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Liability to Tax and Transfer Pricing in the People's Republic of China: A Comparative Analysis

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LIABILITY TO TAX AND TRANSFER PRICING IN THE PEOPLE'S REPUBLIC OF CHINA: A COMPARATIVE ANALYSIS

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Abstract: This Article explains how easy it is to become liable to People's Republic of China ("PRC") income tax, and examines the PRC transfer pricing rules. It compares China's tax regime to that of the United States and Japan, focusing both on China's domestic tax law and its treaty obligations. The purpose of this comparison is to illuminate the inter-related tax rules between China and the United States, and China and Japan. The Article also explains how China has modernized its tax system in line with its economic liberalization, and points out areas of uncertainty regarding China's rules on tax liability and transfer pricing.

CONTENTS

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I. INTRODUCTION

This Article will examine two key tax issues to be considered when a company is involved in any transaction with or investment in the People's Republic of China ("PRC"): (1) liability to tax, that is to say the economic/physical nexus that the PRC considers sufficient to support its claim to levy income tax; and (2) transfer pricing, which is really an investigation of the powers that the PRC has reserved itself to regulate intra-group profit allocations. Both of these issues are concerned with maintaining adequate income levels (and thereby taxation revenues) in the PRC. Neither of these rules is unique to the PRC.

The PRC legal system is based on civil law. It does not recognize the principle of *stare decisis*, and its judicial decisions are of limited value. Thus, unlike the Anglo-American system in which caselaw is essential in order to understand the system and to fill in gaps in legislation, an examination of PRC tax rules is only a statutory endeavor. The relevant PRC enactment is *The Income Tax Law of the PRC for Enterprises with Foreign Investment and Foreign Enterprises*[1] (hereinafter the Unified Income Tax Law, or "UTL"). This enactment is itself relatively brief, consisting of only thirty articles, but is supplemented by *Detailed Rules for the Implementation of the Income Tax Law of the PRC for Foreign Investment*

[1] Zhonghua renmin gonghe guo waishang touzi qiye he waiguo qiye suode shuifa (Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises), National People's Congress (Apr. 9, 1991) [hereinafter UTL], *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-505 (CCH Int'l 1993).

Enterprises and Foreign Enterprises ("UTL Regulations").[2] Also of importance in this area is the *Law of the PRC to Administer the Levying and Collection of Taxes* ("ATC").[3] Once again, this enactment is comparatively brief, consisting of sixty-two articles, but is supplemented by *Detailed Rules for the Implementation of the Law of the PRC on the Administration of Taxes* ("ATC Regulations").[4] In addition to legislation, reference must also be made to relevant Notices and Measures as issued from time to time by the Ministry of Finance, which interpret the law.[5] Since the relevant legislation is young, there are comparatively few Notices and Measures.

In order to appreciate the PRC legislation in the international context, this Article will refer to, in turn, similar provisions in the laws of the United States and Japan. The United States is considered by many to have the most sophisticated tax system in the world, a common law system that extends its tentacles to tax American businesses both at home and abroad. Japan, presently the largest Asian trading nation, has also developed sophisticated tax rules in the area of international transactions.

The comparison of China's tax laws with those of the United States and Japan is driven by economic reality. Since embarking on its economic liberalization program in the late 1970s, the PRC has become a significant force in world trade and a major destination for the world's investment capital. The United States and Japan are two of the PRC's largest trading and investment partners. There is a growing economic interdependence amongst these three countries which makes the study of their tax systems very pertinent. This Article analyzes the PRC tax legislation with reference to liability to tax and transfer pricing. It reviews the tax legislation in the United States and Japan, compares that legislation to the PRC legislation, and finally looks at the tax treaty obligations existing between the PRC and

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2 Zhonghua renmin gongheguo waishang touzi qiye he waiguo qiye suode shuifa shishi xize (Detailed Rules for the Implementation of the Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises), State Council (June 30, 1991) [hereinafter UTL Regs.], *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-507 (CCH Int'l 1993).

3 Zhonghua renmin gongheguo shuishou zhengshou guanlifa (Law of the People's Republic of China to Administer the Levying and Collection of Taxes), National People's Congress (Sept. 4, 1992) [hereinafter ATC], *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 39-620 (CCH Int'l 1993).

4 Zhonghua renmin gongheguo shuishou zhengshou guanlifa shishi xize (Detailed Rules for the Implementation of the Law of the People's Republic of China to Administer the Levying and Collection of Taxes), State Council (Aug. 4, 1993) [hereinafter ATC Regs.], *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 39-622 (CCH Int'l 1993).

5 Notices and Measures are issued sporadically by the PRC tax administration. These are directed to various PRC government departments, such as provincial tax bureaus or finance departments. Some of these Notices and Measures are published, but most are only for internal government circulation.

the United States, and between the PRC and Japan. The Article also compares these treaty obligations with the PRC's domestic obligations.

Following this exercise, several points will be evident. First, since the publication of the first PRC tax law concerning foreign investment, PRC tax legislation has matured rapidly and now has many of the characteristics of a developed tax system. Second, large areas of uncertainty remain concerning vital PRC tax issues. Finally, despite an array of tax incentives, the PRC domestic law has reserved to the PRC government broad taxing power. Moreover, in the international context, the PRC has successfully negotiated the retention of much of its taxing power, thereby retaining the mechanism necessary to prevent revenue leakage to the United States and Japanese tax authorities.

II. LIABILITY TO TAX

A. *Background*

A primary concern for a person who is doing business with the PRC, or establishing business operations in the PRC, is when and how one can become liable to PRC tax. Generally speaking there are two ways to become liable to a tax regime: either one has a sufficient presence in or physical nexus with the country concerned to be taxed on a net income basis as a resident ("physical presence taxation"), or one derives income from a taxable source within the country without having a taxable presence in the country, thereby incurring a withholding tax ("source-based taxation"). Although it is unique in many other ways, the PRC tax system uses both of these methods of tax liability. This part of the Article will examine these two forms of tax liability, source-based taxation and physical presence taxation, in the PRC domestic context. In each instance the PRC law will be compared and contrasted with the rules in the United States and Japan. Thereafter the PRC's tax treaties with the United States and Japan will be examined and compared to each other and with the PRC domestic rules.

B. *Source-Based Taxation in the PRC*

Prior to the enactment of the FEIT in 1991, there were two separate tax laws for foreign-related business in the PRC, the *Income Tax Law of the*

PRC Concerning Joint Ventures[6] (hereinafter Joint Venture Income Tax Law, or "JVITL") and the *Income Tax Law for Foreign Enterprises*[7] (hereinafter Foreign Enterprise Income Tax, or "FEIT"), the latter prescribing source-based taxation within the PRC. The FEIT generally provided that certain PRC sourced income would be taxed by a 20% withholding at source in the PRC.[8] The PRC authorities have carried over this approach into the UTL, which provides that where a foreign enterprise has no establishment or place in the PRC, income that it derives from sources within the PRC, including interest, rental, royalty, profit and other income, is taxed at the rate of 20% of the gross payment.[9] Although tax must be withheld by the payor, the tax itself is borne by the recipient; and since the tax is on the gross income, the recipient is not entitled to deduct any expenses incurred to produce that income. If the taxpayer has an establishment or place in the PRC, but the income is not actually connected with such establishment or place, this withholding regime also applies.[10]

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6 Zhonghua renmin gonheguo zhongwai hezi jingying qiye suode shuifa (Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment), National People's Congress (Sept. 10, 1980), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 800910.1 (Institute of Chinese Law 1987).

7 Zhonghua renmin gongheguo waiguo qiye suode shuifa (Income Tax Law for Foreign Enterprises of the People's Republic of China), National People's Congress (Dec. 13, 1981) [hereinafter FEIT], *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 811213 (Institute of Chinese Law 1987).

8 *Id.* art. 11.

9 UTL, *supra* note 1, art. 19. Although interest on loans to the PRC government or state banks by certain international financial organizations may be entitled to exemption. *Id.* art. 19(2). A loan made by a foreign bank to a PRC state bank at a preferential rate of interest is also eligible for exemption from this withholding tax. *Id.* art. 19(3). Although there is no indication in the FEIT or the FEIT Regulations as to what may constitute a preferential rate of interest, guidance may be found in regulations regarding interest payments. *See* Zhonghua renmin gongheguo caizhengbu guanyu waishang cong woguo suode de lixi youguan jianmian suodo shui de zhanxing guiding (Provisional Regulations of the Ministry of Finance Regarding the Reduction and Exemption of Income Tax Relating to Interest Earned by Foreign Businesses From China), Ministry of Finance (Jan. 1, 1983) [hereinafter Earned Interest Regs.], *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-600 (CCH Int'l 1993). The regulations provide for the provisional exemption of interest income on loans made to Chinese state banks and various other entities where the rate of interest is equivalent to international interbank loans. Earned Interest Regs. art. 2.

