanying notes 322-24 infra.

\textsuperscript{274} Prior to the issuance of the Notice of the Ministry of Finance, supra note 272, considerable uncertainty had existed on this point. In the case of the Jardine Schindler contract, see note 106 supra, the Chinese had reportedly suggested raising the tax to the JVITL rate of 33\% from the 31.5\% provided in the contract. Asian Wall St. J. Weekly, Nov. 24, 1980, at 2, col. 1.

\textsuperscript{275} The Joint Venture Law, supra note 3, art. 12, allows for the extension of a joint venture upon agreement by the parties with the approval of the Foreign Investment Commission. An application for extension must be submitted six months before the expiration of the joint venture term.

\textsuperscript{276} Notice of the Ministry of Finance, supra note 272.

\textsuperscript{277} JVITL, supra note 1, art. 1.

\textsuperscript{278} JVITL Regulations, supra note 107, art. 2.

\textsuperscript{279} No exemption or deduction is provided for dividends received from another Chinese joint venture. In other words, there is no exemption or deduction for intercorporate dividends. For the United States approach, see I.R.C. § 243. Individuals are exempt on dividends received from a joint venture. See text accompanying note 207 supra.

\textsuperscript{280} Bonuses are not defined under the JVITL. For the definition of bonuses under the IITL, see note 198 supra.
other sources."\textsuperscript{281} As is true under the ICITA, there is apparently no capital gains concept;\textsuperscript{282} income from the sale of fixed assets simply enters the year’s loss and gain account.\textsuperscript{283} Taxable income is defined as “net income”\textsuperscript{284} after deduction of costs, expenses and losses.\textsuperscript{285} Taxable income is computed under accrual basis accounting.\textsuperscript{286} Losses may be carried forward for five years.\textsuperscript{287} The taxable year is a calendar year.\textsuperscript{288}

Detailed rules are provided for the depreciation of fixed assets and for the amortization of intangible assets.\textsuperscript{289} These rules follow generally accepted principles of depreciation. Fixed assets include houses, buildings, machinery or other mechanical apparatus, means of transport and other equipment used for production and having a useful life of more than one year. Assets worth less than 500 yuan which have a “short” useful life may be deducted as an expense, rather than depreciated.\textsuperscript{290}

In general, fixed assets are depreciated on an annual basis using the straight-line method of depreciation.\textsuperscript{291} If special circumstances exist, however, a joint venture can apply to the local tax authorities for permission to use accelerated depreciation. This application is “relayed level by level” to the Ministry of Finance for approval,\textsuperscript{292} language that suggests that these other levels might have some input into the final decision.

Fixed assets are depreciated on the basis of their “original price” (cost) less residual value.\textsuperscript{293} In the case of assets that are purchased, original price equals the purchase price plus transportation, installation and other related expenses.\textsuperscript{294} For fixed assets manufactured or constructed by the joint venture, original price equals the expenditures incurred during the course of manufacture or construction.\textsuperscript{295} For fixed assets that are contributed to a joint venture, the original price equals the price agreed upon by

\begin{itemize}
\item \textsuperscript{281} JVITL, supra note 1, art. 1; JVITL Regulations, supra note 107, art. 2.
\item \textsuperscript{282} See text accompanying note 128 supra.
\item \textsuperscript{283} JVITL Regulations, supra note 107, art. 15.
\item \textsuperscript{284} The Chinese text of the JVITL, supra note 1, art. 2, uses the term “ju’ê” (amount remaining), which is a different term from the more standard legal term used for “net profit”—jing li'ran—in the Joint Venture Law, supra note 3, art. 7. See text accompanying notes 320-21 infra.
\item \textsuperscript{285} JVITL, supra note 1, art. 2.
\item \textsuperscript{286} JVITL Regulations, supra note 107, art. 23.
\item \textsuperscript{287} JVITL, supra note 1, art 7. There is no provision for the carry back of losses.
\item \textsuperscript{288} JVITL Regulations, supra note 107, art. 7.
\item \textsuperscript{289} Id. arts. 10, 13, 16, 17.
\item \textsuperscript{290} Id. art. 10.
\item \textsuperscript{291} Id. art. 12.
\item \textsuperscript{292} Id. art. 13.
\item \textsuperscript{293} Id. art. 12. The regulations set forth the general rule that residual value is equal to 10% of the original price. Upon approval by the local tax authorities, however, a residual value of less than 10% can be used. \textit{Id}. 
\item \textsuperscript{294} Id. art. 11.
\item \textsuperscript{295} Id.
the participants in the joint venture at the time of the investment.\textsuperscript{296}

A minimum useful life is prescribed for three broad classes of fixed assets—twenty years for houses and buildings; ten years for trains, ships, machines, equipment and other facilities used for production; and five years for electronic equipment and means of transportation other than trains and ships.\textsuperscript{297} The regulations do not specify what useful life is to apply for assets that might not fit easily within these three classes.

The regulations provide for the amortization of intangible assets, which include know-how, patents, trademarks, the right to use a site and copyrights.\textsuperscript{298} Goodwill is not mentioned. Intangible assets are amortized over the term provided for their use; if no such term is provided, they are amortized over a ten year period.\textsuperscript{299} Expenses incurred in starting up a joint venture are amortized once the venture starts its operations.\textsuperscript{300} The amount of amortization cannot exceed 20\% per year.\textsuperscript{301}

A detailed list of allowable costs, expenses or losses is not set forth in either the law or the regulations. The regulations do list, however, the following items that are not allowable in computing taxable income: \textsuperscript{302} (1) expenditures on the purchase or construction of machinery, equipment, buildings, facilities and other fixed assets; \textsuperscript{303} (2) expenditures on the purchase of intangible assets; \textsuperscript{304} (3) interest on capital; (4) income tax payments and local surtax payments; (5) penalties for illegal operations and losses in the form of property confiscation; (6) overdue tax payments and tax penalties; (7) the portion of losses from windstorms, floods, fire and other disasters for which there is insurance indemnification; (8) donations and contributions other than those for public welfare and relief purposes; (9) expenditures arising from the increase in value of fixed assets as a result of technical reform; and (10) business-related entertainment expenses that exceed either 0.3\% of total sales income or 1\% of total operational income.\textsuperscript{305} Of all these provisions, the denial of a deduction for "interest on capital" has proven to be the most controversial and widely discussed item within the Hong Kong business community.\textsuperscript{306} Neither the definition of

\begin{itemize}
  \item \textsuperscript{296} Id.
  \item \textsuperscript{297} Id. art. 13.
  \item \textsuperscript{298} Id. art. 16.
  \item \textsuperscript{299} Id.
  \item \textsuperscript{300} Id. art. 12.
  \item \textsuperscript{301} Id.
  \item \textsuperscript{302} Id. arts. 9, 14.
  \item \textsuperscript{303} Presumably, this restriction means that such expenditures cannot be deducted in the year incurred but are subject to the rules on depreciation. This statutory pattern is similar to that found in the Internal Revenue Code. \textit{See} I.R.C. \S\S\ 167, 263.
  \item \textsuperscript{304} Presumably these expenditures are subject to the rules on amortization.
  \item \textsuperscript{305} It is unclear whether the alternative test is applied to every enterprise or whether certain types of enterprises use the 0.3\% test while others use the 1\% test. In no event, however, can a joint venture deduct entertainment expenses that are not "relevant to production and operation." J VITL Regulations, \textit{supra} note 107, art 9.
  \item \textsuperscript{306} \textit{Ta Kung Pao}, Dec. 25, 1980, at 16.
\end{itemize}
“interest on capital” nor the scope of the provision is clear. At least three possible interpretations are available. Under the broadest interpretation, the provision may be read to deny a deduction for all interest payments of any kind. Under a second, and more narrow, interpretation, the provision may be read to deny a deduction for interest paid on loans from shareholders. Under this interpretation, loans from shareholders would be treated for tax purposes as an equity investment: dividends and interest paid to shareholders would be treated identically, with no deduction being allowed for either. Under a third interpretation, the provision may be read to require that interest incurred on money borrowed to purchase fixed assets must be capitalized as a part of the cost of the asset and deducted over the useful life of the asset. If the life of a loan is shorter than the useful life of the asset, a requirement that the interest be capitalized rather than deducted as an expense will result in smaller annual deductions of interest. Obviously, the Chinese will have to clarify the meaning of this provision before a joint venture will feel confident in incurring any sizable debt.

