FOREIGN INVESTMENTS, VIS-À-VIS, TAX IMPLICATIONS – AN INTERNATIONAL PERSPECTIVE

A Dissertation submitted in partial fulfilment of requirement for the Degree of

MASTER OF LAWS

Submitted by

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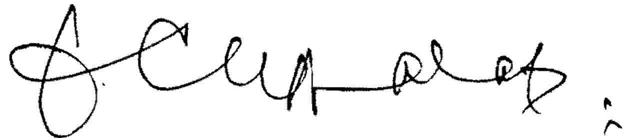
CERTIFICATE

I certify that this is a bonafide work of Mr. SOUMIK GHOSH and is submitted in partial fulfillment of the requirement for the award of the degree of Master of Laws, National Law School of India University, Bangalore.



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DECLARATION

I hereby declare that this dissertation entitled **"Foreign Investments, Vis-à-vis, Tax Implications – An International Perspective"** is the research conducted by me under the guidance and supervision of **Prof. K.C.Gopalakrishnan** of National Law School of India University for the partial fulfilment of the requirement for the award of the Degree of **Master of Laws** in 2002.

I also declare that this work of mine is original except for such help taken from such authorities as have been referred to in the research paper and which has honestly been acknowledged. I further declare that this work has not been submitted either in part or in whole for any other degree or diploma at any other University or Institution.

November 2002 **Soumik Ghosh**

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CHAPTER 1

INTRODUCTION

Double taxation is considered to be one of the most acute problems in international taxation. It occurs when more than one country taxes the same income. The classic case of double taxation arises when a resident of one country produces income in another country and is subject to tax on that income by both her country of residence as well as the country in which her income is earned (the host country). Double taxation is often cited as a major obstacle to unfettered economic progress. Historically, countries have used two approaches to alleviate double taxation: a unilateral approach and a bilateral approach. The unilateral approach offers a range of policies a country may adopt to affirmatively reduce (or altogether eliminate) the double taxation burden placed on its own residents, irrespective of the host country's policy and independent of any bilateral treaty provisions. The bilateral approach, on the other hand, advocates implementation of tax treaties formulated by signatory countries that are aimed at alleviating double taxation on the investments of the residents of the one signatory state in the other signatory state.

It has long been the prevailing assumption that if countries are left to their own unilateral devices, double taxation will result. Tax treaties, under this conventional wisdom, are critical for alleviating this double taxation. Treaties are usually thought to be effective tools (indeed, the most effective tools) for preventing double taxation. The Organization for Economic Co-operation and Development (OECD) has noted that "the purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons"[1] and that the phenomenon of international juridical double taxation... [and its] harmful effect on the exchange of goods and services and movement of capital, technology, and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.[2]

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[1] OECD Model Convention at C(1)-2

[2] OECD Model Convention at I-l

The traditional story tells us that instead of each country collecting its taxes at its regular level of taxation without any alleviation, a treaty makes each signatory country relinquish something in order to avoid double taxation. The residence country is usually willing to grant its residents a credit for the taxes paid to the host country (although an exemption is also feasible), provided that the latter either reduces the taxes it collects on investments from the residence country or grants a reciprocal credit. The residence and host countries' losses of tax revenues are, so they are often presented, the price of enjoying the benefits of higher levels of cross-border investment (with the resulting benefits of greater exports, higher wages, and increased standard of living). Since both countries can gain more from free trade than from the tax revenues they may collect by limiting free trade, it seems reasonable to forego tax revenues in exchange for capturing the benefits of cross-border investment.

I. Fundamental Concepts of International Taxation

Any income which arises from cross-border transactions is potentially subject to tax in two or more jurisdictions: the residence country and the source country. Under the current international tax system,[3] it is generally left to the residence country to alleviate double taxation.[4] There are two common and unilateral methods of alleviating double taxation.[5] The first is the "worldwide" or "credit" method in which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions. The second is the "exemption" method under which the residence country cedes all taxing jurisdiction to the source country.

[3] Peter Harris, Corporate Shareholder Income Taxation and Allocating Taxing Rights Between Countries, pp.72-78 (1996)

[4] Double taxation is highly inefficient. If the foreign investment is subject to two layers of tax, while domestic investment is subject to only one, the tax system would insignificantly discourage investment in foreign countries.

[5] An additional approach for dealing with foreign taxes is to allow them to be deducted from taxable income. This method is rarely used for income taxes. This does not eliminate double taxation rather it simply reduces it. Both countries still tax the income. The total tax paid is higher than the tax rate in either country.

A. Worldwide System

Under a worldwide system,[6] a country taxes all the income of its residents, no matter where they earn it.[7] In order to alleviate potential double taxation, the residence country generally permits its taxpayers a foreign tax credit for income taxes paid on income earned in foreign jurisdictions.[8] Under this system, the income earned by a multinational enterprise (MNE)[9] in a low-tax country will be taxed at least at the residence country's rates[10].

B. Exemption System

Under an exemption system or territorial system, foreign source income generally is not subject to tax in the residence country.[11] The residence country only taxes income earned within its borders.[12] Most exemption systems tax the passive foreign source income of their residents, because passive income is viewed as having no natural location.[13]

[6] Under IRC. $$ 1, 11, and 61, foreign source income is subject to tax under S901. This income is eligible for a foreign tax credit.

[7] Hugh J.Ault, Comparative Income Taxation: A Structural Analysis, 402-406 (1997).

[8] Supra.

[9] A MNE is one which con..... and manages business activities in at least 2 countries.

[10] Hugh J.Ault, Comparative Income Taxation: A Structural Analysis

[11] supra at 381

[12] supra at 381

[13] Passive income in these cases include such items as dividends, interest, and royalties not received from affiliates.

CHAPTER 2

TRANSFER PRICING AND THE PROBLEM OF DOUBLE TAXATION IN THE UNITED STATES

Introduction

One of the more difficult problems facing multinational businesses is the prospect of double taxation. As the term suggests, double taxation occurs when two or more countries claim jurisdiction to tax the same income. Where uncertainty exists as to which of two affiliated or commonly controlled companies in different countries has earned taxable income to which both companies have contributed, both countries might tax the same income. The affiliated group therefore may suffer tax liability in two different tax jurisdictions.

Double taxation generally occurs in the context of transfer pricing adjustments, where tax authorities in competing jurisdictions disagree over income allocations attributable to transfer pricing.[1] Transfer pricing adjustment, at income allocation, is the means by which national tax authorities assign market prices to related-party transactions in order to clarify the income attributable to each segment of a multinational corporation, thereby performing the role reserved to the free market in transactions among unrelated parties.[2] When unmitigated double taxation occurs, the taxpayer ordinarily has recourse only to obtain agreement on its behalf between the two countries' tax authorities. In many cases, however, the means employed to settle such disputes may be cumbersome, overly burdensome for the taxpayer, or may bear little or no binding effect on future tax relations between the countries involved.

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[1] James R.Mogle, Competent Authority Procedure, 23 Geo.Wash.J.Int'l L & Econ, at 725 (discussing requisite conditions for double taxation disputes and observing that double taxation commonly occurs as a result of related party transfers). Double taxation exists because tax authorities often employ different methods for determining the appropriate income allocations attributable to transfers between related parties.

[2] Richard L.Kaplan, International Tax Enforcement and the Special Challenge of Transfer Pricing, 1990 U.Ill.L.Rev at 300-03 (illustrating market role in related party transfers).

I. The Arm's Length Standard

Intracorporate transfers, or trade among entities that share common or centralized management,[3] are not inherently problematic. Rather, they are a requisite to doing business within a multinational corporate structure. These transfers, however, occur without the benefit of a free market. Unrelated companies in competition with each other trade goods and services at rates of consideration that are set by market forces. In contrast, related companies that have no need to compete with each other are not significantly affected by the market. A company that benefits, for example, from the increased profitability of its subsidiary has little incentive to charge that subsidiary a fair market price for goods, services, or intangible property. If the parent company were to manipulate its transfer prices so as to reduce its overall income tax exposure, its actions may constitute tax avoidance and therefore detract from the revenue base of a country in which it does business.

The problem with intracorporate transfers becomes evident when the transfers are made between related parties that are incorporated in different countries and operate under different national tax laws. Most developed nations, the United States foremost among them, have addressed this problem by implementing comprehensive transfer pricing rules that are intended to correct deviations from market prices that may be evident in intracorporate transfers. In essence, transfer pricing adjustments assign a "price," used only for allocating taxable income, that most accurately reflects the amount that the same transferor would have charged an unrelated third party for the same goods or services. Although national rules vary widely in both scope and application, the international standard for transfer pricing is that of arm's length, or the consideration that would have been charged in the same transaction between unrelated parties dealing at arm's length.

Although transfer pricing regulations operate by allocating income earned among related segments of multinational entities, their purpose has less to do with distributing multinational taxpayers' income than with distributing tax revenue among

[3] Karen S.Granens & Howell J.Lynch,Jr. The Spanish Inquisitions: Transer Pricing Implications of the Tax Court Decision in Proctor and Gamble, 39 Oil and Gas Tax Q.at 380 (1991) (noting that transfer pricing issues arise with respect to divisions or profit centres within company or between affiliated companies).

the nations in which those taxpayers do business. While a national revenue authority bears considerable responsibility for enforcing its own tax laws, it must also contend with the possibility that another nation's tax laws may conflict with its own, thereby competing for a common revenue pool. [4] Furthermore, while a country must prevent undertaxation of income earned within its jurisdiction, it must also prevent the overtaxation of its taxpayers by the operation of other countries' transfer pricing laws.

The problems associated with competing tax jurisdictions create the greatest obstacles to establishing fair and uniform international transfer pricing standards. Although the OECD, United Nations, and United States have adopted model conventions that address transfer pricing adjustments,[5] and although the standards set forth therein have received nearly unanimous international support, the application of the arm's length standard imposes many difficulties. For instance, the prospect of applying a fixed price to a transaction that unrelated parties do not ordinarily undertake is daunting to say the least.

Where tax authorities of two or more countries have an interest in the income of the same enterprise but apply different standards for determining arm's length prices and therefore make different adjustments to the same transactions, those countries will assign different tax liabilities to those transactions. Consequently, the multinational enterprise involved in such a transaction may be taxed twice. To resolve this double taxation problem, the U.N. Model Convention and the OECD Model Convention provide dispute resolution procedures.[6] The fact that double taxation still occurs, however, indicates the need for more effective dispute resolution methods, or more importantly, a revised international standard.

A. The Problem Defined

In a 1979 report, the OECD Committee on Fiscal Affairs stated that the phenomenon of related companies operating in concert under some form of central

[4] 1979 OECD Report at 8 suggesting that one nation's aggressive taxation of foreign derived income may harm other involved nations tax base)

[5] OECD Model Convention, art 9 at 30; UN Model Convention art 9, at 10, 577.

[6] OECD Model Convention, art 25, at 42 (establishing competent authority negotiations as means to reach mutual agreements); U.N. Model Convention, art 25, at 40 (providing competent authority procedures as dispute resolution means).

management, but under different national tax laws, naturally gives rise to problems in taxing corporate profits. Although that observation was not new, the increase in the number and influence of multinational corporations in recent decades has made transfer pricing an increasingly relevant concern for tax authorities, which in some cases are dissatisfied with the efficacy of the traditional arm's length standard.

Although transfer pricing questions arise in many different contexts, a few hypotheticals are helpful in understanding the general problem. The following hypotheticals illustrate situations that may be referred to as income expatriation, income repatriation, and round-trip transfers.[7] For simplicity, each example assumes that the interested tax authority in the IRS.

1. Expatriating income to a foreign affiliate

In the first example, a U.S. corporation, X, manufactures a product, which sells for a wholesale price of $ 10, at a unit cost of $ 2. The corporation ordinarily would sell the product to its distributors for $ 10, thereby earning taxable income of $ 8 for each item sold. Rather than sell the product on its own and be subject to income tax on all of its $ 8 profit, however, X sells to a wholly owned foreign subsidiary at a price of $ 4 per unit. The subsidiary then merely distributes the product at the unit price of $ 10.

The result of this hypothetical is that X realizes a net profit of $ 2 per unit sold, while its foreign subsidiary realizes a profit of $ 6 per unit. Because the subsidiary is wholly owned by X, its parent's balance sheet will reflect its profits, meaning that X has realized an actual profit of $ 8 per unit - the same as if it had sold the product on its own. Under this distribution scheme, therefore, X has diverted 75% of its income to a foreign tax jurisdiction. If that jurisdiction assesses a lower corporate tax rate than the United States, X has successfully avoided a significant portion of its cumulative tax burden.

[7] The first hypothetical is derived from Richard L.Kaplan, International Tax Enforcement and the Special Challenge of Transfer Pricing, 1990, U.III.L. Rev. at 301-03.

2. Repatriating income to a foreign parent

In the second hypothetical, a foreign parent corporation maintains a wholly owned manufacturing subsidiary, and supplies this subsidiary with component parts for the sole purpose of assembling the finished product. Assuming that the parent corporation is located in a favorable tax jurisdiction, the following occurs: rather than sell component parts to the subsidiary at market or below-market prices, as in the previous hypothetical, the parent "sells" component parts to its subsidiary at prices so inflated that in spite of the subsidiary's success at producing and marketing its product, the subsidiary earns less than expected or even loses money. By overcharging for the parts, the parent has in effect repatriated its earnings before they were earned and thus has avoided generating income, or income tax liability, within the United States.

3. Round-trip transfers of intangible property

In the third example, the property transferred is not components or finished products, but an intangible such as intellectual property. In this case, a U.S. parent company licenses the intangible to its foreign subsidiary, which uses the intangible to manufacture a product. The subsidiary then sells the product back to the parent company or to other affiliates, or markets the product independently.

This hypothetical differs from the previous two in several key respects. First, the subsidiary has not taken advantage of material value that its parent has added to a finished product. Rather, it has employed only the intangible provided to it by the parent. Second, in selling the product back to the parent company or to another affiliate, the subsidiary need only charge an appropriate market price. As far as the IRS is concerned, the operative segment of the transaction is the initial license to the subsidiary, and any pricing adjustment must accordingly reflect a royalty that might properly be charged for the license. Finally and most importantly, the parties may not have known the ultimate value of the intangible at the time of transfer. Unlike the first two hypotheticals, which involved transfers of tangible goods for which market prices may be available, the value of a newly developed patent is generally speculative. It is this type of transaction and the extraordinary valuation problems associated with it

that led Congress to address the subject of controlled transfers of intangibles in the Tax Reform Act of 1986.[8]

B. The History of the Arm's Length Standard

In 1921, Congress permitted the Commissioner of Internal Revenue to require consolidated tax returns from affiliated domestic corporations if necessary to determine a taxpayer's total taxable income. Congress did not directly address the question of tax evasion through related-party transfers until it passed the Revenue Act of 1928, which permitted the Commissioner to allocate or apportion the incomes of related entities to reflect their true tax liabilities. The legislative history of the Revenue Act of 1928 evidences clear congressional intent to discourage tax evasion through intracorporate transfers, and the language of section 45 of the Act has survived with only cosmetic changes as the first sentence of Section 482 of the current Internal Revenue Code.

In 1963, as Congress first became concerned with the transfer pricing problems associated with multinationals, the OECD articulated an international transfer pricing standard in article 9 of a draft model convention on double taxation. Despite a fair amount of commentary on the transfer pricing standard, the OECD did not formally adopt the draft text until 1977. Three years later the United Nations likewise adopted a model convention on double taxation.

Although the model conventions adopted by the OECD and the United Nations employ identical language in addressing related-party transactions, and although both endorse the arm's length standard, neither prescribes empirical methods for determining an arm's length price. Practical methods for calculating an arm's length price had already been implemented in the United States, however, by amendments in 1968 to the Treasury regulations under Section 482 of Internal Revenue Code.

[8] Tax Reform Act of 1986, Pub.L.No.99-514, 12, I(e)(1), 100 sStat.2085, 2562-63 (codified at 26 U.S.C. 482 (1988).

C. Adjusting Income Under the Arm's Length Standard

In theory, applying the arm's length standard is relatively easy. Prices charged among related parties simply must be adjusted to reflect arm's length prices, which are defined as prices that unrelated parties charge each other in the market. In practice, however, this apparent simplicity disappears. To determine market rates for property transfers, the property in question must be substantially similar or comparable to property commonly traded among unrelated parties. Where transfers defy definition by the market, as do transfers involving proprietary goods or valuable intellectual property that would not ordinarily be the subject of a transaction among unrelated parties, a tax authority must turn to alternative methods for establishing their value. The principal pricing methods that tax authorities use, in an order determined by a transaction's relative comparability to a third-party transaction, are the comparable uncontrolled price, resale price, and cost plus methods.

1. Comparable uncontrolled price

In any tax system that relies on the arm's length standard, the preferred method to determine a transfer price adjustment is to compare a related-party transaction with a substantially identical transaction between unrelated parties. Ideally, a related-party transaction will substantially, if not exactly, resemble a similar transaction between unrelated parties. In such a situation, the "comparable uncontrolled price" method for determining the appropriate arm's length price merely involves comparing the price charged in the related parties' transaction to prices charged in similar transactions between independent parties or between the group enterprise and unrelated parties.

Not every related-party transaction, however, bears a reasonable resemblance to transactions occurring in the market. Even apparently identical third-party transactions may not meet the arm's length standard under the comparable uncontrolled price method. For example, in the case of United States Steel Corp. v. Commissioner,[9] the Tax Court examined the relationship between a U.S. corporation and its foreign shipping subsidiary, which provided transport for iron ore supplied by

[9] 36 T.C.M. (CCH) 586 (1977), rev'd, 617 F.2d 942 (2d cir.1980).

a second foreign subsidiary. Despite the fact that the shipping subsidiary charged third-party purchasers of foreign ore the same rate that it charged the parent, the court did not agree that the third-party transactions adequately reflected market rates. United States Steel therefore raises the difficult problem of defining the phrase "comparable uncontrolled transaction."[10] At a minimum, the Tax Court's decision in the case, when considered together with the U.S. Court of Appeals for the Second Circuit's reversal,[11] indicates that even where identical third-party transactions exist, the circumstances of those transactions must be subjected to complex judicial scrutiny and might not serve properly as comparable uncontrolled transactions.[12]

2. Resale price

Where comparable uncontrolled prices are not available, the next-favored technique for determining an adjustment is the resale price method. This method requires ascertaining a market-based resale price and subtracting an appropriate profit to obtain a reasonable arm's length price. The steps involved in determining a proper transfer price under this method reveal that the resale price method merely constructs an arm's length price where a transaction ordinarily might not occur between unrelated parties. The appropriate resale price is either the price at which resales of the same property are made between unrelated parties, or the final resale price of the property in question.

Accordingly, any application of the resale price method must make reference to comparable transactions undertaken by unrelated parties. To serve the needs of the methodology, appropriate comparable resales by unrelated parties must be sufficiently similar to those made by the related parties so that any substantive differences between the compared transactions may be accounted for accurately. Absent these circumstances, the resale price method ordinarily does not apply.

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[10] Gale Mosteller, Comparability in the U.S.Steel Transfer Pricing Case, 55 Tax Notes 1251, 1253 (1992) (noting that regulations provide little guidance for identifying comparable transactions)

[11] Unitee States Steel Corp. Vs. Commissioner, 617F.2d.942, 954 (2d cir 1980). The appellate court reversed the tax courts decision because it found sufficient evidence to prove that the price the producer paid was arm's length id.at 947. The appellate court found that the shipping subsidiary charged U.S.steel approximately the same price that it charged unrelated parties for similar transactions. Id. Therefore, the court did not reallocate the income to U.S.steel's subsidiary under 482 Id.

[12] 1979 OECD Report (acknowledging that resale price method is used if comparable uncontrolled prices are not available or impracticable to determine).

3. Cost plus

The third method, cost plus, applies to transactions in which a controlled transferee adds value to goods before reselling them.[13] Determination of a transfer price by the cost plus method involves adding the reasonable cost of production to an amount computed by multiplying the production cost by an appropriate gross profit markup. For example, in Edwards v. Commissioner[14] the Tax Court examined a relationship between a partnership and a corporation that shared common owners. The Government contended that the partnership had made sales of construction equipment to the corporation at less than market prices. After quickly dismissing the comparable uncontrolled price and resale price methods, the court turned to the cost plus method. The court's analysis focused on constructing an appropriate gross profit percentage. In rejecting the Government's valuation of the transfers, the court asserted that the best indicator for a gross profit percentage would be the profits realized by the partnership in sales to unrelated parties.

4. "Other methods" and the problem of intangible property

Unfortunately, controlled transactions frequently occur that defy definition by one of the three methods. Transfer pricing methods that can adequately accommodate such circumstances, such as those where a transaction involves unique intangible property that is used to produce a unique product, thus far have eluded international consensus. Generally such transactions may be priced only on a tortuous case-by-case basis. Despite the difficulty involved in applying such case-specific methods, which the Internal Revenue Service (IRS) refers to collectively as "fourth methods," the General Accounting Office has reported that the IRS applies "fourth method analysis" twice as often as the comparable uncontrolled price method.

Moreover, allocations of income attributable to intangibles often cannot rely on similar transactions by unrelated parties. The 1968 regulations provided only summary information for treatment of intangibles. Thus, a price determination relied strongly on the circumstances of a transfer of the same or similar intangible property by the same transferor to an unrelated transferee. When such comparable transactions

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[13] 1979 OECD Report (describing application of Cost Plus method)

[14] 67 T.C. 224 (1976), acq ., 1977-2C.B.2.

were unavailable or inappropriate, the old regulations did nothing more than suggest twelve factors that could be considered in determining an arm's length price.[15] Although the twelve factors did contemplate a failure to obtain satisfactory comparable transactions, the regulations were criticized for providing insufficient guidance for applying them. The IRS therefore often found it necessary to improvise valuation regimes, often loosely following valuation methods prescribed for transfers of tangible property.

Despite the lack of specific guidelines, the Tax Court has consistently established several submethods of transfer price allocation under the fourth method. The most commonly used submethods are profit split, rate of return, and income to expense ratios.[16] Of these procedures, the most commonly used is the profit split method, which simply divides the total profits attributable to the controlled transactions at issue among the related parties. The validity of a court's final determination therefore rests on the accurate determination of actual profits and the reasonableness of the factors the court uses to divide profits among related parties. The factors used to obtain this profit split ratio ordinarily include each party's functions in the overall transaction, the property contributed by each party, and the risks undertaken by each party.

Unlike the three formal methods set forth by the regulations, however, the fourth method permits application of whatever means of analysis a court deems proper under the circumstances. In spite of the growing reliance on the profit split

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[15]
1. The prevailing rates in the same industry or for similar property.
2. Offers of competing transferors or the bids of competing transferees
3. Terms of the transfer, including limitations on the geographic area covered and the exclusive or non-exclusive characters of any rights granted.
4. Uniqueness of the property and the period for which it will remain unique.
5. Degree and duration of protection afforded to the property under the laws of the country.
6. Value of services rendered by the transferor to the transferee in connection with the transfer.
7. Prospective profits to be realised or costs to be saved by the transferee through its use or subsequent transfer of the property.
8. The capital investment and starting up expenses required of the transferee.
9. Availability of substitutes for the property transferred.
10. Arm's length rate and prices paid by unrelated parties, where the property is resold or sub-licensed to such parties.
11. Costs incurred by the transferor in developing the property.
12. Any other factor circumstance would have been likely to be considered.

[16] A Study of Intercompany Pricing under S.482 of the Internal Revenue Code, also called as White Paper.

approach, some courts apply different methods, such as a rate of return approach or an analysis of income to expense ratios.[17] In discussing the approaches available under the fourth method, the IRS has noted that although rate of return and income to expense ratios may provide a reasonable basis for determining transfer prices, courts have yet to develop these methods as a means to fill the analytic holes left by the 482 regulations in cases where it is impossible to locate comparable uncontrolled transactions. An IRS study performed in preparation for promulgating regulations under the revised 482 therefore recommended that the profit split approach or a newly developed method should make clear the most prominent gray areas that fourth method analyses address.[18]

II. The Evolution of Transfer Pricing Methods Under the Tax Reform Act of 1986

In 1986, Congress recognized problems that the IRS faced in applying and enforcing the arm's length standard. Congress articulated growing perceptions that corporations were avoiding taxes in spite of the existing transfer pricing rules. In enacting the Tax Reform Act of 1986, Congress amended the essential articulation of U.S. transfer pricing policy: Internal Revenue Code 482.

