TAX INCENTIVES IN THE PEOPLE'S REPUBLIC OF CHINA: WHO BENEFITS?

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I. INTRODUCTION

Since the promulgation of its first equity joint venture law in 1979,[1] the People's Republic of China (PRC or China) has experienced a tremendous increase in corporate investment. Foreign investment in China amounted to $40 billion in 1995.[2] Foreign investment in China may take a number of forms, including equity joint ventures, cooperative joint ventures, and wholly foreign-owned enterprises. Equity joint ventures are defined as those entities with limited liability that are incorporated and registered in China.[3] Cooperative joint ventures are separate enterprises, but not necessarily separate legal persons.[4] Wholly foreign—owned enterprises are those companies owned completely by one or more foreign investors.[5] Foreign branches located in China are now treated differently due to a newly-promulgated Company Law that

1. *See* The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures Using Chinese and Foreign Investment, adopted on July 1, 1979, at the Second Session of the Fifth National People's Congress, *translated in* 18 I.L.M. 1163 (1979), *also available in* LEXIS, Intlaw Library, Chinal File, Chinalaw No. 41 [hereinafter 1979 Joint Ventures Law].

2. *Foreigners Invest $40 Billion in China*, FIN. TIMES, Jan. 16, 1996, at 6.

3. *See* 1979 Joint Ventures Law, *supra* note 1, arts. 1, 4.

4. *See* David Foster, *Business Operations in the PRC*, Tax Mgmt. (BNA) at A-14(1) to A-14(2), A-15 (1995).

5. Wholly-owned foreign enterprises were first permitted in 1984. They must either utilize advance technology or export all or a major portion of their products and, moreover, are restricted or prohibited from engaging in certain specified industries. *See* COOPERS & LYBRAND, TAX PRIMER: CORPORATE INVESTMENT INTO THE PEOPLE'S REPUBLIC OF CHINA 12 (1994); *see also* Foster, *supra* note 4, at A-16 to A-17.

went into effect July 1, 1994.[6] This law allows foreign branches to engage in production and business activities,[7] whereas they formerly were restricted to only foreign banking and insurance companies.[8]

In 1979, the Chinese government invited several American professors from Harvard Law School's International Tax Program to educate Chinese tax officials on generally-accepted tax practices of the international community.[9] The participants of this seminar observed that the Chinese are cognizant of the fact that many analysts question the efficiency and the effectiveness of tax incentives.[10] Moreover, the participants found that the Chinese government is aware that the role of tax incentives in attracting international investment to China may be less important than such incentives may be to the foreign development of

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6. Company Law of the People's Republic of China, adopted on Dec. 29, 1993, at the Fifth Session of the Standing Committee of the Eighth National People's Congress, 1 China L. Foreign Bus. Reg. (CCH) ¶ 13-518, *translation also available in* CHINA'S COMPANY LAW: THE NEW LEGISLATION 7 (Guiguo Wang trans., 1994).

7. *See id.* arts. 199-205.

8. *See* COOPERS & LYBRAND, *supra* note 5, at 6.

9. *See* Richard Pomp & Stanley Surrey, *The Tax Structure of the People's Republic of China*, 20 VA. J. INT'L L. 1, 2 (1979).

10. *See id.* at 12.

> Tax incentives focus on the impact special tax provisions are intended to have on behavior. A state enacts tax incentives because it wants to encourage certain (economic) activities. Consequently, tax incentives emphasize the purpose the special tax is intended to serve, rather than its nature or effect. Tax incentives are special tax provisions that deviate from the generally accepted structure of the income tax and that are intended to influence economic behavior.

Dr. Harry A. Shannon III, *Tax Incentives and Tax Sparing*, INTERTAX, Jan. 1992, at 84. It is argued that decisions to invest are influenced by a wide variety of factors and that tax considerations may be relatively unimportant. *See* Pomp & Surrey, *supra* note 9, at 12. Although tax incentives may offer marginal encouragement to some investors that perhaps would not have otherwise been available, it is doubtful that such incentives provide the fundamental impetus for such investment. *See* Shannon, *supra*, at 87.

In addition, the report of the Ruding Committee emphasizes the possible side-effects of tax incentives on a country's international competitiveness with respect to goods and services:

> If the tax revenue foregone by a Member State as a result of its implementing investment incentives is not made up by raising other taxes, then the country's budget deficit will increase, unless public expenditures are cut by an equivalent amount. In so far as any increased budget deficit is financed from abroad, there will be a tendency for the country's real exchange rate to appreciate, at least in relation to third countries. This appreciation would tend to make the Member State's tradable goods and services more expensive in relation to foreign tradable goods, thus leading to a decline in its international competitiveness as far as goods and services are concerned.

COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION 43 (1992).

smaller countries.[11] This can be attributed to China's strong, natural appeal to investors from abroad.[12] Nevertheless, the Chinese government currently grants various tax exemptions and reductions to foreign investors.[13]

Taxpayers generally welcome the opportunity to take advantage of tax incentives.[14] However, in the international context, the efficiency of such incentives cannot be assessed solely from the calculation of taxes paid in the host country. Indeed, the foreign investor's country of residence (resident state) may have a claim on the taxation of the income earned by its residents when they do business in foreign states. China will be the focus of this Article and will exemplify the "host state" in the discussion. Two differing models generally define the treatment of taxes claimed by the resident state:

(1) Capital Export Neutrality—If the resident state has adopted a tax system purely based on the principle of capital export neutrality, the income derived in the host state by the foreign investor is likely to be taxed to some extent by the resident state.[15] The resident state should, however, grant a credit equal to the amount of taxes effectively paid to the host government.[16] The resident state is responsible for determining a methodology for defining which taxes paid to foreign governments are creditable and which ones are not.

(2) Capital Import Neutrality—If the resident state has adopted a tax system based on the principle of capital import neutrality,[17] the income that is derived in the host country under the applicable source-of-income rules is normally exempted from taxes in the resident state.[18]

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11. *See* Pomp & Surrey, *supra* note 9, at 12.
12. *See id.*
13. *See* COOPERS & LYBRAND, *supra* note 5, at 39.
14. *See* Shannon, *supra* note 10, at 87.
15. *See* STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 1ST SESS., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 241 (Comm. Print 1991) [hereinafter FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES]. "Capital export neutrality refers to a system where an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax." *Id.*
16. *See id.* "Tax systems, including that of the United States, may adhere to the principle of capital export neutrality by taxing worldwide income and granting credits for income and profit taxes paid to foreign governments." *Id*. at 243.
17. *See id.* "Capital import neutrality refers to a system of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor." *Id.* at 241.
18. *See id.* at 243. "Capital import neutrality may be achieved by the residence country exempting income earned from foreign jurisdictions entirely from tax and allowing the source country's taxation to be the only taxation on the income of international investors." *Id.*

However, most states operating under a system of capital import neutrality do not exempt from taxes passive investment income, generated by foreign investors, such as interest, dividends, or royalties.[19] Instead, passive investment income, even if derived in the host country, is taxed by the resident state.[20] However, taxes paid on this income to the host government are creditable towards taxes due in the resident state.[21]

A comparison of the two systems reveals that certain types of income are subject to concurrent taxation by both governments, but double taxation is avoided by a credit mechanism. However, coordinating both countries' taxation schemes sometimes falls short of full efficiency. Also, tax incentives add a new dimension to these taxation systems. When the resident state's tax rate is higher than the tax rate in the host country, such as China, the incentives offered by the host government may be neutralized. The tax liability assessed by the resident state is increased proportionally by the rate differential of the tax incentive. Essentially, taxes waived by the Chinese government are instead paid to the treasury of the resident state.

The above discussion is extremely simplified primarily because it does not take into consideration the limitations imposed by some states pertaining to the method of determining the creditability of foreign taxes, as well as the effect of tax deferral.[22] Nevertheless, the following question arises: Who benefits from the tax incentives granted by the Chinese government? Is the beneficiary the foreign investor, or the collective fiscal authority of the resident state?

Answering this question depends, in part, on the existence of a tax sparing credit. Under the policy of tax sparing, when the host country reduces its tax rate through the use of tax incentives, the resident state agrees to credit an amount equal to the tax that would have been due in

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19. Such income may be exempted from resident state's taxation if it is attributable to a permanent establishment abroad or it is exempted as a result of a specific provision of the resident state's tax laws.

20. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE U.S., *supra* note 15, at 243.

21. *See id.*

22. Under deferral, the foreign-source earnings of a foreign corporation controlled by resident state shareholders are subject to resident state taxation only when the earnings are distributed as dividends. *See* CHARLES H. GUSTAFSON & RICHARD C. PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 197 (1992). Thus, as long as deferral is the policy of the resident state, a Chinese subsidiary controlled by foreign shareholders can capitalize on the benefits of the Chinese tax incentives by not distributing the earnings concerned. *See id.*

China absent the incentive, rather than the amount that is actually paid.[23] In other words, when a resident state computes foreign tax credits, it treats the taxes that are waived or spared by the Chinese government as if they had actually been paid.[24] This policy serves as an important element in Chinese foreign policy. Accordingly, "China has persistently insisted on inserting a 'tax sparing' clause in its tax treaties . . . [and] except for the treaty with the United States, all of China's Tax Treaties with developed countries include a tax sparing clause."[25]

Various dynamics, in addition to the existence of a tax sparing credit, shape the ultimate effect or benefit of the tax incentives on the foreign investor. This Article traces the impact of such tax incentives through an analysis of specific provisions in over twenty tax treaties entered into by the Chinese government and other countries. These provisions govern the elimination of double taxation, including any tax sparing allowances. It appears that the real benefit of such incentives for a foreign corporation will depend on several factors, including: (1) the type of income at stake (business income vs. investment income); (2) the tax system adopted by the resident state (worldwide taxation with differences depending on the limitations for the foreign tax credit vs. exemption of foreign-owned income); (3) the form of the investment made in China (branch vs. subsidiary); (4) the existence of a tax sparing credit; and (5) the nature of the tax incentives given by the Chinese government.

In organizing the discussion, an overview of the tax regimes applicable to foreign investors doing business in China, as well as any

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23. *See* Shannon, *supra* note 10, at 86; *see also* Richard C. Pugh, *The Deferral Principle and U.S. Investment in Developing Countries, in* UNITED STATES TAXATION AND DEVELOPING COUNTRIES 267, 270-71 (Robert Hellawell ed., 1980).

24. *See* JINYAN LI, TAXATION IN THE PEOPLE'S REPUBLIC OF CHINA 112 (1991) [hereinafter TAXATION IN CHINA].

25. *Id.*; *see also* Shannon, *supra* note 10, at 88. The United States has consistently refused to grant tax sparing to any country, since the negotiations of the Tax treaty with Pakistan in 1957. Indeed, a tax sparing credit had been included in the Pakistan Treaty but the Senate gave its consent to the Treaty with the reservation that the tax sparing credit would not apply. *See id.*

The United States formerly agreed, however, that its tax treaty with China "shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country." Letter from Ronald Reagan, President of the United States of America, to Zhao Ziyang, Premier of the State Council of the People's Republic of China (Apr. 30, 1984), T.I.A.S. No. 12,065, at 56 [hereinafter Letter from Ronald Reagan to Zhao Ziyang]. For further discussion, see Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. REV. 369, 380, 387 (1987) (citations omitted).

available tax incentives, will be discussed initially. Part II will assess the effect of tax incentives on income earned by a branch establishment of a foreign company situated in China. Part III will investigate the consequences of tax incentives on income earned by a Chinese subsidiary of a foreign company. Part IV will explain the policy concerning passive investment income earned directly by a foreign investor. In Parts II, III, and IV, the differing effects of tax incentives will be shown when incorporated in a system of resident-based taxation as compared to a system of source-based taxation. The United States will be used as a primary example of a country employing a residence-based system and France will exemplify a country employing a source-based system. Additionally, taxation systems of other countries will be illustrated where relevant.

This Article is intended to show that the benefits of some incentives are more fully realized when certain defined circumstances are present. Accordingly, some ventures eligible for tax incentives in China may receive more favorable tax treatment depending on the resident state's taxation system.

II. OVERVIEW OF THE TAX SYSTEM OF CHINA AND OF THE VARIOUS TAX INCENTIVES

During the 1980s, China's policy regarding the taxation of foreigners was prompted by three primary goals: (1) using the tax mechanism as a regulatory tool for implementing the nation's economic policies; (2) aligning China's tax system with general international tax practices; and (3) increasing revenue.[26] The first objective (manipulating tax regulations to implement Chinese economic policy) may have been the overriding goal of the Chinese government in enacting this tax regime. This rationale helps to explain China's continued tolerance of the low percentage of tax revenue from foreign investment. For instance, in 1989, tax revenue from foreign investment was less than two percent of the total annual tax revenue.[27] This phenomenon, however, seems to be tapering off. An upsurge in the amount of taxes collected from foreign investment enterprises may be resulting from the fact that many foreign investment enterprises established in China in the early 1980s have now

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26. *See* Jinyan Li, *Taxation of Foreign Investment in the People's Republic of China*, 12 LOY. L.A. INT'L & COMP. L.J. 35, 35 (1989).