The regulations provide a set of rules for computing the taxable income of a service joint venture, a commercial joint venture and an industrial joint venture. The taxable income of a service joint venture is equal to its gross business income less operating expenses, overhead and the business tax, plus its nonoperating income less nonoperating expenditures. In principle, this approach appears to be along customary lines. While no definitions are provided for “operating expenses,” “overhead” or “nonoperating expenditures,” it is likely that these terms will be applied in a conventional manner.

The taxable income of a commercial joint venture is equal to its “sales profit” plus its profit from other operations plus its nonoperating income less its nonoperating expenditures. Sales profit is equal to gross sales proceeds less returns and allowances, the sales tax (presumably the consolidated tax), selling expenses, overhead and the “cost of sales.” The cost of sales is equal to initial inventory plus purchases and purchase expenses less purchase returns, allowances and closing inventory.

The Chinese term “cost of sales” appears similar to the United States concept of “cost of goods sold.” If these terms are similar, the calculation

307. The Chinese follow the United States approach of not allowing a deduction to corporations for dividends paid to shareholders. Neither the JVITL nor the United States Internal Revenue Code contains an express provision denying such a deduction. If interest payments to shareholders are treated as dividends, such payments may be subject to the 10% tax on the remittance of profits. See notes 325-27 infra and accompanying text.

308. This interpretation may not be easy to administer. Because money is fungible, a debt cannot always be meaningfully assigned to any particular asset, even if the borrowed funds were used to purchase a specific asset. See Pomp, Mortgage Interest and Property Tax Deduction: A Tax Expenditure Analysis, 1 CANADIAN TAX. 23, 29 n.32 (1979).

309. JVITL Regulations, supra note 107, art. 8.

310. This is presumably a reference to the consolidated tax on service businesses. See notes 21, 117 supra.
of sales profit seems to correspond to United States accounting practices and, in general terms, the rules for calculating the taxable income of a commercial enterprise seem to be in accordance with United States concepts.

The taxable income of an industrial joint venture is equal to the "profit from the sale of its product" plus the profit from its other operations plus its nonoperating income less its nonoperating expenditures. Profit from the sale of its product is equal to "net volume of sale of product" less sales taxes, "cost of sale of product," selling expenses and administrative expenses. Net volume of sale of product is equal to total volume of sale of product less sales returns and allowances. Cost of sale of product is equal to "cost of product of the year" plus opening inventory of product less closing inventory of product. Cost of product of the year is equal to opening inventory of semifinished and in-production product, plus "cost of production of the year," less closing inventory of semifinished and in-production product. Cost of production of the year is equal to direct material used in production of the year plus direct wages plus manufacturing expenses.

The Chinese rules for determining the profit arising from the sale of a manufactured product suggest an approach similar to that used in the United States. The Chinese definition of "cost of production"—direct material, direct wages and manufacturing expenses—appears similar to the United States definition of "cost of manufacture"—the total cost incurred during the period for raw materials, direct labor and factory overhead. The primary question raised is whether the Chinese use of "manufacturing expenses" encompasses all the elements of "factory overhead" as used in the United States, which include indirect labor, maintenance and repairs, utilities, depreciation on machinery, insurance, rent, supplies and similar costs.

The Chinese term "cost of product of the year"—opening inventory of semifinished and in-production product, plus cost of production, less closing inventory of semifinished and in-production product—may correspond to the United States accounting term "cost of goods manufactured," which refers to the cost of goods that have been completed during the year. The cost of goods manufactured is determined by adding the opening inventory of goods in process to the "cost to manufacture" and then subtracting the closing inventory of goods in process. If the Chinese concept of "semifinished and in-production product" is similar to the United States concept of "goods in process," and if "cost of production" is similar to "cost of manufacture," then the Chinese term "cost of product"

312. J Vitl Regulations, supra note 107, art. 8.
313. J. White & E. Bean, supra note 311, at 263-64.
314. Id. at 264.
315. Id.
corresponds to the United States term "cost of goods manufactured." To the extent this correspondence holds, the Chinese definition of cost of sale of product can be restated as: opening inventory, plus cost of goods manufactured less closing inventory. This formulation of cost of sale of product is similar to the United States definition of cost of goods sold. If the above United States terms are then substituted for their apparent Chinese counterparts, the Chinese definition of "profit from the sale of product" can be rewritten in a form familiar under United States accounting principles: sales less returns and allowances, cost of goods sold, selling expenses, administrative expenses and sales taxes. While this formulation remains to be tested, it does seem consistent with the pattern of the regulations.

Under the regulations, inventory is computed at cost. A joint venture can choose among three methods: first-in, first-out (FIFO), shifting average and weighted average. As is true in the case of the ICITA, the last-in, first-out (LIFO) method is not allowed. The permission of the local tax authorities must be obtained in order to change accounting methods.

The JVITL and its regulations fail to clarify what has been a controversial issue: the treatment for tax purposes of reserve funds, bonus and welfare funds for workers and expansion funds. The Joint Venture Law provides that the net profit of a joint venture shall be distributed after a joint venture income tax is paid on its gross profit (before-tax profit) and after the reserve funds, bonus and welfare funds and expansion funds have been deducted. As this provision suggests, and as Chinese sources have confirmed, payments made into these funds are not currently deductible for tax purposes, a position that is consistent with United States practice. The Chinese have never indicated, however, whether payments made out of these funds would be deductible (or capitalized) for tax purposes and a good deal of confusion has resulted among foreigners. Although no reason exists why such payments should not be deductible, an explicit treatment of the issue in the regulations would have ended the confusion.

C. Tax Rates and Reductions

The JVITL provides for a basic 30% tax rate. In addition, a local surtax of 10% is levied for use by the local treasuries, bringing the total tax rate

316. Id. at 269.
317. JVITL Regulations, supra note 107, art. 18.
318. See text accompanying note 128 supra.
319. JVITL Regulations, supra note 107, art. 18.
320. Joint Venture Law, supra note 3, art. 7. See Pomp & Surrey, supra note 7, at 10 n. 42.
322. JVITL, supra note 1, art. 3; JVITL Regulations, supra note 107, art. 3.
EVOLVING TAX SYSTEM

to 33%. "On account of special circumstances," this surtax can be eliminated or reduced by the government of the province, municipality or autonomous region in which the joint venture is located.\(^{323}\) Perhaps by reducing or eliminating the local surtax the Chinese will "make some adjustments," as a leading economist recently indicated they would, in order to respond to foreign criticism that the 33% rate is too high.\(^{324}\)

A tax rate of 10% is levied on a foreign participant that remits its share of profits out of China.\(^{325}\) Presumably, the Chinese intend to follow the practice of many countries, including the United States,\(^{326}\) of levying a tax on the payment of dividends to foreign shareholders. To implement this tax, however, the Chinese will need to develop rules defining the term "profits." The term cannot be synonymous with taxable income because certain outlays, such as the payment of the 33% tax, reduce the amount of profits available for distribution even if they are not deductible for purposes of calculating taxable income. Unless the calculation of profits takes into account such outlays, the 10% tax might be levied on a distribution that constitutes a return of a shareholder's capital, rather than a distribution of profits.\(^{327}\)

Tax rates for joint ventures exploiting petroleum, natural gas and other resources "shall be stipulated separately."\(^{328}\) China's Finance Minister recently indicated in discussions in the United States that a tax structure entirely separate from the JVITL was being considered for these joint ventures.\(^{329}\)

---

\(^{323}\) JVITL Regulations, supra note 107, art. 3.

\(^{324}\) Wall St. J., Oct. 9, 1980, at 32, col. 1. Chinese commentators, however, have stressed that the 33% rate is low in comparison to rates imposed by other developing countries. See, e.g., Liu Ding, You Li yu Zhongwai Hezi Jingying Qiye Fazhan de Liangge Shuifa (Two Tax Laws of Benefit to the Development of Joint Ventures Using Chinese and Foreign Investment), [1981] Faxue Zazhi (J. Legal Sci.) (No. 1) 12, 13.

\(^{325}\) JVITL, supra note 1, art. 4; JVITL Regulations, supra note 107, art. 4. The procedures for the remittance of profits from China are provided in China's new foreign exchange control regulations. Provisional Regulations for Foreign Exchange Control of the People's Republic of China, promulgated by the State Council, Dec. 18, 1980, art. 24 [hereinafter cited as Exchange Control Regulations], translated in FBIS, supra note 1, Jan. 6, 1981, at L8. Article 22 provides that all foreign exchange receipts of a joint venture must initially be deposited in the Bank of China. Id.

\(^{326}\) See I.R.C. §§ 871(a)(1)(A), 881(a)(1).

\(^{327}\) For the United States rules on what constitutes a distribution of profits, see I.R.C. §§ 301, 312, 316.