10 The exact nature of the connection required is open to some debate. The original Chinese text refers to "shiji lianxi de," which translates roughly as *related/connected in reality* or *according to practical experience*. Some translators omit the exact nature of the connection required, such as in *China Law & Practice*, which translates the provision as simply "[where income is derived] in a manner unconnected with their establishment or sites . . . ." CCH International translates the provision in Americanized tax parlance to read "[where the income] is not *effectively* connected with such establishment or place . . . ." (italics added.) UTL, *supra* note 1, art. 19. *See also* COMMERCIAL BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA, Booklet 5 at 38 (Owen D. Nee ed., 1991) (translating UTL art. 19 to read "[where] income has no *real* connection with such establishment . . . .") (italics added)). I prefer the translation "actually connected."

In the absence of clear guidelines, either in legislation or by way of General Tax Bureau notice or measure indicating how "actually connected" is to be interpreted, it is unclear what nexus is required between the taxpayer's activities in the PRC and the income derived. No regulations have been promulgated to clarify this point. Neither the Provisional Regulations of the Ministry of Finance of the PRC Providing for the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology[11] nor New Tax Regulations Governing Income Received by Foreign Businesses from Transferring Copyright on Audio-Visual Products[12] deal with this issue.

The types of income to which the withholding tax system applies are further defined in the UTL Regulations, where "profit" is defined to include income from shares or investment contribution[13] and other non-claim profit sharing rights.[14] "Other income" is defined to include income from the transfer of real property rights or land use rights.[15] Since these are inclusive definitions, additional types of profit or other income may well be taxable.

Although it does not specifically define the term "royalty," the UTL Regulations treat drawing and information fees, technical service fees, personnel training fees, and other related fees as royalties.[16] Furthermore, the UTL and the UTL Regulations seem to be cast wide enough to encompass both recurrent (revenue) licensing payments made by a PRC party to a foreign licensor and one-off payments made for the (capital) purchase of intellectual property.[17] Note that this is not exactly the western concept of

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11 Zhonghua renmin gongheguo caizhengbu guanyu dui zhuanyou jishu shiyongfei jianzheng mianzheng suode shui de zhanxing guiding (Provisional Regulations of the Ministry of Finance of the People's Republic of China Regarding the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology) (Jan. 1, 1983), *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 39-600 (CCH Int'l 1993).

12 Guojia shuiwuju zuochu waishang yinxiang panquan shuishou xin guiding (New Tax Regulations Governing Income Received by Foreign Business from Transferring Copyright on Audio-visual Products), General Bureau of Taxation (Sept. 1, 1990), *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-684 (CCH Int'l 1993).

13 UTL Regs, *supra* note 2, art. 60.

14 *Id.*

15 *Id.* art. 61.

16 *Id.* art. 59.

17 Technology import contracts are defined broadly under the relevant Chinese contract law, but the law provides little guidance on tax treatment. *See* Zhonghua renmin gongheguo jishu yinying hetong guanli liaoli shixing xize (Detailed Rules for the Implementation of the Administrative Regulations of the People's Republic of China on Technology Import Contracts), arts. 2, 16, Ministry of Foreign Economic Relations (Dec. 30, 1987) [hereinafter Detailed Rules on Technology Import Contracts], *translated in* 1 CHINA LAWS FOR FOREIGN BUSINESS: BUSINESS REGULATION ¶ 5-573 (CCH Int'l 1993) (stating that suppliers of technology must "pay tax in accordance with the provisions of the taxation laws of the

royalty, which is generally considered a fee for the use of proprietary technology and information, usually paid pursuant to the terms of a license agreement.[18]

PRC withholding tax can be reduced or waived in certain defined situations, one of the most important of which is the total exemption from tax allowed where the income is profit derived by a foreign investor from an enterprise with foreign investment.[19] In other words, what would amount to dividends from equity joint ventures, and other profit distributions from cooperative joint ventures and wholly foreign owned enterprises, can be made free from this withholding tax.[20] Pursuant to a July 1993 ruling of the State Tax Bureau, dividends paid to foreign investors on "B" shares issued by companies on the PRC's fledgling stock exchanges can (temporarily) be made free of dividend withholding tax as well.[21] Withholding tax on interest can be reduced in certain situations.[22] Finally, the withholding tax

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People's Republic of China." *Id.* art. 16.) The UTL Regulations impose a withholding tax on payments for the *supply* of proprietary technology. UTL Regs., *supra* note 2, art. 59.

In most of the rest of the world ownership of technology is separated from the licensing of technology, and ownership rests with the licensor until he decides to sell it. In the PRC ownership of technology licensed to a PRC party pursuant to a technology import contract generally becomes the property of the PRC on expiry of the license, so in that way a technology import contract is similar to a time sale. *See* Detailed Rules on Technology Import Contracts, art. 15 ("Unless approval has been obtained from the examining and approving organ, a contract shall not include provisions prohibiting the recipient from continuing to use technology after the expiry of the contract term."). Most foreign licensors negotiate an initial fee or series of fees, paid on an agreed timetable before the commencement of production, into which is factored the capital cost of the intellectual property being transferred. In practice this initial fee (or "one-off payment") is not characterized as a royalty. Were a foreign licensor to neglect to negotiate this initial fee and attempt to recoup the capital cost of its intellectual property prorated over the life of the license agreement and paid with the recurrent license fee, it would seem that this element would constitute a taxable royalty pursuant to the UTL.

18 *See, e.g.*, United Nations Model Double Taxation Convention Between Developed and Developing Countries, 1979, art. 12(2), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS 541, 555-56 (Walter H. Diamond & Dorothy B. Diamond eds., 1992) [hereinafter U.N. Tax Treaty]; Revised Model Convention of the Organization for Economic Cooperation and Development for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, Apr. 1977, art. 12(2), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS 481, 486 (Walter H. Diamond & Dorothy B. Diamond eds., 1978) [hereinafter OECD Tax Treaty] (defining royalty as the payment for the "use of, or right to use" intellectual property). Profits on the alienation of intellectual property are ordinarily taxed as capital gains. *Id.* art. 13. Admittedly it is often difficult to distinguish between royalty and capital gain, since sale of the intellectual property rights will invariably include the right to use the intellectual property.

19 UTL, *supra* note 1, art. 19(1).

20 *Id.*

21 Guojia shui wuzongju guanyu waishang touzi qiye, waiguo qiye he waiji geren qude gupiao (guquan) zhuanrang shouxi he guxi suode shui shou wenti de tongzhi (Notice Concerning Taxation of Income from Stock (Share Right) Transactions and Dividends Received by Foreign Investment Enterprises, Foreign Enterprises, and Foreign Nationals), art. 2(2), State Administration of Taxation (July 21, 1993), *translated in* CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-706 (CCH Int'l 1993).

22 UTL, *supra* note 1, art 19(2), (3). See also *supra* note 9 regarding interest provisions.

on royalties may be reduced or waived where the royalty is paid for the supply of intellectual property which is required by the PRC for scientific research or to better exploit its energy, agricultural, forestry, or animal resources; and withholding tax may also be waived or reduced where the technology is advanced or the terms on which it is provided are preferential.[23]

Despite these tax reductions and waivers, it is clear that the PRC has cast a very wide tax net. Thereafter, tax on certain types of income is either reduced or waived, according to various policy considerations. For example, in keeping with the policy of encouraging foreign investment, withholding tax on dividends or profits from foreign investments are waived; and royalty payments for needed technology are advantaged by reduction or waiver of the withholding taxes that would otherwise apply.

C. Source-Based Taxation in the United States and Japan

1. The United States

Tax liability in the United States is closely tied to the concept of income source. Thus, non-residents and foreign corporations, even if not engaged in a U.S. trade or business,[24] are still required to pay tax on their so-called fixed or determinable annual or periodic ("FDAP") income from U.S. sources.[25] Such FDAP income is subject to a 30% withholding tax. The types of income reached by this tax include interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and other fixed or determinable annual or periodic gains, profits and income.[26] Gains from the sale of intellectual property, to the extent paid for through contingent payments, are also included in FDAP income.[27] Even though the U.S. definition of U.S. source income fails to enumerate certain obvious kinds of income, such as one-off or fortuitous payments, the rule has been interpreted very broadly to include almost all income and gains.[28] One

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[23] UTL, *supra* note 1, art. 19(4); UTL Regs., *supra* note 2, art. 66. These reductions/exemptions are at the discretion of the PRC tax authorities.