27. *See* TAXATION IN CHINA, *supra* note 24, at 103, 119 n.31.

exhausted their initial tax holidays and are starting to pay their share of taxes.[28]

A. Overview of China's Tax System

China's tax policies regarding foreign enterprises that invest in or do business with China is based on the Income Tax Law of the PRC Concerning Foreign Investment Enterprises and Foreign Enterprises (UITL).[29] The UITL was enacted by China's National People's Congress in an attempt to develop a uniform and simplified system of taxation. This legislation went into effect on July 1, 1991.[30] Regulations for the Implementation of the UITL (UITR) were promulgated by the State Council on June 30, 1991.[31] Under previous legislation, Chinese-foreign equity joint ventures were taxed pursuant to the Joint Venture Income Tax Law (JVITL).[32] All other entities and activities were taxed pursuant to the Foreign Enterprise Income Tax Law (FEITL).[33] Both the JVITL and the FEITL were annulled on the date of entry into force of the UITL.[34]

The territoriality rules of the UITL provide that foreign investment enterprises that establish their head offices in China are required to pay taxes on their worldwide income, while other foreign enterprises are taxed only on income derived from sources within China.[35] Under the UITL, income tax is paid on net income from foreign investment enterprises established in China (investment income) and on net income from foreign enterprises that establish a production or

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28. *See* Jinyan Li, *As Tax Holidays Expire, Chinese Government Sees Increase in Tax Revenue From FIEs*, 10 TAX NOTES INT'L 1591, 1591 (May 8, 1995) (citing CHINA TAX'N NEWS, Mar. 10, 1995, at 1).

29. The Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, Apr. 9, 1991 (P.R.C.), *translated in* 5 COM., BUS. & TRADE LAWS 31 (1991) (effective July 1, 1991) [hereinafter UITL].

30. *See id.* art. 30.

31. *See* Regulation for the Implementation of the Income Tax Law of People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, July, 1, 1991 (P.R.C.), *translated in* 957 Tax Mgmt. (BNA) B-201 (1995) [hereinafter UITR].

32. The Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment, adopted at the Fifteenth Session of the National People's Congress Standing Committee, Aug. 26, 1980 (P.R.C.) *translated in* 19 I.L.M. 1452 (1980) [hereinafter JVITL].

33. *See* The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises, adopted at the Fourth Session of the Fifth National People's Congress, Dec. 13, 1981 (P.R.C.), *translated in* 5 COM., BUS. & TRADE LAWS 83 (1991) [hereinafter FEITL].

34. *See* UITL, *supra* note 29, art. 30.

35. *See id.* art. 3.

business operation in China (business income).[36] The total tax rate is equal to thirty-three percent, which is comprised of a flat tax rate of thirty percent plus a local income tax rate of three percent.[37]

Provisions in the UITL also require foreign enterprises that derive investment income, profit, interest, rental, or royalties from sources in China, but have no establishment or place in China, to pay a withholding tax on their gross income.[38] The normal rate of withholding tax is twenty percent;[39] however, this rate does not apply to dividends paid to a foreign partner of a foreign investment enterprise.[40] Income earned in China generally is taxed at the local level.[41]

B. *Tax Incentives Available to Foreign Investors*

Chinese tax laws make provisions for various incentives affecting the taxation of both business income and investment income. Taxpayers may apply in writing to the fiscal authorities for tax reduction and

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36. *See id.* art. 4.

37. *See id.* art. 5.

38. *See id.* art. 19. The same provision also applies to foreign enterprises that have an establishment in China, but that derive income not effectively connected with the establishment. *See id.* The taxation of certain passive income is consistent with the principle stated in Article 3 of the UITL, that foreign enterprises shall be taxable on their income from sources within China and with the definition of income from sources within China, detailed in Article 6 of the UITR. Article 6 of the UITR specifies that in the case of foreign enterprises with no establishments or places in China, income from sources within China shall refer to:

> (1) profit (dividend) derived from enterprises within China;
> (2) interest derived from China on deposits, loans, bonds, advance payments made provisionally on another's behalf, or deferred payments;
> (3) rental on assets leased to and used by parties in China;
> (4) royalties generated by providing for use in China patent rights, proprietary technology, trademark rights, copyright and other such rights;
> (5) earnings from assigning assets and transferring property, such as buildings, structures, and their auxiliary facilities, and land use rights;
> (6) other income derived from China and stipulated as taxable by the Ministry of Finance.

UITR, *supra* note 31, art. 6.

39. *See* UITL, *supra* note 29, art. 19.

40. *See id.* art. 19, paras. 1 & 3, item 1; UITR, *supra* note 31, art. 63.

41. *See* Foster, *supra* note 4, at A-19. "Foreigners normally register with, and direct questions and pay taxes to, the municipal or provincial tax authorities in the area where they are located." *Id.*; *see also* Jinyan Li, *Chinese Tax Collection Jurisdictions Clarified*, 11 TAX NOTES INT'L 411, 411 (Aug. 14, 1995).

exemption.[42] It should be noted, however, that all financial benefits granted by local authorities in violation of national laws or in excess of local governing authority are invalid.[43]

1. Tax Incentives on Business Income

(a) Article 7 of the UITL stipulates lower tax rates for certain types of enterprises that operate in certain specified locations.[44] The tax rate for business income is either fifteen percent or twenty-four percent, depending on the nature and the location of the project.[45]

(b) Article 8, paragraph 1 of the UITL allows for a two year exemption from taxes for production-oriented foreign investment enterprises scheduled to operate for a period of not less than ten years.[46] This two year exemption begins with the first profit-making year.[47] After this exemption expires, these enterprises enjoy a fifty percent tax reduction for three subsequent years.[48]

(c) Article 8, paragraph 2 of the UITL provides for the continued availability of a variety of tax holidays that are listed in Article 75 of the UITR. These tax holidays are either a temporary exemption, followed by a reduction of the income tax rate, or a permanent reduction of the income tax rate.[49] These incentives are contingent upon the

42. *See* Administration Law of the People's Republic of China on the Levying and Collection of Taxes, Jan. 1, 1993, art. 21, 1 China L. Foreign Bus. Reg. (CCH) ¶ 39-621; *see also* UITL, *supra* note 29, art. 9.

43. *See* Detailed Rules for the Implementation of the Law of the People's Republic of China to Administer the Levying and Collection of Taxes, Aug. 4, 1994, 1 China L. Foreign Bus. Reg. (CCH) ¶ 39-622; *see also* UITL, *supra* note 29, art. 9; John S. Mo, *Taxation Power and Invalidity of Certain Local Concessions in China*, 26 INT'L LAW. 933, 942 (1992) (arguing that many local tax concessions are illegal and that the Chinese government is not liable to protect foreign investors' interests granted by these illegal concessions.

44. *See* UITL, *supra* note 29, art. 7. The locations are the Special Economic Zones, the Economic and Technological Development Zones, the Coastal Open Economic Zones and the old urban districts of cities where the Special Economic Zones or the Economic and Technological Development Zones are located. *See id.* Special Economic Zones, Economic Technological Development Zones and Coastal Open Economic Zones are defined in Articles 69 and 70 of the UITR. *See* UITR, *supra* note 31, arts. 69, 70.

45. *See* UITL, *supra* note 29, art. 7.

46. *See id.* art. 8, para. 1; *see also* Arthur Ho, *China Defines "Productive Enterprises" for Income Tax Preferences*, 11 TAX NOTES INT'L 130, 130 (July 17, 1995).

47. *See* UITL, *supra* note 29, art. 8, para. 1.

48. *See id.* art. 8. In addition, Article 76 of the UITR provides that the first profit-making year shall be the year in which the enterprise begins to show a profit after all the losses have been made good. *See* UITR, *supra* note 31, art. 76.

49. *See* UITL, *supra* note 29, art. 8, para. 2; UITR, *supra* note 31, art. 75.

location of the investment and the nature of the corporation's activities.[50] For example, a exporting enterprise established with foreign investment may be granted an additional fifty percent reduction in income tax after the expiration of the reduction or exemption period if that enterprise has an annual export value amounting to seventy percent or more of the value of its product output for that year.[51]

(d) Article 8, paragraph 3 of the UITL specifies that following the expiration of the enumerated tax holidays, foreign investment enterprises that engage in agriculture, forestry, or animal husbandry, or are located in remote, economically underdeveloped regions, may apply to the tax authorities for a reduction of their taxes for the next ten years.[52]

(e) Article 9 of the UITL authorizes local authorities to exempt or reduce local income tax on foreign investment enterprises.[53]

(f) Article 10 of the UITL provides for a forty percent refund of taxes already paid on profits that are directly reinvested for at least five years in the same or another foreign investment enterprise.[54] Under Article 80 of the UITR, "direct reinvestment" means either reinvestment in the same enterprise by a foreign investor before allocation of its share of the profits from the enterprise, or investment by a foreign investor in the establishment of another foreign investment enterprise after allocation of the profits.[55] In addition, a full tax refund is available if the reinvestment is in the establishment or expansion of an exporting enterprise or technologically advanced enterprise.[56]

2. Tax Incentives on Investment Income

Article 19 of the UITL provides for a series of situations in which the twenty percent withholding tax may be reduced or waived completely.[57] In addition to dividends,[58] the exemption covers interest income on loans made to the Chinese government or Chinese state banks

50. *See* UITL, *supra* note 29, art. 8, para. 2; UITR, *supra* note 31, art. 75.
51. *See* UITR, *supra* note 31, art. 75, para. 7.
52. *See* UITL, *supra* note 29, art. 8, para. 3. This provision is similar to Article 5 of the previous JVITL and Article 5 of the previous FEITL.
53. *See id.* art. 9; *see also* Jinyan Li, *Local Chinese Authorities Grant Income Tax Relief to Attract Foreign Investment*, 10 TAX NOTES INT'L 2025, 2025 (June 19, 1995).
54. *See* UITL, *supra* note 29, art. 10.
55. *See* UITR, *supra* note 31, art. 80, para. 1.
56. *See id.* art. 81.
57. *See* UITL, *supra* note 29, art. 19; *see generally* UITR, *supra* note 31, arts. 59-67.
58. *See* UITL, *supra* note 29, art. 19, para. 3, item 1; UITR, *supra* note 31, arts. 60, 63.

by international financial organizations,[59] and interest income on loans made at a preferential rate to Chinese state banks by foreign banks.[60] The reduction covers the tax on certain royalty payments which, upon approval, may be levied at the rate of ten percent.[61] In addition, where the technology is advanced or the terms are preferential, the withholding tax on the royalty payments may be exempted.[62]

III. THE EFFECT OF THE TAX INCENTIVES ON THE INCOME OF A BRANCH

A. *In the Absence of a Tax Sparing Credit*

If the foreign investor's resident state exempts foreign source business income from domestic taxes or the resident state has agreed to exempt such business income in a bilateral treaty with China, no tax is due in the resident state on the business income derived from the operations in China. The overall tax liability of the foreign investor amounts to only the taxes paid in China. Therefore, a reduction in the taxes owed to the Chinese government directly reduces the foreign investor's overall tax liability.

The situation is different if the foreign investor's resident state taxes the worldwide income of its residents and then grants a credit for taxes paid to foreign governments. This difference stems from the fact that the income from the Chinese branch must be included in the branch's current taxable income under the laws of the resident state. The benefit of the tax incentives for the foreign investor will depend on the type of taxes waived and the limitations imposed by the resident state on the creditability of foreign taxes.

1. The Nature of the Taxes Waived

The ultimate benefit of Chinese tax incentives may vary depending upon whether or not the affected taxes are creditable in the resident state. Therefore, it is important to determine the particular nature of the resident state's limitations pertaining to the "creditability" of foreign taxes.

59. *See* UITL, *supra* note 29, art. 19, para. 3, item 2; UITR, *supra* note 31, arts. 64, 65.
60. *See* UITL, *supra* note 29, art. 19, para. 3, item 3; UITR, *supra* note 31, art. 65.
61. *See* UITL, *supra* note 29, art. 19, para. 3, item 4; UITR, *supra* note 31, arts. 59, 66.
62. *See* UITL, *supra* note 29, art. 19, para. 3, item 4; UITR, *supra* note 31, art. 66.