Prior to its amendment, 482 did not address the particularly troublesome question of intangible property. Intangible property generally comprises a broad range of items such as patents, processes, or other proprietary information. The dilemma associated with placing a dollar value on transfers of intangible property mirrors the problems implicit in applying the international arm's length standard. While related parties often trade in goods and other tangible items of a highly proprietary nature, which therefore are difficult to price, they may also undertake patent assignments, licensing agreements, or outright sales of intangibles, the value of which may be measured only after the transferee has derived income from them.

For example, a U.S. corporation may spend a great deal of capital to develop a new product, realizing in the process a substantial tax deduction for its research and development costs. If the corporation then earns significant income by transferring

[17] White Paper at 470.
[18] White Paper at 471.

the new technology to a foreign subsidiary that manufactures and markets the product, the problem becomes one of determining how much profit the transferred property will generate. The 1986 amendment to 482 addressed this difficult question by providing that the transfer price or royalty attributable to the transferred intangible must be commensurate with the income generated through the intangible property's use.

The amendment to 482, however, did more than apply a transfer pricing standard that required consideration for transfers of intangibles to be commensurate with the income attributable to those intangibles. The Tax Reform Act's legislative history acknowledged that the then-existing regulations neither prescribed a means for pricing transfers of intangibles nor provided adequate means for pricing all transfers of tangible property. The legislative history recognized not only that many transactions do not compare objectively with transactions between unrelated parties, but also that some transactions between related entities simply cannot compare to transactions between unrelated parties. The amendment therefore sought to codify existing fourth method analyses with regard to transfers of tangible as well as intangible property.

A. The Commensurate with Income Standard

Although the single-sentence addition to 482 did not significantly alter Treasury's authority under the section, the amendment's history does appear to alter Treasury's responsibilities and offer some significant suggestions as to appropriate regulatory measures. For example, the House Ways and Means Committee recommended that licensing agreements for intangibles be subject to a retrospective review for purposes of maintaining arm's length royalty rates.[19] In addition, the conference committee suggested that the IRS carry out a comprehensive study of transfer pricing rules to determine whether then-existing regulations could be improved.

[19] H.R.Rep.No.426, 99th long, 1st Sess at 424-25.

B. The IRS White Paper and the Basic Arm's Length Return Method

On October 18, 1988, the IRS responded to the conference committee's charge by issuing a comprehensive study of transfer pricing. This study, known as the White Paper, was described as a preliminary "discussion draft," intended to elicit commentary from interested parties. Although the White Paper originally proposed a standard comment period, the volume of generally negative comments received forced Treasury to extend the comment period indefinitely and to postpone issuing its proposed and working regulations until 1992 and 1993, respectively.

1. The White Paper's interpretation of the commensurate with income standard

In discussing the application of the commensurate with income standard, the White Paper distinguished between "normal profit intangibles" and "high profit intangibles." The authors reasoned that comparable uncontrolled transactions are more likely to exist where a transferred intangible is not likely to produce an unusually high profit. The problem with allocating royalties after the fact is that such royalties will likely be so high as to appear to violate the arm's length rule. While an apparently inordinate "super royalty" might cause no problems for the tax authority imposing it, such a policy might concern the country to which the intangible is transferred, thereby leading to double taxation of the income attributable to that intangible.

The authors of the White Paper nonetheless stressed that their goal was not to create international tax conflicts. Rather, they made clear their understanding that "for certain classes of intangibles (notably high profit potential intangibles for which comparables do not exist), the use of inappropriate comparables has failed to produce results consistent with the arm's length standard." Thus, the commensurate with income standard does not conflict with the international arm's length standard, but merely represents an arguably better means to determine an arm's length price.

a. Functional analysis of profit components

The existing international commentary on the arm's length standard embodied in the OECD and U.N. Model Conventions does not avoid reference to profitability as a possible measure of arm's length value. The OECD generally sanctions the application of some type of functional analysis that looks not only to the specific

transaction at issue, but also to the whole relationship between transferor and transferee with regard to the transferred property. The White Paper, on the other hand, proposed to determine transfer prices by a series of methods that would parallel those available under the then-existing regulations. These methods were the exact and inexact comparable methods, the basic arm's length return method (BALRM), and BALRM with profit split.

The methods proposed in the White Paper are based on an interpretation of the commensurate with income standard that anticipates analysis of all aspects of the transferor/transferee relationship that contribute to profit. These aspects include the actual income derived from a transferred intangible, a functional analysis of the related parties' activities in exploiting the intangible, and the allocation of costs and risks between the related parties. In addition, the commensurate with income standard applies to all transfers of intangible property regardless of the nature of the intangible, the amount of income derived from the intangible, or the existence of similar transfers among unrelated entities.

b. Periodic adjustment of pricing allocations

The most troublesome feature of the White Paper's evaluation of the commensurate with income standard is its view that allocation of income attributable to intangibles may be retrospective, involving review and alteration of royalties that appeared to be arm's length in previous tax years. In cases involving long-term licensing agreements, for example, the standard "requires that intangible income be redetermined and reallocated" and that the costs and risks involved in the related parties' activities be reassessed periodically. In the case of a license, periodic adjustments could be required if there were substantial changes in factors such as the income attributable to the intangible, the relative economic activities performed by the related parties, or the assets employed by the licensee.

On its face, the periodic adjustment provision appears to depart from the arm's length standard because it permits the calculation of an appropriate royalty to go forward after information regarding profits realized on a transfer has become available. Nonetheless, unrelated parties ordinarily do not enter into licensing agreements, particularly agreements involving high-profit intangibles, without

including some means of adjusting royalties if actual profitability were greater or less than expected. Despite its superficial conflict with the arm's length standard, periodic review would actually incorporate the spirit of the arm's length standard by permitting a tax authority to set transfer prices by the same means as would unrelated parties, who might be inclined to enter into a royalty agreement that permitted periodic rate adjustments.

2. The basic arm's length return method

The centerpiece of the White Paper's proposals is the functional analysis involved in the BALRM. As its name suggests, the BALRM seeks to determine the return on investment that unrelated parties might expect if they engaged in the same transaction by attributing income to each related member of a multinational group. The BALRM identifies the contributions, including "assets and other factors of production," of each member of a group and allocates each party's income by comparing those contributions to the income earned by the enterprise as a whole.

In a situation where a related foreign licensee takes only the intangible property but contributes all raw materials, labor, and technical know-how to manufacture a finished product, the value of the transferred intangible property is not reflected directly by the sale price of the finished product. Furthermore, comparable uncontrolled transactions may not be adequate to value the intangible in this type of situation.

Despite the BALRM's apparent departure from a standard search for comparable uncontrolled transfers, the departure is largely superficial. Whereas traditional arm's length analysis seeks uncontrolled dealings involving transactions similar to the transfer at issue, the BALRM's method continues to use comparable transaction information to determine the relative effect of each part of a transaction on the profitability of the transaction as a whole.

The BALRM indicates, however, that traditional application of the arm's length standard has limits, especially where certain transactions are so unique to the parties involved that they would not occur between unrelated parties.

C. The Emerging Regulatory Framework

1. The proposed regulations

Early commentary on the White Paper was generally critical of the IRS proposals, particularly the perceived overreliance on the BALRM. In January 1992, the U.S. Treasury responded by proposing regulations that would replace the BALRM with a comparable profit valuation method. This new method coordinated by means of a "comparable profit interval" (CPI), or index of acceptable profit ranges derived from functionally comparable profit indicators observable in uncontrolled transactions.

Although the proposed regulations offered a reliable method for constructing transfer prices, they did so only with great complexity. Despite the presence of fairly orthodox methods based on comparable transactions, the proposals also prescribed a strict priority of application, which itself drew negative criticism. Moreover, the proposals' functional analysis centerpiece, CPI, was intended not only to determine appropriate prices under the comparable profit method, but also to provide a check on the adequacy of adjustments made under the comparable adjustable transaction method.

In fact, merely assembling a CPI is a complex operation requiring careful planning and accounting by a taxpayer who uses the method. Construction of the CPI for any given transaction requires six steps: (1) selecting the controlled entity to be tested (usually the transferee); (2) determining appropriate business classifications associated with the transferred intangible and developing a sample of unrelated entities that engage in similar operations; (3) computing "constructive operating incomes" derived from an application of profit indicators, such as return ratios or profit splits, to the tested party's attributes such as assets and costs; (4) computing an appropriate CPI by isolating the most uniform unrelated-party data; (5) determining "the most appropriate point" in the CPI, if necessary; and (6) determining an appropriate transfer price based on the CPI. Nonetheless, to the extent that the CPI incorporates valuation methods that are already in informal use, such as profit split or rate of return analyses, and to the extent that it offers a reasonably objective means by which to price particularly difficult transactions, the CPI would appear to offer a

measure of objective certainty unavailable under the old regulations. The CPI's reliance on data derived from unrelated-party dealings, while arguably minute in detail, is firmly grounded in the international standard of arm's length. As such, commentary on the proposed regulations criticized not so much the CPI as its predominance over more traditional methodologies.

2. The new regulations

The new regulations provide a total of eight valuation methods: five apply to transfers of tangible property and three apply to transfers of intangible property. Apart from the addition of the comparable profit method, the new regulations' valuation mechanisms do not differ radically from those of the old regulations. The essential differences between the old and new regulations are rooted in the procedural measures provided under temporary Treasury regulation 1.482-1T.[20]

a. Choice of method

In response to comments on the proposed regulations, the IRS acknowledged that problems exist with imposing a rigid hierarchy for applying valuation methods and therefore promulgated the "best method rule." The best method rule provides guidelines by which taxpayers may decide which valuation method will best meet the circumstances of the transaction under review. Rather than force a particular method into use in a given situation, the best method rule permits taxpayers to apply any available method that will allow them to obtain an accurate result. In general, however, the rule requires application of the method that will bring about the most accurate result under the circumstances.

b. Standards of comparability

The regulations that provide for determining relative comparability of controlled and uncontrolled transactions adhere to the principles of the arm's length standard. Because of the lack of comparable uncontrolled transactions in many circumstances, however, the new regulations permit the use of a comparable transaction that incorporates factors present in uncontrolled transactions if the comparable transaction corresponds to factors present in the transaction under review.

Comparability is thus reviewed on the basis of functions, risks, contractual terms, economic conditions, and property or services involved in the controlled and uncontrolled transactions under comparison. Where certain elements of controlled and uncontrolled transfers differ in some material respect, they may be adjusted in order to obtain a functional comparable transaction.

c. Safe harbors

In response to comments advocating adoption of a "safe harbor," or rule permitting before-the-fact election of a strict formulaic means for determining taxable income, the new regulations permit certain taxpayers to elect a safe harbor in lieu of applying other valuation methods. To be eligible for the safe harbor, a taxpayer must be a U.S. entity earning less than $ 10 million in aggregate annual sales revenue or a U.S. entity that engages in controlled transactions with a foreign entity that earns less than $ 10 million in aggregate annual revenue. Eligible taxpayers that elect the safe harbor are insulated against potential income allocations by applying an "appropriate profit level indicator" to be provided in forthcoming revenue procedures.

Although the safe harbor provides a measure of certainty for smaller firms engaged in controlled transactions, the IRS was quick to note that the rigidity of the rules applied to determine income under the safe harbor may produce results less favorable than what might be available under the general rules. Nevertheless, the safe harbor provides a positive means for determining appropriate transfer prices. Taxpayers electing the safe harbor will be able to predict precisely the documentation necessary for reporting income attributable to controlled transactions and may benefit from the highly simplified requirements for tax planning and accounting.

d. The comparable profits method

Despite criticism of the proposed regulations' heavy reliance on the CPI, the new regulations have carried a "comparable profits method" (CPM) into application as an alternative method for valuing controlled transfers of tangible and intangible property. In general, the comparable profits method operates on the principle that "similarly situated taxpayers will tend to earn similar returns over a reasonable period

[20] Temp.Treas.Reg.1.482-IT.58 Fed Reg at 5272-82.

of time." Like the comparable profits method provided by the proposed regulations, the new regulation offers an index, or range of results, that will be deemed appropriate.

In general, the CPM compares a taxpayer's profits with a range of constructive operating profits derived from profit level indicators available from uncontrolled taxpayers. The method operates by first selecting a party to be tested, which ordinarily is the party to the controlled transaction that performs the simplest operations and which need not be the taxpayer under examination. The CPM then requires selection of comparable parties that bear profit level indicators similar to those of the tested party. The term "profit level indicators" generally means financial ratios that measure the relationships among profits, costs, and resources involved in the transactions in question. Appropriate profit level indicators include rates of return on capital and financial ratios such as operating profit to sales or gross profits to operating expenses.

Once a taxpayer determines appropriate comparable profit level indicators, the final step is to determine the arm's length range. Ordinarily, the range includes all of the constructive operating profits derived from the comparable parties. When a taxpayer references appropriate comparable transactions but does not adjust the transactions to account for material differences in profit level indicators, the arm's length range generally will fall between the twenty-fifth and seventy-fifth percentiles of the constructive operating profits derived from the unadjusted profit level indicators.

It is important to note that the comparable profits method is offered only as an alternative; the method may not satisfy the requirements of all possible transactions. The new regulations maintain the taxpayer's recourse to fourth method analysis, provided that adequate documentation exists and that the taxpayer makes appropriate disclosure to the IRS. Preserving the "other methods" analysis perhaps reflects some humility on the part of the IRS, which seems to acknowledge that the methods set forth in the proposed regulations will not satisfy the necessities of every circumstance.

D. The Potential for Conflict with Foreign Tax Systems

From an international perspective, the problem with the new U.S. regulatory scheme may be that it is ahead of its time. For example, Canada, the largest U.S. trading partner, only recently adopted transfer pricing provisions that specifically apply the suggestions of the OECD. Similarly, Japan relies primarily on the comparable uncontrolled price, cost plus, and resale price methods, resorting to other methods such as rate of return or profit split only where necessary. Finally, some foreign commentary on the White Paper asserted vehemently that unilateral adoption of such measures will effectively repudiate U.S. treaty obligations. More than any other, this fact indicates that conflict will most certainly occur under the new regulations. When treaty partners disagree over the "correct" interpretation of arm's length prices, double taxation is the most probable result.

CHAPTER 3

TAXATION OF FOREIGN INCOME IN U.S.

Foreign Parties Defined

U.S. citizens and resident aliens are subject to U.S. taxation on their worldwide taxable incomes. In contrast, the Internal Revenue Code taxes nonresident aliens only on income that is effectively connected with a U.S. trade or business and U.S. source income.[1] Thus, the correct determination of an individual's tax classification is an imperative first step in the calculation of U.S. tax liability.

In a similar manner, corporations are taxable in the United States based on their characterization. Domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations, like nonresident aliens, are taxable only on income that is effectively connected with a U.S. trade or business and U.S. source income.

Non-resident Aliens

A nonresident alien is an individual who neither resides in the United States nor has U.S. citizenship. While the citizenship of a person is often easy to determine, resolving the question of residency for an individual without U.S. citizenship can be rather involved. Generally, U.S. residency occurs when one meets either a lawful permanent residence test or a substantial presence test under I.R.C. 7701(b)(1).

Treas. Reg. 301.7701(b)-1(b)(1) treats persons as lawful permanent residents when the U.S. government grants them the legal right to reside permanently in the United States as immigrants. The U.S. immigration and Naturalization Service issues a card that evidences this right. Though cards issued today are white, they were green at one time. Hence, the lawful permanent residence test is sometimes called the "green card" test.[2] Once individuals secure the right to reside permanently in the United States, they are considered U.S. residents or resident aliens (rather than nonresident

[1] For a detailed discussion of the source rules, see Ernest R. Larkins, Source of Income Rules: The Debits and Credits of international Taxation, U.S. Taxation of International Operations 6111 (1997).

[2] In 1996, nearly 916,000 alien individuals became U.S. immigrants, an increase of 195,000 over 1995 totals. U.S. Department of Justice, Immigration and Naturalization Service, 1996 Statistical Yearbook of the Immigration and Naturalization Service (1996), at 11.

aliens). They continue to qualify as U.S. residents until they abandon such status or their rights as U.S. residents are rescinded.

Even when alien individuals are not residents under U.S. immigration law, they still may be residents under U.S. tax law. The substantial presence test is generally satisfied when an alien individual is physically present in the United States during at least 31 days during the current year and 183 "weighted days" over a three-year period.[3] In testing whether the 183-day threshold is reached, I.R.C. 7701(b)(3) counts each day of U.S. presence during the current year as a whole day. Every day of U.S. presence in the preceding year is counted as one-third of a day, and days of U.S. presence in the second preceding year are weighted by one-sixth. Consider a foreign national who is present in the United States during 140 days in 1999, 90 days in 1998, and 120 days in 1997. This individual meets the substantial presence test during 1999 since her weighted days total 190 (i.e., 140 + 30 + 20). Thus, she is a U.S. resident (or resident alien) in 1999 rather than a nonresident alien.

Individuals close to the 183-day threshold may be able to extend or shorten their U.S. stays depending on whether they desire U.S. residency status. Documentation of U.S. visits and their durations is important. Alien individuals can use airline receipts, passport stamps, and personal logs to support assertions of their status under U.S. law.

When either the lawful permanent residence or substantial presence test is met, an individual generally becomes a U.S. resident on the first day of U.S. presence.[4] Three special elections allow persons who are becoming U.S. residents to accelerate their starting residency dates in some situations: (1) the first-year election permits one who arrives in the United States too late during the year to meet the substantial presence test to become a U.S. resident for at least part of the arrival year, (2) the nonresident election allows a nonresident alien married to a U.S. person to become a U.S. resident for the entire year, and (3) the new resident election permits an

[3] See, e.g., I.R.C. 7701(a)(9). See generally, P.L.R. 9012023 in which the United States generally includes the 50 states, the district of Columbia, and U.S. territorial waters. Thus, an alien individual physically present in a U.S.possession (e.g., Guam or Puerto Rico) is not present in the United States.

[4] I.R.C. 7701(b)(2)(A)(iii); Treas. Reg. 301.7701(b)-4(a).

individual who becomes a U.S. resident for part of the current year to elect U.S. residency status for the entire year.[5]

Using one of these elections to shift the residency starting date assists one in timing income and deduction items so that worldwide income tax is minimized. For example, a deferred bonus from the home country generally should be received before the residency starting date to avoid potential double taxation. However, if the home country exempts bonuses received after the starting date and the U.S. effective tax rate is below that of the home country, the alien individual might shift his or her residency starting date so that the bonus is received as a U.S. resident.

Special rules often preclude certain individuals from becoming U.S. residents even though they meet the substantial presence test. Full-time diplomats and other foreign government-related personnel generally are considered nonresident aliens even though their U.S. stay may be protracted. Teachers, students, and trainees who are temporarily in the United States are usually nonresidents also. The U.S. presence of students is generally temporary if the stay does not extend beyond five calendar years. Teachers and trainees are considered temporarily in the United States for at least two calendar years. Since the special treatment extended to teachers, students, and trainees is partially based on the type of visa held, the strategic application for the right type of U.S. visa can have favorable income tax implications. Of course, some visas may be more difficult to obtain from U.S. immigration authorities than others, depending on an individual's circumstances. Finally, other foreign persons with closer connections to their home country, individuals that regularly commute to work from Mexico or Canada, aliens who must prolong their U.S. stays because of medical conditions that developed while present in the United States, and certain professional athletes temporarily in the United States to compete in a charitable sporting event can avoid U.S. residency status.[6]

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[5] I.R.C. 7701(b)(4), 6013(g), (h).

[6] I.R.C. 7701(b)(5), (7). To qualify under these special rules, alien individuals generally must timely file Form 8843, Statement for Exempt Individuals and Individuals with Medical Conditions, or Form 8840, Closer Connection Exception Statement for Aliens. For a more detailed discussion of U.S. residency, see Ernest R. Larkins, Individual Tax Planning: Resident vs. Nonresident May Be Critical, 7 J. Int'l Tax'n 410 (1996); Ernest R.Larkins, Resident vs. Nonresident: Tax Planning Includes Elections, Timing, 8 J. Int'l Tax'n 172 (1997).

Notwithstanding the rules discussed above, U.S. income tax treaties can affect an individual's residency status in some circumstances. In particular, an alien individual is a "dual resident" if he is a U.S. resident under the above rules and, under local law, also a resident of his or her home country with which the United States has a treaty. Dual residents must apply a series of tie-breaker rules to determine their country of residence under the treaty. For example, the U.S. Model Treaty indicates that one should determine residency, if possible, on the basis of his permanent home.[7] When he has a permanent home available in both countries, his residency depends on his center of vital interests (i.e. the country to which his personal and economic relations are closer). If no permanent home exists or the center of vital interests is not clear, an individual resides in the country of his habitual abode. When he has such an abode in both or neither countries, the U.S. Model Treaty uses citizenship as the determining factor. The competent authorities in the treaty countries (e.g., the IRS) determine the residency status of individuals who are citizens of both or neither countries.

Foreign Corporations

Under I.R.C. 7701(a)(5), a domestic corporation is created under the laws of the United States or one of its states. In contrast, a foreign corporation is organized abroad. Thus, the sole determinant of corporate character under U.S. law is the location where articles of incorporation or similar papers are filed.

Incorporated entities created under the laws of a foreign country or U.S. possession are foreign corporations. A corporation organized abroad is a foreign corporation even if most or all of its employees, assets, or business activities are located in the United States. Unlike the tax laws in many countries, the place from which a corporation is controlled and its "seat of effective management" are irrelevant in determining whether the entity is a domestic or foreign corporation.

Like the choice some alien individuals have between U.S.residency or non-residency, an entity's initial decision of whether to organize as a domestic or foreign

[7] Convention for the Avoidance of Double Taxation, Sept. 20, 1996, U.S.-1 Tax Treaties (CCH) P214 (1998), at art. 4(2) [hereinafter U.S. Model Treaty.

corporation is an important one. As discussed in more detail later, the United States exempts some income of foreign corporations from taxation and taxes other income items at varying rates.

Trade or Business Requirement

Unless a treaty provides otherwise, income of a foreign party that is effectively connected with a U.S. trade or business (ECI) is subject to U.S. taxation at regular rates. ECI cannot generally exist under I.R.C. 864(c)(1)(B) unless the foreign party is engaged in a U.S. trade or business. In other words, the existence of a trade or business is a prerequisite to a finding of ECI. The first line of defense for foreign parties that do not wish to be taxed on ECI is to establish the lack of a U.S. trade or business.

Though the Internal Revenue Code and Treasury Regulations use the Phrase "trade or business" ubiquitously, neither defines it. Moreover, Rev. Proc. 98-7, 1998-1 I.R.B. 222, 4.01(3), indicates that the IRS ordinarily will not rule on whether a party is engaged in a U.S. trade or business nor whether income is effectively connected with a U.S. trade or business. Prior judicial and administrative rulings provide the most relevant guidance on trade-or-business-type questions.

Generally, a trade or business is any considerable, continuous, and regular activity engaged in for profit.[8] Rev. Rul. 73-522, 1973-2 C.B.226, normally characterizes minimal, sporadic, or irregular transactions as investment, rather than business, activities. I.R.C. 875 treats a foreign party as engaged in a U.S. trade or business if the partnership of which the foreign party is a member is so engaged. United States v. Balanovski, treats partnerships as carrying on business when one or more of their partners are conducting business on the partnership's behalf.[9]

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[8] See, e.g., Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); European Naval Stores, Co., S.A. v. Commissioner 11 T.C. 127, 133 (1948); Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953), aff'd per curiam, 221 F.2d 227, 227 (9th Cir. 1955).

[9] United States v. Balanovski, 236 F.2d 298 (2nd Cir. 1956).

