1981

Do Chinese Income Taxes Qualify for the U.S. Foreign Tax Credit

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China, United States—Several technical readjustments in U.S. policy toward China have occurred which may signal increased business opportunities for exports to and investments in China. The U.S. National Security Council has changed China’s security designation which means that China is eligible for assistance under AID programs as well as through other governmental agencies. (Page 3) The U.S. will also permit sales of technology at higher technical levels than has been allowed in the past. (Page 3)

China, United States—U.S. taxpayers doing business in China will want to consider whether the Chinese income tax is creditable against U.S. income taxes. (Page 8)

South Korea—Perhaps the single most important piece of Korean commercial legislation enacted in the last twelve months has been the new antitrust law. This law applies to foreign firms doing business in Korea as well as to foreign invested joint ventures competing in Korean markets. (Page 2) South Korea is studying a plan to make it mandatory for local firms to become prime contractors on all tenders for consulting and engineering. (Page 20)

Japan—Major revisions are adopted in the Company Law. Key provisions include strengthened internal auditing procedures, limitations on intercorporate stock holdings, and a modification aimed at reducing the ability of the sokaiya to extort money from companies. (Page 13) A labor consultant provides pointers on labor dispute resolution in Japan. (Page 14) Japanese banks are showing increasing interest in becoming involved in project financing. (Page 15)

Taiwan—Regulations designed to reassure foreign manufacturers that pirating of trademarks is under control have become effective, but few observers feel that they will have much impact on Taiwan’s illicit exports. (Page 21)

**SOUTH KOREA**

Experimenting With Antitrust Law—II

by Sang Hyun Song, Esq.

(Editors’ Note: Sang Hyun Song is a Professor of Law at Seoul National University and a member of the Seoul First Bar.)

Perhaps the single most important piece of Korean legislation enacted in the last twelve months has been the new antitrust law. Because this law is Korea’s first effort at developing a comprehensive legislative package on the major elements of antitrust law, and because this law applies to foreign firms doing business in Korea as well as to foreign invested joint ventures competing in Korean markets, it is important to explore some of the key details of the new legislation.

In this second of a two-part series, EAER examines false advertising prohibited by the new law, treatment of cartel under the law, the resale price maintenance provisions, and treatment of international agreements under the law.

EAER has obtained English language translations of the antitrust law and implementing Presidential Decree, which are available to subscribers at cost.)

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(b) Untruthfully slandering or calumniating goods or services of a competitor; or

(c) falsifying the true quality or quantity of goods.

As the above definition indicates, falsity or untruthfulness seems to be the essence of this prohibited activity. (Continued on page 18)

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East Asian Executive Reports is published monthly by International Executive Reports Ltd., 1115 Massachusetts Ave., N.W., #6, Washington, D.C. 20005. Subscriptions are $385 per year (U.S.) and $435 per year (Non-U.S.). Two year subscriptions are $695 (U.S.) and $785 (Non-U.S.).

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ISSN 0272-1589
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Chinese Taxes: In General

China's Individual Income Tax Law (IITL) provides an individual not residing in China or an individual residing in China for less than one year is subject to taxation on all of his worldwide income. The tax is levied at an effective rate of 33 percent. The 33 percent tax rate is comprised of a 30 percent national tax and an additional local surcharge of 10 percent of the national tax, that is effectively three percent additional tax on income. There is also a 10 percent gross withholding tax on profits remitted outside of China by a joint venture.

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.

Income Tax Or Tax Paid In Lieu Of An Income Tax?