In a system of pure residence state taxation (capital export neutrality), the overall tax liability of the foreign investor is the same, regardless of whether the investment is made in the investor's state of residence or abroad.[63] Assuming that the Chinese government levies lower taxes than the resident state, the overall tax burden for the investor on the income derived in China is equal to the taxes paid to the Chinese government, plus a residual amount of taxes owed to the resident state's treasury. This residual amount is designed to make up for the difference in tax rates. Typically, this residual amount is equal to the resident state's taxes on the foreign source income less the creditable taxes paid to the foreign government. Thus, if China reduces the amount of Chinese tax recognized as creditable by the resident state, the taxes creditable towards the residual resident state tax are reduced and the resident state tax liability replaces the reduced Chinese tax liability.[64] In this case the tax incentives directly benefit the resident state's treasury. However, if China reduces taxes that are not recognized as creditable, the incentive will benefit the foreign investor.[65] Still, beneficial tax incentives may be nullified if the resident state has enacted tax provisions that prevent any resulting economic benefit to the foreign investor.[66]

The creditability of foreign taxes depends on the definition of a "creditable foreign tax" as construed under the domestic laws of the

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63. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 241.

64. At this point, the limitations on foreign tax credit will not be factored into the analysis.

65. Under U.S. Internal Revenue Code (I.R.C.) § 164(a), income taxes paid to foreign countries are deductible. *See* I.R.C. § 164(a) (1996). However, the benefit of such a deduction is limited to the amount of the foreign income taxes multiplied by the U.S. tax rate. Therefore, a reduction of deductible foreign taxes does increase the U.S. tax liability of the investor, but in an amount less than the economy realized.

66. In the United States, a foreign levy is not a tax and is therefore not creditable to the extent the taxpayer receives a specific economic benefit in exchange for payment of the levy. *See* Treas. Reg. § 1.901-2(a)(2)(i) (1996). A specific economic benefit is defined as

> an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country . . . [I]t includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls; or a reduction or discharge of a contractual obligation.

Treas. Reg. § 1.901-2(a)(2)(ii)(B).

In addition, an amount of foreign income tax is not creditable to the extent it is used directly or indirectly to provide a subsidy by any means to the taxpayer, a related person, or any party to the transaction or to a related transaction and the subsidy is determined by reference to the amount of the tax or to the tax base used to compute the amount of tax. *See* I.R.C. § 901(i) (1996).

resident state,[67] and on the stipulation of specific categories of taxes under the bilateral tax treaty entered into by China and the resident state, if one applies.[68] The UITL, enacted subsequent to the tax treaty between the United States and China, is therefore not mentioned as a creditable tax, but probably serves as a creditable income tax for the purposes of computing the U.S. foreign tax credit.[69] Hence, the possibility exists that tax incentives granted by the Chinese government under the UITL to an American investor that effectively reduce the investor's tax burden may be thwarted by the United States Treasury. In order to ascertain whether or not those incentives will ultimately benefit the foreign investor, a supplementary analysis is necessary.

Initially, research must be conducted as to whether other incentives are possible, such as direct subsidies, remission of indirect taxes, or preferential infrastructure projects undertaken by the government. Then, the impact of such incentives on the creditability of taxes paid pursuant to the UITL must be determined.[70] Indeed,

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67. Under U.S. Treasury Regulation § 1.901-2(a) (1996), a foreign tax is "creditable" if it is a tax, and it is of the predominant character of income taxes in the United States. A tax satisfies the predominant character test if the tax will likely reach net gain under normal, applicable circumstances. *See* Treas. Reg. § 1.901-2(a)(3)(i). In addition, I.R.C. § 903 permits certain foreign taxes paid in lieu of an income tax to qualify for credit under section 901. Under Treasury Regulation § 1.903-1, gross withholding taxes on interest, dividends, royalties, etc., qualify as taxes paid in lieu of an income tax, if the tax is a substitute for, and not in addition to, the generally imposed income tax.

68. The agreement between the United States and China for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income is enforceable in the People's Republic of China when applied to: (1) the individual income tax; (2) the income tax concerning joint ventures with Chinese and foreign investment; (3) the income tax concerning foreign enterprises; and (4) the local income tax. *See* Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, P.R.C.-U.S., art. 2.1(a), T.I.A.S. No. 12,065, *also available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-U.S. Tax Treaty]. It also applies to identical or substantially similar taxes imposed after the signing date of the agreement that add to or replace those taxes. *See id.* A similar provision is found in several other tax treaties to which China is a party.

69. The first argument in support of this interpretation is that the treaty applies to both the JVITL and the FEITL. It also applies to any identical or substantially similar taxes which are imposed after the signing date of the agreement that either add to or replace those taxes. The UITL arguably fits within this definition and, therefore, may qualify as a creditable foreign tax under the treaty. Secondly, the two taxes provided for in the UITL, the tax on net business income and the withholding tax on passive income, should qualify, respectively, as an income tax and as a tax in lieu of an income tax under U.S. tax law provisions. *See* Foster, *supra* note 4, at A-39 (giving detailed analysis of the creditability of the UITL for U.S. foreign tax credit purposes).

70. In the United States, a person who is both a taxpayer and the recipient of a specific economic benefit is denominated in the regulations as a "dual capacity taxpayer." *See* Treas. Reg. § 1.901-2(a)(2)(i) (1996). When claiming a credit for a foreign levy, the dual capacity taxpayer has the burden of establishing the portion of the levy which is a tax. *See id.* It should be noted that if a dual capacity taxpayer's foreign tax levy does not differ from other taxpayers as a result of either

enterprises with foreign investments are eligible for a variety of favorable measures. For example, export-oriented and technologically advanced enterprises may obtain reductions in land-use fees, exemptions from the payment of certain subsidies to staff and workers, and reductions in water, electricity and transportation fees.[71]

2. Resident State Limitations on Foreign Tax Credits

As stated earlier, the U.S. system of taxation is based on the principle of capital export neutrality.[72] In order for a credit system to be fully consistent with capital export neutrality, unlimited credits for foreign tax payments must be available in the resident state to effectively reduce the investor's tax liability in the resident state by the amount of taxes paid in the host country.[73] Under such a system, a tax incentive given by the Chinese government to a foreign investor on creditable taxes would never benefit the investor. However, the U.S. system significantly deviates from a system of pure capital export neutrality. Most importantly, the credit is limited to the amount of tax that would be paid at domestic rates on foreign source income computed under U.S. tax rules, and the excess of foreign taxes paid is not refundable.[74] Thus, foreign source income is subject to the higher of the effective U.S. or foreign tax rate.

The tax rates in the United States and in China are close (thirty-five percent and thirty-three percent, respectively) and do not put the

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higher tax rates or different methods used to compute the tax base, the foreign tax levy for a dual capacity taxpayer is considered to be a tax in full and is creditable under the same analysis as applies to figuring the levy on other taxpayers. *See* Treas. Reg. § 1.901-2A(a)(1) (1996); *see, e.g.*, Priv. Ltr. Rul. 86-18-009 (Jan. 31, 1986).

71. *See* A.J. EASSON & LI JINYAN, TAXATION OF FOREIGN INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA 138 (1989).

72. *See supra* notes 63-66 and accompanying text.

73. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 249.

74. More specifically, I.R.C. § 904(a) provides that

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

I.R.C. § 904(a) (1996).

Indeed, if the rate of taxes paid in the foreign country is higher than the current U.S. rate, the taxpayer is not able to credit all the taxes paid to the foreign country. In this situation he is in an excess credit position; that is he has foreign taxes in excess of the foreign tax credit limitation. The foreign source income is subject to the foreign tax rate. This foreign source income generates a higher tax liability than if the income came from a domestic source. However, excess credits can be carried back or carried over. *See* I.R.C. § 904(c).

taxpayer in a significant excess limit position.[75] However, if the foreign investor receives a tax incentive from the Chinese government, the rate of taxes in China is significantly lower than the U.S. rate (the rate in the PRC can be zero percent, fifteen percent or twenty-four percent). As a result, the foreign investor will be in an excess limit position with respect to its Chinese business income.

Under the overall method of limitation of the foreign tax credit,[76] the foreign investor is allowed to average the tax burden among the rates of those countries in which it conducts business.[77] Therefore, the foreign investor can use high foreign taxes (i.e., taxes in excess of the U.S. rate) to offset the U.S. tax on the business income that has been reduced as a result of the tax incentives. The foreign tax credit reduces the U.S. residual tax on the income from China to less than what it would be if a credit were available only for the Chinese tax on that income. However, the opportunities for averaging foreign taxes may be reduced because certain types of income are subject to separate limitation calculations. This limitation may prevent cross-crediting of foreign taxes on one type of income against U.S. taxes on another type of income.[78]

Essentially, the effect of the tax incentive for a U.S. investor depends on whether the investor is in an excess credit position or in an excess limit position within the basket of income in which the particular

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75. An excess limit position exists when the limitation on the amount of creditable foreign taxes is higher than the foreign taxes effectively paid. In such a case, a residual tax must be paid to the United States on the income from the foreign source.

It should also be noted that, although the tax rate in China is lower than the tax rate in the United States, the existence of a branch-profits tax could cause the foreign investor to be in an excess credit position. China, on the other hand, does not impose such a branch-profits tax.

76. Since 1976, U.S. taxpayers have been required to use the "overall method," and to aggregate all taxes paid to foreign countries for the purpose of computing the limitation on the foreign tax credit. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 124-25. This overall method contrasts with the "per-country method," which separately categorizes the limitation on the foreign tax credit according to profits derived from each foreign country. *See id.*

77. If the taxpayer operates in Country A, where the tax rate is forty percent, and in Country B, where the tax rate is thirty percent, the taxpayer must aggregate the taxes paid to both countries, and then compare this amount to the current U.S. tax rate on the total income from Country A and Country B. More of the taxes that were paid to Country A will be able to be credited than would have been possible if the limitation to the amount of foreign taxes creditable was computed on a country by country basis.

78. As a result of the 1986 Act, eight separate categories (baskets) of income exist. *See* I.R.C. § 904(d). All remaining types of income fall into a residual category, the "general limitation income basket." *See* 904(d)(1)(I). Separate foreign tax credit limitations must be computed for each basket of income. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 125. Cross-crediting between taxes paid on income within different baskets is not allowed. *See id.*

type of income earned by the Chinese branch falls. If the foreign investor is in an excess credit position, the investor has noncreditable foreign taxes and does not have to pay additional U.S. taxes on income effected by the tax incentives. Therefore, such an investor will benefit directly from the incentives.[79]

Indeed, for an investor in an excess credit position, the objective is to develop foreign-source taxable income subject to a lower tax rate than the effective U.S. rate so as to use excess credits carried forward.[80] The business income of a Chinese branch that is eligible for UITL tax incentives constitutes such income. In addition, branch income may fall within the general limitation income basket in section 904(d)(1)(I) of the U.S. Internal Revenue Code. This section includes income from manufacturing, international sales of inventory, and rendering of services.[81] The areas governed by this section remain the focus of most of the tax planning efforts of U.S.-based multinationals. Therefore, tax incentives on income within the general limitation income basket may represent a significant benefit for the U.S. investor.

On the other hand, if the investor is in an excess limit position, the tax incentives will be neutralized by additional U.S. taxes and will ultimately benefit the United States Treasury. Other counties may have other limitations on the foreign tax credit (for example, a per-country limitation as opposed to an overall limitation, or different rules with respect to the computation of separate foreign tax credit limitations) or no limitation at all. Therefore, if the foreign investor is not a U.S.-based company, but resides in a country that taxes the worldwide income of its residents, an analysis similar to the above outline should be structured according to the internal laws of the investor's resident state.

B. Incidence of a Tax Sparing Credit

With the exception of the United States, developed countries that tax the foreign-source income of their residents and are bound by a

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79. According to the staff members of the 1991 Joint Committee on Taxation, "[i]t is believed that currently a substantial proportion of foreign income, but by no means all foreign income, is being earned by taxpayers in an excess credit position." FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 259.

80. In the United States, foreign tax credits in excess of the applicable limitation for any taxable year may be applied to the two preceding taxable years and likewise carried forward five years. *See* I.R.C. § 904(c). The excess credits are available in any year to which they are carried only to the extent that they and the creditable foreign taxes for that year do not exceed § 904 limitations for that year. *See id.*

81. *See* I.R.C. § 904(d)(1)(I).

bilateral tax treaty with China have agreed to provide a tax sparing credit to their foreign investors.[82] When a country espouses the policy of tax sparing, the treaty partner allows its residents a credit for certain Chinese taxes which the Chinese government, in turn, waives, creating an advantageous tax situation. Typically, a tax sparing credit reduces a foreign investor's tax burden to the resident state by the same amount as that waived by the Chinese incentive. Such a credit is particularly attractive to an investor whose resident state taxes are increased as a result of the taxes foregone in China.