Beyond this general definition, certain specific activities have been held to constitute trades or businesses. For example, a foreign party that regularly sells goods into the United States through a dependent or exclusive, independent agent is conducting a U.S. trade or business.[10] Similarly, an agent that regularly exercises broad powers to manage a foreign party's U.S. real estate investments (beyond mere ownership or collection of rent) causes the principal to be engaged in a U.S. trade or business.[11]

Rev. Rul. 56-165, 1956-1 C.B. 849 treats a foreign enterprise as engaged in a U.S. trade or business when it sends an employee or other dependent agent to the United States to sell goods and conclude contracts. Employees that do not have the power to conclude contracts but who must send solicited orders to the home office for approval is one arrangement that can avoid trade or business status. However, if marketing representatives or employees are technically precluded from concluding contracts but the home office approves virtually all orders through no more than a "rubber stamp" procedure, the IRS will likely view the activity as a trade or business; the fact that the representative cannot conclude contracts must be more than a formality.

In contrast to the situations above, direct sales into (or purchases from) the United States are not considered a trade or business if the foreign seller (or purchaser) has no office, employee, or agent in the United States or if sales are made through a nonexclusive, independent agent with multiple principals.[12] Also, technical services performed in the United States incident to the sale of goods are not, by themselves, a trade or business. Absent other activities, the mere creation of a corporation, collection of passive income (e.g., in relation to a net lease), ownership of realty or

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[10] Handfield v. Commissioner, 23 T.C. 633 (1955); Rev. Rul. 70-424, 1970-2 C.B. 150.

[11] Lewenhaupt v. Commissioner, 20 T.C. at 163, aff'd per curiam, 221 F.2d 227 (9th Cir. 1955); Rev. Rul. 73-522, 1973-2 C.B. 226.

[12] Amalgamated Dental, Co., Ltd. v. Commissioner, 6 T.C. 1009, 1018 (1946); Tech.Adv.Mem. 81-47-001 (Jan. 3, 1979).

corporate stock, investigation of business opportunities, or distribution of earnings do not constitute a trade or business.[13]

Higgins v. Commissioner confirms that mere investment activities on one's own account, even if actively and continuously engaged in, are not considered a trade or business.[14] Thus, a foreign investor that trades commodities (of the type normally listed on organized exchanges), stocks, and securities in the United States on its own behalf or through an independent agent is generally not carrying on a U.S. trade or business. However, I.R.C. 864(b)(2) indicates that a trade or business does exist if the investor is a dealer in such stocks and securities or, in the case of trading through an independent agent, the investor has a U.S. office or other fixed place of business at any time during the taxable year through which trading is directed.

Occasional or single, isolated transactions generally do not lead to a finding of trade or business activities.[15] However, the IRS and the courts have held that a single event (often involving substantial personal service income) can be a trade or business. For example, a prize fighter's engagement in one or more boxing matches has been held to be the conduct of trade or business activities.[16] Rev. Rul. 67-321, 1967-2 C.B. 470 held that a French company that contracts to perform a floor show or night club revue in a U.S. hotel over a ten-week period is engaged in a U.S. trade or business. Similarly, the purse winnings of a horse entered in only one race within the United States may be taxable since the IRS has ruled that a single race is a U.S. business activity.[17] On the other hand, Continental Trading, Inc. v. Commissioner held that numerous but "isolated and non-continuous" sales transactions do not

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[13] G.C.M. 18835 (1937), 1937-2 C.B. 141; Neill v. Commissioner, 46 B.T.A. 197 (1942); McCoach v. Minehill & Schuylkill Haven R.R. Co., 228 U.S. 295 (1913); U.S. v. Balanovski, 131 F.Supp. 898 (S.D.N.Y. 1955); Abegg v. Commissioner, 50 T.C. 145 (1968), aff'd on other grounds, 429 F.2d 1209 (2nd Cir., 1970).

[14] Higgins v. Commissioner, 312 U.S. 212 (1941).

[15] Pasquel, 12 T.C.M. 1431 (1954); European Naval Stores, Co., S.A. v. Commissioner, 11 T.C. 127 (1948).

[16] Rev. Rul. 70-543, 1970-2 C.B. 172; Johansson v. United States, 336 F.2d 809 (5th Cir., 1964).

[17] Rev. Rul. 58-63, 1958-1 C.B. 624: Rev. Rul. 70-543, 1970-2 C.B. 172.

constitute a trade or business when motivated for tax avoidance, rather than profit-making, reasons.[18]

The rendition of personal services is generally considered carrying on a trade or business. However, a nonresident alien performing de minimis services in the United States, whether as an employee or independent contractor, is not engaged in a U.S. trade or business when the three conditions of I.R.C. 864(b)(1) are met. First, the compensation cannot be more than $ 3,000 for the U.S. services. Second, the U.S. presence during the taxable year cannot exceed 90 days. Third, the services must be rendered for either a foreign party not engaged in a U.S. trade or business or a foreign office or place of business of a U.S. party.

Effectively Connected Income

Once the existence of a U.S. trade or business is established, the next question is whether any income is effectively connected with it.[19]

Under I.R.C. 864(c)(1)(B), foreign parties do not have ECI unless they are engaged in a U.S. trade or business during the taxable year. Six exceptions to this general rule exist in which the tax law treats income as ECI despite the absence of a trade or business or despite the lack of relationship between the income and a trade or business.

I.R.C. 871(d) and 882(d) allow foreign parties to treat any income from investment realty, including gains from sale or exchange, as ECI. Any such election continues in effect for all subsequent years unless revoked with IRS consent.

Under I.R.C. 882(e), interest on U.S. obligations that a possession corporation receives is ECI if the corporation is carrying on a banking business. The effect of this provision is twofold: (1) it allows possession banks to offset interest income from

[18] Continental Trading, Inc. v. Commissioner, 265 F.2d 40 (9th Cir. 1959).

[19] See, e.g., Alan B. Stevenson, Is the Connection Effective? Through the Maze of Section 864, 5 Nw. J. Int'l. I. & Bus. 213 (1983); Harvey P. Dale, Effectively Connected Income, 42 Tax L. Rev. 689 (1987); and Christine Bouvier, Foreign Corps. in U.S. Must Be Wary of Effectively Connected Income, 2 J. Int'l Tax'n 287 (1992).

U.S. sources with business expenses, such as interest expense they pay to depositors, and (2) it removes a major disincentive for possession banks to invest their capital into the U.S. economy, namely a 30 percent tax on gross interest income.

I.R.C. 897 treats gain from the sale, exchange, or other disposition of a U.S. real property interest as ECI. A U.S. real property interest includes direct holdings in U.S. realty and certain indirect holdings through domestic corporations (as discussed later).

When a foreign party receives deferred compensation during a year when no U.S. trade or business is conducted, I.R.C. 864(c)(6) taxes it as ECI if attributable to a prior year when the foreign party did engage in a U.S. trade or business. For example, assume a foreign corporation carries on a U.S. retail business in 19x1 and makes an installment sale. Before the end of 19x1, the corporation closes the retail establishment and ceases to conduct any U.S. trade or business. When the installment obligation is collected in 19x2 or a later year, the deferred profit from the 19x1 sale is taxed as ECI.

Under I.R.C. 864(c)(7), a foreign party that ceases to use an asset in its U.S. trade or business and disposes of the asset within ten years of such cessation is taxable on any resulting gain as ECI, even if the foreign party is no longer engaged in a U.S. trade or business.

When a foreign party does engage in a U.S. trade or business, I.R.C. 864(c)(3) treats all U.S. source income that the tax law does not explicitly tax or exempt as ECI. This limited "force of attraction" rule assures that income the United States intends to tax is not inadvertently overlooked. In effect, U.S. source income (other than investment income and capital gains) is attracted to the foreign party's U.S. trade or business and taxed the same as business profits or ECI. To illustrate, Treas. Reg. 1.864-4(b) assumes a foreign manufacturer with a U.S. selling branch. If the home office occasionally sells its manufactured products directly to U.S. customers without involving the U.S. branch and title to the sales pass in the United States, such profit is treated as ECI even though the U.S. branch played no role in generating the income.

Note that the simple way to avoid ECI in this case is to pass title on the sale outside the United States; foreign source income is not subject to this force of attraction rule.

When nonresident aliens performing services in the United States meet the three de minimis conditions discussed earlier, they are not engaged in a U.S. trade or business; thus, their compensation is not ECI. In addition, the satisfaction of these three conditions assures that the compensation is treated as foreign source income under I.R.C. 861(a)(3).[20] Since the compensation is foreign source income that is not ECI, it is exempt from U.S. taxation. The rules found in U.S. income tax treaties generally are more lenient than these statutory provisions. Thus, personal service income not exempt under the de minimis test may, nonetheless, be exempt under treaty.[21]

U.S. Source ECI

Once the existence of a U.S. trade or business is established, whether a given income item is taxable as ECI is often clear. For example, the net profit from sales a foreign corporation earns from a sales branch or retail outlet in the United States is ECI. However, types of income that traditionally have been classified as investment or passive in nature are ECI in some cases; it depends on the income's source.

The manner in which ECI is determined differs for U.S. and foreign Source income. U.S. source income that satisfies either the asset use test or business activities test of I.R.C. 864(c)(2) is ECI. Under both tests, one must give due regard to how the U.S. trade or business accounts for the item in question.

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[20] For a specific application, see Rev. Rul. 64-184, 1964-1 C.B. 323. Rev. Rul. 69-479, 1969-2 C.B. 149, indicates that any personal service income above the $ 3,000 threshold causes all of the income to be from U.S. sources, not just the excess portion. A similar interpretation presumably would hold for exceeding the 90-day threshold.

[21] For example, Article 15(2) of the U.S. Model Treaty, supra, note 10, exempts the income from employee services that a nonresident alien renders in the United States if: (1) the recipient's U.S. presence does not exceed 183 days in any 12-month consecutive period that begins or ends in the taxable year, (2) the employer paying the compensation to the nonresident alien (or the employer on whose behalf the compensation is paid) is not a U.S. resident, and (3) a permanent establishment or fixed base that the employer maintains in the United States does not ultimately bear the expense of the compensation.

The asset use test treats U.S. source income as ECI if the income is derived from assets currently used or held for current use in the U.S. trade or business. This test applies primarily to passive income such as interest and dividends. Treas. Reg. 1.864-4(c)(2)(i) indicates that interest from a temporary investment of idle working capital in U.S. Treasury bills is ECI since it is held to meet the present needs of the business. In contrast, the income from a long-term investment of excess funds in U.S. Treasury bills with the expectation of using the accumulations for the future expansion of product lines or to meet future business contingencies is not ECI.

The business activities test concludes that income from U.S. sources is ECI whenever the activities of a U.S. trade or business are a material factor in realizing the income. This test applies to income that, though generally passive, arises directly from business activities. Treas. Reg. 1.864-4(c)(3)(i) indicates that interest income of a financing business, premiums of an insurance company, royalties of a business that primarily licenses intangibles, dividends and interest of a dealer in stocks and securities, and fees of a service business are ECI under the business activities test.

Foreign Source ECI

Prior to 1966, foreign parties often used the United States as a tax haven for sales activities. The United States, at that time, did not tax foreign source income. Thus, a foreign party might establish a U.S. sales office through which it could sell to third countries. The home country did not tax the profit on such sales because, for example, it was derived from foreign sources. The United States did not tax the profit as long as title passed abroad. The third country did not tax the profit because the seller had no permanent establishment there. Thus, the profit on these sales often escaped income tax altogether.

Under current U.S. law, foreign parties are not taxed on most foreign source income. However, to prevent abuses such as those described above, foreign source income is considered ECI when the three conditions in I.R.C. 864(c)(4) and (5) are met. First, the foreign party (or the party's dependent agent) must have a U.S. office or fixed place of business. Second, the office must be a material factor in the production of the foreign source income and must be regularly used in business activities that produce the type of income in question. Third, the foreign source

income must be one of the following: (1) royalties from the use of intangible property abroad or (2) dividends or interest derived in the active conduct of either a U.S. banking or finance business or a corporation whose principal business is trading stocks and securities for its own account.

I.R.C. 864(c)(4)(B)(iii) indicates that foreign source income a foreign party earns through the material effort of a U.S. office is ECI. However, the interaction of this provision with the source of income rules assures that foreign source ECI will never result. In particular, sales of personality (including inventory) through a U.S. office generally result in U.S. source income, which is ECI through the business activities test.[22] On the other hand, if a foreign office materially participates in the sale and the property is sold for consumption abroad, the income is from foreign sources and is not ECI.[23] In effect, when a foreign party sells inventory through a U.S. office, the profit must be either U.S. source ECI or foreign source income that is not ECI; it cannot be foreign source ECI.

Ordinary Income Taxation

I.R.C. 872(a) and 882(b) grant the United States jurisdiction to tax foreign parties on two broad categories of income: (1) ECI and (2) U.S. source income that is not ECI, which is primarily investment-type income. Other income of foreign parties is exempt from U.S. taxation. For example, the foreign source income of a nonresident alien is not taxable in the United States unless it is ECI. When no treaty is in force, I.R.C. 871(b) and 882(a) tax the ECI of foreign parties at the regular rates applicable to U.S. parties. Whether the ECI is from U.S. or foreign sources does not matter. I.R.C. 1231 gain on the sale or exchange of business assets is considered ECI the same as income from business operations.

If an income tax treaty exists, taxation of ECI depends on whether The foreign party has a U.S. permanent establishment. Article 7(1) of the U.S. Model Treaty exempts a foreign party's ECI from U.S. taxation unless the ECI is attributable to a

[22] I.R.C. 864(c)(2), 865(e)(2).

[23] I.R.C. 864(c)(4)(B)(iii), 865(e)(2)(B).

permanent establishment that the foreign party has in the United States. Similarly, the "commercial traveler" article in U.S. income tax treaties can exempt nonresident aliens' income from dependent personal services that otherwise might be taxable as ECI.[24] Among other things, treaty exemption usually depends on the length of stay in the host country. Article 15 of the U.S. Model Treaty and many other treaties allow stays of no more than 183 days.

I.R.C. 871(a)(1) and 881(a) generally tax U.S. source income that is not effectively connected at 30 percent. The 30 percent rate is withheld at the time of the transaction and is applied to gross income; no deductions are allowed. I.R.C. 1441 and 1442 usually designate the last U.S. party to control the income payment as the withholding agent.[25] For example, a U.S. corporation declares a $ 1,000 dividend. A foreign party residing in a country that has no income tax treaty with the United States owns all of the U.S. corporation's stock. The U.S. corporation should pay $ 700 to the foreign party and remit $ 300 in withheld taxes to the U.S. Treasury. Failure to withhold and remit the correct amount of tax can cause the withholding agent to be liable for the tax.[26]

Most U.S. source income taxable at 30 percent is investment income. I.R.C. 871(a)(1)(A) and 881(a)(1) include dividends, interest, rent, royalties, and annuities in this list. Dividends include only gross income received out of a corporation's earnings and profits.[27] Any original issue discount that is accrued on an obligation's sale date is treated the same as interest per I.R.C. 871(a)(1)(C)(ii) and 881(a)(3). Rental income

[24] See, e.g., Lym H. Lowell, et al., Tax Issues in the Provision of Inbound Services, 9 J. Int'l Tax'n 36 (1998).

[25] I.R.C. 1441, 1442. Under some circumstances, a foreign party is the payor and, thus, the withholding agent. See, e.g., Rev. Rul. 80-362, 1980-2 C.B. 208, in which a nonresident alien licensed the rights to use a patent within the United States to a Netherlands corporation. The royalty the corporation paid was subject to withholding as U.S. source income.

[26] I.R.C. 1461, 1463, 6672.

[27] Rev. Rul. 72-87, 1972-1 C.B. 274, clarifies that corporate distributions in excess of earnings and profits are nontaxable returns of capital to the extent of the distributee's tax basis in the stock and capital gain to the extent of any additional amounts received. Since the U.S. corporate distributor may not know what portion of a distribution is from earnings and profits when the distribution is made, it must withhold at 30 percent or a lower treaty rate on the entire distribution. If it is determined later that part of the distribution was not made out of earnings and profits, the foreign distributee will be entitled to a refund.

is subject to the 30 percent withholding tax only if the rental activity is not treated as a trade or business. Commissioner v. Wodehouse clarifies that royalties from non-business activities are subject to withholding whether received periodically or as a lump-sum amount.[28] Only the income portion of annuities are taxable; any annuity amount received that is, in essence, a return of capital is not taxed. Similarly, Rev. Rul. 64-51, 1964-1 C.B. 322 provides that the income due when a life insurance policy matures or from surrendering a life insurance policy is subject to the withholding tax.

U.S. income tax treaties often reduce the tax rate on U.S. source investment income below 30 percent. Interest and royalties are exempt in many treaties and are taxable at 5 to 15 percent in most others. Similarly, treaties normally tax dividends at 5 to 15 percent. The lower 5 percent withholding rate is generally reserved for corporate recipients that own a specified minimum stock percentage of the distributor. For example, Articles 10 through 12 of the U.S. Model Treaty exempt most interest and royalty income from host country taxation and require 15 percent withholding on dividends. However, dividends paid to corporations that own at least 10 percent of the distributor's voting stock are subject to a withholding tax of only 5 percent.

Some types of U.S. source income other than investment returns are subject to a 30 percent withholding tax. For example, amounts received as prizes, awards, gambling winnings (unreduced by gambling losses), and alimony are taxable.[29] I.R.C. 871(a)(1)(B) and 81(a)(2) tax gain on the disposal of timber, coal, and domestic iron ore if the seller retains an economic interest. Similarly, I.R.C. 871(a)(1)(D) and 881(a)(4) tax gain from the sale or exchange of intangibles to the extent the payments are contingent on future productivity, use, or disposition. Treaties may exempt these gains and income items from host country taxation.

Under I.R.C. 871(a)(3), 85 percent of U.S. Social Security benefits are taxable at 30 percent. However, some treaties exempt such benefits from host country taxation. Assume that under the U.S.-France totalization agreement, a French national

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[28] Commissioner v. Wodehouse, 337 U.S. 369 (1949)

[29] Barba v. United States, 2 Cl.Ct. 674 (Cl. Ct. 1983); Howkins v. Commissioner, 49 T.C. 689 (1968); Rev. Rul. 58-479, 1958-2 C.B. 60.

and resident is entitled to a $ 1,000 monthly benefit from the United States. The U.S. Social Security Administration should withhold a tax of $ 255 each month (i.e., $ 1,000 x 85% x 30%). Article 18(1)(b) of the U.S.-France income tax treaty does not exempt the income.[30] Now assume that the individual is a national and resident of Germany instead and that the $1,000 benefit is received pursuant to the U.S.-Germany totalization agreement. Under Article 19(2) of the U.S.-Germany income tax treaty, the Social Security benefit received is exempt from U.S. taxation.[31]

Under Treas. Reg. 1.1441-4(b)(1), compensation from rendering independent personal services (i.e., as a non-employee) may be subject to 30 percent withholding.[32] For example, assume a self-employed, nonresident alien attorney receives $50,000 for his advice regarding an international reorganization. If the services are rendered in the United States and unless a smaller percentage is negotiated with the IRS, the income is subject to 30 percent withholding.[33] Unlike the withholding on investment income, Rev. Rul. 70-543, 1970-2 C.B. 172, clarifies that the 30 percent withheld is an estimated prepayment of the tax liability; the actual tax due might be more or less than the amount withheld. U.S. treaties might provide for a different treatment. Article 14 of the U.S. Model Treaty exempts independent services income from host country taxation unless the recipient has a fixed place of business in the host country that is regularly available to him (e.g., an office) and the income is attributable to such place. Thus, if the attorney in the above example had no fixed place of business in the United States available to him, any treaty between his home country and the United States likely would exempt the $ 50,000 from U.S. taxation.

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[30] Convention for the Avoidance of Double Taxation, Aug. 31, 1994, U.S.-Fr., S. Treaty Doc. No. 103-32 (1994).

[31] Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-F.R.G, 1 Tax Treaties (CCH) P3249 (1998).

[32] See, e.g., Rev. Rul. 70-543, 1970-2 C.B. 173.

[33] See also Rev. Rul. 58-479, 1958-2 C.B. 60, in which commissions that a marine supplier paid to a tramp steamer's foreign shipmaster was subject to U.S.withholding tax.

Capital Gain Taxation

Capital gain of foreign parties that is ECI is subject to U.S. regular rates, the same as I.R.C. 1231 gain.[34] The tax treatment of capital gain that is not ECI depends on the source of the gain and the type of taxpayer. For the remainder of this section, capital gain is assumed not to be ECI.

Foreign source capital gain of foreign parties is exempt from U.S. taxation. In addition, foreign corporations are not taxable on U.S. source capital gain.[35] As a practical matter, most capital gain of foreign corporations is foreign sourced. However, U.S. source capital gain can result in some situations, such as when a foreign corporation sells an intangible asset for a contingent price based on future productivity or use within the United States.[36] If such capital gain is not ECI, it is exempt from U.S. tax.

Under I.R.C. 871(a)(2), a nonresident alien is taxable on U.S. source capital gain only if her presence in the United States is at least 183 days during the taxable year. Recall that an alien individual whose U.S. presence during the taxable year totals 183 days or more is generally a resident under the substantial presence test rather than a nonresident. At first glance, it might appear as though this provision has no application. Nonetheless, foreign government-related persons, teachers, students, trainees, commuters from contiguous countries, and other alien individuals can continue their status as nonresident aliens despite their substantial U.S. presence (as mentioned earlier). When nonresident aliens in one of these special categories have 183 days of U.S. presence, the Internal Revenue Code imposes a 30 percent withholding tax to the difference between capital gains and capital losses for the taxable year. The 50 percent exclusion on capital gains from the sale of certain small

[34] Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988)clarified that a capital asset can be held in connection with a trade or business and that the motivation in acquiring the asset is irrelevant in its classification.

[35] I.R.C. 871(a)(2) imposes a withholding tax on the U.S. source capital gains of nonresident aliens. However, no parallel provision exists to impose a similar tax on foreign corporations; the statute's silence is equivalent to exemption.

[36] I.R.C. 861(a)(4), 865(d)(1)(B).

business stock under I.R.C. 1202 is not allowed. Also, no I.R.C. 1212 capital loss carryovers are allowed to reduce current capital gains.

Several U.S. income tax treaties exempt nonresident aliens from the withholding tax that the Code otherwise imposes on U.S. source capital gains. For example, Article 13(5) of the U.S.-Ireland treaty exempts from host country taxation the capital gains on the disposition of many types of "movable" properties.[37] Article 13(6) of the U.S.-Sweden treaty allows only the home country to tax capital gain from disposing of most investment assets other than real estate.[38]

Real Estate Taxation

The management of U.S. real estate is generally considered to be the conduct of a U.S. trade or business. Fackler v. Commissioner held that, even when substantial time is not required, paying expenses (e.g., utilities and insurance), making arrangements for necessary repairs, and approving new tenants often is sufficient to qualify the activity as a trade or business.[39] Rev. Rul. 73-552, 1973-2 C.B. 226, clarifies that activities beyond merely collecting rent and paying expenses incidental to the col election effort generally result in trade or business status as long as the general conditions of continuity, regularity, and considerableness are met. As discussed earlier, the rental income from business activity, whether directly conducted or carried out through an agent, is taxable at regular U.S. rates since it is ECI. Rental expenses are deductible against rental income only to the extent permitted under U.S. law. Thus, the I.R.C. 469 passive activity rules can preclude deductions otherwise allowed in computing ECI.

Gross income from investment real estate (other than gain from disposition, which is discussed later) is generally taxable at 30 percent or a lower treaty rate with no deductions for expenses related to the investment. The disallowance of depreciation, interest, and other real estate- related expenses can cause a foreign party

[37] Convention for the Avoidance of Double Taxation, July 28, 1997 U.S.-Ir., S. Treaty Doc. No. 105-31 (1997).

[38] Convention for the Avoidance of Double Taxation, Sept. 1, 1994, U.S.-Swed., S. Treaty Doc. No. 103-29 (1994).

[39] Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943).

to pay a very high effective tax rate. Further, the U.S.tenant in a "net lease" arrangement may pay certain expenses directly to the obligee in lieu of additional rental income (e.g., property taxes paid to the state taxing agency). If the foreign landlord is not engaged in a U.S. trade or business, Rev. Rul. 73-552, 1973-2 C.B. 226, clarifies that the substitute rental payment is subject to withholding the same as rental income actually received.