[24] I.R.C. § 864(b) (CCH 1993).

[25] I.R.C. §§ 871(a)(1)(A), 881(a)(1).

[26] Treas. Reg. § 1.1441-2(a), -2(b) (as amended in 1984).

[27] I.R.C. § 871(a)(1)(D).

[28] *See, e.g.*, Rev. Rul. 89-33, 1989-9 C.B. 269 (U.S. partnership required to withhold tax on undistributed amounts of foreign partner's distributive share of fixed or determinable annual or periodic income); A. Uno Lamm, P-H T.C.M. ¶ 75,095 (1975) (Swedish national, resident in United States, must

author posits that the best way to understand the rule is to assume that all kinds of gross income are taxable, except as excluded.[29]

Excluded from the 30% withholding tax are a number of items, including interest paid by U.S. banks on deposit accounts;[30] interest on certain portfolio investments (with a few exceptions);[31] gains from the sale or retirement of original issue discount debt securities maturing in 183 days or less;[32] and gains on the sale of capital assets located in the United States, including stock[33] (but only if the taxpayer is not physically present in the United States for more than 182 days in the tax year).[34] Finally, gains on the sale of U.S. real estate are treated as income from a U.S. trade or business and taxed on a net basis.[35]

Even if the non-resident or foreign corporation is engaged in the conduct of a U.S. trade or business, the U.S. withholding tax will still apply to U.S. source FDAP income that is not "effectively connected"[36] with that U.S. trade or business.[37] The definition of effectively connected income is of fundamental importance to this system. Two alternative tests are used to determine whether income is effectively connected with the conduct of a U.S. trade or business. First, if the income is earned from assets which are "used or held for use" in the conduct of a U.S. trade or business, the income will be considered effectively connected income and not subject to the U.S. withholding tax system.[38] Second, if the taxpayer's U.S. trade or business is considered to be a material factor in the generation of the income, then the income will be considered effectively connected income, and not subject to the U.S. tax withholding system.[39]

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deduct and withhold U.S. taxes from alimony payments to nonresident alien ex-wife, since payments were U.S. source income); Rev. Rul. 71-142, 1971-1 C.B. 265 (interest paid to foreign brokerage for a margin account subject to withholding); Rev. Rul. 80-362, 1980-2 C.B. 208 (withholding required on patent royalties).

29 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ¶ 8.4 (1990) ("[T]he best way to understand [the fixed and determinable income tax rule] is as a ritualistic statement reaching every kind of gross income not excluded . . . .").

30 I.R.C. §1441(c)(10).

31 I.R.C. § 1441(c)(9).

32 I.R.C. § 1441(c)(8); Treas. Reg. § 1.1441-3(c)(6) (as amended in 1984).

33 I.R.C. § 871(a)(2).

34 *Id.*

35 I.R.C. § 897(a)(1).

36 I.R.C. § 864(c).

37 I.R.C. §§ 871(a)(1), 881(a).

38 I.R.C. § 864(c)(2)(A).

39 I.R.C. § 864(c)(2)(B).

Unlike the PRC rules relating to source taxation, the U.S. rules are very detailed. As a consequence both of the long history of the United States as a host for foreign capital and investment, and the peculiar fascination of Americans with fiscal detail, the U.S. tax code and regulations are some of the world's most complicated. Surprisingly, it appears that the U.S. casts a smaller source tax net than the PRC in certain respects. A non-resident who does not carry on a U.S. trade or business can earn certain types of income from U.S. sources without exposure to U.S. tax.[40] As noted above, interest from deposit accounts with U.S. banks[41] or portfolio interest earned by a non-resident who does not carry on a U.S. trade or business[42] do not involve U.S. tax exposure. In similar circumstances such income from the PRC may well involve PRC tax exposure. But it is clear that the PRC tax authorities wrote their tax laws with some regard to the U.S. laws, especially with respect to the concept of effectively connected income, and the exemption from withholding tax where income is effectively connected with a business in the country. The PRC's "actually connected" test, as described in Part II.B above, appears very similar to the "effectively connected" test used in the United States, although the latter is much more thoroughly defined in U.S. tax law.

2. *Japan*

Japan is also a civil law country, and therefore its tax rules are, like those of the PRC, exclusively statute-based. Foreign corporations with a permanent establishment[43] in Japan are generally subject to Japanese tax on income from Japanese sources.[44] Under Japanese domestic law, most items of income paid to a nonresident individual or a foreign corporation without a permanent establishment in Japan are subject to withholding tax at a rate of 15%.[45] The Japanese tax system goes into a great deal of detail itemizing each particular kind of income and prescribing its treatment. Such items of

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[40] See *supra* notes 30-34 and accompanying text.

[41] I.R.C. § 1441(c)(10).

[42] I.R.C. § 1441(c)(9).

[43] Hojinzeihō (Corporation Tax Law) art. 141(i)-(iii) [hereinafter Japanese Corporate Tax Law], *translated in* JOHN HUSTON ET AL., JAPANESE INTERNATIONAL TAXATION CTL-1 (Toshio Miyatake trans., 1994).

[44] *Id.* art. 141.

[45] Shotokuzeihō (Income Tax Law) art. 179, 213(1)(iii) [hereinafter Japanese Income Tax Law], *translated in* JOHN HUSTON ET AL., JAPANESE INTERNATIONAL TAXATION ITL-1 (Toshio Miyatake trans., 1994).

income include interest or income similar in nature to interest income, including profits from the redemption of discounted debentures issued in Japan;[46] dividends from a Japanese domestic corporation;[47] royalties paid for the use of intellectual property in a Japanese business;[48] rent for the use of real property situated in Japan,[49] or industrial or commercial equipment used by an enterprise in Japan;[50] and annuities paid on contracts concluded with offices or agents in Japan.[51] Other items of income subject to withholding tax at a rate of 20% include salaries or similar remuneration paid to an employee for personal services performed in Japan, or remuneration paid to an individual for independent personal services performed in Japan, or remuneration for furnishing performances of public entertainers or professional or technical services; and retirement allowances or pensions paid for past personal services performed in Japan.[52]

In line with most other countries, Japan taxes real property gains even where those gains are earned by nonresident individuals or corporations that do not have a permanent establishment in Japan. A 10% withholding tax applies to payments made to nonresident individuals or foreign corporations on the sale of Japanese real estate, unless the value of the real estate is 100 million yen or less and is for use as the purchaser's family residence.[53]

The Japanese tax system is similar in structure to that of the PRC. Sharing the civil law approach to tax, items of income subject to source taxation are exhaustively listed and their tax treatment codified. But unlike the PRC, Japan does not have an array of withholding tax reductions or waivers. Clearly Japan does not now need to use its tax system to promote foreign investment in its industrial development.

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[46] *Id.* art. 161(iv); Japanese Corporate Tax Law, *supra* note 43, art. 138(iv).

[47] Japanese Income Tax Law, *supra* note 45, art. 161(v); Japanese Corporate Tax Law, *supra* note 43, art. 138(v).

[48] Japanese Income Tax Law, *supra* note 45, art. 161(vii)(a), (b); Japanese Corporate Tax Law, *supra* note 43, art. 138(vii)(a), (b).

[49] Japanese Corporate Tax Law, *supra* note 43, art. 138(iii).

[50] Japanese Income Tax Law, *supra* note 45, art. 161(vii)(c), (i), (ii); Japanese Corporate Tax Law, *supra* note 43, art. 138(vii).

[51] Japanese Income Tax Law, *supra* note 45, art. 161(x); Japanese Corporate Tax Law, *supra* note 43, art. 138(ix).

[52] Japanese Income Tax Law, *supra* note 45, art. 161(viii).

[53] *Id.* arts. 213(i), (ii), 161(i), (ii).