Treaty clauses strictly define the taxes for which a tax sparing credit is available.[83] Most of the tax treaties signed by China were, however, entered into before the enactment of the UITL. Therefore, many of these treaties make reference only to the tax incentives available under the previous legislation. Typically, two types of incentives were covered in the treaties.

1. Exemption and Reduction of Taxes Available Independent of the Location of the Chinese Operations

The typical provision[84] refers to tax incentives given pursuant to Articles 5 and 6 of the JVITL,[85] Article 3 of the Detailed Rules and

82. *See* TAXATION IN CHINA, *supra* note 24, at 112.

83. In addition, the United Kingdom and Australia have negotiated a provision to limit the availability of the tax sparing credit to income generated during a specific period of time. *See* Agreement for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 26, 1984, U.K.-N.Ir.-P.R.C., art. 23(3), 22 COM., BUS. & TRADE LAWS 19, *also available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-U.K. Tax Treaty]; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 17, 1988, P.R.C.-Austl., art. 23.7, *available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-Australia Tax Treaty].

84. For instance, Article 23(3) of the China-U.K. Tax Treaty reads as follows:

> For the purpose of paragraph 2 of this article, the term 'Chinese tax payable' shall be deemed to include any amount which would have been payable as Chinese tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under any of the following provisions of Chinese law:
>
> (a)(i) Articles 5 and 6 of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment and Article 3 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment;
>
> (ii) Article 4 and 5 of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises;
>
> So far as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character; or

Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment,[86] and Articles 4 and 5 of the FEITL.[87] However, due to the annulment of these laws on July 1, 1991 (the date the UITL took effect), the continued availability of a tax sparing credit under the UITL must be questioned. The issue is currently resolved under the laws of the resident state because the credit is claimed against the taxes imposed by the resident state. Two considerations are, however, relevant.

First, it should be noted that most of the treaty clauses providing for a tax sparing credit either fail to make provision for any subsequent changes in the laws of the PRC or they incorporate a stand-still provision.[88] Such a stand-still provision might state that the tax sparing

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> (b) any other provision which may subsequently be made granting an exemption from or reduction of tax which is agreed by the competent authorities of the Contracting State to be of a similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

China-U.K. Tax Treaty, *supra* note 83, art. 23(3); *see also* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 6, 1983 P.R.C.-Jap., art. 23.4, 23 I.L.M. 120, 137-38, *also available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-Japan Tax Treaty]; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 12, 1986 P.R.C.-Can., art. 23.3, 24 COM., BUS. & TRADE LAWS 1, *also available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-Canada Tax Treaty]; China-Australia Tax Treaty, *supra* note 83, art. 23.5; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 12, 1986, P.R.C.-Fin., art. 23.1(d), *available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-Finland Tax Treaty]; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 26, 1986, P.R.C.-Den., art. 23.4, *available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-Denmark Tax Treaty]; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 16, 1986, P.R.C.-N.Z., art. 23.3, *available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-New Zealand Tax Treaty].

85. Article 5 of the JVITL provides (1) for a one year exemption then for a two year reduction from income tax for a newly established joint venture and (2) for a reduction of tax during the next ten years for joint ventures engaged in certain low profit operations or located in remote, economically outlying areas. *See* JVITL, *supra* note 32, art. 5. Article 6 of the JVITL provides for a forty percent refund of income taxes paid for profit that are reinvested for a period of not less than five years in a joint venture. *See id.* art. 6.

86. *See* UITR, *supra* note 31, art. 3. This Article provides for a reduction or exemption of the local surtax of ten percent.

87. Article 4 of the FEITL provides for a local surtax of ten percent levied on foreign enterprises which can be reduced or waived by the government. *See* FEITL, *supra* note 33, art. 4. Article 5 of the FEITL provides for an exemption and a reduction of taxes on foreign enterprises scheduled to operate for a period of ten years in low profit operations. *See id.* art. 5.

88. See China-Japan Tax Treaty, *supra* note 84, art. 23.4; China-Denmark Tax Treaty, *supra* note 84, art. 23.4; and China-Finland Tax Treaty, *supra* note 84, art. 23.1(d) for examples of treaties failing to make provisions for the subsequent changes in the laws of the PRC.

credit shall be available subject to the condition that the provisions of Chinese law pursuant to which the tax incentives are given have not been modified since the date of signature of the treaty, or have been modified only in minor respects so as to not affect their general character.[89] Although the general character of the tax incentives available under Chinese law may not have been fundamentally changed by the enactment of the UITL, it seems difficult to argue that the enactment of a new law that replaces preexisting laws is only a minor modification of those laws.

Secondly, some tax treaties provide for the tax sparing credit to be extended to "similar special incentive measures designed to promote economic development" in the PRC. This provision may be introduced in the laws of the PRC after the signature of the treaty. These "similar special incentive measures" may be designated upon agreement by the governments of the contracting states,[90] or upon agreement of competent state authorities stating that the measures are of a substantially similar character.[91] It can be argued that existing incentives under Article 8, paragraph 1; Article 8, paragraph 3; Article 9; and Article 10 of the UITL are of substantially similar character to the incentives that grant a tax sparing credit in the JVITL.[92] However, the language of the various Chinese tax treaties seems to indicate that before a credit can be claimed by the investor against resident state taxes, the similarity of the tax incentives must be recognized and documented by the competent authorities or by the government of the contracting states.[93] No

89. *See* China-Canada Tax Treaty, supra note 84, art. 21.2; China-U.K. Tax Treaty, *supra* note 83, art. 93(3)(a); China-Australia Tax Treaty, *supra* note 83, art. 23.5; China-New Zealand Tax Treaty, *supra* note 84, art. 23.3.

90. *See* China-Japan Tax Treaty, *supra* note 84, art. 23.4(c); China-Denmark Tax Treaty, *supra* note 84, art. 23.4(c).

91. *See* China-Finland Tax Treaty, *supra* note 84, art. 23.1(d)(iii); China-New Zealand Tax Treaty, *supra* note 84; China-Australia Tax Treaty, *supra* note 83, art. 23.5; China-U.K. Tax Treaty, *supra* note 83, art. 23.3(b); China-Canada Tax Treaty, *supra* note 84, art. 21.2(d).

92. An important difference, however, is that under Article 5 of the JVITL, the one year exemption and the two year reduction of income taxes had to be approved by the tax authorities upon an application of the enterprise. *See* JVITL, *supra* note 32, art. 5. Under Article 8 of the UITL, the exemption and the reduction are automatic. *See* UITL, *supra* note 29, art. 8; *see also supra* note 85 for further explanation.

93. Interestingly, an exception is illustrated in the tax treaty entered into by China and Thailand which broadly provides that the tax sparing credit includes the amount of Chinese tax "exempted or reduced in accordance with the special incentive laws designed to promote economic development in China, effective on the date of signature of this Agreement, or which may be introduced hereafter in modification of, or in addition to, the existing laws." Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 27, 1986, P.R.C.-Thail., art. 23.2, *available in* LEXIS, Intlaw Library, IBFD File. Under this Treaty, Thailand has totally relinquished any control over the tax incentives that China may enact.

agreements or statements of similarity appear to exist. Therefore, an investor considering claiming a tax sparing credit should inquire with the competent authorities of its resident state about their position on this issue.

2. Incentives Granted to Enterprises Located in Specific Areas

A few countries have recognized a tax sparing credit for taxes foregone in accordance with incentives for investment in specific locations.[94] Incentives designed to attract investment to particular locations can be traced back to the creation of the Special Economic Zones under a directive jointly issued in July, 1979 by the State Council and the Central Committee of the Chinese Communist Party.[95] The fiscal incentives available to foreign investors are not legally based on the JVITL or on the FEITL, but, rather, on regulations adopted in 1984 (1984 Regulations).[96] These regulations determined incentives that apply to four Special Economic Zones, fourteen coastal cities, developing economic and technology zones, and old urban areas.[97] The enactment of the UITL does not necessarily result in the modification of the 1984 Regulations. However, some unique features of the 1984 Regulations, such as reduced income tax rates[98] and exemption from local surcharges,[99] have been included in Articles 7 and 8 of the UITL.[100]

Because of these modifications, available incentives may be treated differently. A distinction must be drawn between tax sparing credits for incentives not modified by the UITL or by legislation enacted subsequent to the signing of the relevant tax treaties, and tax sparing

94. *See* China-Canada Tax Treaty, *supra* note 84, art. 21.2(c); China-New Zealand Tax Treaty, *supra* note 84, art. 23.3(c); and China-Australia Tax Treaty, *supra* note 83, art. 23.5. For instance, the tax sparing clause in the treaty with Canada recognizes a credit for exemption or reduction of taxes granted pursuant to "the interim provisions of the State Council of the People's Republic of China concerning reduction or exemption from enterprises income tax in special economic zones and coastal cities." China-Canada Tax Treaty, *supra* note 84, art. 21.2(c).

95. *See* EASSON & JINYAN, *supra* note 71, at 125.

96. *See* The Provisional Regulations Concerning the Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for the Special Economic Zones and Fourteen Coastal Port Cities, Nov. 14, 1984 (P.R.C.) *translated in* 10 COM., BUS. & TRADE LAWS 29 [hereinafter SEZR].

97. *See id.*

98. *See id.* § 1(1).

99. *See id.* § 1(2).

100. *See* UITL, *supra* note 29, arts. 7, 8. On the contrary, Article 8, paragraph 2 of the UITL provides for the continued application of certain regulations promulgated by the State Council. *See id.* Article 75 of the UITR gives a list of regulations which remain applicable. *See* UITR, *supra* note 31, art. 75.

credits for incentives modified after the enactment of the relevant treaty that are available only if the competent authorities recognize these provisions to be substantially similar to incentives covered by the tax sparing clause.

IV. INCOME OF A SUBSIDIARY

Income from outbound investment earned by separately incorporated subsidiaries is not, under the policy of deferral, subject to resident state taxation until it is repatriated.[101] However, the fact that a subsidiary is legally incorporated in a foreign country does not mean that it will automatically be treated as a foreign corporation by the resident state. Indeed, under the "check-the-box" regulations, a Chinese entity (other than a "Gufen Youxian Gongsi") may be classified either as a corporation or as a partnership on an elective basis.[102] A Gufen Youxian Gongsi, in turn, will automatically be treated as a corporation.[103]

Assuming that an entity is treated as a corporation by the resident state, the right to tax the dividends upon repatriation of the earnings is provided for in the tax treaty between the resident state and the Chinese government. Most of the tax treaties entered into by China provide that dividends may be taxed in the resident state and that dividends may also be taxed in China at a rate that cannot exceed ten percent.[104] China does not, however, impose a withholding tax on the distribution of dividends.[105] The taxation of dividends is therefore left entirely to the resident state.

Some tax treaties provide that the treaty partner must allow a credit for a withholding tax that is deemed paid on the dividends. Since China does not impose a withholding tax on dividends, this credit is not a credit given for taxes foregone by China, but rather an additional

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101. There are exceptions to deferral. For example, I.R.C. § 952 (1996) (defining Subpart F income) prohibits foreign operations from serving as potential tax shelters. French law, although it promotes capital import neutrality, also has a provision to prevent the deferral of taxes on certain kinds of income. *See* Code Générale des Impôts [C.G.I] art. 209B (Fr.).

102. *See* Treas. Reg. § 301.7701-2; *see, e.g.*, Alan Shapiro & Barbara Montegani, *From* Morrisey *to Check-the-Box: Can You Get There from Here?*, 26 TAX NOTES INT'L 513 (Feb. 10, 1997).

103. *See* Treas. Reg. § 301.7701-2(b)(8)(i).

104. *See* China-U.S. Tax Treaty, *supra* note 68, art. 9.2; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 30, 1984, P.R.C.-Fr., arts. 9.1, 9.2(d), *available in* LEXIS, Intlaw Library, IBFD File [hereinafter China-France Tax Treaty].

105. *See* UITL, *supra* note 29, art. 19, para. 3; UITR, *supra* note 31, art. 63. It should be noted that under both the JVITL and the FEITL a withholding tax was imposed on dividends.

incentive recognized by the treaty partner.[106] China has implemented such "matching" credits in tax treaties with several countries, which are listed in the following table.[107]

COUNTRY	ARTICLE	RATE
France	Art. 22.2(c)	10% or 20%
Denmark	Art. 23.3(a)	10%
Finland	Art. 23.1(e)	10%
Sweden	Art. 23.3	10%
Italy	Art. 23.4(a)	10%
Germany	Art. 24.2(c)(aa)	10%
Canada	Art. 21.2(e)	10 or 15%
Japan	Art. 23.3	10 or 20%
Australia	Art. 23.6	15%
Norway	Art. 25.2(c)	15%
Pakistan	Art. 24.3(i)	15%
Poland	Art. 23.2(c)	10%

Two situations must be distinguished.