To alleviate the potential inequity or hardship of taxing investment real estate on a gross basis, foreign parties are allowed to elect net basis taxation under I.R.C. 871(d) and 882(d). Once elected, net basis taxation applies to all U.S. investment realty that the taxpayer holds and generally remains in effect for all subsequent years. However, the election is available only if the foreign party derives some income from the property during the taxable year. Failure to generate income at any time during the year causes the deduction for real estate expenses to be lost. Neither can the expenses be capitalized and added to the real estate's basis according to Rev. Rul. 91-7, 1991-1 C.B. 110. As a practical matter, the taxpayer should arrange to earn at least a nominal amount of income from the property to preserve its deductions.

Rev. Rul. 92-74, 1992-2 C.B. 156, holds that any net loss resulting from the election can be used to offset ECI from other business activities and, if some portion of the loss remains, to generate a net operating loss to carryover to other taxable years. If elected, all income from all U.S. real properties must be treated as ECI. Unless revoked with IRS consent, any election remains in effect for all subsequent years. U.S. income tax treaties often allow a similar election.[40]

Prior to 1980, foreign parties could easily dispose of investment real estate held in the United States with no U.S. tax consequences. For example, nonresident aliens avoided tax if their presence within the United States totaled less than 183 days during the taxable year. Foreign corporations escaped U.S. taxation simply because the Internal Revenue Code did not impose a tax on capital gain unless it was ECI (as discussed previously). Amid growing reports that foreigners were amassing vast

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[40] See, e.g., supra, note 10, at art. 6(5).

holdings of U.S. farmland because of the favorable investment climate, Congress enacted the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[41]

Under I.R.C. 897(a)(1), FIRPTA treats a foreign party's gain from the disposition of a U.S. real property interest (USRPI) as ECI, which is taxable at regular U.S. rates, even if the party engages in no U.S. trade or business. The U.S. buyer must withhold income tax on the foreign party's gain. Since the buyer in most cases does not know the seller's adjusted basis in the USRPI,I.R.C. 1445(a) adopts an alternative withholding method to estimate the required withholding. Unless the seller establishes that a smaller amount should be withheld, the buyer must withholding a tax equal to ten percent of the seller's amount realized (rather than the seller's gain). In contrast to most other withholding procedures, the withheld amount is a mere estimate of the tax liability; any additional tax owed or refund due must be settled on the U.S. tax return for the year.

When a loss results from the disposition of a USRPI, it is deductible only to the extent the taxpayer has ECI; that is, it is not deductible against the foreign party's U.S. source investment income. If the loss is from the sale or exchange of a capital asset, Rev. Rul. 92-74, 1992-2 C.B. 156, indicates that the deductibility of the loss is further limited to a foreign corporation's capital gains and a nonresident alien's capital gains plus $3,000. In addition, a FIRPTA loss that constitutes a passive activity loss is deductible only to the extent of the taxpayer's passive activity gain. When a nonresident alien incurs a FIRPTA loss, I.R.C. 897(b) permits a deduction only if the disposed real estate is (1) used in a for-profit activity or (2) damaged or lost through a casualty or theft. Thus, FIRPTA losses must clear several hurdles before their deductibility is allowed.

United States Real Property Interests (USRPI's) take either of the two forms - direct ownership of U.S. real estate and indirect ownership. Under I.R.C.

[41] For a more detailed discussion of the pre-1980 environment, see U.S. Department of the Treasury, Taxation of Foreign Investment in U.S.Real Estate (1979); William H. Newton III, Structuring Foreign Investment in United States Real Estate, 50 U. Miami. L. Rev. 517 (1996); Yoseph M. Edrey, Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer, 15 Va. Tax. Rev. 653 (1996); and Irwin O. Segal, et.al., Foreign Investment in U.S. Real Estate: No Perfect Structure, 9 J. Int'l Tax'n 22 (1998).

897(c)(1)(A)(ii), the indirect ownership involves an interest in a domestic corporation that is a U.S. real property holding company. I.R.C. 897(c)(2) states that a U.S. real property holding company exists if at least 50 percent of the domestic corporation's assets (measured by fair market value) are direct and indirect interests in U.S. realty. Thus, any foreign party that sells stock in this domestic corporation is taxable on any resulting gain at regular U.S. rates.

The alternative test is administratively easier to monitor, but the threshold is only 25 percent (rather than 50 percent). Assuming this alternative test is used, any gain that results when the foreign party in this example sells the domestic corporation's stock is not subject to FIRPTA.

Branch Profit Taxation

The U.S. branch of a foreign corporation is taxed at regular rates on its ECI. The U.S. subsidiary of a foreign corporation is similarly taxed on its ECI. In addition, the dividends that the U.S. subsidiary pays to its foreign parent company are subject to U.S. taxation at 30 percent or a lower treaty rate (as discussed earlier). Absent an equivalent tax on profits that a branch remits to its foreign office, the branch form of operation is treated more favorably than a subsidiary doing business in the United States.

To assure parity between subsidiaries and branch operations, I.R.C. 884 imposes a branch profits tax on foreign corporations with U.S. business operations. Since branch remittances may be difficult to measure or monitor, the tax is based on a "dividend equivalent amount." To determine this base, the foreign corporation's annual earnings and profits from ECI are increased (decreased) for reductions (increases) in U.S. net equity. In other words, reinvestments (withdrawals) of net equity into (from) U.S. operations Reduces (increases) the dividend equivalent amount. Like dividends, the tax rate is 30 percent unless an income tax treaty specifies a lower rate.

Interest that the U.S. branch pays is generally considered to be from U.S. sources. Thus, "branch interest" paid to the home office or any other foreign party is subject to U.S. taxation if not exempted, for example, as portfolio interest (which is

discussed later). If the foreign corporation apportions interest expense to the ECI of its U.S. business activities, I.R.C.884(f) imposes the branch interest tax to the excess of such apportioned deductions over interest the branch pays to a foreign party.[42]

Tax Liability Calculation

The manner in which foreign parties determine their U.S. tax liabilities differs most notably from the procedures of U.S. parties in the types of income subject to taxation. U.S. parties are taxed on their worldwide incomes. In contrast, foreign parties are only taxed on: (1) ECI and (2) U.S. source income that is not ECI. Additionally, foreign parties can exclude specially-designated income items, are restricted in their deductions and credits, and may face more progressive effective tax rates than comparably-situated U.S. taxpayers.

Gross Income Exclusions

Foreign parties generally are entitled to exclude the same items of income as U.S. parties. To increase the flow of foreign capital to the United States, the Internal Revenue Code also excludes portfolio interest and interest from certain deposits. Other exclusions are allowed to facilitate international commerce, to enhance cultural ties with other countries, and for administrative reasons. In addition to exclusions that the Code grants, U.S. income tax treaties often exclude certain items from host country taxation.

Under I.R.C. 871(h) and 881(c), portfolio interest includes U.S. source interest income (or original issue discount) paid pursuant to the terms in qualified debt obligations issued to foreign parties, as long as it is not ECI. Portfolio interest does not include interest income that a U.S. person beneficially receives. That is, the ultimate beneficiary must be a foreign party; otherwise, the policy objective to attract foreign capital is not achieved. Portfolio interest also does not include interest income of a ten-percent owner. For example, interest income that a foreign party receives from a corporation in which the foreign party owns 10 percent or more of the voting power cannot be excluded as portfolio interest. Similarly, when the debtor is a

[42] For background discussion, see Fred Feingold and Mark E. Berg, Whither the Branches? 44 Tax. L. Rev. 205 (1989).

partnership in which the foreign recipient owns at least 10 percent of either capital or profits, the interest income is not portfolio interest.

The exclusion for portfolio interest is allowed on certain obligations that foreign parties hold. In addition, I.R.C. 871(i)(2)(A) and 881(d) attract foreign capital through excluding interest income derived from deposits with banks, savings institutions, and insurance companies. Like portfolio interest, this exclusion is allowed only if the interest income is not ECI. U.S. income tax treaties often exempt these types of interest income also.

Dividends that a foreign party receives from a domestic corporation are generally taxable at 30 percent or a lower treaty rate. However, I.R.C. 871(i)(2)(B) and 881(d) exclude some or all of the dividends when 80 percent or more of the corporation's gross income for the preceding three taxable years is derived from the conduct of an active foreign business. The percentage of dividends excluded is equal to the ratio of the corporation's foreign source gross income to total gross income over the same three-year testing period.

The United States allows the income of foreign parties from the International operation of ships or aircraft to transport people or cargo to be excluded. Income from the full or bareboat rental of ships or aircraft is excluded also. However, the exclusion is available only to residents of countries that provide an equivalent exemption to U.S. parties engaged in international transportation activities.[43] The reciprocal exemption often is formalized in an international transportation agreement between the two countries or in a U.S. income tax treaty.

I.R.C. 872(b)(3) permits nonresident aliens participating in certain exchange or training programs in the United States to exclude the compensation their foreign employers pay them. For this purpose, a foreign employer is either a foreign party or the foreign office of a U.S. party. The exclusion applies only for nonresident aliens

[43] I.R.C. 872(b)(1), (2), (5), 883(a)(1), (2), (4). U.S. source gross transportation income that cannot be excluded and that is not ECI may be subject to a four percent excise tax under I.R.C. 887. For more information, see Ernest R. Larkins, Locating a Transportation Company Offshore May Still Be the Best Route, 3 J. Int'l Tax'n 218 (1992).

who are temporarily in the United States as non-immigrants. Generally, the individuals who qualify are students, teachers, or trainees.

Income that nonresident aliens derive from certain gambling activities is excluded from U.S. taxation under I.R.C. 871(j). Winnings from blackjack, baccarat, craps, roulette, and big-six wheel are exempt. Presumably, this exclusion exists because collection of the tax on these types of gambling income is administratively infeasible.

Deductions and Credits

If a foreign party fails to file a "true and accurate" return in the United States, I.R.C. 874(a) or 882(c)(2) disallows all deductions and credits. Absent a showing of good cause, a return that is not timely filed fails the true-and-accurate standard. U.S. returns of nonresident aliens filed 16 months late are deemed not to be timely filed. Similarly, foreign corporations that file their U.S. returns 18 months late may lose deductions and credits. Some foreign parties that believe they have no ECI may nonetheless choose to file a "protective return" to preserve future deductions and credits in the event the IRS determines that they do, in fact, have ECI.[44]

Assuming a true and accurate return is filed, foreign parties are entitled to deductions and credits only against ECI.[45] No deductions are permitted against U.S. source investment income and other amounts of gross income taxable at 30 percent or a lower treaty rate. Business and un-reimbursed employee expenses are generally deductible to the extent related to ECI. If otherwise allowed, the expenses of moving to the United States are deductible, but the expenses incurred when returning to the home country are not.

Most deductions are determined through allocation and apportionment procedures. Expenses are allocated to classes of gross income according to their

[44] Treas. Reg. 1.874-1(b), 1.882-4(a).

[45] I.R.C. 873(a), 882(c)(1), 906(a). Also, the instructions to Form 1040NR, U.S. Nonresident Alien Income Tax Return, allow nonresident aliens to deduct expenses incurred to (1) produce non-business income and (2) determine tax liability.

degree of relatedness to the classes. Then, the allocated expenses are apportioned between ECI and non-ECI income according to some factual relationship. Special allocation and apportionment rules apply to interest expense, research and development costs, stewardship expenses, legal and accounting fees, income taxes, and certain losses. As noted above, only those expenses apportioned to ECI are deductible.

I.R.C. 63(c)(6)(B) precludes nonresident aliens from claiming the standard deduction; thus, they must itemize. Several personal-type expenses that U.S. individuals can deduct are disallowed since the expenses are not allocable to ECI. Among these items are interest on residential mortgages, personal property taxes, and medical expenses. Nonetheless, if they otherwise quality, I.R.C. 873(b) allows nonresident aliens to deduct some items in full without apportionment: charitable contributions to qualified U.S. organizations, casualty losses on U.S. property, and one personal exemption. Nonresident aliens residing in some locations can claim additional personal or dependency exemptions. For example, I.R.C. 151(b)(3) grants residents of Canada, Mexico, and American Samoa exemptions for their dependents and, if they have no U.S. source income, their spouses. Residents of Japan and South Korea can claim some pro rata portion of dependency exemptions for their spouses and children who live with them at some time during the taxable year.[46]

Tax Rate Schedules

The same tax rate schedules that U.S. parties use apply to the ECI of foreign parties. However, nonresident aliens are ineligible to file in certain ways. I.R.C. 6013(a)(1) generally requires married nonresident aliens to file separate U.S. returns from their spouses, the worst possible filing status (i.e., the most progressive tax rates). Married nonresident aliens can file a joint return only if they make either the nonresident or new resident election.

[46] Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365, art. 4(5), reprinted in 1 Tax Treaties (CCH) P5203 (1998); Convention for the Avoidance of Double Taxation, June 4, 1976, U.S.-Korea, 30 U.S.T. 5253, T.I.A.S. No. 9506, art 4(7), reprinted in 1 Tax Treaties (CCH) P5403 (1998).

The nonresident election in I.R.C. 6013(g) allows an individual who is otherwise a nonresident alien during the taxable year to be treated as a U.S. resident for the entire year and, thus, to file jointly. To be eligible, the person must be married to a U.S. citizen or resident at year end, and both spouses must join in the election. Once made, the election remains in effect until either spouse revokes it, one of the spouses dies, the spouses legally separate, or the IRS unilaterally terminates the election for failure to maintain or supply tax-related information. Each married couple can make this election only once during their lifetimes.

The new resident election in I.R.C. 6013(h) allows an individual with dual status during the taxable year (i.e., nonresident alien on the first day and resident alien on the last day) to be treated as a U.S. resident for the entire year. This provision allows an individual who becomes a U.S. resident during the year to file a joint return. As with the nonresident election, the nonresident alien must be married to a U.S. person to be eligible, both spouses must join in making the election, and the spouses can never join in making this election again.

Both the nonresident and new resident elections grant joint filing benefits to nonresident aliens who qualify. In addition to the preferential tax rate structure, joint filers have higher adjusted gross income thresholds for phasing out itemized deductions and personal and dependency exemptions under I.R.C. 68(b)(1) and 151(d)(3), respectively. Further, joint filers are entitled to larger exemptions for alternative minimum tax purposes per I.R.C. 55(d)(1), larger exclusions for gain from sale of small business investment company stock under I.R.C. 1202(b)(3), and several other tax benefits.

When neither election discussed above is made, unmarried nonresident aliens must file as single individuals. I.R.C. 2(b)(3)(A) does not permit nonresident aliens to file as head of households. Also, filing as a surviving spouse is allowed only if the deceased spouse was a U.S. citizen or resident and the surviving spouse resides in Canada, Mexico, Japan, Korea, American Samoa, or the Northern Mariana Islands.[47]

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[47] I.R.C. 2(a)(2)(B); Treas. Reg. 1.2-2(a)(4). See also Treasury Department, U.S. Tax Guide for Aliens, Pub. 519 (1997) 20.

The U.S. tax liability of foreign parties depends on special residency elections, whether a U.S. trade or business is conducted, whether income is effectively connected with a U.S. trade or business, and net basis elections for real estate income. In addition, foreign parties exclude some income items, such as portfolio interest and capital gains from selling investment assets, on which U.S. parties are taxed. Income tax treaties often grant benefits beyond those the Internal Revenue Code provides. For example, treaties generally exclude ECI when no permanent establishment exists and tax U.S. source investment income at rates below the 30 percent statutory rate. Finally, to preserve tax deductions and credits and avoid statutory penalties, foreign parties should be careful to file true and accurate returns on a timely basis.

CHAPTER 4

TAXATION OF FOREIGN INVESTMENTS IN PEOPLE'S REPUBLIC OF CHINA

I. INTRODUCTION

Following its break with the Soviet Union in 1960, China adhered firmly to a policy of self-reliance. China's opening to the West, in economic terms, did not really begin until approximately 1978.[1] Given the type of economic system which had evolved in China before that date, it was also assumed, although not entirely accurately, there could be little scope for a tax system of any type.

In fact, despite the great expansion of state ownership or direction of industry and commerce, especially following the Cultural Revolution in 1966, taxes continued to play an important role in China's economy. As a percentage of total budget revenue, taxation had fallen from 75% to about one-half that level during the 1950s; thereafter it remained more or less constant.[2] Tax revenues were provided almost entirely by indirect taxation, with some three-quarters of the total coming from the Consolidated Industrial and Commercial Tax,[3] a form of turnover tax on goods and services. China introduced an income tax levied upon business profits in 1950,[4] but this source of revenue never assumed any great importance. State-owned enterprises simply accounted to the state for all of their profits[5] and most other enterprises, notably communes and collectives, benefitted from special rates and exemptions. In addition, a number of other taxes existed, one of which -- the salt tax -- had provided

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

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

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

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

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

a stable source of revenue for most of the preceding 2,000 years. To the extent that these various taxes are still in force and may have an impact upon foreign investors, they will be discussed briefly.

A. Consolidated Industrial and Commercial Tax

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

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

It is this tax on services which is of primary interest and concern to foreign businesses. Although there was some initial uncertainty as to whether the CICT applied at all to foreign enterprises operating in China,[8] it is now well established that the tax does apply.[9] There is, of course, nothing surprising about this; any enterprise

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

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

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

[9] This is confirmed by the Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Business Income Tax from China-based Foreign Companies, issued by the Ministry of Finance on May 14, 1985, reprinted in BUS. CHINA, May 30, 1985, at 77. For the answers given by Chinese legal experts, see also Chinese Legal Experts' Answers to Questions on China's Foreign Tax Legislation (I), CHINA ECON. NEWS, Sept. 30, 1985, at 1-2. It is also confirmed in a number of

operating in another country would expect to be subject to the local taxes on its sales and on its imports. However, a tax on services supplied is less familiar, especially when it appears to take the form of a tax on gross income. Thus, for example, when a Hong Kong company entered into a contractual joint venture with a Shanghai research institute to repair and resell computer equipment, the company was liable for the CICT (at 3%) on the repair fees charged as well as for tax under the Foreign Enterprise Income Tax Law[10] on net profits.[11]

B. Industrial and Commercial Income Tax

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

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rulings given by the Tax Bureau of the Ministry of Finance; see, e.g., (82) Cai Shui Wai Zi, No. 199; (83) Cai Shui Wai Zi, No. 88; (83) Cai Shui Wai Zi, No. 155. The recent Provisions of the State Council for the Encouragement of Foreign Investment, promulgated on Oct. 11, 1986, exempt from the CICT most exported products, other than oil and minerals, of enterprises with foreign capital. The text of the provisions is reproduced in Provisions of the State Council Encouraging Foreign Investment, BEIJING REV., Oct. 27, 1986, at 26.

[10] See infra notes 48-71 and accompanying text.

[11] Tax Bureau of the Ministry of Finance, (82) Cai Shui Wai Zi, No. 199.

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

[13] ICIT, art. 1 (emphasis added).

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

C. Other Taxes

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

D. Modern Legislation

From the point of view of foreigners wishing to do business in and to invest in China, the government radically altered the tax scene by the adoption of two laws in 1980, another law in 1981, and a series of accompanying regulations. The real impetus for the tax reforms was the adoption of the Joint Venture Law[18] in 1979. The law permits, for the first time since Liberation, the investment of foreign capital in new enterprises. Rather than remodel the existing ICIT, the government introduced a new tax -- the Joint Venture IncomeTax ("JVIT") -- the following year.[19] Simultaneously, a new individual Income Tax ("IIT") was also introduced.[20] Although the IIT applies to resident and nonresident individuals, its main impact will

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

[16] This is levied on the value of the property, at an annual rate of 1.2%, or on its rental income, at 1.8%.

[17] See 19 TAX NEWS SERVICE, Mar. 15, 1985, at 39 (International Bureau of Fiscal Documentation).

[18] Law on Joint Ventures Using Chinese and Foreign Investments, adopted July 1, 1979.

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

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

undoubtedly be felt by foreigners working in China or by those receiving various types of income from Chinese sources. The present picture was completed in 1981 with the introduction of the Foreign Enterprise Income Tax ("FEIT").[21] The rest of this Article will be concerned primarily with these three taxes.

II. THE CHOICE OF BUSINESS MEDIUM

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

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

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

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

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

It is not always necessary to have a Chinese coventurer. A foreign enterprise which sells its products or services in China may, with the necessary permissions, establish a representative office, send maintenance crews, technical advisers or instructors to China, or otherwise carry on business activities sufficient at least to be regarded as having an establishment. Apart from such activities, wholly foreign-owned enterprises operating independently in China are relatively rare.[23] In the past, such operations apparently were carried out by branch establishments. Under a recent law, however, the creation of wholly foreign-owned corporations in China is permitted.[24] Before the enactment of this law the choice of business medium rested between a branch operation (normally with local participation) – commonly referred to as a contractual joint venture – and the creation of a separate corporation (jointly with one or more Chinese coventurers) – called an equity joint venture.[25]

III. EQUITY JOINT VENTURES

A joint venture with foreign participation incorporated under the Joint Venture Law, therefore a Chinese "citizen" and resident for tax purposes, is subject to tax on its income under the JVIT law and is also liable to pay the CICT. The corporation is taxed as a single entity on its total profits. In other words, the share of profits of the Chinese partner (which might be a state enterprise) is also subject to the JVIT. The profits of any branches[26] are included in the joint venture's income. This sum

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

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

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

[26] The Chinese term translated as "branch" could, perhaps, also include a subsidiary. See Pomp, Gelatt & Surrey, supra note 12, at 52.

presumably includes income of any branch situated in another country, as a Chinese corporation is taxable on its world income.[27]

A. Taxable Income

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

Taxable income is defined as "net income in a tax year after deduction of costs, expenses and losses in that year."[31] More detailed formulas are set out in the regulations[32] and provide methods of computation of income from industrial, commercial, and service operations, and from "other lines of operations." Profits must be computed, and accounts drawn up, in accordance with the relevant accounting regulations.[33] An auditor's report prepared by a public accountant registered in the PRC must be submitted with the tax return. For the most part, the relevant accounting

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27 A credit is allowed for foreign tax paid. JVIT, art. 16.

28 JVIT Regs., art. 2.

29 Id.

30 The JVIT refers only to "net income." Id. art. 2. The Regulations require revenue and expenditure to be accounted "on accrual basis." Id. art. 23. This is expanded upon in art. 15 of the Accounting Regulations for Joint Ventures using Chinese and Foreign Investment, promulgated on Mar. 4, 1985,[hereinafter Accounting Regulations]. The tax treaties entered into by China specifically allow for the taxation of certain capital gains; e.g., art. 12 of the Agreement between China and the United States for the Purpose of Avoidance of Double Taxation, signed on Apr. 30, 1984 entered into force Nov. 21, 1986. Tax Treaties (CCH) P 1406 [hereinafter China-United States Agreement].

31 JVIT, art. 2.

32 JVIT Regs., art. 8.

33 Accounting Regulations, art. 9.

principles will cause little surprise to Western business executives. With respect to stock valuation, for example, a variety of methods -- first-in-first-out ("FIFO"), shifting average, and weighted average -- are permitted, although permission of the local authorities must be obtained in order to change accounting methods.

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

1. Capital Expenditures. The regulations specifically disallow the deduction of capital expenditure for the purchase or construction of machines, equipment, buildings, and other fixed assets. However, depreciation or amortization is permitted on an annual straight-line basis over prescribed periods of the useful life of the assets in question. Thus, houses and buildings are normally depreciated over a period of twenty years, machinery, equipment, and other facilities used in production are depreciated over a period of ten years, and electrical equipment and motor vehicles are depreciated over a period of five years.[34] Intangible assets, including know-how, patent rights, and trademarks are normally amortized over a period of ten years (unless they have a specific lifespan). Finally, the initial costs of establishing a joint venture may be amortized at a maximum rate of 20% each year.[35]

2. Interest on "Equity Capital. "The restriction on interest on equity capital has caused some confusion.[36] The restriction seems to prohibit the deduction of interest on original loan capital and, perhaps, on loans from shareholders. Once operations have commenced, interest on subsequent borrowing should be deductible. However, if funds are borrowed to acquire fixed assets, it may be that the interest is not deductible and that the interest charges may be included in the cost of the assets for the purpose of calculating depreciation.

[34] In special cases, shorter periods may be permitted by the Ministry of Finance.

[35] JVIT Regs., arts. 10-17.

[36] See Pomp, Gelatt & Surrey, supra note 12, at 55-56; Simon, supra note 8, at 540.