C. *Effect of Tax Treaties on PRC Source Taxation*

1. *Reduction of Withholding Taxes*

The PRC's tax treaties with the United States and Japan generally reduce withholding taxes on dividends, interest, and royalties to 10%.[54] The reduction of PRC dividend withholding tax is of limited importance to most investors, since, as indicated in Part II.B above, the PRC does not impose any withholding tax on profit distributions (dividends) derived by a foreign investor from an enterprise with foreign investment.[55] Both treaties cede taxing authority regarding the use of real property to the state where the property is situated.[56] The U.S.-PRC treaty also cedes the taxation of other income to the state from which that income arises.[57] In the case of the PRC-Japan treaty, this provision is restricted to income from immovable property.[58]

Both of the tax treaties define royalties as payments for the use of, or right to use, intellectual property.[59] Note that this is the right to use the intellectual property, not the purchase of the same. Given this definition, the capital element of payments made pursuant to technology transfer contracts, which are in the nature of time sales payments, will not qualify for reduced rates of withholding taxes pursuant to this article. This capital element usually constitutes a significant portion of the total payments, and is usually paid for through an initial fee or series of fees prior to production.

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54 Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, U.S.-China, arts. 9-11, 23 I.L.M. 677, 686-90 [hereinafter U.S.-China Tax Treaty]; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, P.R.C.-Japan, arts. 10-12, 23 I.L.M. 120, 128-31 [hereinafter China-Japan Tax Treaty].

55 *See supra* notes 19-20 and discussion; UTL, *supra* note 1, art. 19(1).

56 U.S.-China Tax Treaty, *supra* note 54, art. 6, 23 I.L.M. at 683; China-Japan Tax Treaty, *supra* note 54, art. 6, 23 I.L.M. at 125-26.

57 U.S.-China Tax Treaty, *supra* note 54, art. 21, 23 I.L.M. at 695-96.

58 China-Japan Tax Treaty, *supra* note 54, art. 22(3), 23 I.L.M. at 136.

59 For example, art 11(3) of the U.S.-China tax treaty defines royalties to mean payments of any kind received as a consideration for the use of, or right to use, any copyright or literary, artistic or scientific work, including cinematographic films or films or tapes used for radio or television broadcasting, any patent, technical know-how, trademark, design or model plan, secret formula or process, or for the use of, or right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. U.S.-China Tax Treaty, *supra* note 54, art. 11(3), 23 I.L.M. at 689.

2. *Effect of Tax Treaties on the Tax Base of the PRC*

One of the purposes of a tax treaty is to reduce taxes on income and capital which would otherwise be imposed on residents of a treaty partner by the domestic law of the host state. The UTL provides that where the provisions of a tax treaty concluded between the PRC and a foreign government differ, the provisions of the treaty apply.[60] However, the PRC appears to have given up little revenue by way of reduction of its withholding taxes in these two tax treaties. There are some minor reductions, but the PRC has ceded much more tax revenue through unilateral domestic tax reductions and waivers than it has done pursuant to these treaties. Furthermore, at article 21 of the PRC-U.S. treaty the PRC has negotiated broad rights for the state of source to tax income arising in its territory. This article, which is modeled after article 21 in the United Nations Model Tax Treaty,[61] gives the state of source of the income the coterminous right to tax income not otherwise specifically dealt with in the treaty. This is a very important provision, because it allows income which is not otherwise specifically dealt with in the tax treaty (and there may be a significant amount of such income, as not all types of payments can be foreseen in advance) to be taxed in the state of source. This provision favors the less developed treaty partner, since that party is more likely to play host to the economic activity of the more developed treaty partner. Treaty partners are able to take advantage of this provision by enacting broad-based domestic source taxation.

The PRC has broad-based domestic source taxation, and therefore can take full advantage of article 21 of the PRC-U.S. tax treaty. Article 19 of the UTL, examined in Part II.B above, is very broadly drafted such that it could apply to tax practically any profit. It applies to tax all imaginable types of passive income, including profits, interest, rental, royalty, and other income from sources in the PRC.[62] As a result, any income that is not specifically mentioned in this tax treaty falls to be taxed in accordance with the equivalent of article 21, in which case the PRC domestic tax law applies, which in turn will apply to tax almost any conceivable profit sourced in the PRC. Notably, it appears that the Japanese tax treaty negotiators were able

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60 UTL, *supra* note 1, art. 28.

61 U.N. Tax Treaty, *supra* note 18, art. 21, *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 561.

62 UTL, *supra* note 1, art. 19. *See also* UTL Regs., *supra* note 2, arts. 60-61 and discussion at Part II.B.

to negotiate the relinquishment of the right to tax other income not connected with real property to the state of residence of the taxpayer.[63]

II. LIABILITY TO TAX: PHYSICAL PRESENCE

A. *Physical Presence Taxation in the PRC*

The UTL imposes net tax on foreign companies that have a physical presence in the PRC on their taxable income from PRC sources.[64] For this purpose, foreign companies are referred to as either enterprises with foreign investment, or foreign enterprises with establishments or places in the PRC.[65] Enterprises with foreign investment are PRC entities which have some foreign capital elements. Enterprises with foreign investment that establish their head offices in the PRC will be subject to tax under the UTL on their worldwide income. This is consistent with the tax regimes of other countries such as the United States and Japan, which impose a system of worldwide taxation on companies that are incorporated or resident within their borders. On the other hand, foreign enterprises with establishments or places in the PRC are liable to tax under the UTL only on their income derived from sources within the PRC.[66]

It will not normally be difficult to confirm the existence of an enterprise with foreign investment, and once that status has been achieved, that entity will be subject to the UTL. Such vehicles include equity joint ventures, wholly foreign owned enterprises, or companies limited by shares.[67] In each case a separate PRC legal entity is established. On the other hand, it is possible to establish a foreign investment enterprise that is not itself a separate entity. This is the situation in a true Sino-foreign

63 China-Japan Tax Treaty, *supra* note 54, art. 22, 23 I.L.M. at 135-36.

64 UTL, *supra* note 1, art. 1.

65 UTL, *supra* note 1, art. 2.

66 UTL, *supra* note 1, art. 3.

67 *See generally*, Zhonghua renmin gongheguo zhongwai hezi jingying qiyefa (The Law of the PRC on Joint Ventures Using Chinese and Foreign Investment), National People's Congress (July 8, 1979), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 790708 (Institute of Chinese Law 1987); Zhonghua renmin gongheguo waizi qiyefa (Law on Enterprises Operated Exclusively with Foreign Capital), National People's Congress (Apr. 12, 1986), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 860412 (Institute of Chinese Law 1987); and Zhonghua renmin gongheguo gongsifa (Company Law of the PRC), National People's Congress (Dec. 29, 1993), *translated in* 2 CHINA LAWS FOR FOREIGN BUSINESS: BUSINESS REGULATION ¶ 13-518 (CCH Int'l 1993).

cooperative joint venture.[68] No legal person is created and the enterprise is carried on in the form of a joint venture, with both parties to the venture maintaining separate management and accounting systems. In such a case the foreign party is regarded as a foreign enterprise with an establishment or place in the PRC, and taxed accordingly.[69]

A more difficult determination is whether a foreign enterprise *acting on its own* has an establishment or place in the PRC. This is of critical importance, because in the absence of an establishment or place in the PRC, tax will be levied on a gross withholding basis.[70] Unfortunately, the section of the UTL which imposes source withholding tax does not define the term "establishment or place" for its purposes. However, the term "establishment or place" does appear elsewhere in the UTL,[71] and is defined in the UTL Regulations for those purposes to include administrative organizations, business organizations, representative offices, factories, places where natural resources are exploited, places where construction, installation, assembly, exploration and other contract projects are undertaken, places where labor services are provided, and business agents.[72]

Little difficulty arises from much of this definition, as it is normally easy to determine, for instance, whether one has a factory in the PRC. Similarly straightforward is a branch,[73] or a representative office which is akin to a liaison office in many other countries,[74] both of which contemplate

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68 *See generally,* Zhonghua renmin gongheguo zhongwai hezuo jingying qiyefa (The Law of the PRC on Sino-Foreign Cooperative Enterprises), National People's Congress (Apr. 13, 1988), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 880413.1 (Institute of Chinese Law 1987).

69 For the State Taxation Bureau's position on this matter, see Guanyu guanche zhixing shewai qiye suode shui fa ruogan yewu chuli wenti de tongzhi (Operational Problems in the Thorough Implementation of the Foreign Related Enterprise Income Tax Law), ¶ 4, Dec. 23, 1991, *translated in* CHINA LAW & PRACTICE, Feb. 27, 1992.

70 UTL, *supra* note 1, art 19.

71 *Id.* art. 2(2).