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 provided that the tax levied by the JVITL or the IITL would be assumed to be an income tax levied on income derived from the "production, business and other sources." The tax is levied at an effective rate of 33 percent. The 33 percent tax rate is comprised of a 30 percent national tax and an additional local surcharge of 10 percent of the national tax, that is effectively three percent additional tax on income. There is also a 10 percent gross withholding tax on profit remitted outside of China by a joint venture.
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 interpretative 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 questions regarding the U.S. approach to defining an "income tax."
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could count as the tax otherwise generally imposed, unless the revenue collected under it is so insignificant that it cannot reasonably be a benchmark. The second requirement is that of "comparability." The comparability requirement must be 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." The application of these two requirements can be illustrated in the context of the 20 percent 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 two requirements—substitutability—seems to be satisfied because the 20 percent 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 percent 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 percent rate while the tax on wages and salaries is progressive, ranging from 5 percent to 45 percent. 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 or a deduction for his actual costs. Depending on how these issues are resolved, the comparability requirement may or may not be satisfied. Similar issues are raised in characterizing the 20 percent taxes on rents and royalties as in lieu taxes.

**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 percent gross taxes. The creditability of each of these three taxes is tested independently of the others.

Because of the denial of any deductions, none of these 20 percent 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 and 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 a gross basis and those situations in which the income is taxed on a net basis. 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. However, the approach taken by the foreign country must be reasonable.

Consider, for example, the 20 percent gross tax on nonresidents receiving income from personal services. In order for the "reasonable distinction" test to be met, 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 percent of income.

If it is determined that residents are taxed on their income from personal services on a net income basis, 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. An analysis of the creditability of the 20 percent gross taxes on rents and royalties proceeds 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 percent taxes on residents are not creditable as income taxes, the 20 percent gross taxes on nonresidents would also be noncreditable. Furthermore, the 20 percent 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. The analysis of the creditability of these 20 percent gross taxes on nonresidents is thus similar to the analysis above in the case of residents.

**Footnotes**

1See I.R.C. §§ 901-03.
2For example, assume that the United States corporation is a 50 percent shareholder in a Chinese joint venture. Assume further that the joint venture earns $100, pays $33 tax on its profits and distributes all of its remaining profits to its shareholders. The United States shareholder receives a distribution of $33.50 (50 percent of $67), which it remits from China. The United States corporation pays a tax of $3.35 (10 percent 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 the $16.50, the amount of the 33 percent 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.
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If the JVITL were to serve as "an income tax otherwise generally imposed," the comparison would be between a taxpayer's liability under the JVITL and his liability under the IITL. The regulation allows a deduction for actual 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, 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 represents such costs.

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 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 nondeductible with respect to such persons, without jeopardizing its deductibility for other persons. Under this carve-out provision, perhaps a distinction can be drawn among various forms of service, permitting a 20 percent nondeductible tax on services in industries with 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.

An earlier version of the regulations provided that if the income from personal services was not significant, Taxes on the gross amount of those items of income satisfy the net income requirements." Prop. Treas. Reg. § 1.901-2(b)(ii), 46 Fed. Reg. 36073-74 (June 20, 1979), see also note 10 supra.

An earlier version of the regulations provided that if the taxes on the gross amount of those items of income satisfy the net income requirements." Id.

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 suggests 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 the income tax.


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 Consolidated Industrial and Commercial Tax may also count, assuming that the revenues collected under it are sufficiently significant. (See Aug. 15, 1980 EAER, p. 2.

For income in excess of 4,000 yuan, the 800 yuan deduction under the wage and salary tax will be less than the statutory deduction allowed under the 20 percent tax, increasing the likelihood that the 20 percent tax will satisfy the comparability requirement. Since actual costs are likely to exceed the statutory allowance under the 20 percent tax, a deduction for actual costs decreases the likelihood that the 20 percent tax will satisfy the comparability requirement.

If the JVITL were to serve as an income tax otherwise generally imposed, the comparison would be between a taxpayer's liability under the JVITL and his liability under the IITL. A taxpayer's liability under the IITL may be greater than his liability under the JVITL, because the latter allows a deduction for actual costs. While it seems odd to compare the tax liability of an individual under the 20 percent tax with what it would have been under the JVITL, which applies to corporations and not to individuals, such a comparison is suggested by Temp. Treas. Reg. § 4.901-2(d)(1980).

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 12 supra, the in lieu regulations do not provide that a particular industry can be carved out. See Temp. Treas. Reg. § 4.902-1(d)(1980).