\(^{328}\) JVITL, supra note 1, art. 3.

\(^{329}\) Two oil exploration agreements were concluded before the adoption of the JVITL, one between China and the Japan National Oil Corporation and the other between China and the French companies Elf-Aquitaine and Total. The taxation provisions of these contracts have not been made public. One recent report, based on an interview with a top Chinese official, indicates that the Chinese are planning to impose a production tax and customs (export) tax on joint ventures involved in the exploitation of natural resources. The production tax would be 8% for coal, 5% for crude oil and an unspecified higher amount for natural gas. Williams, supra note 164, at 6.
The JVITL provides for a number of possible tax reductions or exemptions. Implementing an incentive referred to in the Joint Venture Law, the JVITL allows a newly established joint venture that is scheduled to operate for a period of ten years or more to apply for a full exemption from tax in its first profit making year, and a 50% reduction in its second and third profit making years. The first profit making year is defined as the year in which a joint venture begins to make a profit after taking into account any loss carryovers. Under the Joint Venture Law, the exemption and reduction are made available only to a joint venture "equipped with up-to-date technology by world standards." This requirement is not found in the JVITL, but it is unclear whether its absence signals any change in policy.

Certain types of enterprises are entitled to additional tax reductions that extend beyond three profit making years. Joint ventures in "low-profit" operations such as farming or forestry or ventures located in remote, undeveloped outlying areas may apply for a 15% to 30% reduction in income tax for an additional ten year period. The local tax authorities are empowered to approve the first three years of exemption and reduction, but the Ministry of Finance must approve the additional ten year reduction.

The JVITL implements another tax incentive referred to in the Joint Venture Law. A participant that reinvests in China for at least five consecutive years its share of profits from a joint venture may, upon approval by the tax authorities, obtain a refund of 40% of the income tax paid on the reinvested funds. The refund is apparently granted upon

---

330. Joint Venture Law, supra note 3, art. 7.
331. JVITL, supra note 1, art. 5.
332. JVITL Regulations, supra note 107, art. 5. This approach favors investors since it means that an initial period of start-up losses will not count against the joint venture's period for obtaining an exemption or reduction.
333. Joint Venture Law, supra note 3, art. 7.
334. The requirement that technology be "up-to-date by world standards" differs in wording from the provision found elsewhere in the Joint Venture Law that "technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China's needs." Id. art. 5. Technology that is up-to-date by world standards may have been developed for capital-intensive economies and thus may not be appropriate for labor-intensive sectors of China's economy. See Torbert, supra note 3, at 854.
335. JVITL, supra note 1, art. 5.
336. Id.
337. Joint Venture Law, supra note 3, art. 7.
338. The JVITL states that the profits must be reinvested in "China." JVITL, supra note 1, art. 6. It is unclear whether reinvestment in Hong Kong would qualify for the refund. See note 267 supra. A similar issue is raised by the status of Taiwan. In any event, the JVITL regulations specify that the profits must be reinvested in the same or another Chinese joint venture. JVITL Regulations, supra note 107, art. 6. The regulations would apparently deny a refund for profits reinvested in China through the purchase of Chinese bonds. See note 196 supra.
339. JVITL, supra note 1, art. 6; JVITL Regulations, supra note 107, art. 6. Although these articles could be read as requiring that all of a participant's after-tax profit must be reinvested to obtain a refund, China's Finance Minister, Wang Bingqian, in discussions in September 1980 with American lawyers in Washington, D.C., indicated that any part of the
the taxpayer's stated intent to reinvest for the five year period; if the funds are withdrawn before the end of the period the taxpayer must pay back the refunded tax.\footnote[40]{JVITL, supra note 1, art. 6. It is unclear whether during the five year period reinvested funds can be withdrawn from one joint venture in China and reinvested in another joint venture in China without triggering the payback requirement. It is also unclear what approach, for example FIFO or LIFO, will be used in determining the "age" of any withdrawn funds for purposes of the five year rule.}

The above exemptions, reductions and refunds refer to "the income tax."\footnote[41]{Id. art. 4; JVITL Regulations, supra note 107, art. 4.} Presumably, the "income tax" includes both the basic 30% tax rate as well as the 10% local surtax. Although the 10% tax on remittances is also described in both the JVITL and the regulations as "an income tax,"\footnote[42]{JVITL, supra note 1, art. 16; JVITL Regulations, supra note 107, art. 32. See Section VI, B infra. It is unclear whether the Chinese plan to grant an indirect tax credit, that is, a credit for the tax paid on the profits out of which a dividend is paid. For the United States rules on the indirect tax credit, see I.R.C. § 902.} it is unclear whether the exemptions, reductions and refunds are meant to apply to this tax as well.

As the final step in the calculation of its tax liability, a joint venture may take a credit for income taxes paid abroad on income earned outside of China. The credit cannot exceed the Chinese tax payable on the income abroad.\footnote[43]{JVITL, supra note 1, art. 11. The Foreign Tax Collection Office, referred to in the text accompanying note 239 supra, is also responsible for the joint venture income tax.}

\section*{D. Payment and Collection Procedures}

Joint ventures must, within thirty days of their registration with the General Administration for Industry and Commerce (GAIC),\footnote[44]{Joint Venture Law, supra note 3, art. 3. Detailed procedures for the registration of joint ventures with the GAIC or any of its local branches are provided in Regulations on the Registration of Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council, July 26, 1980, translated in CHINA ECON. NEWS, Sept. 15, 1980, Supp. No. 5.} register with the local tax authority.\footnote[45]{JVITL, supra note 1, art. 11. The Foreign Tax Collection Office, referred to in the text accompanying note 239 supra, is also responsible for the joint venture income tax.} Provisional returns and payments, based either on the previous year's actual income or the current year's estimated income, are due within fifteen days after the end of each quarter.\footnote[46]{JVITL, supra note 1, art. 8; JVITL Regulations, supra note 107, art. 19.} The final return, accounting statement and final tax payment are due within three months after the end of the year.\footnote[47]{JVITL, supra note 1, art. 9.} A return and a final accounting statement must be filed regardless of profit or loss.\footnote[48]{JVITL Regulations, supra note 107, art. 20.} Audit reports of profit reinvested would entitle the investor to a proportional refund. Thus, if a participant reinvested 50% of its after-tax profit, it would receive a refund of 40% of 50% of the tax paid on the pretax profit. Presumably, a participant will be deemed to have paid a portion of the JVITL tax equal to the percentage of its equity participation in the venture. It is unclear whether profits that have already been distributed can later be reinvested and qualify for a refund.
“chartered public accountants registered in the People's Republic of China” must also be submitted. Applications to extend the deadlines for filing returns on account of “special circumstances” must be made to the local tax authorities within the deadline in question.

Income is denominated in RMB and tax is paid in RMB. Foreign currency income is converted at the exchange rate of the State General Administration of Exchange Control as of the date of tax payment.

The 10% tax on profits remitted abroad is collected by the remitting agency, which, under China's new foreign exchange control regulations, is the Bank of China. A foreign participant in a joint venture which wishes to remit its profits from China must "report" to the local tax authorities.

E. Violations and Penalties

A late payment of tax is subject to a daily fine of 0.5% of the overdue tax beginning from the first day of arrears. No interest is levied in addition to this fine. The failure to file a return in a timely and proper fashion, to register with the tax authorities when required, or to provide all relevant facts and information to tax officials subjects the taxpayer to a fine of up to 5000 yuan. Tax evasion or the refusal to pay tax may be punished by a penalty of up to five times the unpaid tax; cases of "gross violation" may involve a penalty of five times the unpaid tax.

---

349. Id. China is currently reviving its accounting profession. An "accountants' office" has recently been opened in Shanghai; this office has reportedly been retained by the Jardine Schindler joint venture, discussed in note 106 supra. Renmin Ribao (People's Daily), Oct. 6, 1980 at 1. This office can submit tax returns on behalf of joint ventures. CHINA ECON. NEWS, Feb. 2, 1981, at 9. Whether China intends to restrict the auditing role to Chinese accounting firms remains unclear. One of the larger multinational accounting firms, Ernst & Whinney, has been granted permission to station a representative in Beijing. Wall St. J., Oct. 9, 1980, at 32, col. 2. Perhaps once this representative is registered in accordance with the regulations cited in note 164 supra, he will be considered a chartered public accountant registered in the People's Republic of China. Coopers & Lybrand has also opened a representative office in Beijing and has registered under the regulations. CHINA ECON. NEWS, Mar. 2, 1981, at 5.