72 UTL Regs, *supra* note 2, art. 3.

73 Company Law of the PRC, *supra* note 67, arts. 199-205.

74 The scope of activities of a representative office is limited to support services such as gathering information, serving as liaison to the head office and similar activities; technically it cannot engage in profit-making activities. However, in recognition that some representative offices perform profit-making activities, in 1985 the PRC issued rules regarding their taxation. *See* Zhonghua renmin gongheguo caizhengbu dui waiguo qiyechang zhudaibiao jigou zhengshou gongshang tongyishui, qiye suode shui de zhangxing guiding (Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Business Income Tax from China-based Foreign Companies) (May 15, 1985), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 850515 (Institute of Chinese Law 1987). Where a representative office serves as liaison, or performs negotiation or agency services within the PRC or receives funds on behalf of its head office for those services; or where the representative office receives payment for information or consulting services, the office will be subject to tax. *Id.* art. II. Furthermore,

registration with the relevant PRC authorities. Factories, mines, oil-wells, assembly operations, and the provision of services are matters of fact, and one can accept that, if one is involved in these activities, one will have an establishment or place within the meaning of the UTL.[75] Of more concern are items such as administrative organizations, business organizations, and business agents. Unfortunately there does not seem to be a definition of administrative or business organizations in the UTL or the UTL Regulations. By way of comparison, both the OECD and U.N. model tax treaties provide that a place of management is a taxable presence.[76] Are administrative organizations and business organizations simply the PRC terminology for the tax treaty definition of "place of management"? No guidance is given.

The UTL Regulations do clarify the term "business agent," which is defined to refer to organizations or individuals who: (1) regularly represent a principal in sourcing and purchasing work, including the signing of purchase contracts, and buying goods on behalf of the foreign principal; (2) enter into an agency agreement with a foreign principal and regularly store products owned by the principal and deliver these products to other parties on the principal's behalf; or (3) are authorized to regularly represent the principal in signing sales contracts and in accepting purchase orders.[77]

It has long been accepted international tax practice to tax a non-resident company on the basis of the activities of an agent that it appoints in a host state. Both the OECD and the U.N. model tax treaties provide for such treatment.[78] However, the model treaties attribute different tax consequences to the activities of these agents on the basis of the degree of

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where the representative office is unable to provide accurate records of its profits, a deemed profit of 15% of business proceeds is provided. *Id.* art. IV.

75 The establishment of a service center for the maintenance of a foreign company's equipment or the sale of its parts, or the establishment of a contracting business such as a construction project or hotel management services, may subject the foreign company to a turnover tax as well. *See* Ministry of Finance Circular 149, July 5, 1983.

76 U.N. Tax Treaty, *supra* note 18, art. 5(2)(a), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 547; OECD Tax Treaty, *supra* note 18, art. 5(2)(a), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483.

77 UTL Regs., *supra* note 2, art. 4.

78 *See* U.N. Tax Treaty, *supra* note 18, art. 5(4), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548; OECD Tax Treaty, *supra* note 18, art. 5(4), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483-84. In certain cases, an appointed person or agent may constitute a "permanent establishment" under both treaties, which thereby triggers tax liability for business profits derived from the permanent establishment. U.N. Tax Treaty, *supra* note 18, art. 7, *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548; OECD Tax Treaty, *supra* note 18, art. 7(1), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 484.

control exercised by the offshore principal. Neither the OECD nor the U.N. model tax treaty will impute the activities of truly independent agents, such as brokers or general commission agents, to an offshore principal.[79] Even where the existence of an agent of non-independent status is demonstrated, under the model tax treaties the tax authorities must go further and demonstrate that the non-independent agent has the authority to conclude, and habitually does conclude, contracts on behalf of its offshore principal.[80] The U.N. model also provides that where a non-independent agent habitually maintains a stock of goods in the host state from which he regularly delivers goods or merchandise on behalf of the offshore principal, that non-independent agent will constitute a taxable presence (or permanent establishment) of the foreign principal.[81]

It is apparent that the definition of business agent adopted by the PRC is much wider than that found in both model treaties. Under the PRC's definition, there is little or no safety zone for independent agents. An independent agent who represents many foreign principals, but who "regularly" represents the foreign principal, would qualify as a business agent. Those same activities would not constitute a taxable presence under either model tax treaty. Entering into an agency agreement to buy merchandise for a foreign principal would also constitute a business agent under the UTL Regulations.[82] Under both the OECD and U.N. tax treaty models such activity (essentially a buying office) does not constitute a taxable presence, whether undertaken by the foreign company or an agent on its behalf.[83] In any event, how are the net profits of a PRC buying office to be ascertained, since there is only buying and no selling activity? The PRC rules are silent on such matters. If the PRC's definition is strictly enforced, it would subject any foreign company which appointed an agent in the PRC to buy or sell its goods to net tax under the UTL.

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[79] OECD Tax Treaty, *supra* note 18, art. 5(5), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483; U.N. Tax Treaty, *supra* note 18, art. 5(7), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548.

[80] OECD Tax Treaty, *supra* note 18, art. 5(4), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483; U.N. Tax Treaty, *supra* note 18, art. 5(5)(a), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548.

[81] U.N. Tax Treaty, *supra* note 18, art. 5(5)(b), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548.

[82] UTL Regs., *supra* note 2, art. 4.

[83] OECD Tax Treaty, *supra* note 18, art. 5(4)-(5), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483-84; U.N. Tax Treaty, *supra* note 18, art. 5(4)-(5), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548.

B. Comparison of Physical Presence Tests with Those of Other Countries

1. The United States

Companies incorporated in the United States are taxable on their worldwide earnings. As discussed at Part II.C.1 above, foreign companies without a physical presence in the United States are subject to withholding tax on certain U.S. sourced income.[84] The physical presence test is referred to as being engaged in the conduct of a "trade or business within the United States."[85] Companies that carry on a U.S. trade or business are taxable on their net income from U.S. sources which is "effectively connected" with the conduct of their U.S. trade or business.[86] There is no statutory definition of what constitutes the carrying on of a U.S. trade or business. Further, there is no single test to determine its existence, but regulations and revenue rulings shed considerable light on the interpretation of specific facts.[87] The existence of a U.S. trade or business is a question of fact depending on the circumstances of each case. In general terms, the activity must be considerable, continuous, and regular. Trading in U.S. securities or commodities through an agent is usually not sufficient to constitute a U.S. trade or business.[88]

A foreign company that is engaged in a U.S. trade or business through a branch will, in addition to the usual U.S. tax on business income, be subject to a further gross tax on profit repatriations out of the United States.[89] This additional gross tax is called a branch profits tax, and is intended to roughly equate the tax position of a foreign company which establishes a branch in the United States with that of a foreign company that establishes a subsidiary corporation in the United States.[90] In addition to

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[84] See *supra* notes 36-39 and accompanying text.

[85] I.R.C. § 864(b).

[86] I.R.C. § 882(a)(1).

[87] There are a few safe harbor regulations which indicate, for example, that the performance of personal services in certain very limited circumstances will not create U.S. tax liability. *See, e.g.*, Treas. Reg. § 1.864-2, -4, -6 (as amended in 1975); Rev. Rul. 70-424, 1970-2 C.B. 150 (transactions conducted through a U.S. agent constitute a U.S. trade or business); Rev. Rul. 55-182, 1955-1 C.B. 77 (Canadian mutual fund with U.S. shareholders but no U.S. office or management does not constitute a U.S. trade or business).

[88] I.R.C. § 864(b)(2)(A); Treas. Reg. § 1.864-2(c) (as amended in 1975).

[89] I.R.C. § 884.

[90] The intent of the branch profits tax is to tax U.S. branches of foreign corporations on their *repatriated* business profits, thereby imposing two levels of tax: one on the branch's annual taxable income,

the usual corporate tax on income, the former will suffer an additional branch profits tax (intended to be similar to a withholding tax),[91] while the latter will suffer an additional dividend withholding tax.[92]

A foreign company that carries on a U.S. trade or business may still be subject to withholding tax on certain kinds of income from U.S. sources if that income is not effectively connected with its U.S. trade or business. For example, fixed or determinable annual or periodic income will be taxed on a withholding basis to a foreign company that carries on a U.S. trade or business if the income is not effectively connected with the United States trade or business carried on by the foreign company.[93] For this purpose, effectively connected income means: (1) it is derived from assets used or held for use in a U.S. trade or business;[94] *or* (2) the activities of the U.S. trade or business are a material factor in the realization of the income.[95] The U.S. trade or business would be a material factor in the derivation of the income insofar as it carried on any activity that would be considered an essential economic element in the production of such income.[96]

The United States defines "effectively connected" broadly, which allows it to tax most business-related income in the United States. Aside from fixed or determinable annual or periodic income and capital gains from U.S. sources, most U.S. source income is treated as effectively connected with the conduct of a U.S. trade or business and taxed accordingly.[97] Even gains from the sale of U.S. real property are treated as effectively connected with the conduct of a U.S. trade or business, whether one exists in fact at all, and accordingly taxed on a net basis.[98]

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and a second on repatriated dividends. This bi-level tax regime is meant to mirror the two levels of tax faced by corporations and corporate shareholders in the United States. In effect, the branch profits tax makes it more costly for foreign companies to remove capital from the United States than to reinvest it there. *See* ISENBERGH, *supra* note 28, at 368-69.