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

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

5. Losses Covered by Insurance.

6. Donations and Contributions. No deduction is permitted except in the case of donations for public welfare and relief purposes. There is some doubt as to whether this permits the deduction of amounts which are required to be set aside as reserves or contributed to welfare or bonus funds.[37]

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

8. Losses. Losses may be carried forward for up to five years.[38]

B. Tax Rates

The taxable income of a joint venture is taxed at a flat rate of 30%. In addition, a local surcharge of 10% of the basic tax is levied on this amount, bringing the total tax rate to 33%. The local authorities in the province or region where the joint venture is located may reduce or waive this tax. It appears that the local surcharge may be levied only once; consequently, if the joint venture conducts operations in more than one region, the region where the head office is situated has the exclusive right to tax.[39]

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[37] See Rasmussen & Theroux, China's New Tax Laws for Joint Ventures and Individuals, CHINA BUS. REV., Nov. Dec. 1980, at 36; Gelatt & Pomp, supra note 6, at 454-55.

[38] JVIT, art. 7.

[39] Rasmussen & Theroux, supra note 38, at 37.

In addition to the flat rate of tax on profits, a further tax of 10% is levied on profits remitted by the foreign investor outside China. Presumably what is intended to be covered here are dividends paid to the foreign shareholders. The use of the word "profits" would seem to exclude interest paid to a foreign shareholder or a return of capital, unless either payment could be regarded as a disguised distribution of profits. The additional tax appears to have the effect of a withholding tax. Consequently, the 10% tax applies, rather than the 20% tax imposed by both the IIT and the FEIT, on investment income paid to nonresidents.[40] This may be less important if a tax treaty applies, as the rate on dividends is normally reduced to 10% in any event.[41]

This withholding tax must be considered in conjunction with a provision which permits a refund of tax paid with respect to profits reinvested in China. Article 6 of the JVIT law provides that a participant in a joint venture which reinvests its share of profit in China for a period of not less than five years may, upon approval of the tax authorities, obtain a refund of 40% of the income tax paid on the reinvested amount.[42] In other words, the participant or shareholder must reinvest in order to recover a proportion of the underlying tax paid by the corporation on the distributed profits. To qualify as a reinvestment, the participant (foreign or Chinese) must invest the profits in the same joint venture, in some other joint venture, or establish a new joint venture in China.[43] If the refunded tax is remitted abroad, this amount is not treated as a repatriation of profits and no withholding tax is levied.[44] A participant who withdraws invested funds within five years must pay back the amount of tax

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

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

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

[43] Ministry of Finance Notice of Sept. 16, 1981, (81) Cai Shui Wai Zi, No. 82.

[44] Ministry of Finance Notice of June 8, 1981, (81) Cai Shui Wai Zi, No. 188.

refunded; presumably, if those funds are remitted out of China, the additional 10% withholding tax will also apply.

C. Exemptions and Reliefs

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

Two other important incentives are provided. First, newly established joint ventures scheduled to operate for ten years or more may be exempted from the JVIT in the first two profit-making years and allowed a 50% reduction in the following three years.[45] Second, certain low profit operations (notably farming, forestry, and ventures located in remote or economically-underdeveloped areas) may, with approval, be allowed a reduction of up to 30% for an additional ten years.[46]

IV. BRANCHES AND ESTABLISHMENTS

Foreign enterprises carrying on business in China, other than as participants in equity joint ventures, are subject to the Foreign Enterprise Income Tax ("FEIT").[47] Whereas an equity joint venture is treated as a separate entity (whose profits are taxed before distribution to the foreign and local participants), a contractual joint venture has no separate status for tax purposes. The foreign participant is taxed on its share of

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

[46] JVIT, art. 5.

[47] Income Tax Law concerning Foreign Enterprises, adopted Dec. 13, 1981. See also Han, People's Republic of China's Foreign Enterprises Income Tax Laws and Regulations, 6 HASTINGS INT'L & COMP. L. REV. 689 (1983).

the profits under the FEIT law and the Chinese participant is taxed on its share under the relevant domestic law. The other major difference is that the JVIT is essentially a flat-rate tax whereas the FEIT is levied at progressive rates if the foreign enterprise has an establishment in China. A foreign enterprise which does not have an establishment in China is subject to a flat-rate tax of 20% -- which is essentially a withholding tax -- on certain types of passive investment income from Chinese sources.

Article 1 of the FEIT law provides that income tax shall be charged on the income derived from production, business, and other sources by any foreign enterprise operating in the People's Republic of China. "Foreign enterprises" are defined as "foreign companies, enterprises and other economic organizations which have establishments in the People's Republic of China engaged in independent business operations or cooperative production or joint business operations with Chinese enterprises."[48]

A. Enterprises

The word "enterprise" is defined to include foreign companies and other "economic organizations." Consequently, a foreign partnership, limited partnership, trust, and various hybrid organizations are included. Less clear is the position of a foreign individual who carries on business activities in China, and, as such, might also be liable to tax under the IIT law. The latter legislation, which sets out a number of categories of income, has no category for "business income," although it does apply to "remuneration for personal services."[49] What then would be the position of a self-employed business consultant or a touring concert musician who earns income in China? It would seem that a single individual may be regarded as an "enterprise" or, more accurately, that the business carried on by that individual may be so regarded and its profits taxed under the FEIT law.[50] It would still be necessary, however, to

[48] FEIT, art. 1.

[49]

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

[50] Ministry of Finance Notice of Aug. 2, 1982, (82) Cai Shui Wai Zi, No. 99.

draw a distinction between "business income," subject to the FEIT, and "remuneration for personal services," subject to the IIT.[51]

B. Establishments

Another vital question is to determine whether the foreign enterprise has an establishment in China. According to the regulations, "establishments" are "organizations, places or business agents established in the Chinese territory by foreign enterprises and engaged in production and business operations."[52] These establishments "mainly include management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building, installation, assembly and exploration are operated."[53]

The definition is, on its face, fairly broad. Nonetheless, it seems that Chinese authorities interpret the term quite narrowly. In practice the word seems to correspond to the notion of "permanent establishment" used in tax treaties and may even be less extensive than the definition commonly given in the treaties negotiated so far by China. It is clear that foreign enterprises involved in construction projects or in oil or mineral exploration are regarded as having an establishment in China for purposes of the FEIT. In contrast, foreign firms which have set up exhibitions at trade fairs and subsequently sell their products generally seem to be treated as not having an establishment and are not subject to the FEIT.[54] Similarly, foreign enterprises involved in "compensation trade" -- in which products are sold to Chinese concerns in return for Chinese products which the foreign enterprise will market in other countries -- are normally not considered to be operating in China through an establishment.

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[51] This is considered further, infra notes 113-22, in connection with the IIT.

[52] JVIT Regs., art. 2.

[53] Id.

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

The most difficult cases appear to involve situations in which the foreign enterprise has an agent or representative office in China. Two significant questions must be asked concerning the status of agents. First, whether the agent act for a single principal rather than for a number of firms. Second, whether the agent have authority to enter into contracts binding upon the principal? If the answer to both questions is affirmative. then it seems clear that the principal is regarded as having an establishment in China and is subject to the FEIT.[55] Less clear is the position where the agent may have authority to bind two or more principals, especially if these happen to be affiliated concerns. It would normally be in the interests of the Chinese tax authorities to assert that the agent itself was an independent enterprise carrying on business in China through an establishment. In that way, the earnings from both principals would be aggregated and subject to progressive rates of tax.

The position regarding representative offices has been clarified by the recent adoption of special rules.[56] These rules adopt a view similar to that taken by most other countries. In effect, if the activities of the office are restricted simply to marketing, promotional, and liaison work on behalf of its home office, and if the office receives no payment as such for that work, the foreign enterprise is not considered to have an establishment in China. To the extent that the office provides a wider degree of services or receives commissions, rebates, or fees or payments by scheduled installments or in accordance with the volume of the commissioned services, the income of the office is taxable.[57]

C. Taxable Income

Foreign enterprises with establishments in China are taxed on their income "derived from production, business and other sources" which, in turn, is defined as the

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[55] See Han, supra note 48, at 691-94. See also China-United States Agreement, supra note 30, art. 5.

[56] Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Business issued on May 14, 1985, reprinted in BUS. CHINA, May 30, 1985, at 77 [hereinafter Interim Provision].

[57] It is also liable to pay the CICT, as the Interim Provisions make clear, normally at the rate of 5% of the commissions or fees received. Interim Provisions, art. IV.

"net income in a tax year."[58] The regulations set out detailed rules for the computation of income[59] which are essentially similar to those applying to joint ventures. Among the differences in computation, it should be noted that reasonable interest and reasonable administrative expenses are expressly stated to be deductible,[60] but that royalties paid to the head office are not a deductible expense.[61]

As is the case with any other branch operation, determining precisely how much income should be attributed to a branch or establishment in China is not a simple matter. For example, a foreign company might sell a product or license the use of a process to a Chinese enterprise for a particular price. Typically, such activity would not involve any liability to income tax in China. However, the agreement might include a provision that the vendor provide servicing and maintenance facilities, training programs for local operators, assistance with installation, and other services. The result may be the setting up of an establishment in China and, consequently, liability for tax on the income earned by that establishment.[62]

If a foreign enterprise cannot provide accurate evidence of costs and expenses and cannot correctly compute its taxable income, the local tax authorities may make an estimate of the enterprise's profits based on its net sales or gross business income.[63] In practice, it seems that foreign enterprises may elect to be taxed on this basis. In the case of representative offices, the special interim provisions expressly provide that,

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

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

[60] FEIT Regs., arts. 11-12.

[61] FEIT Regs., art. 10.

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

[63] FEIT Regs., art. 24.

where satisfactory documentation is not available, taxable income will be deemed to be 15% of "business proceeds."[64]

D. Tax Rates

The FEIT is assessed at progressive rates, ranging from 20% on the first 250,000 yuan[65] of annual taxable income to 40% on the income in excess of one million yuan.[66] A local income tax of an additional 10% is levied on the same income.[67] Unlike the local tax on equity joint ventures, this local tax is imposed on income (i.e., the local tax is not a percentage of the tax payable to the central government). Thus, the effective rates of tax on foreign establishments vary from 30% to 50%. Except in the case of small operations, an equity joint venture will pay a lower rate of tax on its profits. It must be remembered, however, that there will be a further 10% tax charged on profits remitted out of China by the equity joint venture. As in the case of equity joint ventures, the tax rate on foreign enterprises established in the SEZs is commonly reduced to 15% or, in some cases, 10%.

E. Exemptions and Reliefs

In addition to the reduction of taxes in SEZs and the possible reduction of or exemption from local taxes, the FEIT law contains a "tax holiday" provision of more general effect.[68] Foreign enterprises scheduled to operate for a period of ten years or more in farming, forestry, animal husbandry, coal mining, or other low-profit operations may, with the approval of the tax authorities, be exempted from income tax in the first profit-making year and allowed a 50% reduction in second and third years. A further reduction, from 15% to 30% may be allowed for an additional period of up

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[64] Interim Provisions, supra note 57, art. IV. This appears to be acceptable under China-United States Agreement, supra note 30, art. 7(4).

[65] 1 yuan = US$ 0.26 (approximately).

[66] FEIT, art. 3.

[67] The local tax may be reduced or waived by the local authorities in cases of small-scale production or low profit. FEIT, art. 4.

[68] FEIT, art. 5.

to ten years. Special extensions are given for export enterprises and technologically-advanced enterprises.

Important reliefs and exemptions are also provided in the case of certain types of interest and rental income. Entirely exempted from income tax is interest on loans to the Chinese government or to China's state banks and interest on certain loans to China's National Offshore Oil Corporation. Under a provisional regulation, interest on loans made by foreign enterprises between 1983 and 1985 was scheduled to be taxed at the reduced rate of 10%.[69] This reduction also applied to income from leasing equipment to Chinese concerns. The government subsequently decided to extend these concessions until the end of 1990.[70]

V. PASSIVE INVESTMENT INCOME

The FEIT Law also imposes what is in effect a withholding tax at a flat rate of 20%[71] on the income obtained in China from dividends, interest, rentals, royalties, and other sources by foreign companies, enterprises, and other economic organizations having no establishments there.[72] The exemptions and reductions for certain types of interest income and income from equipment leasing, discussed in the preceding section, also apply to non-establishment income. Indeed, the exemption for loans to the government and the state banks ostensibly applies only to enterprises without an establishment in China.[73] In practice, however, it seems that a lender will not be refused the exemption simply because the lender also has a branch or office in China.

The treatment of an enterprise which has an establishment in China and which also receives passive investment income is somewhat uncertain. For example, the

[69] Provisional Regulations concerning the Reduction and Exemption of Income Tax relating to Interest earned by Foreign-Businesses from China, issued Jan. 7, 1983.

[70] Ministry of Finance Notice, Jan. 6, 1986, (86) Cai Shui Wai Zi, No. 1.

[71] Treaty provisions commonly reduce these rates; e.g., to 10% in the China-United States Agreement, supra note 30, arts. 9-11.

[72] FEIT, art. 11.

[73] Id.

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

A literal interpretation of the FEIT law and of the regulations would support the latter conclusion. Once the foreign enterprise has an establishment in China, the enterprise is apparently taxed on its income from production, business, and other sources.[74] In computing the foreign enterprise's income, net "non-business income" is included.[75] This literal interpretation would support the force of attraction doctrine according to which all Chinese-source income of an enterprise having an establishment in China is attributed to that establishment.[76] However, since the term "enterprise" is not clearly defined, some doubt remains. For example, a foreign parent company may receive patent royalties while a separate foreign subsidiary provides services through a branch in China; the royalties are paid directly to the parent and the fees for services to the branch. Is there one foreign enterprise or two and does the force of attraction doctrine apply?[77]

We have already considered the question of whether a single individual may constitute an enterprise for the purposes of the FEIT. In many respects, "enterprise" appears to be synonymous with "business," and an individual carrying on business in

[74] FEIT, art. 1.

[75] FEIT Regs., art. 9.

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

[77] It is submitted that the doctrine should not apply. The parent should be subject to flat rate withholding tax on the royalty and the subsidiary should be taxed on the income of its branch.

China through an establishment is apparently taxed under the FEIT law. But what of a foreign individual who receives dividends, interest, royalties, or other passive income and who has no establishment in China? At first, it would not seem to be important whether the individual was taxed as an "enterprise" under the FEIT law[78] or as a nonresident individual under the IIT law (as would normally be the case). In either situation, a withholding tax of 20% (or a lower treaty rate) would apply. However, some of the reliefs and exemptions referred to above apply only to the FEIT, no mention being made of the IIT law.[79] Consequently, a passive investor in China (for example, someone lending money to a foreign enterprise operating there) would be advised to invest through the medium of a personal corporation rather than individually.

VI. INDIVIDUAL INCOME TAX

China had no individual income tax of general application before 1980.[80] Before that time, individuals could have been subject to income tax under the ICIT, introduced in 1950, which applied to business profits. Farmers or peasants working on their own account were also liable to pay the agricultural tax. As for investment income, this had largely ceased to exist. For a period following the end of the civil war in 1949, "former capitalists" (if they had not actively opposed the new regime or fled to Taiwan) continued to receive dividends from the property or enterprises they had owned. In time, these payments were converted into interest payments from the state banks. Following the Cultural Revolution in 1966, the number of "private" incomes, whether from business or property, decreased dramatically. Consequently, it was felt that there was no need for a personal income tax.

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[78] FEIT, art. 11.

[79] For example, no mention is made of certain types of leasing income and income from investment in the SEZs. Interest on loans to state banks is exempt under both FEIT and IIT laws.

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

This picture changed considerably with the introduction of economic reforms in the late 1970s. The ICIT[81] and agricultural tax assumed new importance as many new privately-owned businesses (especially in the retail and service sectors) were established and the government encouraged farmers to increase private production. Certain categories of individual income, however, escaped tax entirely. These categories included the income of artists, writers, inventors, some doctors with private practices, and, of course, the salaries and other income of foreigners working in China.[82] In reality, foreigners were the main target of the IIT introduced in 1980. It was estimated at the time that, out of a population of approximately one billion, only about twenty Chinese citizens (mostly artists whose works were sold abroad) were likely to be affected by the tax.[83] While no statistics appear to have been published, it is reasonable to assume that several thousand Chinese are now affected by the tax. Nonetheless, the IIT remains a tax principally affecting foreigners.

A. Residence

As is the case in most countries, residence is an important factor in determining liability to personal income tax. Longtime residents of China are, at least in theory, subject to tax on their world income; nonresidents are taxed only with respect to Chinese-source income. However, "residence" is not defined by the current law, and the Chinese concept of residence appears to be somewhat different than that found in most Western tax systems.[84]

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

[82] See Individual Income Tax in China, CHINA ECON. NEWS, May 4, 1981 (interview with Liu Zhicheng, Director of the Taxation Bureau).

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

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

The basic rules defining residency in the IIT law are quite complex.[85] It is clearly possible to be "resident" in China for less than one year, however the law does not precisely define what activity constitutes residence. The regulations do provide some guidance.[86] Articles 3[87] and 5[88] of the regulations are also important to arriving at a definition. The latter provision suggests that one may be "resident" in China even for a period of less than ninety days. If a tax treaty applies, however, it is probable that such a person would not be treated as resident in China.[89]

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

1. The taxpayer has resided in China for more than five years. In this instance the individual is taxed on income from all sources regardless of whether it is remitted to China. Presumably this taxable income includes foreign business income. (As discussed below, the IIT is not levied on income from business as such.) It should be noted that foreign-source income is not aggregated with Chinese-source income; it is net income (computed in accordance with the Chinese rules) which is taxed and a

[85] According to IIT Regs., art. 1: An individual income tax shall be levied in accordance with the provisions of this Law on the income gained within or outside China by any individual residing for one year or more in the People's Republic of China.

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

[86] Art. 2 of the IIT Regs. states:
Any individual residing for one year or more in the People's Republic of China mentioned in Article 1 of the Tax Law refers to any individual who resides in China for a full 365 days of a tax year. No subtractions shall be made therein of the number of days of temporary absence from Chinese territory within the tax year.

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

[87] According to IIT Regs., art. 3:
Individuals who reside in the People's Republic of China for one year or more but not exceeding five years shall pay tax only on that part of their income received outside China which is remitted to China; individuals whose residence in China exceeds five years shall pay tax on all their income received outside China from the sixth year of residence.

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

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

credit for foreign taxes may be claimed.[90] In practice, however, foreigners working in China for non-Chinese enterprises, even if resident for more than five years, are not taxed on foreign-source income so long as they do not intend to become a permanent resident.[91]

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

3. The taxpayer has resided in China for less than one year but for at least ninety days. The law is not entirely clear how to treat the income of individuals in this category although the problem would normally be resolved by treaty. Essentially, such a person is treated in the same way as a nonresident and is taxed only on income "gained within China."[92] By implication, salary paid by a foreign employer for services performed in China is taxable regardless of whether it is remitted to China.[93] The tax treaties generally exempt such income if the recipient has spent no more than 183 days in China during the year and the remuneration is paid by a nonresident employer and is not borne by a permanent establishment or fixed base in China.[94]

4. The taxpayer has resided in China for ninety days or less. As in the case of persons qualifying under the third category, only Chinese-source income is taxable; however, remuneration paid by a foreign employer is exempt from taxation.[95]

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[90] IIT Regs., art. 16.

[91] Ministry of Finance Notice, Mar. 7, 1983, (83) Cai Shui Zi, No. 62.

[92] IIT, art. 1.

[93] IIT Regs., art. 5.

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

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

5. The taxpayer has not resided in China. In this instance, only Chinese-source income is taxed.[96] Tax is effectively restricted to income such as royalties, interest, dividends, and rent. For individuals in this category, tax is imposed on gross income.[97]

It may still be necessary to define "residence" in each particular case. The practice of the tax authorities is to base the determination of residence principally upon the taxpayer's residence status and upon the type of visa held.[98] A foreigner holding a residence permit is normally considered to be resident in China for as long as the permit is valid. Typically, a residence permit is issued only to individuals working in China on a full-time basis or on an extended assignment. A permit is normally valid for six months and may be renewed or extended. The permit holder is treated as resident in China and temporary absences for business trips, vacations, or other reasons are ignored. Consequently, a person could be physically present in China for less than ninety-one days in a tax year but still be taxed on remuneration for services performed in China paid by a foreign employer (unless relieved by a treaty provision).

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

[96] IIT, art. 1.

[97] IIT Regs., art. 11.

[98] Ministry of Finance Notice, June 2, 1981, (81) Cai Shui Zi, No. 185. Local authorities may interpret the rules in a way more favorable to the taxpayer.

first entry until the last date of exit under that visa, regardless of any absences from China during that time.

A foreigner deciding between the two types of visas should weigh the greater convenience of a multiple-entry visa against the increased likelihood of liability for income tax on salary earned by services performed in China.[99] Recently, however, the rules relating to holders of multiple-entry visas have been relaxed. If the holder of such a visa makes a number of visits to China while the visa is valid and the visits are interrupted by a series of absences, the person will still be able to claim the benefit of the ninety-day rule if the total period spent in China does not exceed ninety days and is not longer than one-third of the valid period of the visa.[100]

The operation of the 365-day rule is also a matter of uncertainty. A literal interpretation of Article 2 of the regulations suggests that an individual could be present in China from January 2 of one year until December 30 of the following year without becoming a resident subject to tax liability on foreign-source income. Chinese tax officials have apparently not accepted this view and consider that the period may span two years.[101] The issue is no longer important for most foreigners (i.e., those working for non-Chinese employers) as the current practice is not to tax foreign-source income regardless of whether it is remitted to China.[102]

B. Income and Tax Rates

While the IIT law is, at first glance, extremely simple -- having only fifteen short articles[103] -- the law has a number of striking features. First, the IIT is a schedular tax. Not only are different categories of income computed separately, they are taxed separately according to different rules and are not aggregated to determine total income or the total amount of tax payable. Second, with the exception of

[99] Only if the visa is for more than 90 days is the visitor required to register with the tax authorities.

[100] Ministry of Finance Notice, Feb. 18, 1986, (86) Cai Shui Wai Zi, No. 34.

[101] See Gelatt & Pomp, supra note 6, at 430.

[102] See supra note 92.

[103] The detailed Regulations have an additional 27 articles.

employment income taxed at progressive rates of 5% to 45%, all income is taxed at a flat rate of 20%. Third, although reference is made to the "tax year,"[104] the relevant period for most purposes is the month. Fourth, while certain basic exemptions do exist, no recognition is given to the personal circumstances of the taxpayer based upon marital status, number of dependants, or other factors. Fifth, the IIT does not apply to business income[105] other than what might be termed "professional income." The categories of income subject to tax under the IIT are: 1) wages and salaries; 2) remuneration for personal services; 3) royalties; 4) interest, dividends, and bonuses; 5) income from the lease of property; and 6) other kinds of income specified as taxable by the Ministry of Finance.[106]

1. Employment Income

The effective rates of tax are relatively low. Most executives are likely to pay less income tax in the People's Republic of China than in Hong Kong, which is known for its low taxes. The basic exemption, equal to approximately US$ 200 a month, may not seem high but it is about eight times greater than the average wage in China. Consequently, very few Chinese wage earners were ever affected by the tax.[107]

The legislation provides very little detail regarding the computation of income from wages or salaries. The regulations simply include: "bonuses and year-end extras earned from work in offices, organizations, schools, enterprises, undertakings and other entities."[108] Further, it is generally provided that, if income is paid "in kind or in marketable securities," the value of such income is to be included.[109]

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[104] E.g., IIT Regs., art. 2.

[105] As previously mentioned, business income is subject to the FEIT in the case of foreign businesses and to a variety of taxes in the case of domestic businesses.

[106] IIT, art. 2.

[107] They are now subject of the IIRT. The new basic monthly exemption figure is 400 yuan, although this is increased in some regions. See supra note 20.

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

[109] IIT Regs., art. 7.

No general principles have yet evolved dealing with fringe benefits, allowances, and similar items. In practice, it seems that cash allowances, especially "foreign service" or "hardship" allowances paid on a per diem basis, are treated as part of taxable income. Reimbursement of actual expenses, in so far as they are company expenses, are not considered to be income. However, the treatment of expenses paid by the employer is less clear. It appears that benefits such as accommodations, local transportation, moving costs, and home leave are not considered part of the employee's income.[110] In contrast, food allowances are specifically taxable as a personal benefit.[111] It should also be noted that there is no provision for the deduction of any expenses from such income, other than the basic 800 yuan per month. Consequently, it is preferable for the employer to pay actual expenses for travel, accommodations, entertainment, and other items, rather than paying the employee an allowance to cover such expenses.