A. *Dividends are Not Taxed by the Resident State*

Dividends received by a parent company from a foreign subsidiary may be exempted from taxation under internal laws of the resident state. For instance, in France, dividends received by a French parent company are tax free whether they are paid by a French subsidiary or by a foreign subsidiary.[108] The exemption can also be stated in the relevant tax treaty. For instance, the tax treaty between China and Sweden provides that dividends paid by a company resident in China to a company in Sweden are exempt from Swedish tax to the extent that the

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106. When most of the tax treaties used in this paper were signed, China imposed a withholding tax on dividends distributed to foreign investors. Therefore, the credit for the deemed paid withholding tax was really a tax sparing credit to account for taxes foregone by China.

107. *See* GUY GEST & GILBERT TIXIER, DROIT FISCAL INTERNATIONAL (INTERNATIONAL TAX LAW), 125 (1990). "Unlike traditional tax sparing credits, the matching credit applies whether or not the source state actually enacts specific tax incentives under its domestic law." Shannon, *supra* note 10, at 89. It should be noted that in some treaties the application of the deemed credit is limited to a specified number of years after the treaty enters into force. No such limitation exists in the treaty with France. *See* China-France Tax Treaty, *supra* note 104, art. 22.2(c).

108. *See* C.G.I., *supra* note 101, arts. 145, 216.

dividends would have been exempt under Swedish law if both companies were Swedish companies.[109]

The policy of exempting from resident state taxes the dividends earned by foreign subsidiaries is fully consistent with the principle of capital import neutrality. For instance, a French investor in China keeps the benefit of the Chinese tax incentives applicable to its Chinese subsidiary even after repatriation of the profits.

In addition, France grants a tax sparing credit to its investors in China. This credit is equal to the Chinese tax levied on the dividend.[110] Correspondingly, the Chinese tax rates are deemed to be equal to ten percent of the gross dividends paid by Chinese companies with mixed capital, or twenty percent of other dividends.[111] However, this credit cannot exceed the amount of French tax on the dividends. Because no French tax is due on the dividends, the credit cannot be applied directly to reduce the investor's French tax liability. Yet, it can be used in two situations:

(1) If a French company distributes dividends generated by its Chinese subsidiary that are not taxed in France, a compensatory tax is imposed on the dividends distributed in order to compensate for the French integration system.[112] The deemed credit on the dividends received from the Chinese subsidiary can be credited against this compensatory tax.[113]

(2) If a French investor distributes dividends generated by the Chinese subsidiary to a foreign shareholder, a withholding tax is imposed by the French Treasury on the dividends distributed. The deemed credit on the dividends received from China can be credited against this withholding tax.[114] In this situation, the compensatory tax is, as a general

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109. *See* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, May 16, 1986, P.R.C.-Swed., art. 23.2.(c), 24 COM. BUS & TRADE LAWS 7, 32, *also available in* LEXIS, Intlaw Library, IBFD File.

110. *See* China-France Tax Treaty, *supra* note 104, art. 22.2(b).

111. *See id.* art. 22.2(c). The meaning of "Chinese companies with mixed capital" is unclear since the terms are not defined and are not usually employed in the context of foreign investment in China. *See id.* By comparison, the treaty with Japan seems to be more clearly drafted by providing a rate of ten percent "in the case of dividends paid by a joint venture in the People's Republic of China" and twenty percent in the case of other dividends. *See* China-Japan Tax Treaty, *supra* note 84, art. 23.3(a).

112. The French company may be exempted from the compensatory tax if it is a holding company. *See* C.G.I., *supra* note 101, art. 223; GEST & TIXIER, *supra* note 107, at 338.

113. *See* BRUNO GOUTHIERE, LES IMPÔTS DANS LES AFFAIRES INTERNATIONALES (TAXATION OF INTERNATIONAL TRANSACTIONS) 492 (1989).

114. *See id.* at 497.

rule, refundable if the foreign shareholder is a resident of a country that has entered into a tax treaty with France.[115] Incidentally, a withholding tax is also imposed on the refund of the compensatory tax, and the deemed credit on the dividends received from China cannot be credited against this withholding tax.[116] This makes the arrangement of a French holding company in China almost tax-free regarding withholding taxes on the repatriation of earnings via dividends, assuming that the rate of withholding tax on dividends provided for in the tax treaties between France and the particular country of residence of the foreign parent company is lower than ten percent.[117]

By contrast, the deemed credit does not seem to be available where a French company earns income in China through a branch. Therefore, if the French investor plans to remit to its shareholders some of the profits derived in China, the existence of the deemed credit can be an element to consider in deciding whether or not to create a Chinese branch or a Chinese subsidiary.

B. *Dividends Are Taxed by the Resident State*

1. In the Absence of a Tax Sparing Credit

If the resident state taxes the worldwide income of its residents, as the United States does, dividends received from a foreign subsidiary are typically not tax exempt. Moreover, the parent company is allowed a credit for taxes paid by its Chinese subsidiary if the parent owns more than a certain percentage of the voting rights in that Chinese subsidiary.[118] The availability of such an indirect foreign tax credit results either from the domestic laws of the resident state or from the tax treaty, if any, existing between China and the resident state.[119]

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115. The refund is paid directly to the foreign shareholder. Consequently, the treatment of the refund by the country of residence of the foreign shareholder is then at issue.

116. *See* GOUTHIERE, *supra* note 113, at 497.

117. The tax burden is limited to the withholding tax on the refunded compensatory tax. This withholding tax may be creditable against the tax liability of the foreign shareholder, if any, on the refund of the compensatory tax. However, the interposition of a French holding company may have significant consequences on the taxation of the repatriated earnings in the country of residence of the foreign shareholder.

118. In the United States, the deemed paid credit results from I.R.C. § 902 and is only available if the domestic corporation owns ten percent or more of the voting stock of the foreign corporation.

119. *See, e.g.*, China-U.S. Tax Treaty, *supra* note 68, art. 22.2(b). *See also* China-U.K. Tax Treaty, *supra* note 83, art. 23.2(b); China-Japan Tax Treaty, *supra* note 84, art. 23.2(b); China-Australia Tax Treaty, *supra* note 84, art. 23.3; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 15, 1990, P.R.C.-Pak.,

If the effective Chinese tax rate of thirty-three percent is below the resident state's rate, payment of the resident state's tax will be deferred until earnings are repatriated. In other words, the investor is granted an interest free loan on tax that would have been due in the resident state.[120] Therefore, the larger the discrepancy between the resident state's tax rate and the Chinese tax rate, the larger the benefit of deferral. Since tax incentives granted by the Chinese government increase the difference between the effective tax rates, a foreign investor who would otherwise lose the benefit of the Chinese tax incentives if operating as a Chinese branch, has a clear incentive to incorporate a Chinese subsidiary and to not repatriate these earnings.[121]

However, deferral is only an interest free loan; upon repatriation of the earnings, the dividends are taxed in the resident state subject to a credit for taxes paid in China. This indirect credit allowed in the resident state is a function of both the Chinese income tax and the ratio that the dividend bears to the subsidiary's undistributed earnings. Furthermore, in the United States, the allowable indirect credit is based on "post-1986 foreign income taxes" and "post-1986 undistributed earnings."[122] Thus, both taxes and earnings are pooled, rather than being determined on a year-by-year basis. Essentially, tax incentives that reduce the amount of income taxes paid in China for a specific year carry a reduction of the indirect foreign tax credit attached to dividends distributed in a subsequent year. Therefore, the distribution of dividends will create excess limitation and will trigger additional U.S. taxes. Excess credits accruing from other sources of foreign income may be used to offset U.S. tax on the dividends; yet, there are limitations to this strategy as well.

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art. 24.1(b), *available in* LEXIS, Intlaw Library, IBFD File; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 26, 1991, P.R.C.-Mong., art. 23.1(b), *available in* LEXIS, Intlaw Library, IBFD File; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 17, 1992, P.R.C.-Hung., art. 23.2(b), *available in* LEXIS, Intlaw Library, IBFD File.

120. *See* Joint Comm. on Taxation, 102d Cong., 1st Sess., Proposal Relating to Current U.S. Taxation of Certain Operations of Controlled Foreign Corporations (H.R. 2889-American Jobs and Manufacturing Preservation Act of 1991) and Related Issues, 2, 44 (Comm. Print 1991); *see also* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 252-53.

121. In the United States, it is argued that "if the goal of tax sparing were to relieve U.S. tax burdens that might otherwise deter active foreign investment, then under present law, tax sparing is actually unnecessary, given the deferral permitted on active foreign income earned by a U.S. person through a subsidiary." FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 262.

122. *See* I.R.C. § 902(c) (1996).

The ability to cross-credit is limited, as noted previously, by the basket system. The basket of limitation to which the dividends are allocable depends on whether or not the Chinese subsidiary is a "controlled foreign corporation."[123]

An alternative strategy to forming a foreign branch for an investor may be to create a wholly foreign-owned enterprise. This type of establishment is clearly a controlled foreign corporation. An equity joint venture or a cooperative joint venture may or may not be a controlled foreign corporation depending on the foreign partners' equity. If the Chinese subsidiary is not a controlled foreign corporation, the dividends are placed in a separate limitation basket for dividends generated from noncontrolled section 902 corporations. A separate limitation applies to each noncontrolled section 902 corporation from which a dividend is received. In such a case, the ability to average is simply eliminated. Repatriation of the earnings generates additional U.S. taxes, negating the tax incentives. Thus, the real benefit of the tax incentives for the American investor depends on the length of time during which repatriation of the earnings is deferred.

If the Chinese subsidiary is a controlled foreign corporation, the proper basket for the dividends received is determined by "looking through" to the character of the underlying income of the subsidiary out of which the payment was made. Therefore, the ability to average depends on the character of the income of the Chinese subsidiary. In this case, the policy of an American company, with respect to the remittance of the earnings of its Chinese subsidiary, is likely to depend on the existence of excess credits that can be used to offset the additional U.S. tax burden. From the point of view of the tax planner, the ability to regulate the generation and timing of income carrying an excess limit, but not confined to a specific basket of limitation, may be very advantageous.

2. In the Presence of a Tax Sparing Credit

The computation of the indirect foreign tax credit can be affected by the existence of a tax sparing credit. For instance, the treaty signed by China and the United Kingdom requires that the Chinese tax payable by the subsidiary on the profits which generated the dividend must be taken

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123. A "controlled foreign corporation" is a foreign corporation in which more than fifty percent of either the total combined voting power of all classes of stock entitled to vote or of the total value of all stock is owned by U.S. shareholders, i.e., U.S. persons owning directly, or by attribution, ten percent of the voting stock of the controlled foreign corporation. *See* I.R.C. § 957(a) (1996).

into account when calculating the indirect foreign tax credit. In addition, such treaty also provides that the term "Chinese tax payable" is deemed to include certain taxes foregone by the Chinese government.[124] By increasing the amount of taxes deemed paid in China by the Chinese subsidiary, the tax sparing credit indirectly increases the amount of the indirect foreign tax credit.

The indirect foreign tax credit and the tax sparing credit can also be combined with a "matching credit" for a deemed paid withholding tax on the dividends. For example, the treaty with Japan operates in the following way: The amount of Chinese tax payable in China is creditable under Article 23.2(a).[125] When the income derived from China is a dividend, the credit takes into account the Chinese tax on the dividend.[126] Additionally, if the enterprise remitting the dividends is a joint venture, the Chinese tax is deemed to have been paid at a rate of ten percent.[127] Finally, the treaty construes "Chinese tax payable" to include certain taxes foregone by China.[128]

Generally, if a foreign subsidiary's resident state taxes the dividends that are distributed to the stockholders, the credit allowed for deemed paid withholding taxes on the dividends permanently reduces the investor's overall tax burden. This benefit, however, only results if the rate of tax is higher in the resident state than in China.

C. *The Treatment of the Refund of Taxes Already Paid on Profits that Are Reinvested*

To qualify for the refund, a foreign investor in a Chinese joint venture must reinvest the profits either in the same enterprise before the investor actually receives the profits, or in another enterprise after it receives them.[129] To qualify for the refund, the foreign investor must provide proof of actual reinvestment to the local Chinese tax authorities

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124. *See* China-U.K. Tax Treaty, *supra* note 83, arts. 23(2)(b), 23(3). *See also* China-Japan Tax Treaty, *supra* note 84, arts. 23.2(b), 23.4; China-Australia Tax Treaty, *supra* note 83, arts. 23.3, 23.4.