91 I.R.C. § 864(a).

92 I.R.C. § 1441(a).

93 I.R.C. § 881(a).

94 I.R.C. § 864(c)(2)(A).

95 I.R.C. § 864(c)(2)(B).

96 I.R.C. § 864(c)(2).

97 I.R.C. § 864(c)(2), (3). The only exception arises in situations where a foreign corporation does not carry on a U.S. trade or business, and thus does not have effectively connected income, but still manages to earn non-FDAP income from the United States. A foreign mail-order business with no active presence in the United States is such an example.

98 *See* I.R.C. § 861(a)(5) (disposition of U.S. real property is U.S. source income); I.R.C. § 864(c)(3) (all U.S. source income, except certain fixed and determinable income, is treated as effectively connected with a U.S. trade or business).

2. *Japan*

Unlike the United States, Japan generally collects taxes on foreign businesses through a system of withholding. Thus, foreign corporations with branch offices in Japan are subject to Japanese income tax on a withholding basis on income derived from sources in Japan.[99] A foreign corporation is one that has its head office outside Japan.[100] As indicated in Part I.B.3 above, the Japanese tax system defines a range of different kinds of income, and prescribes the tax treatment to be accorded to each type.

In certain situations, a foreign corporation may be able to get around Japan's withholding rules and pay tax on a net basis. For example, where a foreign company has a branch or permanent establishment in Japan, certain types of income—including interest on loans extended for business carried on in Japan, rent for the use of real property or industrial or commercial equipment located in Japan, remuneration for furnishing the services of a public entertainer, royalties, and annuities paid on contracts concluded with offices or agents in Japan—may be taxable on a net basis rather than a withholding basis if the permanent establishment has obtained a certificate from the tax authorities permitting this and presents that certificate to the payor.[101] In such case, the permanent establishment is subject to net tax on the same basis as a resident Japanese company.[102] Where, however, the permanent establishment is of a special type, such as a dependent agent or a construction site for more than one year, and the income is not attributable to that special type of permanent establishment, the withholding tax system will apply.[103]

A foreign corporation can also be drawn into the tax net by appointing a Japanese agent. This can occur in one of three situations: (1) where the agent has and habitually exercises the authority to conclude contracts (excluding contracts for the purchase of goods) on behalf of his overseas principal; (2) where the agent habitually maintains a stock of goods in Japan from which he regularly fills orders and delivers goods on behalf of his overseas principal; or (3) where the agent habitually conducts important activities for securing orders, such as negotiating with customers on behalf

99 Japanese Income Tax Law, *supra* note 45, art. 212(1).
100 *Id.* art. 2(vi), (vii).
101 *Id.* arts. 180, 214.
102 *Id.* arts. 180, 214.
103 *Id.* art. 180(ii), (iii).

of his overseas principal.[104] In the event that the foreign company has so appointed a Japanese agent, Japanese income tax will be assessed on the income attributed to the business of that agent.[105] The Japanese concept of agency for the purposes of constituting a taxable presence under Japanese tax law is very similar to that set out in the U.N. model tax treaty. The U.N. model will deem the existence of an agent in the first two situations described above. The Japanese rules add a third situation, to include agents that habitually conduct important activities for securing orders.

Japan's concept of agent for the purpose of constituting a taxable presence under Japanese tax law is narrower than the concept of business agent used by the PRC. Japan's tax system is similar to the PRC tax system in that both Japan and the PRC legislation detail the tax consequences of physical presence or agency in each country. However, the PRC has reserved to itself broader powers by way of imposing tax on a wider variety of agents, as well as business and administrative organizations.

C. *Effect of Tax Treaties on PRC Physical Presence Taxation*

1. *Comparison of Permanent Establishment Definitions*

The definition of permanent establishment in a tax treaty defines what physical nexus is required of a taxpayer resident in the contracting state in order to become liable to the tax regime of that state.[106] Once this threshold has been reached, a permanent establishment is said to have been created, and the company may be liable for taxes due in the host state. This definition is therefore of crucial importance to tax advisers, and is typically contained in article 5 of the tax treaty.[107] The two main tax treaty models deal with the issue in the same format, but the OECD model, coming as it does from the first world or developed countries, tends to favor capital exporting countries. Therefore, primacy is given to the taxing powers of the state of residence in this treaty model, since comparatively more capital exporting companies are resident OECD countries. The U.N. model,

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104 Japanese Corporate Tax Law, *supra* note 43, art. 141(iii); Hosinzeihō Shikorei (Corporation Tax Law Enforcement Order) art. 186 [hereinafter Japanese Corporate Tax Law Enforcement Order], *translated in* JOHN HUSTON ET AL, JAPANESE INTERNATIONAL TAXATION EOCTL-1 (1993).

105 Japanese Corporate Tax Law, *supra* note 43, art. 141(iii)(b).

106 OECD Tax Treaty, *supra* note 18, art. 5, *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483-84; U.N. Tax Treaty, *supra* note 18, art. 5, *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 548.

107 *Id.*

designed by an organization dominated by third world countries for use between them and developed countries, tends to cede taxing power to the state in which the income arises, which is often the third world country. This is the basic philosophical split between the two tax treaty models, but in format they are much alike.

The PRC-U.S. tax treaty generally follows the U.N. model treaty, with a few exceptions that clearly derive from the OECD model. The definition of permanent establishment in the PRC's tax treaty with the United States provides that a resident of one state will have a permanent establishment in the other state if its building site, construction, assembly or installation project, or supervisory activities in connection therewith continue for more than six months.[108] The furnishing of services on the same or connected project for an aggregate period of six months in any twelve months will likewise constitute a permanent establishment.[109] This article also contains a deeming provision whereby the activities of an agent are deemed to be those of an agent of other than independent status where his activities are undertaken wholly, or almost wholly, on behalf of the resident of the foreign state.[110] These provisions are drawn from the U.N. model tax treaty.[111]

The OECD model requires a period of twelve months in order to constitute a permanent establishment by similar activities; and there is no comparable provision to deem the acts of an agent to be those of an agent of other than independent status. It is noteworthy that the PRC-U.S. treaty further provides that oil field exploration for more than three months will also constitute a permanent establishment, a term which is even more stringent than the U.N. model.[112] On the other hand, it contains a clause which specifies that a combination of otherwise non-taxable activities will not lead to the creation of a permanent establishment, as long as those activities are kept to a preparatory or auxiliary character.[113] This provision

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108 U.S.-China Tax Treaty, *supra* note 54, art. 5(3)(a), 23 I.L.M. at 681.

109 *Id.* art. 5(3)(c), 23 I.L.M. at 681.

110 *Id.* art. 5(6), 23 I.L.M. at 682.

111 U.N. Tax Treaty, *supra* note 18, art. 5(3), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 547.

112 U.S.-China Tax Treaty, *supra* note 54, art. 5(3)(b), 23 I.L.M. at 681. If the taxpayer is not extracting those natural resources, which constitutes a permanent establishment under art. 5(2)(f) of the U.N. model tax treaty, the exploration for natural resources would not constitute a permanent establishment under the treaty model unless performed as a service for a taxpayer in the host country. *See* U.N. Tax Treaty, *supra* note 18, art. 5(3)(b), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 547.

113 U.S.-China Tax Treaty, *supra* note 54, art. 5(4)(f), 23 I.L.M. at 682; OECD Tax Treaty, *supra* note 18, art. 5(4), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483-84.

is drawn from the OECD model tax treaty,[114] and clearly favors investor countries.