350. JVITL Regulations, supra note 107, art. 21.
351. JVITL, supra note 1, art. 10; JVITL Regulations, supra note 107, art. 22.
352. See text accompanying notes 325-27 supra.
353. JVITL Regulations, supra note 107, art. 4.
355. JVITL Regulations, supra note 107, art. 4.
356. JVITL, supra note 1, art. 13.
357. In addition to its initial registration, see notes 344-45 supra and accompanying text, joint ventures must register when they change the nature of their business, change their addresses, shut down operations or transfer their registered capital. JVITL, supra note 1, art. 11. The concept of changing the nature of a joint venture's business (zhuanchan) could include a change in the product produced as well as a more fundamental change in the type of operations in which a joint venture is engaged.
358. JVITL Regulations, supra note 107, art. 28.
be referred to the courts.\textsuperscript{359} Joint ventures are required to keep their accounting records for at least fifteen years; the failure to do so may be penalized by a fine of up to 5000 yuan.\textsuperscript{360} A similar penalty may be imposed for a venture's failure to submit its sales invoices and business receipts to the local tax authorities for approval "before using them."\textsuperscript{361}

Tax authorities must give notice whenever penalties are to be imposed.\textsuperscript{362} Taxpayers who disagree with the tax authorities may, after first paying their tax, apply to higher tax authorities for reconsideration.\textsuperscript{363} These authorities must render a decision within three months of receiving the taxpayer's application.\textsuperscript{364} Taxpayers have a further appeal to the local people's court.\textsuperscript{365}

V. TAXATION IN THE SPECIAL ECONOMIC ZONES

In the late 1970s, as part of its drive to enlist foreign participation in the "four modernizations,"\textsuperscript{366} China began to formulate plans for the establishment of "special economic zones" in South China, similar to the free trade or export processing zones used in Taiwan, Hong Kong, Sri Lanka and other parts of Asia. These economic zones will, in a manner that has yet to become clear, function under a legal and administrative framework separate from and independent of the framework governing foreign investment in other parts of China.\textsuperscript{367}

\textsuperscript{359} JVITL, supra note 1, art. 14. See notes 89, 92, 258, 264 supra; text accompanying note 90 supra.
\textsuperscript{360} JVITL Regulations, supra note 107, arts. 25, 29.
\textsuperscript{361} Id. arts. 26, 29.
\textsuperscript{362} Id. art. 30.
\textsuperscript{363} JVITL, supra note 1, art. 15.
\textsuperscript{364} JVITL Regulations, supra note 107, art. 31.
\textsuperscript{365} JVITL, supra note 1, art. 15.
\textsuperscript{366} The four target areas of this program are industry, agriculture, technology and defense.
\textsuperscript{367} The Joint Venture Law, supra note 3, would appear to apply to all joint ventures in China, and to require all ventures to be governed by Chinese national laws and regulations. Joint Venture Law, supra note 3, arts. 1, 2. The Shekou regulations, note 369 infra, purport to be issued "in accordance with the [Joint Venture Law] and other pertinent decrees." The new special zone regulations discussed in the text accompanying notes 382-95 infra indicate, however, that national legislation, decrees and regulations are to apply only if there are no "specific provisions contained in the present regulations." Regulations on Special Economic Zones in Guangdong Province, adopted at the 15th Meeting of the Standing Committee of the Fifth National People's Congress, Aug. 26, 1980, art. 2 [hereinafter cited as Guangdong Regulations], translated in FBIS, supra note 1, Aug. 28, 1980, at L9.

There is some confusion over the extent to which approval of the Foreign Investment Commission, which the Joint Venture Law seems to require for all ventures in China, Joint Venture Law, supra note 3, art. 3, will be required for ventures in special economic zones. Some foreigners had initially been given the impression that local committees in the special zones would have unlimited authority to approve joint ventures. Recently, two reports have indicated that if the foreign investment were to exceed a certain amount, authority from the central body would be required. One report, citing a Guangdong official, quoted the figure
The first zone to be formally announced was Shekou, a district of the municipality of Shenzhen (Shumchun). Shekou is located on the east coast of the Pearl River estuary in the Canton area and is within close traveling distance of Hong Kong by either road or water.368 This area has been earmarked for industrial joint ventures.369 General regulations for the operation of ventures in Shekou were released in January 1980.370 The regulations provide for a complete exemption from the "import tax," presumably referring both to customs duties and the consolidated tax,371 for "all supplies furnished to [the zone] ranging from equipment, construction materials, raw materials to daily necessities."372 Finished and semi-finished products that are exported are exempted from tax.373 Products "imported" from the zone for sale in China's domestic market are taxed "in accordance with Customs regulations."374

Ventures in Shekou are subject to a profits tax. A three to five year tax holiday is provided375 from the "start-up" of production.376 A 10% tax rate applies after the expiration of the tax holiday, at least for ventures contracted for before August 1980.377 The regulations do not refer to a withholding tax on remittances, do not contain rules for the determination of taxable income and do not encompass any of the other provisions found of $1 million. S. China Morning Post, July 1, 1980, § 2, at 1, col. 4. Another report, quoting Beijing authorities, put the limit at $5 million. Lubman, supra note 110.

368. For background on Shekou and an analysis of the Shekou regulations, cited at note 369 infra, see Chong, An Invitation with Some Uncertainties, FAR E. ECON. REV., Feb. 1, 1980, at 48; see also CHINA TRADE REP., March 1980, at 5.

369. Joint ventures will be equity ventures with each partner generally contributing not less than 25% of the total investment. Shekou Regulations, art. 5, para. 1, translated in Shekou Industrial Zone Ready to Accept Investment, Ta Kung Pao, Jan. 17, 1980, at 5 [hereinafter cited as Shekou Regulations]. The Chinese partner in such ventures will be the China Merchants Steam Navigation Company, a Beijing controlled, Hong Kong based firm authorized by the State Council to develop and oversee the Shekou zone. The average term of a venture will be 25 years, although the actual term is to be determined by the type of business. Id. art. 5, para. 3.

370. Id.

371. See note 15 supra; text accompanying note 31 supra.

372. Shekou Regulations, supra note 369, art. 5, para. 5. See also text accompanying notes 389-90 infra.

373. Shekou Regulations, supra note 369, art. 5, para. 5. But see text accompanying notes 109-11 supra.

374. Shekou Regulations, supra note 369, art. 5, para. 5. It is unclear whether the consolidated tax will be imposed in this case. See text accompanying note 31 supra; note 391 infra.

375. Initial reports of projects starting up in the Shekou zone indicate that a three year holiday will be granted to light industrial ventures, and a five year holiday to heavy industrial projects. CHINA ECON. TIMES, Feb. 1980, at 141; see Asian Wall St. J. Weekly, Nov. 10, 1980, at 4, col. 3.

376. Shekou Regulations, supra note 369, art. 5, para. 5. The Chinese term translated as "start-up" in the text is translated as "commissioning" in the Shekou Regulations, supra note 369. This provision could be less generous than the provision in the JVITL which provides that the tax holiday starts from the first "profit-making year." JVITL, supra note 1, art. 5. See notes 331-32 supra and accompanying text.

377. Shekou Regulations, supra note 369, art. 5, para. 5. See notes 385-86 infra and accompanying text.
in the JVITL or its regulations.\textsuperscript{378} The extent to which these national tax rules will be used to supplement the Shekou tax provisions remains unknown.\textsuperscript{379}

The Shekou regulations also provide that “foreign and Hong Kong staff shall pay a certain sum of personal income tax.”\textsuperscript{380} No details are given, raising the question whether this tax will be paid in accordance with the IITL and its regulations.\textsuperscript{381}

In August 1980 regulations were published for the special economic zones in the three cities of Shenzhen, Zhuhai and Shantou in Guangdong province.\textsuperscript{382} Insofar as these regulations cover Shenzhen municipality,\textsuperscript{383} of which Shekou is a district, they presumably supersede the Shekou rules to the extent that inconsistencies exist.\textsuperscript{384}

One significant difference in the new regulations, which are directed at both joint ventures and wholly foreign owned projects in heavy and light industry and agriculture, is the rate of profits tax. The new regulations provide for a 15\% rate rather than the 10\% rate of the Shekou regulations.\textsuperscript{385} A source close to China has indicated that the lower 10\% rate would remain effective for Shekou contracts signed before the promulgation of the Guangdong regulations, but that the 15\% rate would apply to ventures concluded thereafter.\textsuperscript{386}

Another difference between the two regulations is that no automatic tax holidays are provided for under the new regulations, although “special