2. Income from Personal Services, Royalties, and Rents

While only employment income is taxed at progressive rates, other income is divided into two basic categories: 1) types of income from which certain deductions are permitted, and 2) types of income in which tax is levied on the gross amount received or payable. It should be noted that this distinction does not apply if the income is received by an individual who is not resident in China.[112]

For income derived from "remuneration for personal services, royalties or lease of a property," a deduction of 800 yuan is allowed if the amount is less than 4,000 yuan; if the amount exceeds 4,000 yuan, the deduction is restricted to 20% of the amount.[113] Remuneration for "personal services" is defined as income earned "in designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting, free-lance writing, translating, calligraphy and painting, sculpture, films, drama and comic talk, sports, technical

[110] See Byrres & Shum, supra note 85, at 16; see also Ministry of Finance Notices of Oct.2r4, 1980, (80) Cai Shui Wai Zi, No.189 and of June 2, 1981, (81) Cai, Shui Zi, No.185.

[111] Ministry of Finance Notice of July 7, 1981, (81) Cai Shui Wai Zi, No.,60.

[112] IIT Regs., art. 11.

[113] IIT, art. 5(2).

services and other personal services."[114] It should be remembered that income "derived from production and business" is taxed under the FEIT law at progressive rates which can rise as high as 50%. Clearly, there may be some types of activity which will be difficult to categorize, for example, "consultation" or "technical services" (subject to the IIT) or "commerce" or "service trades" (subject to the FEIT). The individual will typically prefer to pay the IIT because of the lower tax rates, however the FEIT rules may be more favorable at times as most expenses incurred in earning the income are deductible.

"Royalties" are defined as income "from the provision and transfer of patents, copyright, the right to use technical know-how and other rights."[115] "Income from lease of property" refers to income "from lease of houses, machinery and equipment, motor vehicles and ships, and other kinds of property."[116] With regard to these sources of income, it should be recalled that, if the recipient may be regarded as a foreign enterprise, these payments will be subject to the FEIT. Under the FEIT law, progressive rates apply if the taxpayer is established in China and there are various exemptions and reliefs for certain types of rental income and for royalty payments for technology transfer.

The Chinese deduction system is unusual and gives rise to many interesting situations. In some respects the system corresponds with the deduction from employment income and performs the function of a basic personal deduction. In other respects the deduction system is more like a notional cost of earning income. The recipient is taxed on gross professional fees, royalties, or rental income, less only the standard deduction and without regard to actual expenses incurred earning the income.[117] The deduction of 800 yuan, or 20%, applies to each single payment. This

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

[115] IIT Regs., art. 4(3).

[116] IIT Regs., art. 4(5).

[117] It is nevertheless eligible for the foreign tax credit in the United States. China-United States Agreement, supra note 30, arts. 2 & 22.

system produces some unusual results. For example, if property is leased at an annual rent of 9,600 yuan, then, if the rent is payable monthly (800 yuan per month), there will be no taxable income. If the rent is payable quarterly, there will be a deduction of 800 yuan from each payment of 2,400 yuan; taxable income for the year will be 6,400 yuan. If the rent is payable in one lump sum, there will be a 20% deduction, leaving taxable income of 7,200 yuan.

In order to prevent income splitting, the regulations provide that "single payment" refers to the income earned on one occasion or the income earned for performing one piece of work.[118] Clearly, an artist may receive only one payment for a painting and, presumably, a concert pianist may not receive a separate fee for playing each of Bach's forty-eight preludes and fugues.[119] Nonetheless, it is unclear to what extent a lawyer or accountant may be able to bill separately for completing various stages of, what is essentially, the same piece of work. The regulations also provide that, if income is earned consecutively from the same item, the income received within one month is aggregated.[120] The effect of this earned income deduction appears to be that, while payments such as rent may be made monthly and treated separately, the deduction may not be multiplied by applying it to a weekly or daily rent.

One further provision should be mentioned. While certain payments from the same source may be aggregated in order to prevent multiple deductions, the basic rule is that each category of income is computed and taxed separately.[121] Thus, an individual receiving income from personal services of 1,200 yuan and rental income of 400 yuan may claim deductions of 800 yuan and 400 yuan respectively; the income derived from the two sources cannot be added together in order to claim two deductions of 800 yuan each.

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[118] IIT Regs., art. 12.

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

[120] IIT Regs., art. 12.

[121] IIT Regs., art. 6.

3. Other Chinese-Source Income

Interest, dividends, bonuses,[122] and other kinds of income (if specified as taxable by the Ministry of Finance) are taxed at a flat rate of 20% on the full amount received. In other words, no deduction may be made for any cost incurred on such income.[123] This is true regardless of whether the recipient is resident in China.[124]

4. Foreign-Source Income

As mentioned previously, the IIT law provides for the taxation of longtime residents of China based upon their world income.[125] Persons resident in China for less than five years pay tax only on foreign income remitted to China.[126] A separate tax return of foreign source income is required on a yearly basis.[127]

Most foreigners living in China work for foreign employers and are not taxed on non-Chinese source income regardless of whether it is remitted to China.[128] However, Chinese citizens and some foreigners will be taxed on foreign source income. Such income is calculated and taxed separately from taxable income earned within China; nevertheless this income must be allocated to the appropriate category and is eligible for the relevant deductions.[129] If foreign source income is taxable, a credit is given for foreign tax paid.

C. Exemptions and Reliefs

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[122] This term is defined as "bonuses from investment." IIT Regs., art. 4(4). These payments are not to be confused with bonuses forming part of a salary.

[123] IIT Regs., art. 5(3).

[124] The rate is commonly reduced to 10% by treaty. See China-United States Agreement, supra note 30, art. 5.

[125] IIT, art. 1.

[126] IIT Regs., art. 3.

[127] IIT, art. 7.

[128] See supra note 92 and accompanying text.

[129] IIT Regs., art. 16.

Chinese tax legislation exempts certain categories of income from the IIT, including prizes and awards for scientific, technological, or cultural achievements, interest on deposits in state banks, welfare benefits and certain pensions, or severance pay and salaries of foreign diplomatic and consular officials.[130] Certain other forms of income may be approved as tax free by the Ministry of Finance.[131] In the SEZs, a lower rate schedule for wages and salaries, ranging from 3% to 30% has been operative since 1981; nonetheless, no official regulations appear to have been published to that effect. The SEZs also apply reduced rates of withholding tax on dividends, interest, rental payments, and royalties although the tax regulations sometimes state that these reduced rates apply only to "foreign business people" (for the purposes of the FEIT) and do not mention the IIT.[132]

VII. SEZs, EDZs, AND OTHER SPECIAL REGIONS

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

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[130] IIT, art. 4.

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

[132] See, e.g., Provisional Tax Regulations for 14 Open Cities, Special Economic Zones and Hainan Island, art. 4, which came into force on Dec. 1, 1984, reprinted in CHINA ECON. NEWS, Dec. 3, 1984.

More systematic rules have been promulgated for the SEZs, Economic Development Zones ("EDZs") and certain other special areas, such as the "industrial development districts" and "old urban zones."[133] The most important of these areas are the four SEZs. Three are in the southern province of Guangdong -- Shenzhen, Zhuhai, and Shantou -- and the fourth is located in Fujian Province on the coast facing Taiwan -- Xiamen. Of the four SEZs, Shenzhen is the most important. It is situated close to Hong Kong and accounts for almost half of all foreign investment in the People's Republic of China.

In many respects the SEZs resemble the export processing zones which have been established in countries such as India and Korea. Special facilities are provided to attract foreign investment including a modern communications infrastructure, simplified procedures for obtaining development permits and visas for staff, relaxed currency controls and import restrictions, and other benefits. Local taxes and property taxes are reduced or waived, the tax rates on joint ventures and foreign enterprises are reduced (generally to 15% but sometimes to 10%), withholding taxes on dividends, interest, and royalties are reduced (to 10%) or waived, tax holiday periods are extended, and tax rates on salaries are reduced.[134]

In addition to the SEZs, a number of other special zones have been established. These include the industrial development districts of Hainan Island (in the extreme south), Minhang (near Shanghai), and the fourteen "open" coastal cities known as EDZs. Foreign enterprises operating in these zones enjoy various tax exemptions which, in some respects, are even more favorable than those granted in the SEZs.[135] Additional exemptions and reliefs are granted, notably for investment

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[133] See generally Nishitateno, supra note 22; Klitgaard & Rasmussen, Preferential Treatment for Foreign Investment in the People's Republic of China: Special Economic Zones and Industrial Development Districts, 7 HASTINGS INT'L & COMP. L. REV. 377 (1984).

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

[135] Gelatt, Interim Provisions Sharpen EDZ's Competitive Edge, EAST ASIAN EXEC. REPORTS, Dec. 1984, at 9-10.

involving advanced technology, in what are termed "old urban zones" of the open coastal cities and certain other large cities.[136]

VIII. TAX TREATIES

Whenever taxation has an international element, domestic rules may be modified by the provisions of a relevant tax treaty. Although the main laws governing the taxation of foreign investment and business have been in existence for such a short time, China has been remarkably quick in instituting a program for the negotiation of tax treaties. Tax treaties are already in force between China and France, the Federal Republic of Germany, Japan, Malaysia, Singapore, the United Kingdom, and the United States of America.[137] China has concluded additional treaties with Belgium, Canada, Denmark, Finland, New Zealand, Norway, and Sweden which await ratification. Finally, negotiations are being conducted with Australia, Austria, Czechoslovakia, Italy, Netherlands, Romania, Switzerland, Thailand, and Yugoslavia.[138]

China's tax treaties generally adhere to the OECD Model[139] with additional elements drawn from the United Nations Model.[140] China is particularly eager to negotiate tax sparing provisions which avoid nullifying the tax holidays extended to foreign enterprises. Following its standard practice, the United States has not accepted the inclusion of any such provisions. However, the China-United States treaty is accompanied by an exchange of diplomatic notes stating that, if at some future date the United States should amend its laws to provide a tax sparing credit or should agree to grant such a credit to any other country by treaty, then the same privilege will be extended to China. Several other countries, however, have been willing to adopt tax

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[136] These are also governed by the Provisional Regulations, supra note 133.

[137] The treaty between China and the United States was executed on Apr. 30, 1984. For an analysis, see Schreyer, A Guide to the China-U.S. Tax Treaty, EAST ASIAN EXEC. REPORTS, Aug. 1984.

[138] See China Daily, Beijing, Oct. 24, 1986.

[139] OECD Model Double Taxation Convention on Income and Capital (1977).

[140] United Nations Model Double Taxation Convention between Developed and Developing Countries, U.N. Doc. ST/ESA/102 (1980).

sparing, either for specific exemptions or reliefs contained in Chinese legislation[141] or by deeming a higher rate of tax to have been withheld regarding dividends, interest, and royalties.[142]

IX. CONCLUSION

In a remarkably short period of time, China has created a tax system which, as one commentator has remarked, "is very much within the mainstream of international taxation systems."[143] At the same time, China has also established a substantial network of tax treaties. China seeks to retain a reasonable proportion of the profits generated by foreign investment in the form of taxes. For the most part, China's tax system is conducive to such investment and should not produce any unpleasant surprises to foreign enterprises. Nonetheless, additional changes in Chinese tax law will take place in the years to come. To observers in the West, the present system appears to be lacking both detail and precision -- much of the law is left to be negotiated with the local tax administration. This situation is not unique to China, however, and the existing laws undoubtedly provide an adequate framework within which foreign investment can continue to take place.

[141] Notably JVIT, arts. 5 & 6; JVIT Regs., art. 3; and FEIT, arts. 4 & 5. See the treaties with Canada, Japan, and the United Kingdom.

[142] See the treaties with Belgium, France, Germany, and Japan.

[143] Schreyer, supra note 138, at 10.

CHAPTER 5

THE OECD MODEL AND ITS CORRESPONDING CHALLENGES

I. THE CONFRONTATION: TAXATION AND THE OECD IN THE FACE OF GLOBAL CHANGE

Historically, fiscal legislation was a national issue with exclusively domestic implications. Increasing transnational economic relations, however, challenged this nation-centered approach by introducing the potential for double taxation. This resulted in a cooperative effort between nations and multinational organizations, such as the OECD, to establish remedial principles and guidelines. Currently, the OECD seeks to address the growing issue of tax competition, which is facilitated by another trend: globalization.

B. Internationalization and Its Impact on Traditional Taxation

The proliferation of cross-border economic activities introduced new problems to nations drafting their respective fiscal legislation. Internationalization made people question the traditional notion of absolute domestic fiscal sovereignty. As a result, a cooperative approach to address internationalization emerged.

1. Double Taxation

Geographic jurisdictional boundaries failed to address fiscal issues associated with the increasing number of persons and firms generating foreign-based income from transactions in other countries. Consequently, nations modified their jurisdictional reach to enable taxation of persons and entities via an appropriate fiscal attachment: personal, territorial, or functional.

Taxpayers extending their operations into other jurisdictions, however, potentially subjected themselves to double taxation. A taxpayer's country of residence claimed authority to tax the taxpayer's foreign-sourced income, while the country in which the income was generated also claimed authority to tax revenue. Additionally, situations arose where a third country claimed taxing authority if a taxpayer maintained citizenship in one country, resided in a second country, and transacted business in a third country.

Absent an agreement to alleviate double taxation, few international transactions would occur, because the excessive tax burden would render most transactions economically unfeasible. Remedying double taxation requires the cooperation of multiple nations. Consequently, internationalization challenged the traditional notion of absolute fiscal sovereignty.

2. Questioning Absolute Fiscal Authority

Historically, international law and fiscal law developed independently of each other. Internationalization, however, spawned an academic debate regarding the effect of international considerations on national fiscal sovereignty. Some scholars believe that nations could no longer develop their respective fiscal legislation in a vacuum and were limited because of the increasing effect national tax systems had on international economic relations.

3. Emergence of International Taxation

Mounting fiscal problems of internationalization, most notably double taxation, required immediate remedial measures. Adhering to the principle that authority to tax exists at the national level, it became necessary for nations to devise a cooperative multinational approach that would be acceptable to all affected nations. Thus, the area of international taxation emerged.

A system of international treaty agreements arose, which even today, remains the framework of international taxation. Multiple nations could negotiate the terms of an agreement and, upon completion, expect full compliance by all signatory nations. This allows for remedial measures to international fiscal issues without usurping the fiscal sovereignty of each nation.

Tax treaties are also used to prevent tax evasion. These agreements generally provide for mutual assistance between the signatory nations on information sharing and enforcement. Additionally, these agreements include resolution methods for tax disputes to address international enforcement issues. Nations entering into these arrangements contribute to the intangible benefits of improved foreign relations and increased clarity for non-resident investors of another country's tax system and administration.

Unlike the widespread use and beneficial results of double taxation treaties, tax evasion treaties have not been as successful. Developing countries refused to enter into tax evasion treaties because of the unilateral harm they receive due to decreased tax revenue and resulting lack of offsetting investments. Some developing nations have requested agreements calling for tax-sparing arrangements, which would enable developing countries to maintain desirable levels of tax revenue and non-resident investment. This request is not often recognized by the United States, the most prolific treaty nation.

C. OECD

Formed in an effort to represent the concerns of its member nations, the OECD is rapidly transforming itself into a global consultant. In the area of international taxation, the OECD made a major contribution to the alleviation of double taxation with its Model Double Tax Convention of 1977 ("OECD Model"), which served as a template for subsequent treaties. Additionally, the OECD has addressed an increasing range of issues within the area of international taxation.

1. Background

As the successor to the Organisation for European Economic Cooperation, ("OEEC") the OECD's mission is to strengthen the economies of its member countries, improve the efficiency of market systems, and contribute to free trade expansion between both industrialized and developing nations. Initially focusing on its member countries and their respective policies, the OECD has altered its focus to advising emerging market economies and analyzing the impact of the increasing interaction of various policies across the world. Ultimately, the OECD aims to increase its membership and broaden its scope to interconnect various economies into a unified global economic system.

The OECD also plays an important role in non-economic issues. By providing a venue for the governments of industrialized nations to meet, the OECD plays a significant role in structuring global governance by promulgating legislative instruments. As a prolific research institution, the OECD provides data, forecasts, and policy options addressing various social concerns. The OECD maintains an

interdisciplinary approach in addressing these non-economic issues, however, by focusing on the economic impacts of these various areas.

2 . OECD's Role in International Taxation

International tax policy is among the issues addressed by the OECD. For example, multilateral treaties, primarily based on the OECD Model, alleviate double taxation problems. Furthermore, the OECD analyzes, and consults on, a variety of additional global fiscal issues.

a. Entrance Into International Taxation

The OECD introduced its first OECD Model agreement for multilateral tax treaties in draft form in 1963 and subsequently updated and published it in 1977. The OECD Model facilitated the treaty process by standardizing treaty structure and content, which contributed greatly to the proliferation of the tax treaty network. The expanded treaty network facilitated global economic agreements and promoted growth in international trade.

At first, the OECD Model did not receive unanimous acceptance. For example, in 1977, the United States Treasury developed its own model agreement that reflected U.S. interests. Additionally, the United Nations ("U.N.") developed yet another model agreement in 1980. The OECD Model, however, gained widespread acceptance and has become the dominant model for treaty arrangements.

b. OECD's Increasing Influence in International Taxation

In addition to addressing double taxation, the OECD analyzes a variety of other global taxation issues. Annually, the OECD publishes statistics on tax revenues generated in OECD member countries. OECD initiatives also include recommendations on fighting corruption and implementing transfer-pricing policies. Recently, the OECD shifted its focus to harmful tax practices facilitated by globalization.

D. Globalization and Increasing Tax Competition

Globalization is transforming international economic relations. The increased mobility of information and capital alters the way business and finance transactions are conducted. Moreover, globalization has contributed to the proliferation of the tax competition that the OECD seeks to curb.

1. Globalization

While internationalization marked a fundamental change for trade since the Middle Ages, post World War II globalization is having a far greater impact on the world. Globalization emphasizes global perspectives while minimizing those of individual nations; it stresses the interdependence of national interests. Consequently, a substantial shift away from public interests to private interests occurs. This shift results from a unified effort between businesses and governments to globalize the world economy.

Globalization affects many areas of international law. For example, cross-border mergers and acquisitions complicate the traditional regulatory schemes of competition law. Global environmental problems are spawning multi-national agreements that serve as influential legal instruments. Additionally, criminal and civil law are affected by an increasing international impact on state jurisdictional authority. International taxation is similarly affected, as demonstrated by globalization's impact on tax competition.

2. Increasing Tax Competition

Since World War II, the demand for financial services in developing jurisdictions has grown significantly. High taxation and increased regulation in developed nations encouraged individuals and corporations to seek more favorable locations to deposit their funds and transact business. Recognizing the impact this trend has upon their national economies, tax haven governments have attempted to attract this capital by providing favorable tax rates for non-resident monetary deposits. As a result, these jurisdictions greatly depend on the income from financial services and the products of more industrialized nations.

Globalization facilitates the trend towards financial tax havens. The connection of regional markets through networked computers and high-speed telecommunications increases the mobility of capital and financial flows between nations. Previously remote tax regimes are now readily accessible; communication improvements allow for the spreading and sharing of tax planning techniques between regions. The result is lost revenue for high tax jurisdictions.

II. OECD'S ASSAULT ON TAX COMPETITION

As a response to the concerns and requests of its member nations, the OECD undertook an affirmative effort to address the issue of tax competition. The OECD issued its 1998 Report, discussing the impact of globalization, identifying jurisdictions engaging in harmful tax competition, and establishing a preliminary framework to counteract the resulting effects of these jurisdictions. Subsequently, the OECD issued its 2000 Report, which updated the work being done with jurisdictions seeking to cooperate with the OECD and published defensive measures that member countries could adopt to counteract uncooperative jurisdictions.

A. Harmful Tax Competition: An Emerging Global Issue--The 1998 Report

In 1998, the OECD published the results of its study, which identifies the causes and effects of harmful tax competition. The 1998 Report identifies jurisdictions engaging in harmful tax competition in both OECD member countries and non-member countries. Furthermore, it proposes various defensive measures to aid affected countries in curbing the effects of tax competition.

1. Background of the 1998 Report

The OECD initiated its study to determine the extent of global tax competition. Focusing on geographically mobile activities, the Committee on Fiscal Affairs ("Committee") examined provisions in various tax systems across the world. The Committee aimed to determine which tax systems had characteristics intended mainly to divert capital from higher tax jurisdictions.

The study specifically notes the beneficial effects of globalization, such as facilitating tax system reform that focuses on base-broadening and rate reductions.

Moreover, globalization encourages reassessment of domestic tax systems to reduce governmental spending and induce investment. Additionally, expansion of financial markets facilitate capital flows for increased global welfare.

The 1998 Report also emphasizes the negative impact of globalization and its impact on tax competition, including the increased ability to move mobile capital into lower tax jurisdictions. This raises the potential for political pressure in countries to lower their tax rates to attract investments, which could result in the erosion of tax bases of other countries. The 1998 Report states that this distortion of capital flows will hinder the expansion of global economic growth.

The 1998 Report, however, does not distinguish between beneficial and harmful jurisdictions. Instead, the OECD merely suggests that the criteria be analyzed in the context of whether a nation shifts investment activity to its jurisdiction solely to exploit tax benefits. Additionally, the presence and level of activities in the host country must be commensurate with the amount of investment or income generated by such activities. Furthermore, an assessment should be made as to whether tax benefits are the primary motivation for the location of an activity.

The OECD seeks to promote and maintain the economic growth brought about by cross-border trade and investment. Consequently, the OECD asserts that the distortion of capital flow induced by tax competition must be addressed, as it is becoming an increasing problem. The OECD opines that an international cooperative effort is required because of the inherently global nature of tax competition.

2. Tax Competition

The 1998 Report asserts that detrimental tax practices can take the form of tax havens or harmful preferential tax regimes. Although some criteria for identifying both are similar, specific provisions vary enough to allow a jurisdiction to be classified as either a tax haven or one that has a harmful preferential tax regime. The two are distinguished throughout the 1998 Report.

a. Tax Havens

Generally, tax havens are jurisdictions with nominal tax rates, or no tax rates, that fail to generate significant revenue. The 1998 Report enumerates specific criteria for identifying tax havens: the jurisdiction imposes no or only nominal taxes; the jurisdiction lacks policy of effective exchange of information; the jurisdiction lacks transparency; and the jurisdiction has no requirement of "substantial activities."

OECD nations subjectively analyzed these factors in determining whether a jurisdiction offers itself as a place to be used by non-residents to evade their domestic tax authorities. Essentially, these jurisdictions allow non-resident taxpayers to hold passive investments, book paper profits, and hide their affairs from discovery by their resident-country taxing authorities. The 1998 Report, however, does not state what tax rate would be considered nominal and characteristic of a tax haven.

b. Harmful Preferential Tax Regimes

Harmful preferential tax regimes occur in non-haven countries that derive significant revenue from their respective tax policies, but whose tax systems have features sufficient to classify them as engaging in harmful tax competition. The four main factors in identifying a harmful preferential tax regime are: no or low effective tax rates; ring-fencing; lack of transparency; and lack of effective exchange of information. The 1998 Report lists additional criteria to be analyzed upon confirmation of the four previous criteria, but fails to propose a specific tax rate that would be considered part of a harmful preferential tax regime.

3. OECD's Response to Tax Competition

Asserting that governments need to proactively counter the impact and spread of tax havens and harmful preferential tax regimes, the 1998 Report lists 19 recommendations ("Recommendations"), which countries may adopt to counteract the negative impacts of the tax systems of these jurisdictions. The recommendations focus on encouraging and providing guidance to harmful tax jurisdictions to enact or reform their tax legislation and practices. Additionally, the Recommendations encourage harmful jurisdictions to alter treaty arrangements with OECD member

nations. OECD countries are encouraged to terminate existing treaties with tax havens, or those countries that have dependencies that are tax havens, and not to enter into treaties with such countries until the harmful tax features are removed.