The PRC-Japan tax treaty defines permanent establishment in a slightly different manner. For example, the treaty omits a safe harbor provision declaring that a combination of otherwise non-taxable activities will not be deemed a permanent establishment, as long as those activities are kept to a preparatory or auxiliary character.[115] In this way, the PRC-Japan treaty tracks the U.N. model. Also, the treaty provision which deems an agent to constitute a permanent establishment on behalf of an overseas principal differs from both the OECD and U.N. model treaties. The PRC-Japan treaty provides that a person who regularly *secures orders* wholly or almost wholly for a foreign enterprise will likewise constitute a permanent establishment of that foreign enterprise.[116] This provision appears in neither the OECD or U.N. model treaties, which restrict themselves to the act of *concluding contracts*.[117]

2. *Comparison with PRC Domestic Legislation*

Since the United States and Japan (both capital exporting countries) gave up several of the most important OECD model tax treaty terms, it is clear that the PRC was able to extract considerable source taxation concessions when negotiating these treaties. However, this is not to say that the PRC won at every turn. The U.S. treaty includes the OECD provision declaring that a combination of otherwise non-taxable activities will not lead to the creation of a permanent establishment, as long as those activities are kept to a preparatory or auxiliary character. However, at least one author has suggested that the United States was overly generous to the PRC.[118]

Despite the PRC's leverage, these tax treaty provisions go a long way towards trimming the wide PRC residence taxation net. For example, the

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114 OECD Tax Treaty, *supra* note 18, art. 5(4), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 483-84.

115 China-Japan Tax Treaty, *supra* note 54, art. 5(4), 23 I.L.M. at 124. There is no counterpart to art. 5(4)(f) of the OECD model.

116 China-Japan Tax Treaty, *supra* note 54, art. 5(6)(b), 23 I.L.M. at 125.

117 U.N. Tax Treaty, *supra* note 18, art. 5(5), *in* 25:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 547; OECD Tax Treaty, *supra* note 18, art. 5(5), *in* 4:B INTERNATIONAL TAX TREATIES OF ALL NATIONS at 484.

118 Paul Reese, *United States Tax Treaty Policy Towards Developing Countries: The China Example*, 35 UCLA L. REV. 369-97 (1987).

concept of business agent is replaced by the more widely understood concept of independent agent, and the term is defined. Also, the terms "business organization" and "administrative organization" are excluded, and in their place the concepts of place of management, branch and office are included. Safe harbor rules are provided for non-taxable activities such as storage or maintenance of a stock of goods, and maintenance of an office for the purpose of purchasing goods.[119] As all of the aforementioned treaty concepts have some definition in international tax practice, the foreign business person can plan his or her affairs with a bit more certainty knowing that such a tax treaty will apply.

IV. TRANSFER PRICING

A. *In the PRC*

In contrast with many other areas of its law which are characterized by generality and brevity, the PRC has adopted detailed transfer pricing rules. Under the UTL, the general rule is that the payment or receipt of charges or fees between "associated" foreign investment enterprises, or their establishments or places set up in the PRC, must be made in the same manner as the payment or receipt of those charges in transactions between independent enterprises.[120] Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of taxable income,[121] the UTL empowers the tax authorities to make reasonable adjustments.[122]

The UTL includes detailed regulations to fill out the coverage of the general transfer pricing rule. Thus, the term "associated" is defined in terms of one of three alternative relationships: (1) direct/indirect ownership or control of one party by the other; (2) a third party directly/indirectly owns or controls the two enterprises; or (3) another mutually beneficial association exists.[123] In terms of ownership and control, these tests are met if there is a direct/indirect ownership of 25% or more of the total share capital of the

119 *See* U.S.-China Tax Treaty, *supra* note 54, art. 5(4), 23 I.L.M. at 681; China-Japan Tax Treaty, *supra* note 54, art. 5(4), 23 I.L.M. at 124.

120 UTL, *supra* note 1, art. 13.

121 The UTL Regulations define taxable income for various kinds of businesses. Taxable income is generally defined as the net profits of the business on which PRC tax will be levied. UTL Regs., *supra* note 2, art. 10.

122 UTL, *supra* note 1, art. 13.

123 UTL Regs., *supra* note 2, art. 52.

associated enterprise, or the direct/indirect ownership of 25% or more of the total share capital of both the transferee and transferor entities by a third entity.[124] Other relationships which will create associated enterprises within the meaning of the law include where an entity provides 50% or more of the total loan capital of another,[125] or where 10% or more of one entity's loan capital is guaranteed by another entity.[126] In addition, the following mutually beneficial associations will constitute associated enterprises: (1) where one enterprise's production and business operations are dependent on the other for the provision of industrial property or intellectual property; (2) where one enterprise controls the prices and terms upon which the other can purchase its inputs; (3) where one enterprise controls the sales of the other's outputs; or (4) where an enterprise has effective control over the business operations of another, or other relationships (including family and relatives) exist.[127]

There are several uncertainties regarding the application of the PRC transfer pricing rule. Particularly troubling is the broad definition of mutually beneficial associations. Licensors, suppliers and distributors which lack ownership or family relationships with a PRC business partner could nevertheless be found to have a mutually beneficial association with that PRC business partner. If so, this relationship would be sufficient to taint the foreign party as an associated party for the purposes of the PRC transfer pricing law. Also, the concept of control is not adequately defined in the rules. For example, it is unclear whether the power to veto, or negative control, is sufficient to constitute control in this context. Finally, the nature of the family relationship necessary to constitute control is not adequately defined.

A transfer pricing rule very similar to that in the UTL is contained the ATC.[128] However, one striking difference is that the ATC states that the PRC tax authorities may apply the transfer pricing rule not only if an enterprise reduces its taxable income, but also if it reduces its *earnings*.[129]

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124 Guojia shui wu ju guanyu guanlian qiye jian yewu wang lai shui wu guanli shi shi banfa (Implementation Rules for the Tax Administration Concerning Transactions Between Related Parties), art. 2(1), (2), State Tax Bureau, (Oct. 29, 1992) [hereinafter Implementation Rules]. *See also* Desmond Yeung, *Transfer Pricing Investigations*, 1 CHINA TAX REVIEW No. 2, at 11 (1994).

125 Implementation Rules, *supra* note 123, art. 2(1), (2).

126 *Id.*

127 *Id.*

128 ATC, *supra* note 3, art. 24. This legislation applies to all enterprises, both foreign and PRC domestic.

129 *Id.*

Therefore the ATC is slightly broader in scope. For example, if a foreign-invested enterprise ("FIE") sells its product at an artificially low level to a related non-resident, under the UTL it would only violate the transfer pricing rule if, on re-adjustment of that price to a price that would obtain between independent enterprises, the extra profit would cause the FIE to earn taxable income. If the FIE had sufficient other expenses (or losses carried forward) such that an upward adjustment of the transfer price to a price that would obtain between independent enterprises would still not put the FIE in a taxable position, then article 13 of the UTL would not apply. This defect has been remedied by the ATC, which would allow the PRC tax authorities to re-adjust the price to reduce the loss. Where the transfer price was not one which would obtain between independent enterprises, article 24 of the ATC could be applied to reduce the losses of the FIE. The ability to reallocate prices regardless of the tax position of the parties involved is a significant advantage of the ATC.

Another uncertainty under the transfer pricing rules is determining which actors are affected. The UTL transfer pricing rules do not relate solely to companies, but also to enterprises and other economic organizations.[130] They do not, however, extend to PRC individuals. The ATC transfer pricing rules apply to enterprises or foreign enterprises with establishments in the PRC, and their affiliated enterprises.[131] Presumably PRC individuals are given a free hand when setting transfer prices with related enterprises.[132]

Rules governing transfer prices have arisen in large part to prevent revenue leakage to other states. Many jurisdictions have framed their transfer pricing rules such that they apply to transactions between residents and non-residents.[133] Neither the UTL, nor the ATC, nor regulations made pursuant to these laws makes specific reference to cross-border situations, which leads to the conclusion that the UTL and the ATC are not limited by

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130 UTL, *supra* note 1, art. 13; UTL Regs., *supra* note 2, art. 52.

131 ATC, *supra* note 3, art. 24; ATC Regs., *supra* note 4, art. 36.

132 This is only of academic interest to foreign parties. The Foreign Economic Contract Law governs all contracts between foreign and PRC parties. *See* Zhonghua renmin gongheguo shewai jingji hetongfa (Foreign Economic Contract Law of the PRC) National People's Congress (Mar. 21, 1985), *translated in* STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA Law No. 850321 (Institute of Chinese Law 1987). The Foreign Economic Contract law applies to contracts between foreign enterprises/individuals and PRC enterprises/economic organizations. *Id.* art. 2. Thus, only PRC enterprises or organizations can enter into economic contracts with foreign parties.