\textsuperscript{378} See Section IV supra.
\textsuperscript{379} See note 367 supra.
\textsuperscript{380} Shenzhen Regulations, supra note 369, art. 5, para. 8.
\textsuperscript{381} See Section III supra.
\textsuperscript{382} Guangdong Regulations, supra note 367. For an analysis of the regulations, see Loong, Special Zones, Special Rules, FAR E. ECON. REV., Sept. 12, 1980, at 56; BUS. CHINA, Sept. 24, 1980, at 137.
\textsuperscript{383} Shenzhen has been under development as a special economic zone for approximately the last two years. Areas other than Shekou have been the site of a number of compensation trade and processing projects. For the possible tax consequences of such projects, see notes 113-16 supra and accompanying text. Favorable tax treatment may be more easily obtained in the special zones than elsewhere.
\textsuperscript{384} The Guangdong Regulations, supra note 367, were formally passed by the National People's Congress Standing Committee, whereas the Shekou Regulations, supra note 369, were simply issued in Hong Kong by the China Merchants Steam Navigation Company, see note 369 supra, although with the apparent approval of the Chinese government.
\textsuperscript{385} Guangdong Regulations, supra note 367, art. 14.
\textsuperscript{386} ECON. REP., ENG. MONTHLY, Aug. 1980, at 11. A Chinese investment official indicated that the 10\% rate would apply only if the venture had been approved by the relevant authorities before the new regulations. Ta Kung Pao, Oct. 12, 1980, at 2. Recently, it was reported that a wholly foreign owned feed production venture in Shekou will be taxed at 15\% after a three year holiday. Asian Wall St. J. Weekly, Nov. 10, 1980, at 4, col. 3. See note 387 infra.
preferential treatment" is promised to certain types of enterprises established within two years of the promulgation of the regulations. In addition, investors who reinvest profits in the special zones for five years or longer may apply for an "exemption or reduction" of tax on profits from such reinvestment.

A tax exemption is provided for machinery, spare parts, raw materials, vehicles and other means of production imported by enterprises in these zones. Necessities imported for the personal use of those living in the zones may, according to the "merits of each case," be fully taxed, taxed at a lower rate or exempted. A venture wishing to sell its products in China's domestic market must obtain special approval from the local authorities and pay customs duties. Exports appear to be nontaxable, but customs procedures must be followed. Foreign employees in the Guangdong zones are subject to a personal income tax on their salaries "and other proper earnings."

Formal approval has recently been granted for the establishment of a special zone in the city of Xiamen (Amoy), Fujian province. The regulations for this zone apparently will state that taxation will be "in accordance with China's tax laws." Indications, however, are that tax incentives will be modeled on those contained in the Guangdong and Shekou regulations.

VI. FOREIGN TAX CREDIT AND TAX TREATY CONSIDERATIONS

The Chinese are aware of the problem of double taxation and provide in both the IITL and JVITL for a credit against Chinese tax for foreign

---

387. Guangdong Regulations, supra note 367, art. 14. It is not clear if the tax holiday automatically granted by the Shekou regulations, see notes 375-76 supra and accompanying text, will apply in light of the new regulations. It was not reported whether the feed project referred to in note 386 supra was signed or approved before or after the promulgation of the Guangdong regulations.

388. Guangdong Regulations, supra note 367, art. 16. This provision differs from a similar one in the JVITL, see notes 337-40 supra and accompanying text, in which a portion of the tax already paid is to be refunded if profits are reinvested for five years, but the profits from the reinvestment are fully taxed.

389. Guangdong Regulations, supra note 367, art. 13. For the approach under the Shekou regulations, see note 372 supra and accompanying text.

390. Guangdong Regulations, supra note 367, art. 13. For the approach under the Shekou regulations, see text accompanying note 372 supra.

391. Guangdong Regulations, supra note 367, art. 9. For the approach under the Shekou regulations, see note 374 supra and accompanying text.


393. Id. art. 15. See text accompanying notes 380-81 supra.


395. An official in Xiamen recently announced that the tax rate in the zone will be 15% and that tax exemptions or reductions for the "first three to five years' would be available "depending on the conditions in each case." FBIS, supra note 1, Apr. 8, 1981, at O3.
In addition, Chinese officials have indicated their willingness to enter into tax treaties in order to reduce any problems of double taxation. For United States taxpayers, however, a more immediate concern is whether the Chinese income taxes are creditable against United States income taxes.

A. The Creditability of the Chinese Income Taxes Against United States Tax

A Chinese income tax that is not creditable for purposes of the United States foreign tax credit would tend to discourage United States investment. Presumably, the Chinese expect that both the JVITL and the IITL will be creditable against any income tax levied by the United States (or other countries using a foreign tax credit approach) on the income from Chinese sources received by United States individuals or participants in joint ventures. This expectation appears justified regarding the JVITL, but doubts may exist regarding certain aspects of the IITL.

The general rule governing the application of the United States foreign tax credit is that a credit is allowed for foreign income taxes paid or accrued, or for foreign taxes paid in lieu of income taxes. The credit is allowed to United States citizens, residents and corporations for foreign income taxes levied directly on income received by them, such as dividends, royalties or income from a branch. A United States corporation can also claim a credit for any income taxes levied on the income of a foreign corporation from which it receives a dividend. A United States corporation that is a shareholder in a Chinese joint venture would, assuming that the taxes levied by the JVITL were income taxes, be able to obtain a credit both for the 10% gross tax on the remittance of profits from China and for the portion of the 33% tax allocable to the profits of the joint venture out of which the distribution was made.

---

396. See JVITL, supra note 1, art. 16; JVITL Regulations, supra note 107, art. 32; IITL Regulations, supra note 171, art. 17.

397. Speech by Ren Jianxin, Chief of the Legal Affairs Department, China Council for the Promotion of International Trade (CCPIT), in Hong Kong (Sept. 1980), reprinted in 1 CHINA L. REP. 85 (1980). One such treaty has already been signed with the United Kingdom. Agreement on the Avoidance of Dual Taxation for Airlines and Airline Personnel, Mar. 10, 1981, United Kingdom-People's Republic of China, described in Renmin Ribao (People's Daily), Mar. 16, 1981, at 4; see CHINA ECON. NEWS, Mar. 16, 1981, at 2. The authors have not seen this treaty. A United States Department of Treasury delegation visited China in November 1980 and briefed the Chinese on the general nature of tax treaties. A return delegation of Chinese officials will visit the United States in May 1981. See also Pomp & Surrey, supra note 7, at 22-23.

398. See I.R.C. §§ 901-03.

399. Id. § 901.

400. Id. § 902. The text oversimplifies what are exceedingly complex rules. See generally E. OWENS, supra note 26; 1 E. OWENS & G. BALL, THE INDIRECT CREDIT (1975).

401. See text accompanying notes 325-27 supra.

402. See text accompanying notes 322-23 supra.

403. For example, assume that the United States corporation is a 50% shareholder in a Chinese joint venture. Assume further that the joint venture earns $100, pays $33 tax on its
The crucial question is whether the taxes levied by the JVITL and the IITL are either income taxes, or are paid in lieu of income taxes, for purposes of the United States foreign tax credit. The United States has recently issued extensive temporary and proposed regulations providing detailed rules and examples to define an "income tax" and to distinguish that form of tax from excise taxes, royalty payments and so forth. These rules are more detailed than those utilized in other countries. Under these regulations, the general principle governing the classification of a foreign tax as an income tax is whether the foreign tax is imposed on net income. Each foreign tax is separately analyzed and tested to determine whether it is an income tax. If a foreign tax does not qualify as an income tax, it may still be creditable if it satisfies the criteria for a tax paid in lieu of an income tax.

The regulations apparently were drafted without any consideration of the Chinese tax on individuals, and numerous aspects of the IITL raise difficult interpretive issues. Quite possibly, the regulations will not be interpreted in a rigorous or literal manner and borderline issues may be resolved in favor of creditability. The tortuous path, however, that must be followed in tracking the Chinese tax system through the intricacies of the regulations raises broad questions of policy regarding the United States definition of an "income tax" and of an "in lieu tax" under the United States foreign tax credit and also regarding the technical articulation of these definitions in the regulations.

profits and distributes all of its remaining profits to its shareholders. The United States shareholder receives a distribution of $33.50 (50% of $67), which it remits from China. The United States corporation pays a tax of $3.35 (10% of $33.50) upon its remittance of the profits. For United States tax purposes, the United States corporation is treated as having received a dividend of $50, its share of the pretax profits of the joint venture out of which it received its distribution. The $3.35 tax levied on the remittance of profits would qualify for the foreign tax credit. The corporation would also receive a foreign tax credit for $16.50, the amount of the 33% tax which is allocable to the United States corporation's share of the profits of the joint venture out of which it received its distribution. See I.R.C. §§ 78, 901, 902. For a detailed treatment, see E. OWENS & G. BALL, supra note 400.