125. *See* China-Japan Tax Treaty, *supra* note 84, art. 23.2(a).

126. *See id.* art. 23.2(b).

127. *See id.* art. 23.3(a).

128. *See id.* art. 23.4. The Chinese Tax Treaty with Australia also provides for an indirect foreign tax credit mechanism, a tax sparing credit for taxes foregone on business income, and a deemed rate of withholding taxes on dividends of fifteen percent. *See* China-Australia Tax Treaty, *supra* note 83, art. 23.

129. The practice under the previous JVITL was that profits reinvested after having been first remitted abroad for deposit or other use failed to qualify for the refund. *See* Foster, *supra* note 4, at A-31.

that initially processed the foreign investor's taxes.[130] The refund is then paid directly to the foreign participant, even though the initial tax was paid by the joint venture.

Consider the following example. A foreign investor is a fifty percent investor in a Chinese joint venture, that produces income of $1000 and pays $330 in taxes—no tax holiday is available. The joint venture's after-tax profits are $670, with it distributing a dividend equal to $335 to the foreign investor. The foreign investor then reinvests the funds in another enterprise. This entitles her to a refund of $66. Essentially, forty percent of the investor's share of the taxes that were originally paid can be refunded. Altogether, the foreign investor receives $401, comprised of the $335 dividend, plus a $66 tax refund. $335 is reinvested.

1. The Foreign Investor is a U.S. Company

It is somewhat unclear how the receipt of the refund of the Chinese tax will be treated for U.S. income tax purposes.[131] A difficulty arises from the fact that the refund is paid directly to the foreign investor, yet the party responsible for initially paying the income tax was the Chinese joint venture. Two interpretations are possible. The first follows the form of the transaction. This analysis treats the refund as a direct payment from the Chinese Treasury to the U.S. investor. The second construction looks to the underlying economic substance of the transaction. Here, the Chinese joint venture that initially paid the tax "takes possession" of the refund and then distributes the refund to its U.S. investors as a taxable dividend. Needless to say, each analysis raises a number of additional questions.

a. U.S. Tax Treatment of the Refund Compared to the Treatment of Other Foreign Taxes

The refund of the Chinese tax is not the only example of a foreign tax being directly refunded to one of the participants in a joint venture. Other examples include the refund of the French tax credit (*avoir fiscal*) to U.S. portfolio investors,[132] the refund of the French prepayment

130. *See id.*

131. See *id.* at A-32.

132. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31 1994, U.S.-Fr., art. 10.4(a) (entered into force Dec. 30, 1995) [hereinafter U.S.-France Tax Treaty of 1994].

(*précompte*) to U.S. direct investors,[133] and the refund of the United Kingdom Advance Corporation Tax (ACT) to U.S. portfolio and direct investors.[134] The refund of the French tax credit and of the U.K. ACT are both treated as a dividend received by the U.S. investor.[135] However, this evidence does not necessary require identical treatment of the Chinese tax refund.

First of all, both the treaty between the United States and France and the treaty between the United States and the United Kingdom include specific provisions stating that the refund is to be treated as a dividend.[136] The treaty between the United States and China is silent on the treatment of the refund of the Chinese tax. Furthermore, the legislative history of the U.S.-U.K. Tax Treaty indicates that the stipulations regarding the treatment of the refund of the ACT were not intended to serve as a model for future treaties.[137]

Moreover, the refund of the Chinese tax is not comparable to the refunds of either the U.K. ACT or the French tax credit. The provisions in the French and U.K. treaties represent an approach to reconciling, by treaty, tax systems which differ in their treatment of corporations and shareholders. The United States operates under a classical system where corporate profits and dividend income are taxed separately when in the hands of the corporation and the shareholder. In comparison, France employs an imputation system under which a portion of the tax collected at the corporate level is refunded to the shareholder to satisfy the tax liability on the dividend distribution. In both cases, the refund was negotiated after the United States objected to the fact that the imputation credit was restricted to only residents of the U.K. and France, thus discriminating against U.S. residents.

China, on the contrary, does not have an imputation system. The Chinese tax refund was not the product of bilateral negotiations responding to discrimination complaints. It, on the contrary, was implemented by China to encourage foreign businesses to reinvest in

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133. *See id.* art. 10.4(e)

134. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975 - Apr. 13, 1976, U.S.-U.K.-N.Ir., art. 10(2)(a), 31 U.S.T. 5668, 5677 [hereinafter U.S.-U.K. Tax Convention].

135. In addition, the tax treaty between the United States and France specifies that the refund of the prepayment shall be treated as a dividend. *See* U.S.-France Tax Treaty of 1994, *supra* note 132, art. 10.4(h).

136. *See* U.S.-France Tax Treaty of 1994, *supra* note 132, art. 10.4(4); U.S.-U.K. Tax Convention, *supra* note 134, art. 10(2)(a)(iii).

137. *See* S. EXEC. REP. NO. 95-18, at 37 (1978), *reprinted in* 1980-1 C.B. 411, 429.

China. Essentially, the refund of the Chinese tax serves as a tax incentive. Thus, the Chinese refund should not necessarily be treated in the same manner as the French tax credit refund or the U.K. ACT refund.[138]

An analogy can also be drawn between the tax treaty entered into by the United States and the Federal Republic of Germany and the China-U.S. Tax Treaty. The German system taxes distributed profits at a lower rate than it taxes retained earnings. Accordingly, the refund of the Chinese tax results in a similar split-rate method of corporate taxation. The U.S.-F.R.G. Tax Treaty states that Germany has agreed to reduce its withholding rate on dividends paid to U.S. portfolio investors from fifteen percent to ten percent.[139] The United States, in turn, treats this reduction as a partial imputation refund, considered a supplementary dividend. United States portfolio investors are granted a tax credit as if the full fifteen percent withholding tax had been paid, while only a ten percent tax was actually collected.[140]

The German system, however, differs from the Chinese system in significant ways. Germany's refundable imputation credit is only available to German investors. The U.S.-F.R.G. Tax Treaty rules were negotiated to compensate for the disparity created by the German system. On the contrary, no such incongruity exists under the Chinese taxation system because foreign investors are treated more favorably than domestic investors. Therefore, this analogy to the German system is not entirely helpful.[141]

In short, the refund of the Chinese tax is not comparable to the refund of foreign taxes addressed in the other U.S. treaties. This brief analysis, however, shows that where the United States intends to treat the refund of a foreign tax as a dividend, it conspicuously notes this intention

138. One should note, however, that the legislative history of the treaty entered into by the United States and the United Kingdom indicates that the agreement of the United Kingdom to make partial ACT refunds available to U.S. direct investors was perceived as an important concession by the United Kingdom, in part, to encourage additional investment by U.S. direct investors. *See id.* In this sense the partial ACT refund to U.S. direct investors serves as a tax incentive.

139. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., art. 10.3, S. TREATY DOC. NO. 101-10 (1990) (entered into force Aug. 21, 1991).

140. *See id.* Protocol, para. 8.

141. The analogy to the German treaty, however, raises an interesting question: Is the United States actually recognizing a tax sparing credit by allowing the fifteen percent German withholding tax credit to be perceived at ten percent credit? The answer to this question has interesting implications due to promises made at the signing of the China-U.S. Tax Treaty. In notes exchanged at the signing, the United States specifically agreed to grant a tax sparing credit to China upon allowing one to any other country. *See* Letter from Ronald Reagan to Zhao Ziyang, *supra* note 25, at 56.

in the relevant treaty. Because no such provision exists with respect to the refund of the Chinese tax, the best approach appears to be to honor the form of the transaction.[142] Accordingly, the refund would be treated as received directly by the American investor.[143]

b. Treatment of the Refund of the Chinese Tax for U.S. Tax Purposes

If the form of the transaction is honored, the refund of the Chinese tax should be considered a direct subsidy paid by the Chinese government to the U.S. investor. In the United States, a subsidy is normally taxed as general income under Internal Revenue Code (I.R.C.) § 61, unless it qualifies as a nonshareholder contribution to capital under I.R.C. § 118. In order to fall in the latter category, the motivating factor behind the capital contribution must be to benefit the community at large. In addition, the person making the contribution must not anticipate any direct benefit from the contribution.[144]

An analysis of the treatment of the Chinese tax refund under I.R.C. § 118 suggests that the primary motivation behind the implementation of the Chinese tax refund was to increase foreign direct investment in China. If this analysis is correct, the refund would arguably meet the above "intent-of-the-transferor" test. However, mere evidence of a nonshareholder's intent to make a contribution to capital will not, in an of itself, satisfy the test under U.S. law. The contribution must also become a permanent part of working capital; it cannot be compensation for specific quantifiable services; it must be bargained for; it must

142. The American investor has no say regarding the person to whom the refund of the Chinese tax is directed. This direct payment is the result of a legal provision of Chinese law, not an arrangement organized by the American investor.

143. If the refund is treated as received by the Chinese subsidiary, it may affect the United States investor's foreign tax credit. Under Treasury Regulation § 1.905-3T (1996), the Chinese subsidiary must reduce its pool of foreign taxes and increase its earnings and profits to reflect the Chinese tax refund. Consequently, this impacts the foreign taxes deemed paid by the U.S. investor under I.R.C. § 902. Depending on the timing and importance of the refund, the U.S. investor may be required to either redetermine her U.S. tax liability or to adjust the pools of foreign taxes, earnings, and profits of the Chinese subsidiary for purposes of calculating foreign taxes deemed paid in subsequent taxable years. *See* Treas. Reg. § 1.905-3T(d)(2).

An alternative approach would be to consider that the refund reduces only the U.S. investor's share of the Chinese subsidiary's taxes, rather than the joint venture's taxes. *See* Foster, *supra* note 4, at A-32.

144. In *Brown Shoe Co. v. Commissioner*, 399 U.S. 583 (1950), the United States Supreme Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. *See id.* at 589.

foreseeably benefit the corporation in an amount commensurate with its value; and it must ordinarily be employed to generate additional income.[145]

An analysis of the Chinese refund under this subtest shows that although the refund must be approved by the Chinese authorities, it essentially fails to be the object of a bargaining process.[146] Additionally, a further complication in the refund calculation is presented by the requirement that the participant must pay back the amount of tax that is refunded if the reinvested funds are withdrawn before the five year reinvestment period. No requirement prevents the refunded amounts from being used for noncapital expenditure. It is therefore unclear whether the refund of the Chinese tax should be treated as a nonshareholder contribution to capital or as a taxable subsidy.[147]

If the refund is treated as a nonshareholder contribution to capital, it cannot be included in the gross income of the U.S. investor.[148] However, under I.R.C. section 362(c), if the contribution is monetary, its amount must be subtracted from the property basis held or acquired by the U.S. investor. Over time, this results in a loss of tax savings generated by depreciation.[149]

2. The Foreign Investor Resides in a Country That Allows a Tax Sparing Credit

Tax sparing reflects the prevailing attitude regarding the use of the tax system to promote goals unrelated to raising revenue, such as the promotion of resident state's investment in China through favorable tax benefits and exemptions.[150] Tax sparing also reflects the goal to respect the sovereign tax policy of China. Consistency with these objectives mandates that the resident state exempt from domestic taxation the refund of the Chinese tax. Still, if the resident state taxes the refund, the foreign investor has the option of petitioning the competent resident state authorities for reconsideration. If the foreign investor is successful in this appeal, the full benefit of the refund can be retained.

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145. *See* Springfield St. Ry. v. United States, 577 F.2d 700, 703 (1978); *see also* United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401, 413 (1973).

146. Previous law (which may still apply) required the foreign investor to submit an application to the original taxing authority with copies of the relevant documents. *See* Foster, *supra* note 4, at A-31.

147. *See id.*

148. *See* I.R.C. § 118(a) (1996).

149. *See* I.R.C. § 362(c) (1996).

150. *See* Shannon, *supra* note 10, at 89.

Some countries have agreed, by treaty, to allow a tax sparing credit for taxes foregone by the Chinese government under Article 5 of the JVITL. This Article provides a tax refund for profits reinvested under the JVITL. The foreign investor should, however, verify that the relevant tax treaty with China provides for an extension of the tax sparing credit to cover the refund available under Article 10 of the UITL (which is similar to Article 5 of the JVITL).[151]

3. The Foreign Investor Is a French Company

No tax sparing provision covering the Chinese tax refund has been agreed upon between France and China. However, the refund may be exempted from French taxes simply by application of the China-France Tax Treaty.