The 1998 Report also established a Forum to implement the Recommendations and consult jurisdictions with harmful preferential tax regimes seeking to reform their respective tax systems. The Committee mandated the Forum to establish a list of tax havens and countries with harmful preferential tax regimes. Additionally, the Committee instructed the Forum to engage in a dialogue with cooperative non-member countries to promote the 1998 Report's Recommendations. The Recommendations set forth a deadline when identified harmful features of these regimes are to be eliminated.

B. Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices--The 2000 Report

In June 2000, the Forum presented the OECD Ministers with a progress report ("2000 Report") on the implementation of the Recommendations. Particularly, the 2000 Report identifies OECD member countries with harmful preferential tax regimes, provides an update on consultations conducted with non-member countries, and specifies proposals for further work. Additionally, the 2000 Report identifies jurisdictions that met the criteria for being tax havens. The 2000 Report enumerates various defensive measures that OECD member countries could adopt against uncooperative jurisdictions.

1. Preferential Regimes

The 2000 Report identifies the process by which the individual tax policies of OECD member countries were analyzed. This process identifies OECD member countries with harmful preferential tax schemes. Furthermore, the 2000 Report provides an update on consultations conducted with non-member countries and specifies the plan for further work with these countries.

a. OECD Member Countries

The Forum requested that each member country perform a self-review of its tax systems in relation to the harmful preferential tax regime criteria.

Simultaneously, the Forum conducted abstract cross-country reviews, followed by a peer review process that consisted of extensive questionnaires requiring responses to specific regime questions and more general questions about the harmful tax regime criteria. The Forum evaluated the responses and data from these review processes.

The 2000 Report identifies forty-seven potentially harmful preferential tax regimes in member countries. These regimes are identified as potentially harmful, however, even though an accurate assessment of the regime's harmful effects have not been determined. As a result, the list of regimes includes jurisdictions whose tax systems may not actually be harmful under their particular circumstances.

The Forum intends to develop guidelines, known as application notes, on applying the harmful tax regime criteria in an objective manner, equally applicable to any potentially harmful regime. These application notes will assist member countries in determining whether their tax systems are, or could be, harmful and the procedure for removing the harmful features of such regimes. Such assistance is intended to allow harmful jurisdictions to meet the deadlines for compliance, which will be verified by the Forum.

b. Non-Member Countries

The Committee states that non-member countries must have a key role in the efforts against harmful tax competition. Citing the global nature of harmful tax competition, the Committee seeks to include non-member jurisdictions by encouraging non-members to familiarize themselves with the 1998 Report and to adopt its features. Additionally, the Committee plans to hold regional seminars to assist with and facilitate the removal of harmful features in the tax systems of non-member jurisdictions.

2. Review of Tax Havens

The 2000 Report identifies thirty-five jurisdictions as tax havens, because they meet the criteria described in the 1998 Report. The OECD requests that such jurisdictions make adjustments to their respective fiscal policies to conform with the Recommendations of the 1998 Report. Any tax haven jurisdiction that fails to

comply will be deemed uncooperative and may be subject to defensive measures by the OECD member countries.

a. Identification of Tax Havens

During the evaluation process, the Forum requested that these jurisdictions submit relevant information about their specific tax systems. The Forum analyzed this information and, based on this analysis, produced jurisdiction reports. In many cases, jurisdictions with harmful practices provided input and agreed to the provisions of the jurisdiction reports. Based on these procedures, the Forum made technical evaluations of the jurisdictions meeting the tax haven criteria and these evaluations are the basis for the preliminary list of identified tax havens.

The preliminary list excluded a number of jurisdictions, however, if they made an advance commitment n198 to eliminate the harmful features of their tax systems and comply with the Recommendations of the 1998 Report. In furthering a cooperative effort between the OECD and the listed jurisdictions, the Forum will continue to solicit commitments from these jurisdictions. Alternatively, jurisdictions that failed to make advance commitments can still demonstrate their interest in cooperating with the OECD by making "scheduled commitments," agreements occurring after the release of the preliminary list of identified tax havens.

Acknowledging the efforts of advance commitment and scheduled commitment tax havens, the Committee will continue to consult with these cooperative jurisdictions to complete the information process. The 2000 Report asserts that this work will entail developing a multilateral agreement for exchange of information, evaluating the transitive assistance that jurisdictions will require, and encouraging such jurisdictions to consult with existing worldwide organizations to improve tax administration and enforcement. The Committee also intends to work with other international organizations to address the potential adverse economic effects that cooperative jurisdictions may encounter in the transition process of reforming their tax policies.

b. Defensive Measures Against Non-Cooperative Tax Havens

Jurisdictions from the preliminary list that failed to make an advance commitment or fail to make a scheduled commitment will be deemed uncooperative and included in the OECD List of Uncooperative Tax Havens. This list, originally scheduled for completion by July 31, 2001, will also include any advance commitment jurisdiction or scheduled commitment jurisdiction that has failed to meet its respective deadlines for eliminating the harmful features of its tax systems due to a failure to act in good faith with respect to its commitments. The Committee encourages its member countries to refer to this uncooperative list to identify jurisdictions against which retaliatory measures should be undertaken.

Recognizing that a multilateral cooperative effort may better curb harmful tax practices than any unilateral effort, the Committee recommends a general scheme wherein member countries can implement a unified approach. This scheme would facilitate the use of defensive measures by member countries against jurisdictions that do not reform their harmful tax system. Each member country has discretion to implement or not implement the defensive measures and adoption would be pursuant to their domestic legislation or executed tax treaties. Additionally, each member country may enforce any defensive measure in proportion to the alleged harm done by a particular jurisdiction.

The defensive measures enumerated in the 2000 Report contain some of the defensive measures from the 1998 Report as well as additional measures recommended by the Forum. The Committee plans to evaluate these measures, approve its final recommendations, and implement an applicable defensive strategy. Subsequently, cooperating countries can adopt any of the Committee's recommended measures to implement against uncooperative jurisdictions.

III. THE OECD'S COERCIVE AND DEVIANT EFFORT TO COUNTERACT TAX COMPETITION

The OECD's 1998 and 2000 Reports addressing tax competition mark a coercive and intrusive solution that deviates from traditional fiscal remedies. The substantive provisions of these reports are vague and subjectively reflect the

exclusive interests of the OECD. Furthermore, success of the OECD's efforts will result in hindering future global economic growth.

A. OECD's Effort Deviates From Traditional International Taxation Principles

Notwithstanding the substantive findings of the OECD in the 1998 and 2000 Reports, their efforts to curb tax competition marks a substantial deviation from the treaty network established to address international fiscal problems and usurps a basic tenet of fiscal legislation: national sovereignty. The 1998 Report requires tax competitive jurisdictions to alter their fiscal legislation and accompanying practices. Although the OECD claims that adoption of these fiscal reform Recommendations are voluntary, the threat of targeted jurisdictions being subjected to the defensive measures outlined in the 2000 Report effectively coerces these jurisdictions into an involuntary compliance.

Consideration of the economic disparity between OECD nations and targeted jurisdictions is demonstrative. The OECD is a group of the most industrialized and economically powerful nations in the world. Collectively, the nations of the OECD monopolize the production of global goods and the allocation of capital and resources. Thus, the OECD members are an indispensable part of the global economy, able to leverage their monopolistic economic position in global affairs.

Conversely, the tax competitive nations targeted by the OECD are much weaker economically and more dependent on OECD nations as trading partners. Tax competitive nations' lack of resources and labor requires such jurisdictions to seek goods and resources from the more industrialized nations of the OECD. This reliance precludes tax competitive jurisdictions from effectively generating sufficient internal revenue to develop a globally competitive economy. Consequently, this weaker and more reliant position of tax competitive nations hardly places them in any position to refuse the OECD's monopolizing demands.

The OECD attempts to rationalize infringing on developing nations' sovereign right to tax by stating that such a right also confers upon the OECD nations the right to protect their revenue bases. This argument, however, does not accurately reflect the effect of the OECD's effort. Although the implementation of

the Recommendations and defensive measures of the 1998 and 2000 Reports may allow OECD member nations to protect their respective revenue bases, a concurrent effect is a trespass on fiscal sovereignty. The 1998 and 2000 Reports effectively dictate legislative and practice reforms targeted jurisdictions must enact, thus violating international taxation principles.

The OECD's coercive trespass on national fiscal sovereignty deviates from the traditional fiscal remedial system of tax treaties. Throughout the rise of internationalization and the resulting problems of double taxation and tax evasion, treaties constituted the measures used to address these issues. Nations maintained control of their fiscal authority and this allowed for effective negotiations regarding international fiscal issues.

The OECD's effort essentially undermines a nation's ability to negotiate. By leveraging their dominant economic power, the OECD member nations are usurping the fiscal authority of tax competitive nations. Because treaty-negotiating power is a reflection of a nation's effective fiscal authority, this usurpation of fiscal authority results in a nation's lack of treaty negotiating power, thus rendering such agreement attempts fruitless.

Although the reluctance of tax competitive jurisdictions to enter into tax evasion treaties made these agreements less effective than double taxation treaties, the lack of success of tax evasion treaties can be rectified by the willingness of OECD member nations to compromise in negotiating these treaties. Tax evasion treaties can be more effective and amenable if industrialized nations agree to tax-sparing arrangements. These arrangements would enable tax competitive jurisdictions to maintain their respective influx of investments from non-resident taxpayers. Also, OECD member nations would likely receive the reciprocal benefit of tax enforcement assistance by the tax competitive jurisdictions. Thus, tax-sparing arrangements are likely the best solution to appease both tax competitive countries and the OECD member nations.

B. OECD Reports Are Vague and Subjective

The fundamental make-up of the OECD illustrates the organization's inappropriate position in leading this effort. The OECD is comprised of only twenty-nine countries, thus representing a limited scope of global interests. This scope is further reduced when accounting for the abstentions by Luxembourg and Switzerland during the approval of the 1998 Report by the OECD Council. Consequently, the 1998 and 2000 Reports utilize an OECD-centered approach that significantly omits a substantial number of interests in the world, especially those of the targeted nations.

Moreover, the OECD's failure to solicit design schemes for domestic tax regimes from non-member nations, further demonstrates its self-centered focus in curbing tax competition. Although the 1998 Report recommends establishing the Forum, in part to facilitate dialogue between member and non-member nations, no effective consultations with tax havens occurred during the drafting of the 1998 Report. In fact, such failure to consult with these affected jurisdictions contributed to the abstention of Luxembourg during the approval of the 1998 Report.

Although the OECD claims to represent world interests by having open discussions, the Forum's dialogue with non-member and tax haven jurisdictions following publication of the 1998 Report consisted of consulting with jurisdictions on complying with the OECD-established principles of the 1998 Report and acknowledging those jurisdictions that agreed to comply. Thus, the only level of participation by non-OECD countries was to either comply with the 1998 Report or to refuse. As stated by the OECD, addressing the issue of tax competition would require a coordinated global approach, which should include the proactive and substantive input of all affected nations.

In addition to being too OECD-centered, the 1998 and 2000 Reports are also vague. In determining whether a jurisdiction has an appropriate tax rate, as opposed to low or nominal, the 1998 Report fails to provide an exact figure or tax range that would be considered appropriate. Additionally, the 1998 Report fails to provide comparative guidelines to determine if jurisdictions are engaged in harmful tax competition in the context of their respective economic situations. Furthermore, the

tax haven requirement of no substantial activities has no determinative guidelines, and is vague enough to allow an OECD nation to subjectively determine what is 'substantial.' Thus, the OECD's effort outlined in the 1998 and 2000 Reports provides no constructive assistance to guide alleged competitive jurisdictions to unilaterally reform their respective tax systems.

C. OECD's Effort Will Stymie Global Economic Growth

The OECD's effort to curb tax competition is likely to hinder overall global economic development. Inherently, international taxation principles foster growth through international trade. Tax treaties alleviate the encumbered movement of capital, goods, and services that result from the harmful effects of double taxation. Additionally, national tax systems provide tax incentives to business enterprises in an effort to encourage their international development. These characteristics of international taxation enhance the profitability of international trade and allow developing nations to participate in the growth of the global economy.

Although the industrialized nations argue that their depleted tax revenue resulting from the effects of tax competition diminishes the amount of aid provided to developing nations, effective and sustainable economic development is most beneficial when it is internally generated. Tax competition allows developing nations to build their economies without relying on subsidies of more industrialized nations. Increased economic independence will potentially allow for more input on global economic policy.

Because competition, on many scales, is characteristic of the free market global economy, tax haven jurisdictions are appropriately addressing the need to develop their respective economies. Due to a lack of natural resources and capital, alleged tax haven jurisdictions are at a significant disadvantage compared to industrialized nations in their ability to contribute to the global economy. Consequently, the only recourse for these jurisdictions is to provide investment incentives to individuals and multinational corporations in an effort to develop a financial industry that is vital to their success. These jurisdictions, in turn, will be able to develop a stable and growing economy that will provide for the development and improvement of the necessary infrastructure to allow their health care and

educational systems to become commensurate with those of more industrialized nations.

Additionally, this economic growth is likely to result in growing markets for products and services of the industrialized nations. The dominating trade positions of the United States and fellow OECD members can offset the loss of fiscal revenue with the increase of export gains that is likely to result from the increasing strength of these developing economies.

CHAPTER 6

DOUBLE TAXATION AVOIDANCE AGREEMENTS VERSUS UNILATERAL POLICIES ADOPTED BY THE HOST/RESIDENCE COUNTRIES TO PREVENT DOUBLE TAXATION

I. Introduction

The prevailing view of tax treaties is misguided. The benefits countries reap from easing the double taxation burden on their residents investing abroad are sufficient to induce them to alleviate double taxation on a unilateral basis. Treaties are not the only workable solution. Without offering any significantly greater degree of stability, treaties often just replicate the mechanism that countries unilaterally use to alleviate double taxation.

One substantial difference, however, does distinguish the unilateral solution from the treaty mechanism. While unilateral solutions tend to allow "host" countries to benefit from collecting tax revenues, tax treaties usually allocate the revenues more to the benefit of "residence" countries.[1] The revenue disparity is probably insignificant between two developed countries. But in treaties between developing and developed countries, usually host and residence countries respectively, reallocating tax revenues means regressive redistribution - to the benefit of the developed countries at the expense of the developing ones.

"There is remarkably broad and well-established consensus among governments of various political and economic persuasions that it is in their interest to enter into income tax treaties...."[2] This consensus, unfortunately, is misguided. Treaties do not offer a "benefit for all" solution under any and all circumstances. Treaties can offer some benefits for some countries while entailing substantial costs for others. The signatory countries should be careful when assessing the costs and benefits of treaties.

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[1] The "host" country refers to the country where the investment is made, while the "residence" country refers to the country where the investor resides.

[2] American Law Institute. Federal Income Tax Project: International Aspects of United States Income Taxation II, Proposals on United States Home Tax Treaties 5 (1992).

Interaction of National Policies

In order to understand fully the role tax treaties play, we first need to imagine a world without them. Discussing optimal policies in isolation - that is, discussing a country's optimal policies detached from the policies of other countries - is admittedly oversimplified since it is more plausible to assume that countries do not operate in isolation but rather continually refine their own policies in response to actions taken by other countries.[3] Because the outcomes of their policies are interdependent, both the host country and the residence country take each other's policies into consideration; each formulates its international tax policy in a strategic manner.

A. The International Tax Game

International tax policies are not crafted in a vacuum. Residence and host countries make strategic policy choices that result in an outcome affected by the interaction of those policies with the chosen strategies of other countries. In other words, one country's policies affect the outcome of another country's policies and vice versa. Therefore, policy planners must be aware of actions taken by other countries with tax policies that may influence domestic economic behavior and must devise their country's policy in a way that would best serve the country's interests.

Since a country's national interests are affected not only by its own policies but also by those of other countries, we should try to imagine the optimal policy for each country while considering the possible responses of other countries to such policy. The policies chosen unilaterally by the different countries interact to create an international taxation landscape devoid of any treaties. Unilateral alleviation of double taxation emerges not only as the common practice among nations, but also as a stable condition (or a "stable equilibrium"). In essence, unilateral alleviation of double taxation is a stable mechanism that could be a successful technique for preventing double taxation.

In bilateral treaties, each country is assigned two different roles - that of the investor's country of residence and that of a host country (where the investment, or the

[3] Countries interested in attracting investors must realise that the incentive for cross border investment is created by the taxes of the host country and residence country combined.

economic activity, takes place). The countries have reciprocal rights and duties, since each country is both a residence country to its resident-investors and a host to the other country's residents. But one could also conceive of a treaty as an agreement between a residence country and a host country in which the former provides some alleviation from double taxation in return for some reduction by the host country in its tax rates for investors who are residents of the residence country.

B. The National Interests of Host Countries

One of the tenets of international economics is that cross-border investment, just like cross-border trade, is beneficial to both residence and host countries. In order to maximize the benefits from cross-border investment and avoid the welfare-reducing effects of taxes, a small open economy should not tax foreign investments. The rationale behind this is that, if the international capital market is competitive, a small country (whose market power can have no effect on the worldwide rate of return) seeking to attract foreign investment must compete with investment opportunities offered in other countries. In other words, if a host country decides to tax capital investment, investors will prefer other countries. As a result, the increased tax revenues that the host country reaps will not compensate for the loss of greater foreign investment; that is, such a tax increase would be economically inefficient.[4] Therefore, in order to maximize benefits from foreign investments, the host country has a genuine interest in reducing the tax wedge, since it will thus attract foreign investors by enabling them to pay as little tax as possible.

It is important to note that the tax wedge - namely, the efficiency loss due to the imposition of taxes - comprises all the taxes imposed by the host and the residence countries combined. Minimizing the tax wedge therefore means reducing the combined taxes of the host and residence countries. Hence, the host country should take the residence country's policies into consideration when determining which policy is optimal.

[4] Lans Bovenberg et.al., Tax Incentives and International Capital Flows: The Case of the United States and Japan, in Taxation in the Global Economy, 283.

If the residence country exempts its residents' foreign investments, the host country's best policy would be not to tax such investors, since any tax will create a tax wedge.[5]

If, however, the residence country taxes its residents on their foreign investment activities, then the host country will not be able to completely eliminate the tax wedge unilaterally. It can, on the other hand, capture tax revenues from foreign investment without increasing the tax wedge if the residence country provides a credit for foreign taxes paid by its own residents. The residence country would, in effect, be reimbursing its residents for the taxes they pay to foreign governments. A host country would then benefit most from this credit granted by the residence country if it were to impose the highest possible tax rate on foreign investment that the residence country is willing to credit. (Levying taxes that are creditable against a foreign investor's domestic tax liability would not discourage foreign investors, but would instead raise tax revenues for the host country.)[6] Under a limited credit mechanism (i.e., a credit limited to foreign taxes at or below the residence country's tax rates, as is the case in the United States), this would mean taxing foreign investors at rates equal to those set by the residence country.

Finally, if a residence country allows a deduction for foreign taxes, then the host country would be better off not taxing foreign investors from that residence country. Deductions do not fully offset the amount of foreign taxes paid. Therefore, any tax imposed by the host country increases the tax wedge and does not advance the host country's goals.

In sum, if a host country's primary policy goal is to eliminate the tax wedge, it must sacrifice tax revenues to increase foreign investment. However, if completely eliminating the tax wedge is an impossibility because the residence country does not exempt its residents' foreign-source income from taxation, then the host country

[5] A subsidy would also not be desired as it would create a tax wedge of its own. Mark Cersovitz, The Effect of Domestic Taxes on Foreign Private Investment, in the Theory of Taxation for Developing Countries, 615, 619-22 (David Newbery and Nicholas Stern eds. 1987.

[6] In fact under these circumstances would be to tax foreign investments and then provide them with a subsidy that would reimburse the taxes paid.

should try to collect as large a portion of the tax imposed as possible. Under a limited credit mechanism, this would mean taxing foreign investors at rates similar to those of the residence country, whereas an exemption or deduction mechanism would entail not imposing any tax whatsoever on foreign investment in the host country.

Based on this analysis we can conclude that the host country's order of preferences (the order in which it would rate its policy choices) would be as follows:

1. To prefer most that no taxes be levied by either country (exemption in the residence country/no tax in the host country), thereby preventing any tax wedge from forming.
2. To prefer less that a moderate level of cross-border investment take place and that the host country gets to collect tax revenues. This would be the case if the residence country were to provide a credit and the host country to tax foreign investments at rates equal to the residence country's rates (credit/tax).
3. To prefer even less that a moderate level of cross-border investment take place, but the host country does not get to collect any tax revenues. This would occur when the residence country employs either a credit or a deduction mechanism and when the host country does not tax foreign investment (deduction or credit/no tax).
4. To prefer least that a low level of cross-border investment take place, which would be the case if the residence country opts for a deduction mechanism and the host country taxes foreign investment (deduction/tax).

C. The National Interests of the Residence Country

There is widespread agreement that a residence country should alleviate double taxation unilaterally rather than let its residents bear the burden of double taxation (which would limit the level of outbound investment). There is much less consensus, however, as to which unilateral mechanism for alleviating double taxation best serves the interests of a residence country.[7]

[7] There are those (mostly in the business community) who support exemption as it would improve the competitiveness of the residence country's investors abroad with a corresponding improvement in

The debate as to the optimal policy for a residence country centers on three common unilateral mechanisms for alleviating double taxation: exemptions, credits, and deductions. An exemption allows residents investing in foreign countries to exclude foreign income earned when calculating their income subject to residence country taxes. A credit system allows taxes paid in a foreign host country to be credited against residence country taxes that are assessed on aggregate income earned in the residence country and in the host country. Finally, under a deduction system, a resident may deduct the taxes paid to a host country as deductions in calculating his taxable income in his residence country.

The traditional debate between proponents of the different mechanisms has revolved around the different concepts of neutrality associated with the three mechanisms: National Neutrality (deduction); Capital Export Neutrality (credit); and Capital Import Neutrality (exemption).

1. Deduction

In assuming that the optimal policy of a residence country would be to provide a low incentive for outbound investments and collect more tax revenues per investment, a forceful explanation for the need for tax treaties. It seems logical to assume that both the host country and the residence country would benefit by reducing, through agreement, the combined level of taxation in order to achieve a higher level of cross-border investment flowing from the residence country to the host country. Cross-border investments entail benefits to both the host and the residence countries. While the cost in tax revenues could be too high if borne by one country alone, it should be a reasonable price if paid by both countries. Moreover, prevailing international tax policies do not support deduction as a way of serving a residence country's national interests.

If only tax revenues and investors' income are taken into account by a residence country in determining its optimal policy, a small open economy would encourage outbound investments as long as the return on those investments

national welfare. Others emphasize that exempting foreign investment would create an incentive for residents to invest abroad, thus creating a misallocation of resources, efficiency damage, and possibly damage to immobile resources (labor in particular).

(excluding the tax paid to foreign governments) exceeds the return on domestic investments (including any tax paid to the residence country's government).

Essentially, under these circumstances, any taxes paid to a foreign government would not be part of the national benefits from outbound investment. The residence country could encourage investment under these terms by applying a personal taxation system (i.e., taxing residents/citizens on their worldwide income) and allowing taxpayers to deduct foreign taxes from their taxable income. The deduction would be a unilateral mechanism for maximizing the revenues both of the investors residing in such a country and of the residence country itself. Such a policy is often labeled "National Neutrality,"

It is not clear whether the "other countries" allegedly injured by this policy are other residence countries that compete with the non-cooperative country, or host countries that would enjoy less foreign investments due to the higher total level of taxation. Competing residence countries could only benefit from a "National Neutrality" policy, since it might give their own investors a competitive advantage. Host countries, on the other hand, would most likely be harmed by such a policy. The latter, however, would probably not be able to retaliate against such a policy, since host countries do not necessarily have reciprocal investments in residence countries.

In any case, implied in this criticism is the belief that cooperative behavior - a mutual effort on the part of both the host and the residence countries to lower the level of taxation on cross-border investment - would be to the benefit of both countries. If, indeed, the combined level of taxation in the host and residence countries when there is no treaty between them is high (meaning that a relatively low level of cross-border investment is occurring), then a treaty can help by reducing the total level of taxation and splitting the tax revenues between the host and the residence countries.