The taxes that will apply in the special economic zones have yet to be detailed sufficiently to allow for a reliable determination of their creditability. The ICITA, if it applies to a Chinese branch or a Chinese subsidiary of a United States corporation, see text accompanying notes 160-66 supra, would appear to be a creditable tax, assuming that it is intended to reach net income, as is evidently the case.
1. The Joint Venture Income Tax

The basic 33% JVITL tax, including the local surtax, would appear to qualify easily as a foreign income tax for purposes of the United States tax credit. The earlier discussion of the JVITL rules for calculating taxable income indicates that those rules correspond reasonably closely to United States principles.\textsuperscript{406} The requirement in the regulations that gross receipts be reduced by "expenses and capital expenditures ("costs") attributable, under reasonable principles, to such gross receipts"\textsuperscript{407} appears satisfied. It seems clear that the Chinese intend to use net income as the tax base of the JVITL. Any questions that may arise will presumably be answered by the Chinese in a manner that will preserve the creditability of the 33% tax.

The 10% tax on the remittance of profits from a joint venture appears to be of a type similar to that levied by the United States\textsuperscript{408} and other countries to tax dividends paid by their corporations to foreign shareholders. The Chinese 10% tax—and the similar taxes used by other countries—are all levied on a gross basis. The United States recognizes such taxes as qualifying for the foreign tax credit.\textsuperscript{409}

2. The Individual Income Tax

The creditability of the IITL is cloudy, because the law does not allow deductions for actual expenses incurred in the production of each category of taxable income. Depending on the category of income received, a taxpayer may be entitled to a statutory deduction, may not be entitled to any deductions or may be entitled to a statutory deduction only if he is a resident of China.\textsuperscript{410} Wages and salaries are subject to a set of progressive rates; other categories of income are subject to a flat 20% tax. The tax levied on each category of income is apparently treated as a separate charge for purposes of determining its creditability.\textsuperscript{411}

\textit{a. Residents of China}

Residents who receive income from personal services, royalties or rent are allowed a monthly statutory allowance equal to either 800 yuan or 20\% of the income, whichever is greater. In calculating taxable income, each category of income is treated independently; excess deductions against one category of income cannot be used against any other category of income.


\textsuperscript{408} See I.R.C. §§ 871(a), 881(a).


\textsuperscript{410} See text accompanying notes 210-21 supra.

Each of the 20% taxes levied on these categories of income is characterized under the temporary regulations as a separate tax for purposes of determining its creditability.\textsuperscript{412}

The use of a statutory allowance does not necessarily mean that each of these 20% taxes fails the net income test. The approach in the regulations, at least in the case of business income, is to qualify a foreign tax as an income tax if the costs incurred in “deriving gross receipts” do not “frequently exceed” the amount of deduction actually allowed the taxpayer.\textsuperscript{413} Accordingly, each of the three taxes must be tested against this criterion.

Assuming that business income covers personal services (or that the test for personal services will be the same as that for business income), the creditability of the 20% tax on personal services would depend on the actual situation in China regarding costs associated with the production of such income. It is likely that in the case of some personal service activities, customary expenses or costs would be considerably in excess of the 20% statutory allowance. The tax on personal services is thus likely to fail the net income test, although the issue will remain in doubt until the IRS rules on the question.\textsuperscript{414} The separate 20% taxes on rents and royalties raise similar issues.

The preceding taxes can be usefully contrasted with the tax on wages and salaries. A resident is allowed a monthly statutory allowance of 800 yuan against such income. Whatever expenses are associated with the

\textsuperscript{412} Id.

\textsuperscript{413} Temp. Treas. Reg. § 4.901-2(e), ex. 22 (1980). The language in Temp. Treas. Reg. § 4.901-2(c)(4)(i)(B) (1980) states that costs can be computed under a method that is designed to produce an amount that is not less than costs attributable, under reasonable principles, to such gross receipts and that, in fact, produces an amount that approximates, or is greater than, such costs, but only in the case of transactions with respect to which it is reasonable to believe that costs may not otherwise be clearly reflected. This language appears to provide a substantive rule tempered by permission for administrative flexibility. Example 22, \textit{supra}, seems to interpret that administrative flexibility quite generously, since the example does not consider whether a country could in fact determine actual costs, but only requires that the approach used by the country fairly represent such costs.

\textsuperscript{414} In issuing a ruling, the IRS would apparently consider each separate foreign tax in its entirety for all persons subject to the tax. Temp. Treas. Reg. § 4.901-2(a)(1) (1980). A taxpayer would therefore seem precluded from arguing that in his particular situation his actual costs were less than the statutory deduction. The regulations provide, however, that if the foreign tax law “contains provisions that significantly increase the liability only of persons engaged in a particular industry or industries, and if those provisions would prevent the [foreign tax] from being an income tax if persons engaged in the industry or industries were the only persons subject to the [tax],” the tax can be treated as a separate tax on such persons. Temp. Treas. Reg. § 4.901-2(d)(4) (1980). Presumably, the tax would be held non-creditable with respect to such persons, without jeopardizing its creditability for other persons. Under this carve-out provision, perhaps a distinction can be drawn among various forms of services, permitting the 20% tax on those services which do not involve significant expenses to qualify. Those services which were carved out would, under a literal reading of the regulation, have to constitute an “industry,” rather than merely constituting an “activity.”
earning of wages and salaries probably will not exceed the 800 yuan deduction. Consequently, the tax on wages and salaries is likely to satisfy the net income test and be characterized as a creditable income tax.

In the case of the three separate 20% taxes levied on interest, dividends and bonuses, no deductions are allowed. The creditability of these three separate taxes as income taxes thus depends on the amount of costs customarily associated with the generation of such income. If expenses are not normally associated with these categories of income, each of these three taxes will be creditable.416

A tax that fails the net income test will still be creditable if it can be characterized as a tax paid in lieu of an income tax. In order to be considered an in lieu tax, a foreign tax must satisfy two requirements. First, the foreign tax must be "imposed in substitution for, and not in addition to, an income tax otherwise generally imposed."417 An income tax is otherwise generally imposed if a foreign "country imposes an income tax or a series of separate income taxes . . . on significant amounts of income."418 For this purpose, the tax on wages and salaries, assuming that it is an income tax, could count as the tax otherwise generally imposed, unless the revenue collected under it is so insignificant that it cannot reasonably be a benchmark.419 The second requirement is that of "comparability." The comparability requirement is met unless the liability of persons under the tax being tested is "significantly greater, over a reasonable period of time, than the amount for which such persons would be liable if they were subject to the income tax otherwise generally imposed."420

415. An earlier version of the regulations provided that "[e]xpenses and capital expenditures incurred by any . . . employee in deriving income from personal services are presumed to be not significant. Accordingly, taxes on the gross amount of those items of income satisfy the net income requirement." Prop. Treas. Reg. § 1.901-2(b)(4)(ii), 44 Fed. Reg. 36073-74 (June 20, 1979). See also note 414 supra.

416. An earlier version of the regulations provided that "[e]xpenses and capital expenditures incurred by any person in deriving interest or dividend income not derived from the conduct of a trade or business in any country . . . are presumed to be not significant. Accordingly, taxes on the gross amount of those items of income satisfy the net income requirement." Id.

417. Temp. Treas. Reg. § 4.903-1(b) (1980). The regulation also requires that the tax be clearly intended, and in fact operate as a tax imposed in substitution for an income tax otherwise generally imposed. Id. An example in the regulations interprets that requirement as being met if substantially all business income is subject to one of several income taxes and if persons paying the in lieu tax are not subject in fact to any of these income taxes. Temp. Treas. Reg. § 4.903-1(f), ex. 8 (1980). Under the facts of example 8, the taxpayer does not have to prove a causal connection between the in lieu tax and his exemption from the income tax. The heart of the substitution requirement is apparently that the in lieu tax not be paid in addition to an income tax.


419. An example in the regulations suggests that the JVITL can also count in determining the existence of an "income tax otherwise generally imposed." See Temp. Treas. Reg. § 4.903-1(f), ex. 2 (1980). In this regard, the ICITA may also count, assuming that the revenues collected under it are sufficiently significant.

The application of these two requirements can be illustrated in the context of the 20% tax on personal services, which is unlikely to qualify as an income tax and therefore, if it is to be creditable, must be characterized as an in lieu tax. The first of the two requirements—substitutability—seems to be satisfied because the 20% tax on personal services is imposed in substitution for and not in addition to the tax on wages and salaries.