If the form of the transaction is honored, the refund of the Chinese tax should, under French law, be considered a subsidy that increases the net wealth of the French investor.[152] France's right to tax the subsidy may, however, be modified by the China-France Tax Treaty. To obtain the most favorable tax treatment, the French investor must first classify the refund of the Chinese tax under the categories of income provided in the China-France Tax Treaty. Article 7 of the treaty stipulates that the "profits of an enterprise of a Contracting State enterprise shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein."[153] The phrase "profits of an enterprise" is not defined in the treaty. Therefore, by application of Article 3.2 of the treaty, the term must be interpreted under French tax law.[154] This seems to mandate a broad interpretation covering all of an enterprise's revenues.[155] In such a case, the refund is taxable in France unless it is attributable to a permanent establishment in China. Article 5 of the China-France Tax Treaty defines the term "permanent establishment" as a "fixed place of business through which the business of an enterprise is wholly or partly carried on."[156] Article 5.7 of the treaty specifies that a French company's control over a Chinese company does not in itself render the Chinese company a

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151. *See* UITL, *supra* note 29, art. 10; *see also* JVITL, *supra* note 32, art. 5.
152. Further research into French law may be necessary to determine whether or not a subsidy is taxable.
153. China-France Tax Treaty, *supra* note 104, art. 7.
154. *See id.* art. 3.2.
155. *See* GOUTHIERE, *supra* note 113, at 178.
156. *See* China-France Tax Treaty, *supra* note 104, art. 5.

permanent establishment of the French company.[157] Notably, however, in order to qualify for the refund, the profits must be reinvested before actually remitted abroad.[158] The question then becomes whether this activity of reinvesting the profits through the intermediary of the Chinese subsidiary recharacterizes the Chinese subsidiary as a permanent establishment of the French company.[159] If this recharacterization occurs, the Chinese Tax refund would be taxable in China to the extent it is deemed to be attributable to the permanent establishment.[160] Although China may be willing not to tax the refund of its own tax, there does not seem to be an official position on this issue. The refund would also be exempted from French taxes by application of Article 22.2(a) of the treaty.[161] As a result, it may be advisable for a French company to create a permanent establishment in China in order to avoid French taxation.

In addition, the French company may also take the position that Article 7 of the China-France tax treaty does not apply to the refund of the Chinese tax.[162] The French company may argue that the Chinese tax refund is not a per se business profit of the French company, but rather an incentive separate from the French company's business activity. In this case, the refund of the Chinese tax would not fall into any of the treaties specified income categories. Therefore, the refund would be covered by the catch-all provision found in Article 21 referring to "other income."[163] Article 21 provides that the income of a French resident arising in China and not covered by any of the other treaty articles may be taxed in China.[164] Moreover, Article 22.2(a) of the treaty exempts from French taxation income that is taxable in China under the treaty.[165] However, Article 22.2(b) lists categories of exceptions to this rule which indicate types of income that are taxable in France although derived in China.[166] This list does not include income classified as "other income" under the treaty. One can therefore argue that, by operation of Article 22.2(a), the Chinese tax refund on income that arises and is taxable in China under Article 21 of the treaty is not taxable in France.

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157. *See id.* art. 5.7.
158. *See* Foster, *supra* note 4, at A-31.
159. The Chinese subsidiary may also perform services for the French company, such as applying for the refund on its behalf.
160. *See* China-France Tax Treaty, *supra* note 104, arts. 7.1-7.2.
161. *See id.* art. 22.2(a).
162. *See id.* art. 7.
163. *See id.* art. 21.
164. *See id.*
165. *See id.* art. 22.2(a).
166. *See id.* art. 22.2(b).

4. The Foreign Investor is a U.S. Company that Creates a Holding Company Which it Locates in a Third Country That Does Not Tax the Refund

As stated earlier, the refund of the Chinese tax is paid to the foreign subsidiary rather than to the Chinese company that actually paid the tax in the first place. If the shares of the Chinese company are not owned directly by an American company, but instead by a holding company, the holding company is considered the foreign investor and is entitled to the refund. If the holding company is located in a country that does not tax the refund of the Chinese tax, no tax is imposed at this level. Under U.S. tax principles, the shareholders are not taxed on the income brought in by the holding company until the income is repatriated and distributed.[167] However, this deferral period is curtailed for foreign corporations engaged in certain tax haven activities.[168] The so-called "subpart F" provisions operate when the foreign corporation is a Controlled Foreign Corporation,[169] and when the foreign corporation receives subpart F income.[170] A holding company is likely to be a Controlled Foreign Corporation. In addition, the dividends received by the holding company are clearly subpart F income.[171] However, little justification exists for classifying as subpart F income the Chinese tax refund received by the holding company. If this refund is not taxable under the laws of the country in which the holding company is situated, the U.S. investor may defer the payment of U.S. taxes, thereby retaining

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167. This income is designated in the Internal Revenue Code's "subpart F" income. Internal Revenue Code § 952(a) subpart F income includes foreign base company income, which under I.R.C. § 954(a) includes foreign personal holding company income, which, under I.R.C. § 954(c), includes dividends. *See* I.R.C. §§ 952(a), 954(a), (c) (1996).

168. *See* PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 109 (3d ed. 1989).

169. *See* I.R.C. § 952(a).

> [T]he term "controlled foreign corporation" means any foreign corporation if more than 50 percent of—
> (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or
> (2) the total value of the stock of such corporation,
> is owned (within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

I.R.C. § 957; *see also* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, *supra* note 15, at 90-91.

170. *See* I.R.C. § 952.

171. *See id.*

the benefit of the Chinese tax refund until the earnings are redistributed by the holding company.[172]

One country where the Chinese tax refund is probably not taxable is China, even though no official position on this issue appears to exist. Consequently, an American company may consider establishing a holding company in China.[173] France could also serve as a potential location for such a holding company, assuming France exempts the refund of the Chinese tax.[174]

D. *Illustration of the Differing Impact of Each System: The Example of a Newly-Created Company Paying Taxes in China at One-Half the Prevailing Rate*

Assume a company has also obtained an exemption of local income tax pursuant to Article 9 of the UITL.[175] This company reports income of 100 yuan and pays taxes in China at a rate of 15%. The company's after-tax profit is 85 yuan. Assume that the foreign investor has a one-half (50%) shareholding, which would confer on the company a dividend equal to 42.5 yuan. No withholding tax is imposed in China.

If the foreign investor is a French company, the dividend is not taxed in France. The company's after-tax earnings are therefore equal to 42.5 yuan.

If the foreign investor is a U.S. company, the dividend is taxed and the U.S. government grants a credit for taxes that are deemed paid in China. The Chinese tax incentives, however, reduce the effective Chinese tax rate and this, in turn, reduces the amount of the foreign tax credit available to the U.S. investor under I.R.C. section 902. In the example, the credit is equal to 7.5 yuan [15 yuan (the amount of Chinese taxes owed initially) x 42.5 yuan (dividend distributed) ÷ 85 yuan (the

172. The creation of a holding company would have to be carefully considered and evaluated. Notably, when the indirect foreign tax credit is applied to a holding company, a supplementary tier is added.

173. Codified regulations authorizing the establishment of holding companies by foreign companies were issued by the Ministry of Foreign Trade and Economic Cooperation on April 4, 1995. *See* Jinyan Li, *PRC MOFTEC Issues New Rules on Establishing "Holding Companies,"* 11 TAX NOTES INT'L 22, 22-23 (July 3, 1995).

In addition, wholly foreign-owned holding companies are considered to be foreign investors, and are therefore eligible for the tax refund. Jinyan Li, *China's SAT Provides Clarification on Tax Refund for Reinvestment*, 11 TAX NOTES INT'L 74, 74 (July 10, 1995).

174. *See supra* Part IV.C.3.

175. *See* UITL, *supra* note 29, art. 9.

undistributed after-tax earnings) = 7.5 yuan].[176] The U.S. tax rate is equal to 35%. The base amount is determined by the amount of the dividend (42.5 yuan) plus the I.R.C. section 78 gross-up (here, 7.50). Therefore, the U.S. taxes are equal to 17.5 yuan (35% x 50 yuan = 17.5 yuan). After this amount is adjusted by the 7.5 yuan credit, the U.S. tax liability is equal to 10 yuan (17.5 yuan - 7.5 yuan = 10 yuan).

As previously noted, if the Chinese subsidiary is not considered a Controlled Foreign Corporation for the purposes of the foreign tax credit, dividends distributed by corporations under I.R.C. section 902 are subject to separate limitations on a corporation-by-corporation basis. In other words, no cross crediting or averaging is possible regarding dividends from noncontrolled I.R.C. section 902 foreign corporations. Therefore, 23.5%, or 10 yuan, of the dividend received must be paid to the U.S. Treasury. The U.S. investor's after-tax earnings are equal to 32.5 yuan.

If no tax incentives was available in China, the China-based company would have owed 33 yuan in taxes to the Chinese government for an after-tax profit equal to 67 yuan. The U.S. investor would receive 33.5 yuan as a dividend. The section 902 credit would be equal to 16.5 yuan [33 yuan (amount owed in Chinese taxes) x 33.5 yuan (amount of dividend to U.S. investor) ÷ 67 yuan (amount retained after-Chinese taxes are subtracted) = 16.5 yuan]. The U.S. tax liability would be equal to 1 yuan [35% x (33.5 yuan + 16.5 yuan) - 16.5 yuan = 1 yuan]. The total after-tax earnings (32.5 yuan) would match the after-tax earnings where the tax incentives are available. In other words, the tax incentives granted by the Chinese government result in no after-tax benefit for the U.S. investor.

If the foreign investor is a Japanese company, the credit is determined by computing the Chinese tax as if it were paid at a rate of 33%. In addition, a deemed credit of 10% is added as if a withholding tax had been paid on the dividends.

V. INVESTMENT INCOME

Investment income is taxed in China by way of a withholding tax. Typically, the rate is twenty percent; however, several reduced rates or exemptions are available.[177] In addition, this withholding tax may also

176. This example is extremely simplified. Indeed, if the dividend is distributed in year n+1, the earnings and profits considered in the indirect credit should include the earnings and profits of the year in which the distribution is made.

177. *See* UITL, *supra* note 29, art. 19.

be reduced by the income tax treaty entered into between the resident state and China. For instance, the China-U.S. tax treaty provides that the withholding tax on interest or royalties cannot exceed ten percent of the gross amount of the interest or royalties.[178] The China-U.K. tax treaty limits the withholding tax on interest to ten percent.[179] This treaty also distinguishes between (1) royalties received as a consideration for the use of, or the right to use, any copyright, patent, know-how, trademark, design or model, plan, secret formula or process; and (2) payments of any kind received as a consideration for the use of, or the right to use, any industrial, commercial or scientific equipment.[180] The withholding tax on the first category of royalties is limited to ten percent of the gross amount of the royalties.[181] The tax on the second category of royalties is levied at ten percent of seventy percent of the gross amount of the royalties.[182]

A similar distinction seems to result from the tax treaty between China and France. This treaty provides that the withholding tax in China cannot exceed ten percent of the gross amount of royalties.[183] Furthermore, Article 11, paragraph 3 of the Convention provides that royalties paid for the use of, or the right to use, industrial, commercial or scientific equipment, are subject to a tax rate equal to sixty percent of the gross amount of such royalties.[184] In addition, the withholding tax on interest is limited to ten percent.[185]

Under a pure system of capital import neutrality, investment income earned in China should be exempted from resident state taxation.[186] However, none of the treaties reviewed strictly adhere to this principle. On the contrary, the provisions seem to authorize concurrent taxation on either all income taxable in China or on certain specifically-mentioned income, including the investment type income.[187] In addition, provision is made for a credit in the resident state for the

178. *See* China-U.S. Tax Treaty, *supra* note 68, arts. 10.2, 11.2.

179. *See* China-U.K. Tax Treaty, *supra* note 83, art. 11(2).

180. *See id.* art. 12(3).

181. *See id.* art. 12(2)(a), (3)(a).

182. *See id.* art. 12(2)(b), (3)(b).

183. *See* China-France Tax Treaty, *supra* note 104, art. 11.3 (defining royalties).

184. Paragraph 2 of the Protocol of the China-France Tax Treaty was concluded at the same time as the treaty itself and forms an integral part of the treaty.

185. China-France Tax Treaty, *supra* note 104, art. 10.2.

186. *See* FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE U.S., *supra* note 15, at 244-46.

187. *See, e.g.*, China-U.K. Tax Treaty, *supra* note 83, arts. 7, 10-13, 16, 17.

amount of taxes levied in China.[188] However, several treaties also provide that the amount of this credit may not exceed the tax levied by the resident state on the relevant income.[189] Therefore, the effect of an exemption of withholding tax in China is likely to depend on the limitations of the creditability of foreign taxes imposed by the resident state.