Conventional view tends to think of a deduction mechanism as limiting cross-border investment and, thus, non-cooperative, because it assumes that the host country taxes foreign investment. If the host country does, indeed, tax foreign investments and the residence country allows only a deduction for this tax, then a relatively high level of taxation (and a low incentive for cross-border investment) will be created. But if

the host country does not tax foreign investments, then the total level of taxation of both countries combined for the investor will be moderate (as will the incentive for cross-border investment), whether the residence country adopts the deduction mechanism or the credit mechanism. In both cases, the combined level of taxation will be equal to the residence country's taxes.

b. The Host-Residence Interaction Under the Deduction Assumption

A residence country that chooses the deduction mechanism over a credit indicates that it prefers to collect tax revenues even though the level of outbound investment would drop. The rationale underlying such a preference is that tax revenues are part of the national welfare. There is no doubt, however, that the residence country would prefer to avoid foregoing outbound investment if it can maintain its tax revenue levels.[8] This outcome is possible if, for example, the host country does not tax income earned by foreign residents. In such a case, only the residence country would collect tax revenues from the investments of its residents in the host country. Thus, cross-border investments between the two countries would be subject to a single level of taxation (that of the residence country), and the level of cross-border investment would increase. The residence country's tax revenues would not suffer either. On the contrary, a higher level of outbound investment means more income for the residence country's investors, which means a higher level of tax revenues alongside the higher benefits to the investors.

The choice of a deduction over an exemption, on the other hand, implies that the residence country is not interested, under any circumstances (i.e., whether the host taxes or not), in exempting its residents from taxes.

Thus, we can infer that a "deduction country" has the following order of preferences:

1. The residence country would most prefer a moderate level of outbound investment provided that it (and not the host country) collects the taxes imposed. This policy would be implemented by either a deduction or a

[8] Those who support a deduction policy as serving the sectarian interest of a certain interest group aimed at restricting the level of outbound investment might still object to such a result.

credit mechanism in the residence country, but only where the host country does not tax the foreign investment.

2. The second preference of the residence country would be a low level of outbound investment, provided that its national welfare (i.e., the profits to its residents investing in the host country as well as its tax revenues) is maximized, as under a deduction mechanism in the residence country and taxation in the host country.

3. The residence country would prefer least a moderate level of outbound investment if the host country collects all the tax revenues, as is the case when the residence country implements a credit system.

2. Credit

Under a credit mechanism, residents of one country investing in another country can credit the foreign taxes they pay in the host country against their residence country taxes. The credit granted is often limited to the level of the residence country taxes. Thus, residents of a credit-granting country pay tax at the higher of two rates - the host country's tax rate or the residence country's tax rate. If the host country taxes foreign investments and the residence country provides a credit, the host country collects all the tax revenues and (assuming equal tax rates in both countries) the residence country collects none. The credit mechanism creates a moderate incentive for outbound investment.

a. Credit as an Optimal Mechanism for Residence Countries

One reason that might be given in support of a credit mechanism is that a credit is a cooperative strategy that is aimed at promoting global welfare. The rationale behind this can be presented this way: although a deduction policy best serves national interests, global welfare would actually be reduced due to the restrictions such a policy imposes on the free flow of capital if all countries were to adhere to it. Therefore, it can be contended that residence countries should adopt policies that are more cooperative in nature - policies that will reduce tax barriers and thus increase global welfare.

b. The Residence-Host Interaction under the Credit Assumption

In adopting a credit mechanism, the residence country indicates that it is willing to give up all of its tax revenues in order to achieve a moderate level of outbound investment. Presumably, a residence country that grants a credit does so because the benefits generated from the moderate level of investment outweigh what it loses in tax revenues by granting the credit. Assuming the residence country prefers a credit to a deduction implies the following order of preferences:

1. The residence country would most prefer a moderate level of incentive for cross-border investment (the case under a credit system) and that it (rather than the host country) collect all the tax revenues. Under a credit mechanism, the residence country would be willing to forego its revenues unilaterally in order to achieve a moderate level of outbound investment. Thus, it can safely be assumed that it would prefer to achieve the same moderate level of outbound investment and still be able to collect taxes.
2. The second-most preferred option would be that the level of incentive for outbound investment remains moderate, but the host country collects all taxes. This option is obviously less desirable for the residence country than option 1 above, but it is still preferable to reducing the level of outbound investments as described in option 3. If the residence country were to prefer a lower level of outbound investment, it would opt for a deduction over a credit mechanism.
3. The residence country would least prefer one of the following options: either that no taxes are collected from its residents (meaning a high incentive for cross-border investment) or that a low level of incentive for foreign investment is created (by imposing a high level of taxation). If no taxes are collected, a high level of outbound investment will necessarily result, which may be higher than what the residence country considers optimal. As explained above, the option of a high level of taxation, which reduces the incentive to invest abroad, is worse than option 2, since we are dealing here with a country willing to forego its tax revenues in order to achieve the optimal incentive for outbound investment.

3. Exemption

The third and final unilateral mechanism that may serve to alleviate double taxation is an exemption granted by the residence country for any foreign source income. Under this mechanism, someone who invests in a foreign country is subject only to host country taxation on his foreign source income.

a. Exemption as an Optimal Mechanism for Host Countries

When a residence country adopts an exemption policy, it indicates that it believes it would gain more from a larger level of outbound investment than from the revenues from taxes levied on outbound investment and the higher incentive to invest domestically as created by a credit or deduction mechanism.

A policy of exempting foreign source income is associated with Capital Import Neutrality (CIN). Proponents of CIN advocate a policy that would make investments in a given host country subject to the same overall level of taxation irrespective of the nationality of the investor. Residence countries that would adhere to such a policy by exempting their residents from taxes on outbound investments would enjoy a competitive advantage over residence countries that do not adopt such a policy. Some countries view this competitive advantage as good reason for exempting their residents from taxation on their foreign-source income.

b. The Host-Residence Interaction under an Exemption

If a residence country prefers the high level of incentive provided by the exemption mechanism at the cost of losing tax revenues and domestic investment, then there is no real conflict between the interests of the residence and host countries. The order of preferences of both the residence country and the host country would be as follows:

1. Neither country imposes taxes. This would maximize the benefits from cross-border investments.
2. A moderate level of taxation is imposed, but each residence or host country would condition this on it being the one collecting the revenues.

3. A moderate level of taxation is imposed, but the other country collects it.

4. A low level of outbound investment is created, and each country collects some portion of the total tax revenues.

B. The Tax Treaties Solution

The structure of tax treaties indicates that they are supposed to prevent double taxation.

1. Preventing Double Taxation by Tax Treaties

In a typical treaty, the two signatory countries agree on how to allocate between them the right to tax various types of income. Typically, the host country may either tax the foreign income without limitation, it may tax up to a maximum, or it may not tax at all. Thus, for example, income from business activity can be taxed by the host country without limitation provided that the business income is attributable to the activities of a "permanent establishment."[9] If, on the other hand, no permanent establishment exists, the host will usually cede taxing jurisdiction to the residence country.[10] Income from personal services, to take another example, is typically taxed by the host country without limitation[11] except in special cases specified in the treaty, such as situations involving, *inter alia*, students and trainees,[12] and diplomatic staff.[13]

In cases where tax treaties grant both countries the right to tax the income (with or without a limitation on the rates of taxation at source), they often provide a mechanism for alleviating double taxation. The model treaties suggest either a credit for taxes paid in the source country (the mechanism more commonly opted for by treaty signatories) or an exemption for income that is taxed by the source country.[14]

Some treaties offer some host countries (typically developing countries) a "tax sparing mechanism." Under a tax sparing mechanism, the host countries' incentive programs (designed to attract foreign investors) are ignored by residence countries.

[9] OECD Model Convention, art.7
[10] OECD Model Convention, art 5 (defining permanent establishment)
[11] OECD Model Convention, art 15.
[12] OECD Model Convention, art 20.
[13] OECD Model Convention, art 19.
[14] OECD Model Convention, arts 23A, 23B.

Instead, residence countries provide their residents credits for taxes they would have paid to the host country if not for the specially targeted concessions. Such mechanisms serve to reduce the total level of taxation on foreign investments subject to the treaty, thereby increasing the level of cross-border investment and the benefits derived therefrom by the host country. It is important to note that the residence country not only foregoes the tax revenues it would have collected absent the credit, but also allows a higher level of outbound investment into the host country than it would ordinarily prefer. Under the assumption that the unilateral position taken by a residence country generally promotes its national interests, the tax sparing mechanism indicates that the residence country is willing to forego some of the domestic, social, and economic benefits that might otherwise derive from a lower level of outbound investment.

2. The Distributive Consequences of Tax Treaties

There are important similarities, but no less significant differences, between the equilibrium achieved by tax treaties and the alternative unilateral equilibria described above. Although treaties are as capable of preventing double taxation and achieving the same moderate level of taxation as a credit mechanism (or, when the treaty assigns jurisdiction to the host country, the same level of taxation as under an exemption mechanism), the equilibrium reached under treaties differs from both the credit/tax equilibrium and the exemption/no tax equilibrium. The main difference is in the way in which the tax revenues are distributed.

Treaties provide residence countries with a larger slice of the revenue pie than do the unilateral mechanisms described above. Due to the reduction in the host country's tax rates (to a certain extent) and in light of the fact that jurisdiction to tax in certain tax categories is granted solely to the residence country, the host country collects a smaller portion of the revenues. Although at times, treaties effect the same allocation of revenues as would be achieved by unilateral mechanisms, in many cases they do not. As described above, treaties tend to limit the tax rate a host country can impose on passive income. When a treaty adopts a credit mechanism, limiting the tax rates on passive income means that the treaty reduces the host country's share in the tax revenues. Except in cases where tax sparing is granted, such a reduction in host

country taxation does not translate into a larger volume of foreign investment, but rather amounts to no more than a revenue shift. Therefore, under the credit mechanism, the residence country collects taxes that the host country has foregone.

The difference between the treaty solution and the unilateral solution is also manifested in cases where treaties limit the jurisdiction of host countries to tax certain kinds of income, such as business income in its pre-permanent establishment phase and certain types of income from personal services. In such cases, the treaty would prevent the host country from imposing any taxes whatsoever, which would mean that the residence country would collect all of the tax revenues.

Therefore, although treaties and unilateral solutions achieve approximately the same reduction, they allocate tax revenues between the contracting states differently. Essentially, in reducing host countries' taxation, tax treaties allow residence countries to take a larger bite of the tax-revenue pie.

3. Other Consequences of Tax Treaties

In addition to their distributive consequences, tax treaties may provide the signatory countries with a number of supplementary advantages, including: improved compatibility between the tax rules of the signatory countries, assistance in tax enforcement, reinforcement of investor certainty, and strengthened general cooperation in tax enforcement among nations.

As noted, treaties can improve the compatibility between the tax rules of the co-signatories[15]. By addressing specific conflicts between the tax laws of signatory nations, treaties can improve the operation of existing unilateral mechanisms. For example, a treaty can design a set of uniform source rules for the two countries n90 and can set specific tests of residency for tax purposes. Moreover, a treaty can set forth the rules that determine the legal status of entities; and it can codify agreements with regard to which taxes are to be considered creditable. These are issues that are extremely difficult to settle on a unilateral basis.

[15] American Law Institute (A.L.I) Tax Treaties at 6.

Treaties can also increase the ability of countries to collect tax revenues. Countries may encounter practical difficulties in collecting taxes from foreign residents whose only nexus to the source country is the fact that they earned income within its territorial borders. Tax treaties allow host countries to trade the tax revenues they find difficult to collect (i.e., taxes owed by foreign investors) for tax revenues that are easier to collect (i.e., taxes owed by their own residents on their foreign activities). Such a trade-off also makes it easier for the residence country to employ a truly progressive tax system based on its residents' worldwide income. Of course, learning about the existence of such income is always going to be very problematic, but inter- nation cooperation can help in this matter as well.

An important function of tax treaties is to marshal international cooperation against tax avoidance and evasion. To this end, some treaties[16] contain rules on mutual assistance in collection of information and on mutual assistance in enforcing substantive tax rules. Most treaties include sections that concern mutual sharing of information[17] in order to help residence countries collect taxes from foreign residents and activities abroad.[18] Mutual assistance in collecting information is essential for carrying out an effective war against tax avoidance and, therefore, is considered one of the important achievements of tax treaties. Rules to this effect, however, are very hard to enforce. While each country has a clear incentive to enforce its own tax rules, it generally has no incentive to enforce collection of another country's taxes. On the contrary, foreign investors who avoid residence country taxation bypass the tax wedge, thus helping the host country to encourage more foreign investment. Countries have little interest in providing other countries with information if they have no real expectation that the latter will reciprocate in turn. Moreover, as hard as it is to ensure that another country will actually reciprocate and provide the information it has collected, it is even harder to ensure that such information will be actively collected. In contrast to the written norm of mutual assistance in collecting information routinely included in treaties, countries often, in reality, refuse to provide help in enforcing foreign taxes. On the enforcement front, it is openly stated that countries are concerned with the possibility of defection by the other side.

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[16] American Law Institute (A.L.I) Tax Treaties at 9-14.
[17] U.S. Model Income Tax Treaty art.26
[18] A.L.I.(Tax Treaties) at 477.

In addition, treaties often serve as a vehicle for establishing harmonious international relations. Treaties serve as proof of good faith and signal a certain respectability of the contracting country in the eyes of the other contracting country (and thus in the eyes of other countries). The United States, for example, used to sign tax treaties with countries as a first step towards establishing wider diplomatic relations.

And finally, treaties increase the certainty with which an individual investor can measure his tax liability in a foreign country. Treaties may help clarify existing tax rules, set limits on certain host country tax rates (as in the case of passive activities), and lower (though not eliminate) the risk of future changes to existing tax laws. Treaties also provide some administrative help for taxpayers who sometimes are able to turn to their domestic tax authorities to work their way through the foreign system. The dispute resolution mechanism provided for in most treaties tends to reassure investors that they may turn to their official representatives to negotiate a reasonable solution with the tax authorities of the other signatory country.

Surely all of these aspects of tax treaties represent a significant advantage to this mechanism and produce major incentives for countries to sign treaties. Not one of these benefits, however, is as heroic a purpose as the prevention of double taxation.

1. Symmetrical Tax Treaties

In a treaty, each signatory country serves simultaneously as a host country for foreign investment and as a residence country for its own residents. Assuming an equal level of investment by residents of Country A in Country B and by Country B's residents in Country A, neither A nor B should be concerned with the taxes they collect from each individual transaction. The taxes they lose from lowering their taxes on foreign investments (in their capacity as host country) will be offset by the taxes they collect from their own residents (in their capacity as residence country). If investment in both countries is, indeed symmetrical, the final outcome of the reduction in taxes for each of the countries is no more than a switch in the identity of the tax-collecting agent. This result may, indeed, be beneficial for both administrative and enforcement reasons.

Moreover, the other advantages of treaties - such as more compatible tax laws, improved collection of revenues, assistance in fighting tax avoidance, mutual supply of information, reduced bureaucratic burden for taxpayers, increased investor certainty, and improved foreign relations - make a treaty arrangement beneficial to both sides even though none of these important advantages is as heroic as the prevention of double taxation.

CHAPTER 7

CONCLUSION

1. Developing Countries and Tax Treaties

When a developing country enters into a treaty with a developed country, the symmetry of the treaty breaks down as each of the countries takes a dominant role. Developing countries are, more often than not, capital importers. Their outbound investments are typically insignificant in comparison to the amounts of inbound investments they receive. Therefore, in tax treaties with developed countries, the developing country will typically play the role of a host country, while the developed country will predominantly be the residence country. Thus, when a treaty reduces the taxes that the host country can collect, it necessarily reduces tax revenues available for the developing country. The treaty arrangement offers no compensation to the developing country in terms of either the level of investments (as the total level of taxation is not reduced) or the level of tax revenue on foreign income from its own residents (since the number of its residents investing abroad is insignificant).

Under these circumstances, the obvious outcome for a developing country that moves from a unilateral program to the treaty regime is that it is forced to give up tax revenues that it could have collected without attracting more investments.

Even benefits that are seemingly unrelated to whether a country is a net capital importer or exporter do not affect both countries symmetrically when the volume of cross-border investment is asymmetrical. Thus, for example, enforcement or even collection of information is much more significant for a residence country interested in taxing its residents investing abroad than for a host country. Since a host country is interested in lowering the tax burden on foreign investors, it has a strong incentive to assist foreign investors in avoiding their residence country taxes.

All this does not mean that tax treaties are not beneficial for developing countries. On the contrary, developing countries benefit from the other advantages treaties offer. Indeed, the administrative convenience, certainty, and international economic recognition the treaty regime provides may prove much more important for

developing countries than for developed countries. In other words, unlike the benefits that accrue to developed countries, the main benefits for developing countries are increased legitimacy on the international level and, at times, a more robust foreign policy. However, developing countries, unlike developed countries (which receive symmetrical benefits), must make a sacrifice in the guise of tax revenues to win these benefits.

2. Stand of Developing Countries

Developing countries do not resist a "benefit for all" solution out of some non-cooperative whim. Rather, they refuse to enter into an arrangement that may harm them in terms of the tax revenues they can collect, without improving the level of foreign investment. While developing countries may be expected to give up at least some of their tax revenues in order to encourage more foreign investment, there is no reason for them to forego tax revenues without increasing the incentive for foreign investment - which is the case when the residence country collects the tax revenues that the host gives up. Mechanisms like exemptions and tax sparing are intended to encourage more foreign investment into host countries, rather than raise their tax revenues. This is the reason why, despite the fact that tax sparing does not harm the revenues of the residence country from a single transaction, developed countries are not thrilled to grant it.

Tax treaties are an important mechanism for a host of good reasons. Treaties coordinate the rules of their signatories, they provide some certainty for investors and ease their bureaucratic hassle, and they may even assist in collecting information and in establishing diplomatic relations between countries. But tax treaties are not required to prevent double taxation.

Treaties are not necessary for preventing double taxation because unilateral mechanisms could alleviate double taxation just as effectively. Residence countries, as well as host countries, share a strong incentive to alleviate double taxation unilaterally. The interaction of their unilateral mechanisms creates a stable equilibrium under which double taxation is prevented. Although the unilateral equilibrium reduces double taxation to the same extent and as effectively as the treaty

arrangement, the two mechanisms differ in the way in which they allocate tax revenues between the signatory countries.

From this we can conclude that the function of preventing double taxation attributed to tax treaties is highly overrated.

Countries do enjoy administrative, economic, political, and social benefits from signing treaties, even if such treaties are not necessary to alleviate double taxation. The costs of these benefits differ though, depending on whether the country is a developed or a developing country. Developed countries do not have to pay any price above what they would pay unilaterally for the benefits of the treaty. Developing countries, however, have to sacrifice more.

India can benefit from China's experience. Operationally, the Chinese model is not very applicable to the economies of Eastern Europe or the former Soviet Union. These countries have largely rejected the planning model, which has remained an integral part of the Chinese development strategy. The countries in Eastern Europe have already evolved far closer to the market model than China. The countries emerging out of the former Soviet Union, on the other hand, are still struggling with the problem of macroeconomic stabilization. The country for which the Chinese experience is most relevant is India.

Both are highly populous and, by developing-country standards, large economies. They began their development process approximately at the same time and stressed self-reliance. Both relied increasingly heavily on import substitution policies and ended up with a highly capital intensive production structure. China changed course in 1979 while India continued (with modest liberalization) on the old course.

In 1991, in many ways, India stood where China stood in 1979. The trade-to-GDP ratio was the same as China's in 1979. Import and investment controls were rampant and the domestic currency was overvalued. Despite these similarities, even in India's case, lessons from China are limited. In addition to the obvious differences in political systems which lead to very different political-economy processes in the two countries, there are three reasons for this.

First, the Chinese approach has been highly interventionist. This approach can be successful--as it has been in China and elsewhere in East Asia--provided the government can implement "right" interventions judiciously. India's experience during the last four decades in this respect has not been encouraging.

Second, India's economy has already evolved far closer to a market economy than that of China. For instance, export targets and foreign exchange contracts, which have arguably helped create a pro-exports ethos in China are neither desirable nor feasible in India. Similarly, private sector plays a far greater role in India than in China.

Finally, India has already carried out many reforms that China is still contemplating. For example, in the area of exchange rate, China has a multiple exchange rate system and its exchange market is not organized along the lines of market economies. India has achieved virtual current account convertibility and its foreign exchange market is organized along modern lines.

Of the lessons that have general relevance to India, the following points would seem to be the most pertinent.

First, creating a liberal and flexible economic environment along the lines of SEZs in China would stimulate greater foreign investment. The country can begin with a small number of cities--e.g., Bombay, Bangalore, Cochin, and Madras--and, as in China, local governments may be given full authority to approve foreign investment up to a certain limit. Most important, rules of entry and exit in the zones can be made more flexible. Because these zones will be introduced in limited areas with a high growth potential, political consensus may be easier, even if this requires new legislation. Eventual success in the open zones may open the way for political consensus on a wider scale. Currently, India does have export processing zones. But the geographical area over which such zones operate is far too limited to allow for the full play of liberal policies and make them focal points of investment activity.

Second, provision of infrastructure facilities through active participation of local authorities in the reform process is critical. In the fast growing provinces in China, local authorities--especially mayors of the cities--have been deeply involved in

the process of development. They try to ensure that investors get speedy clearance with respect to land use, supply of electricity, water and other facilities. In India, so far, it seems that the enthusiasm for reforms has not filtered to state governments and the center may well have to take a lead in this regard, offering both carrot and stick. All incentives and reforms at the central level can be rendered ineffective if the state and local authorities, which must provide land, power, communications facilities, and environmental clearance, do not cooperate. There is an urgent need to study carefully how such bottlenecks can be removed.

Third, there is a need for a shift in the production structure towards more labor intensive industries. The share of capital goods imports in total imports is rather small in India when compared with China and other fast-growing countries in East Asia. This, combined with the fact that India's import-to-GDP ratio is small, suggests that India is far more deeply into the production of capital goods than China and other competitor countries. In late 1970s and early 1980s, China also suffered from this problem and adopted policies to change the structure of production in favor of labor intensive goods. An important part of this strategy was targeting of a few sectors, especially for exports. For India, it is perhaps unwise to follow this route. Given the country's generally neutral and rules-based approach to reforms, it is perhaps best to rely on the standard trade policy tools, particularly the structure of tariffs. Recent reduction in tariffs on capital goods should help move the economy towards more labor intensive goods. What is needed is resistance to policies that reverse the impact of this policy change. In particular, there is need for labor-market reforms. The country will not be able to take advantage of low wages of skilled and unskilled labor unless potential investors are sure that they can operate factories around the year without fears of recurrent labor disputes. This fear has been behind the highly capital intensive technologies chosen by investors in recent years.

Fourth, duty exemptions for assembly type operations combined with rapid processing of imported inputs and materials by customs authorities made a significant contribution to China's export growth. In India, duty exemptions for exporters exist but an improvement in their administration and simplification of procedures leading to speedy processing by customs will help boost exports. Also, for small exporters

who rely on duty drawbacks, delay in getting the drawback as well as in obtaining inputs from abroad are common. An improvement in this direction is also desirable.

Fifth, it is important to note that China was welcoming of foreign investment for both domestic and foreign markets. Most of the incentives-- tax holidays, lower fees on land use, flexibility in the employment of labor etc., were available to all foreign investors. For export-oriented joint ventures, some extra incentives were provided. The lesson here is that fears of tariff-jumping type of foreign investment should not lead to erection of barriers. Instead, if the regime is to be tilted in favor of export-oriented foreign investments, it should be done through positive incentives. Imposition of barriers to foreign investment will only add noise to signals of openness that India has been sending.

A final point concerns the importance of a "Hong Kong" connection. In India's case, there are no geographic neighbors that are as economically dynamic as Hong Kong or Taiwan, Province of China. But through cultural ties, the most India can do is to attract investments from Indians in Hong Kong and Non Resident Indians (NRIs) elsewhere in the world. While this is obviously worth doing, India has to rely on a more diversified base of foreign investors.

It may be argued that to meet the East Asian challenge, investors in the United States and Europe will be increasingly looking for sources of cheap labor. With its vast pool of cheap unskilled to middle-level skilled labor, India clearly fulfills this requirement. Moreover, India's economic and political institutions are also familiar to western investors. What is needed is more open policies, transparency, and infrastructure. If this can be accomplished, India may well become the primary export base for the United States and European Community in the 21st century.

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