To test for comparability, the second of the two requirements, the liability of a taxpayer under the 20% tax on personal services is compared to what his liability would have been under the tax on wages and salaries. Two difficulties arise in making this comparison. First, the tax on personal services is levied at a flat 20% rate while the tax on wages and salaries is progressive, ranging from 5% to 45%. The results of the comparability test will therefore vary depending on the amount of income involved. Second, a taxpayer is granted an 800 yuan deduction in calculating his taxable income from wages and salaries. Because the 800 yuan deduction is likely to exceed actual employee expenses, the tax on wages and salaries can be characterized as an income tax, and thus serve as an "income tax generally imposed." For purposes of comparability, however, the question arises of what deductions a taxpayer should be given under the wage and salary tax—an 800 yuan deduction\(^{421}\) or a deduction for his actual costs.\(^{422}\) Depending on how these issues are resolved, the comparability requirement may or may not be satisfied. Similar issues are raised in characterizing the 20% taxes on rents and royalties as in lieu taxes.\(^ {423}\)

b. Nonresidents of China

Nonresidents receiving income from personal services, rents or royalties are not allowed any statutory deduction, unlike residents. Nonresidents are therefore subject to three separate 20% gross taxes. The creditability of

---

421. For income in excess of 4000 yuan, the 800 yuan deduction under the wage and salary tax will be less than the statutory deduction allowed under the 20% tax, increasing the likelihood that the 20% tax will satisfy the comparability requirement.

422. Since actual costs are likely to exceed the statutory allowance under the 20% tax, a deduction for actual costs decreases the likelihood that the 20% tax will satisfy the comparability requirement.

423. In issuing a ruling, the IRS would consider each separate foreign tax in its entirety for all persons subject to the tax. Temp. Treas. Reg. § 4.903-1(f), ex. 2 (1980). See note 419 supra.

424. In issuing a ruling, the IRS would consider each separate foreign tax in its entirety for all persons subject to the tax. Temp. Treas. Reg. § 4.903-1(e)(4) (1980). While this approach is similar to that discussed in note 414 supra, the in lieu regulations do not provide that a particular industry can be carved out. See Temp. Treas. Reg. § 4.901-2(d)(4) (1980), discussed in note 414 supra.
each of these three taxes is tested independently of the others.\textsuperscript{424}

Because of the denial of any deductions, none of these 20\% gross taxes is likely to pass the net income test. The regulations, however, provide an exception to the net income test for a gross tax on fixed or determinable, annual or periodical income, such as dividends, interest, rents, royalties and personal services. A gross tax on such income will be creditable as an income tax if "foreign law makes a reasonable distinction, based on the degree of contact that the foreign country has with the recipient of the income or with the activities or assets that generate the income," between those situations in which the income is taxed on the basis of gross income, and those situations in which the income is taxed on the basis of net income.\textsuperscript{425} A foreign country does not have to levy its gross tax under exactly the same circumstances as those under which the United States levies its gross tax;\textsuperscript{426} however, the approach taken by the foreign country must be reasonable.

Consider, for example, the 20\% gross tax on nonresidents receiving income from personal services. In order for the "reasonable distinction" test to be applied, a group of persons who are taxable on a net income basis on their personal services must first be identified. The only group that might satisfy this net income requirement is that of residents, who are entitled to a deduction from income equal to the greater of 800 yuan or 20\% of income.

If it is determined that residents are taxed on their income from personal services on a net income basis,\textsuperscript{427} the next question is whether China has drawn a reasonable distinction between residents, who are taxed on a net basis, and nonresidents, who are taxed on a gross basis. The answer seems uncertain under the regulations.\textsuperscript{428} An analysis of the creditability of the

\textsuperscript{426} The United States levies a gross tax on fixed or determinable annual or periodical income received from United States sources by nonresidents provided the income is not effectively connected with the conduct of a trade or business within the United States. I.R.C. § 871(a). An earlier version of the regulations provided an exemption from the net income test if a foreign gross tax were imposed on fixed or determinable annual or periodical income derived by nonresidents, provided the income was not derived from the conduct of commerce within the country levying the gross tax. Prop. Treas. Reg. § 1.901-2(b)(4)(iii), 44 Fed. Reg. 36074 (June 20, 1979). Apparently, this requirement was meant to be a more flexible rule for determining the creditability of a foreign gross tax than the requirement that foreign law adopt the United States concept of "effectively connected." The "reasonable distinction" test in the temporary regulations is apparently an even more flexible rule than the "conduct of commerce" rule.
\textsuperscript{427} See text accompanying notes 412-14 supra. The creditability of the 20\% gross tax on nonresidents receiving income from personal services is thus linked to the creditability of the 20\% tax on residents receiving income from personal services, because if it is determined that residents are taxed on net income, then the 20\% tax on their personal services is creditable.
\textsuperscript{428} An example in the regulations allows a credit for a 20\% gross tax levied on income from technical services partially performed within the country by nonresidents that have no
20% gross taxes on rents and royalties would proceed in a similar fashion, raising similar issues.

If it is determined that residents receiving personal services, rents or royalties are not taxed on a net income basis, the "reasonable distinction" test would be inapplicable. If residents, who receive a statutory allowance, are not taxed on their net income, then nonresidents, who receive no statutory allowance, would not be taxed on their net income either. Consequently, if these 20% taxes on residents are not creditable as income taxes, the 20% gross taxes on nonresidents would also be noncreditable. Furthermore, the 20% gross taxes on nonresidents would be unlikely to pass the in lieu tests.

In the case of wages and salaries, nonresidents receive the same 800 yuan deduction allowed to residents. The tax on nonresidents is thus likely to be creditable as a net income tax. In the case of dividends, interest or bonuses, neither residents nor nonresidents receive any deduction. An analysis of the creditability of these 20% gross taxes on nonresidents would thus be similar to the analysis above in the case of residents.

B. The Chinese Foreign Tax Credit

Both the JVITL and the IITL allow foreign income taxes to be credited against the Chinese tax on income from sources abroad. Few details are provided, however, regarding the manner in which the Chinese foreign tax credit will be implemented. This section highlights those issues needing further resolution.

The Chinese foreign tax credit, like the United States credit, extends only to foreign "income taxes." China will therefore have to develop a definition of an "income tax." This task, if rigorously pursued, is not an

permanent establishment within the country. A nonresident has a permanent establishment within the country if it has a place of business in the country for a period of more than one year. Temp. Treas. Reg. § 4.901-2(e), ex. 31 (1980). The example suggests that a distinction between nonresidents having a place of business in the country for less than one year and all other taxpayers is reasonable. The relevance of this example to the Chinese 20% gross tax on services is uncertain. The Chinese draw a distinction between nonresidents and residents; they do not draw a distinction on the basis of the length of time that a nonresident has a place of business within China. A nonresident of China who has a place of business within China for more than one year would be outside the fact pattern of example 31. Example 31 evidently overrules Rev. Rul. 78-234, 1978-1 C.B. 237, which held that a Tanzanian gross tax on management fees received by a nonresident was not creditable because, under I.R.C. § 864(b), such income was derived from the conduct of a trade or business in Tanzania. Rev. Rul. 78-234, 1978-1 C.B. at 238.

430. See text accompanying notes 417-23 supra.
431. See text accompanying note 415 supra.
432. JVITL, supra note 1, art. 16; JVITL Regulations, supra note 107, art. 32; IITL Regulations, supra note 171, art. 17. The ICITA apparently does not provide for a foreign tax credit.
433. JVITL, supra note 1, art. 16; JVITL Regulations, supra note 107, art. 32; IITL Regulations, supra note 171, art. 17.
easy one. As discussed above, the United States has recently issued exten-
sive temporary and proposed regulations providing detailed rules and ex-
amples to define the term “income tax.” Presumably, all countries using
the foreign tax credit approach are aiming at the same target in confining
the credit to an “income tax,” and thus the Chinese rules, once they are
fully developed, are not likely to vary from the general pattern.