In the event that China unilaterally reduces the rate of its withholding tax below the rate authorized by a particular tax treaty, the resident state authorities may provide a tax sparing credit. The resident state may also recognize a matching credit when taxes paid in China are deemed levied at a higher rate than authorized by treaty. For instance, under Article 22.2(c) of the China-France tax treaty, France deems the Chinese tax to be equal to ten percent of the interest and twenty percent of the royalties paid by Chinese-based foreign companies on the gross amounts of such income items.[190] Similar credits for deemed paid withholding taxes are recognized in several Chinese bilateral treaties. Some of these treaty partners are indexed below:

TAX TREATY		TAX RATES	
PARTNER	ARTICLE	INTEREST	ROYALTIES
Canada	Art. 21.2(e)	10%	15%
Japan	Art. 23.3	10%	20%
Australia	Art. 23.6	10%	15%
Sweden	Art. 23.3	10%	20%
Norway	Art. 25.2(c)	10%	20%
Denmark	Art. 23.3(b),(c)	10%	20%
Finland	Art. 23.1(e)	10%	20%
Italy	Art. 23.4	10%	15%
Netherlands	Art. 23.1(d)	10%	15%
Switzerland	Art. 22.2(c)	10%	10%
Poland	Art. 23.2(c)	10%	10%

188. *See id.* art. 23.

189. *See id.* art. 23(1)(a); *see also* China-France Tax Treaty, *supra* note 104, art. 22.2(b), (c).

190. Article 2 of the Protocol to the China-France Tax Treaty provides that certain royalties shall be subject to tax on only sixty percent of the gross income. One may wonder whether the deemed paid withholding tax should be calculated on the basis of the entire amount of such royalties, or on the basis of only sixty percent of the gross amount. Since the Protocol refers to the taxation of the royalties and to Article 11 of the treaty, it seems possible that it does not affect the calculation of the deemed paid withholding tax under the treaty. *See* China-France Tax Treaty, *supra* note 104, art. 22.2(c).

The United States does not recognize a tax sparing or a matching credit. Royalties or interest derived in China by an American investor are taxed first under the Chinese withholding tax, which is levied at a rate not to exceed ten percent of the gross amount paid.[191] Applicable U.S. tax laws then take effect. United States taxes cannot be deferred because this investment income, by definition, is a direct earning of the American investor and is automatically subject to U.S. taxation.

Furthermore, the creditability of the withholding tax in the United States may be limited by "sourcing" rules. As a general rule, interest is sourced at the location of the payor and royalties are sourced at the location where the rights are used.[192] Under I.R.C. section 904(d)(1)(A), however, the overall limitation of the foreign tax credit pertaining to passive income must be computed separately because the sourcing rules of passive income are easily manipulated by taxpayers. The passive income basket, in general, includes dividends, interests, annuities, certain rents and royalties, and net gains from sales or exchanges of property that generate passive income.[193]

Moreover, the ability to average high and low tax rates on passive income is prevented by the application of the "high-tax kick-out" rule.[194] Under this rule, the effective foreign tax rate must first be computed by dividing the foreign taxes paid by the net passive income as determined under U.S. rules. If this computed foreign tax rate exceeds the highest applicable U.S. tax rate,[195] the passive income is placed in the general limitation basket, rather than in the passive income basket. Therefore, the passive income basket does not include income subject to high foreign taxes. As a result, averaging of foreign taxes within the passive income basket is not possible.

Moreover, because cross-crediting between baskets is not allowed, the ability to use passive income taxed at low rates to permit the current crediting of excess foreign taxes paid on other income is substantially reduced. In other words, manipulating the basket system to obtain credit for excess foreign taxes paid on other income is prohibited. Therefore, if the withholding tax on the gross investment income is lower than the tax on the net income as determined under U.S. tax laws (i.e., the

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191. *See* China-U.S. Tax Treaty, *supra* note 104, arts. 10.2, 11.2.

192. *See* I.R.C § 861(a)(1), (a)(4) (1996).

193. *See* I.R.C. § 904(d)(2) (1996).

194. *See* I.R.C § 904(d)(2)(F); *see also* MCDANIEL & AULT, *supra* note 168, at 176.

195. A foreign withholding tax is levied on the gross income at, for example, ten percent; the U.S. tax is, on the other hand, assessed on the net income.

U.S. investor is in an excess limit position with regard to the specific income), an additional tax is due in the United States. If, however, the withholding tax on the gross investment income exceeds the U.S. tax on the net income (i.e., the U.S. investor is in an excess credit position with regard to the specific income), the income is placed in the general limitation basket and is not subject to any additional U.S. tax. The Chinese tax on this income may be averaged with taxes on foreign-source income taxed at lower rates in the general limitation basket.

If the withholding tax is foregone by China, the interest or royalties must be placed in the passive income basket. An additional tax is due in the United States if the net income is positive. This does not result in any savings for the U.S. investor unless the withholding tax exceeds the applicable U.S. tax on the net income (i.e., the passive income is "kicked out" in the general limitation basket), and averaging would not have been possible.[196] Therefore, as a general rule, it is difficult for a U.S. investor to keep the benefit of an exemption of the Chinese withholding tax unless the withholding tax is not creditable in the United States.

By way of comparison, the Chinese withholding tax can be credited in France, but the amount of the credit cannot exceed the amount of the French tax on the relevant income. The relevant income can be defined as the net income after all the deductions are taken.[197] In addition, the final credit amount (i.e., the withholding tax paid in China or deemed paid as a result of the matching credit) is included in the net income to determine the applicable limitation to the creditable withholding tax. If the credit exceeds the limitation, it is not refunded.[198] Finally, the credit effectively imputable is taxable as the income to which it is attached.

The investment income may also be subject to preferential treatment in the resident state. For instance, France treats certain royalties received by French companies as long term capital gains which are taxed at a favorable rate (nineteen percent in 1996).[199] If the Chinese

196. Although averaging would have been possible, a saving can still result from the exemption of the withholding tax due to other opportunities to average which may exist in the same or another year. Indeed, unused foreign tax credits generated in other taxable years can be carried back or forward. *See* I.R.C. § 904(c).

197. Because the relevant income is the net income, the creditability of a foreign withholding tax on a gross income may be limited, although the withholding tax is levied at a lower rate than the French tax.

198. *See* GEST & TIXIER, *supra* note 107, at 315.

199. *See* C.G.I., *supra* note 101, art. 39.

authorities decide to waive the withholding tax, the investor determines the amount of tax that is creditable by computing the French tax on the net income, including the matching credit, at a rate of twenty percent. If there is no deduction, the entire matching credit can be credited. For example, if income is 100 yuan, then the tax rate is 19% x (100 yuan + 20 yuan) = 22.8 yuan. The only French tax levied is on the matching credit [19% x (100 yuan + 20 yuan) - 20 yuan = 2.8 yuan]. Therefore, it seems that where the Chinese withholding tax is creditable in France, a reduction of the withholding tax, through the operation of the matching credit, results in tax savings for the French investor.

If, however, the Chinese withholding tax is not creditable in France, because, for instance, the net income is negative, the French investor's overall tax burden is equal to the Chinese withholding tax. A consequent reduction in the withholding tax reduces the tax liability of the investor and, thus, constitutes a benefit for the French investor.

In effect, a foreign investor operating from a country that recognizes a credit for a deemed paid withholding tax will normally benefit from tax incentives granted on the investment income. Moreover, through the operation of a matching credit, a reduction the resident state tax liability is possible, even in the absence of specific tax incentives in China.[200]

As a general rule, the after-tax rate of return on passive income is more favorable for an investor who operates from a country that accepts matching credit than it is for an investor who operates from the United States. Technology transfers are, however, often considered an alternative to direct investment in China. This alternative would appeal to a U.S. company that has the flexibility to structure its operations so that its royalties are paid to a holding company that is set up in a country that gives a credit for withholding taxes deemed paid in China.[201]

A hypothetical may aid in illustrating this principle. A Chinese company pays a royalty equal to 100 yuan, which qualifies for an exemption of withholding tax under Article 66 of the UITR, but fails to qualify for any other exemption. No withholding tax is due in China.

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200. The restrictions on the creditability of foreign taxes may limit the reduction of the resident state tax liability. Without such a limitation, the matching credit could create unusual results. For instance, in the area of arm's-length loan interest, a matching credit would enable the creditor to lend at interest rates lower than the rates paid on the service funds. *See* CANADA TAX TREATIES 685 (Buttersworths 1995).

201. The applicability of subpart F to such an investment scheme is beyond the scope of this article.

The deductible expenses generated in the earning of this income are 50 yuan.

(a) If the royalty is paid to a French company, it is taxed in France at a rate equal to 33.33%, plus 10% temporary surtax. The deemed paid withholding tax in China is equal to 20 yuan (20% x 100 yuan). The French tax on the net royalty income, including the deemed paid withholding tax, is equal to 25.66 yuan [33.33% x (100 yuan - 50 yuan + 20 yuan) + 10% temporary surtax]. Therefore the entire deemed paid withholding tax is creditable. As a consequence, the final French tax liability is equal to 5.66 yuan (25.66 yuan - 20 yuan). The after-tax return is 44.34 yuan (100.00 yuan - 50 yuan - 5.66 yuan).

(b) If the royalty is paid to an American company, it is taxed at the U.S. rate of 35% and no credit is allowed for withholding taxes foregone in China. Therefore, the final U.S. tax liability is equal to 17.5 yuan (35% x (100 yuan - 50 yuan = 17.5 yuan), and the after-tax rate of return is equal to 32.5 yuan (100 yuan - 50 yuan - 17.5 yuan = 32.5 yuan).

VI. CONCLUSION

In general, because tax incentives passed to induce foreign investors to locate in a host county reduce the amount of tax a foreign investor would otherwise pay, they also reduce the revenue that the host government would otherwise receive. Therefore, these incentives can be viewed as direct expenditures by the host government equal to the amount of the foregone revenue. In other words, the tax incentive is actually a government subsidy equivalent to the revenue loss of the incentive.[202] Whereas this type of government subsidy is targeted at attracting foreign investment, this article has shown that the distribution of the subsidy is largely disparate, and that in many cases, the incentives may be thwarted by the resident state's treasury. Having considered the impact of this tax incentive expenditure, one wonders whether it is logical for the Chinese government to implement a subsidy program that benefits investors from certain countries more readily than it benefits investors from other countries.[203]

It also appears that the treatment of the Chinese tax incentives varies, depending on the circumstances surrounding the foreign investor's position in its resident state tax system (i.e., whether a U.S. company is in an excess limit or an excess credit position). As stated earlier, it seems

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202. *See* SHANNON, *supra* note 10, at 87.
203. One justification could be that only certain countries recognize tax sparing.

incredible that the benefit of a subsidy granted to foreign investors should vary according to the country in which the foreign investor resides. It seems even less sensible to distinguish between foreign investors residing in the same country on the basis of the investor's foreign tax credit position.

One way to eliminate this difference is for the foreign investor's resident state to provide for a tax sparing credit. Yet, even in the absence of a tax sparing credit, the tax incentives received by all the investors who operate from a specific country can be treated uniformly if the subsidy element of the tax incentive is treated evenhandedly. This can be achieved if the resident state grants a credit for the Chinese tax that would have been effective without the tax incentive, and either requires a basis reduction or immediately includes, in income, the subsidy attributable to the tax incentive.

This would generalize the analysis of the U.S. tax treatment of the refund of the Chinese tax. Indeed, this refund of the Chinese tax is comparable to a government subsidy because it involves a direct expenditure paid to an entity that is distinct from the one that originally paid the tax. Yet, the refund of the Chinese tax, which is an incentive designed to promote foreign investment in China, is tantamount in theory to other Chinese tax incentives. Therefore, uniform treatment of all tax incentives appears most logical.

APPENDIX 1

LIST OF THE TAX TREATIES USED IN THIS ARTICLE PRESENTED BY THE NAME OF THE TREATY PARTNER OF CHINA

Australia, November 17, 1988
Brazil, August 5, 1991
Canada, May 12, 1986
Denmark, March 26, 1986
Finland, May 12, 1986
France, May 30, 1984
Germany, July 1, 1985
Hungary, June 17, 1992 (not yet in force)
Italy, October 31, 1986
Japan, September 6, 1983
Mongolia, August 26, 1991 (not yet in force)
Netherlands, May 13, 1987
New Zealand, September 16, 1986
Norway, February 25, 1986
Pakistan, November 15, 1989
Poland, June 7, 1988
Romania, January 16, 1991
Sweden, May 16, 1986
Switzerland, July 6, 1990
Thailand, October 27, 1986
United Kingdom, July 26, 1984
United States, April 30, 1984