A more difficult—and unanswered—question involves the form of “lim-
itation” on the use of the credit under the JIVITL regulations and the IITL
regulations. Every country using a foreign tax credit places some limita-
tion on the amount of foreign income taxes that can be credited. This
limitation is designed to prevent the foreign tax on the foreign source taxable
income from exceeding the domestic tax on that same income. With-
out such a limitation, a higher foreign tax on the foreign source taxable
income could, if credited in full, “spillover” and reduce domestic tax on
solely domestic income. To prevent this spillover, most countries use a
“per country” limitation. Under this form of limitation, the credit for the
income tax of a foreign country on income arising in that country cannot
exceed the amount of domestic tax imposed on that same foreign source taxable income. The United States, contrary to the practice of most other
countries, uses an “overall limitation” under which all foreign taxes and all
foreign source taxable income are aggregated; the credit for the total for-
eign income taxes cannot exceed the United States tax on the total foreign source taxable income. The Chinese regulations, while indicating that a
limitation will be applied, do not specify which form of limitation—the per
country or the overall—will be used. The authors understand, however,
that the Chinese are leaning towards the overall limitation.

In order for the limitation to work properly, the amount of foreign
source taxable income must be determined. A subtle aspect of the limita-
tion involves the allocation of expenses to foreign source income in order
to determine foreign source taxable income. China will have to develop
rules concerning how the expenses, costs and losses of a joint venture will
be allocated to its foreign source income. Furthermore, China will have to
decide what types of expenses are to be allocable. For example, are re-
search and development expenses for activities performed domestically,
but which enable a joint venture to obtain foreign royalties, to be allocated
in part to those foreign royalties? While all countries that utilize a foreign
tax credit must struggle with these issues, so far only the United States has

435. For the United States rules, see I.R.C. § 904.
436. For a discussion of the per country and overall limitation, see E. Owens, supra note 26, at 291-314.
437. JIVITL Regulations, supra note 107, art. 32 (which states in pertinent part: “the credit . . . shall not exceed the payable tax on the income abroad computed according to the tax rate prescribed by China’s tax law”); IITL Regulations, supra note 171, art. 16.
developed a detailed set of rules.\textsuperscript{438} A foreign tax credit system requires a differentiation between "domestic source income" and "foreign source income." A foreign income tax on domestic source income is not creditable. In addition, for the limitation on the credit to work properly, foreign source income must be identified so that the tax on foreign source income does not exceed the domestic tax on that income. The source rules used by the tax credit countries vary in detail and degree of certainty. Although a generally recognized international pattern of source rules exists, in part because of bilateral tax treaties, the specific rules do vary and thus hinder the smooth application of the credit. The Chinese regulations are very sketchy and offer little insight into what China regards as foreign source income.

Source rules can be found in only one regulation.\textsuperscript{439} This regulation first states that the "place of payment" is not relevant in deciding whether income is from sources in China. The regulation then specifically refers to "services within China," "dividends . . . gained within China," "royalties and interest derived . . . within China" and "income from lease of property within China." In broad outline, these rules are similar to those used by other countries,\textsuperscript{440} but they lack the detail that experience has shown is necessary to give precise content to the terms. Moreover, there is no explicit statement indicating whether these general rules will be utilized to determine what constitutes foreign source income from a particular foreign country, should the Chinese adopt a per country limitation on the credit.

C. Tax Treaties

All developed countries have entered into bilateral tax treaties that modify their domestic tax rules, provide for the exchange of tax information and establish the mechanics through a "competent authority procedure" for bilateral administrative discussions of disputes between the two countries concerning the treatment of a particular taxpayer. The tax treaties of the developed countries generally follow the Organization for Economic Cooperation and Development (OECD) model.\textsuperscript{441} Under this model, the country of the source of income yields a considerable portion of its jurisdiction to tax and the country of residence of the income earner grants a foreign tax credit or an exemption for foreign source income in order to reduce double taxation.

There are also treaties between developed and developing countries

\textsuperscript{439} IITL Regulations, supra note 171, art. 5. Although these source rules are contained in the IITL regulations, presumably they will also be applicable to the JVITL, which does not contain its own set of source rules.
\textsuperscript{440} For the United States rules, see I.R.C. §§ 861-63.
which are shifting away from the OECD model and toward the United Nations model.\textsuperscript{442} Under the United Nations model, the country of source—usually the developing country—retains more jurisdiction to tax than under the OECD model, while the country of residence still grants a foreign tax credit or exemption. Developing countries also have treaties with each other.\textsuperscript{443}

China undoubtedly will enter this world of bilateral income tax treaties.\textsuperscript{444} Article 16 of the IITL specifically refers to the future conclusion of such treaties and states that “income tax credits shall be handled in accordance with the provisions of the related agreements.”\textsuperscript{445} While the language refers only to “income tax credits,” it is to be expected that other areas usually covered in such treaties will also be dealt with. The pace at which China enters into these bilateral treaties presumably will depend on the developing confidence of the Chinese authorities to deal with international tax transactions, and also on the rate at which joint ventures are established. If China were to request the negotiation of a tax treaty with the United States,\textsuperscript{446} it would seem highly probable that the United States would respond affirmatively.

CONCLUSION

The clearest impression that emerges from a study of China’s tax system is one of change and adaptation. In many areas—economic, legal and political—China is at a turning point in its history, a time when basic assumptions are being challenged and long standing policies are being reviewed. The developments in the area of taxation are a microcosm of the

\textsuperscript{442} United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102 (1980); see S. Surrey, United Nations Model Convention for Tax Treaties Between Developed and Developing Countries: A Description and Analysis (International Bureau of Fiscal Documentation, Selected Monographs on Taxation, Monograph No. 5, 1980).

\textsuperscript{443} There does not appear to be any comparative study of the terms of these treaties or of which model they tend to follow.

\textsuperscript{444} China does have agreements in the area of shipping, see note 14 supra, and aviation. A recent treaty with the United Kingdom deals with the double taxation of airlines and their personnel. See note 397 supra.

\textsuperscript{445} IITL, supra note 2, art. 16.

\textsuperscript{446} Uncertainties regarding the creditability of any of the Chinese taxes, see text accompanying notes 398-431 supra, could be resolved in a tax treaty. In other words, the United States could agree as part of the treaty to allow United States taxpayers to credit the Chinese taxes. The United States policy in crediting a specific tax in a treaty, where the status of the tax under the Internal Revenue Code is uncertain, is to apply the per country limitation, see text accompanying notes 435-37 supra, to the credit. As a consequence of the per country limitation, excess credits could be generated. This situation can result because the United States tax is levied on a net income basis while the Chinese either use a system of statutory allowances, or deny any deductions whatsoever. The effective Chinese tax rate on a particular category of income may therefore exceed the effective United States tax rate. Under a per country limitation, the resulting excess tax credit cannot be utilized against the income taxes of other countries.
new course that the People's Republic is charting as it enters its fourth decade.

As the Chinese reexamine the structure of their economy, the tax system is being asked to play an increasingly important role going well beyond the taxation of foreign investment. The experiment with the taxation of state enterprises, rather than having them turn all their profits over to the state, is an effort to inject a measured dose of accountability, initiative and incentive into a planned economy. The panoply of new taxes under consideration reflects efforts to accomplish through measures the Chinese call "economic law" what used to be attempted, often haphazardly and unevenly, through ad hoc state action. The revisions of the ICITA indicate that small-scale enterprises are being encouraged in order to satisfy the demand for goods and services which is not being met by production from state enterprises. The degree to which these changes will serve as models for future revisions will ultimately depend on whatever balance the Chinese achieve between a competitive and a controlled economy.

The experiments with the consolidated tax illustrate the emphasis now being placed on the goal of economic efficiency. The pyramiding features of the consolidated tax can frustrate that goal by favoring integrated enterprises and by discouraging the growth of specialized enterprises. The trial replacement of the consolidated tax with a value-added tax, which eliminates any pyramiding, is intended to achieve a more neutral tax.

A tax system that can cope with foreign individuals and businesses—both integral parts of China's new economic order—is an outgrowth of the restructuring of the Chinese economy. Many aspects of the taxation of foreign individuals and entities in China clearly remain to be developed. Areas requiring further attention include the tax regime that will be applied to companies not covered by the joint venture tax; the relationship between the tax system in the special economic zones and that used elsewhere in China; the negotiation of tax treaties; and a refinement of the rules on taxable income, source, residency and the foreign tax credit.

As China struggles to develop a tax system suitable for the 1980s, it is burdened by its neglect of legal, financial and economic training, and its dearth of contact with other countries, during the 1960s and early 1970s. Moreover, China has little experience to draw upon—for nearly twenty-five years, the Chinese tax structure remained virtually unchanged, a record probably unparalleled by any other country. In this context, the adoption of the new tax laws on joint ventures and individuals represents a significant achievement. It would be unrealistic to expect the Chinese to have anticipated all of the questions raised throughout this article. We can expect, however, that as China's growing corps of able taxation officials continues to gain insight and experience, and to examine and adapt foreign learning, answers will gradually emerge.