133 *See, e.g.*, Laws of Hong Kong, ch. 112, Inland Revenue Ordinance, §§ 20, 20A, 20B, (1989) (imposing tax liability on certain non-resident persons).

geography in their application. It seems that both sets of transfer pricing rules could be used in purely domestic situations. Two such situations come to mind: (1) an arrangement whereby profits are unjustifiably transferred from a profitable to a loss-making company; or (2) an arrangement whereby profits are unjustifiably transferred from an enterprise paying the standard rate of tax to an enterprise located in a Special Economic Zone ("SEZ") paying little or no tax. Unfortunately, the PRC tax authorities have not yet indicated whether they will apply these transfer pricing rules in domestic situations.

Another uncertainty under the transfer pricing rules is just how an appropriate transfer price is to be determined in a particular case. The UTL requires that business transactions between associated enterprises be carried on in the same manner as those between independent enterprises. "Business transactions between independent enterprises" is defined to mean business dealings between unassociated enterprises at fair transaction prices conducted in accordance with common business practices.[134] The PRC tax authorities are given broad power to adjust prices when this rule has been violated. In that event, the adjusted prices are to be determined in accordance with one of four alternative methods: (1) comparable price for the same or similar transaction between unassociated enterprises; (2) according to the profit margin normally obtainable in transactions with unassociated enterprises; (3) the cost of the transaction, plus a reasonable profit margin; or (4) any other appropriate method.[135] As the UTL regulations do not specify a hierarchy for the application of these tests, there is plenty of room for argument between the State Tax Bureau and the taxpayer about which test should be applied in any particular situation. The ATC Regulations have overcome this difficulty by specifying a hierarchy for the substantially similar tests. The taxation authorities are to apply the methods in the order in which they appear (i.e., from (1) to (4) immediately above).[136] No further guidance is given in the ATC Regulations.

In a departure from the standard practice of determining the appropriate arm's length price, there is an indication that, at least in Shenzhen, other methods may apply. One writer has indicated that the tax authorities may use a comparable profit standard whereby the taxpayer's competitors'

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[134] UTL Regs, *supra* note 2, art. 53.

[135] UTL Regs., *supra* note 2, art 54. ATC Regs., *supra* note 4, art. 38. The wording of the four alternative methods under the two articles is substantially the same.

[136] ATC Regs., *supra* note 4, art. 38.

profitability is used as a yardstick and then the taxpayer's transfer prices are adjusted accordingly to achieve a comparable profitability.[137] This is a draconian measure and the writer has not learned of other instances of the use of this method in the PRC.[138]

Other questions remain about the PRC's disclosure requirements. The taxpayer is specifically obliged to disclose details of prices, fee standards and other relevant information in relation to its business.[139] This is usually very confidential information, and foreign business persons doing business in the PRC would want the confidentiality of this information protected. Although there is provision for maintaining information in relation to a tax investigation confidential, there are no penalty provisions should the information be disclosed.[140] There does not appear to be a blanket requirement that tax officials maintain confidentiality of the information that comes into their hands.

The PRC transfer pricing laws are monitored and administered in at least two ways. Foreign enterprises must complete and submit to the tax authorities an annual information return concerning transactions with associated enterprises along with their annual tax return. In addition, in 1993 the State Tax Bureau established an anti-tax avoidance group of experienced tax officers who are charged with monitoring and dealing with transfer pricing issues in the PRC.[141]

In addition to these general transfer pricing provisions, the PRC has enacted specific transfer pricing provisions to counter inaccurate transfer pricing in the form of loan interest,[142] through the pricing of labor services,[143] through the assignment of assets or the provision of property rights,[144] and through purchasing and marketing.[145]

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137 Tang Tengxiang, *Guanyu zhuanrang dingjia shui zhi de xin sikao* [*New Ponderation on Transfer Pricing*], 56 INT'L TAXATION IN CHINA 12 (1993).

138 *Id.*

139 UTL Regs., *supra* note 2, art. 53.

140 The UTL requires tax officials to "be responsible for confidentiality" when making an inspection. UTL, *supra* note 1, art. 20.

141 Yeung, *supra* note 123, at 12.

142 UTL Regs., *supra* note 2, art 55; ATC Regs., *supra* note 4, art. 39.

143 UTL Regs., *supra* note 2, art. 56; ATC Regs., *supra* note 4, art. 40.

144 UTL Regs., *supra* note 2, art. 57; ATC Regs., *supra* note 4, art. 41.

145 ATC Regs., *supra* note 4, art. 38.

B. Transfer Pricing in Other Countries

1. The United States

The United States has long recognized that it could be unjustly deprived of tax revenue through the use of manipulative transfer pricing, especially given the number of multinational corporations in the United States. Therefore, the Internal Revenue Code empowers the U.S. tax authorities to review and reallocate or reapportion income between businesses which are owned or controlled directly or indirectly by the same interests in order to clearly reflect the income of such businesses.[146] It would be fair to say that these rules have been the target of much criticism.[147] Very detailed and specific regulations deal with most aspects of transfer pricing in the United States. In general, however, the U.S. regulations seek to impose an arm's length pricing standard in transactions between related parties.[148]

Control in this context is defined very broadly to include all kinds of control, whether direct or indirect, and whether legally enforceable or not.[149] The regulations do not go into detail to define all relationships that will be considered to constitute the requisite element of control. Instead, the general proposition of de facto control is laid down,[150] to be applied in each situation as it arises.

Arm's length pricing, in the case of tangible property, is to be determined by one of six methods: (1) by reference to a comparable uncontrolled price;[151] (2) resale price;[152] (3) cost-plus;[153] (4) comparable

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146 I.R.C. § 482 (1988).

147 *See, e.g.*, George Carlson, et al., *The U.S. Final Transfer Pricing Regulations: The More Things Change, the More They Stay the Same*, 9 TAX NOTES INT'L 333 (1994); Steven Hannes, *An Evaluation of IRS's 1993 Transfer Pricing and Related Penalty Proposals: Round Three*, 6 TAX NOTES INT'L 397 (1993).

148 Treas. Reg. § 1.482-1(b) (1994).

149 Treas. Reg. § 1.482-1(i)(4)-(6), (8) (1994).

150 Treas. Reg. § 1.482-1(i)(4) (1994) ("It is the *reality* of control that is decisive, not its *form* or the *mode of its exercise*.") (italics added).

151 Treas. Reg. § 1.482-3(b) (1994). The comparable uncontrolled price method evaluates whether the amount charged between controlled parties is arm's length by reference to *the amount charged* in a comparable transaction between two uncontrolled parties. Treas. Reg. § 1.482-3(b)(1) (italics added).

152 Treas. Reg. § 1.482-3(c) (1994). The resale price method evaluates whether the amount charged between controlled parties is arm's length by reference to *the gross profit margin* realized in a comparable uncontrolled transaction. This method is normally used in cases involving the purchase and resale of tangible property where the reseller has not added substantial value to the tangible goods. Treas. Reg. § 1.482-3(c)(1) (italics added).

profit;[154] (5) profit split;[155] or (6) other unspecified methods that may be applicable in the facts and circumstances of the transaction.[156] The regulations do not specify which method is to be used in which circumstances, but instead provide that the method to be used is that which provides the most reliable measure of an arm's length result under the facts and circumstances.[157] Four separate methods are available for use to determine the arm's length price of intangibles.[158] The U.S. transfer pricing regulations are extremely detailed. They indicate how a taxpayer can demonstrate comparable transactions;[159] the tax accounting treatment of adjustments required to be made once an appropriate transfer price is determined;[160] and the use of multiple year data to arrive at profits.[161]

A high degree of disclosure is required of taxpayers in order to implement this system. The regulations require taxpayers to marshal

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153 Treas. Reg. § 1.482-3(d) (1994). The cost-plus method evaluates whether the amount charged between controlled parties is arm's length by reference to the *gross profit markup* realized in comparable uncontrolled transactions. This method is ordinarily used in cases involving manufactured goods that are to related parties. Treas. Reg. § 1.482-3(d)(1) (italics added).

154 Treas. Reg. § 1.482-5 (1994). The comparable profits method evaluates whether the amount charged between controlled parties is arm's length based on *objective measures of profitability* derived from uncontrolled taxpayers that engage in similar business activities in similar circumstances. Treas. Reg. § 1.482-5(a) (italics added).

155 Treas. Reg. § 1.482-6 (1994). The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the *relative value of each controlled taxpayer's contribution* to that combined operating profit or loss. Treas. Reg. § 1.482-6(a).

156 Treas. Reg. § 1.482-3(e) (1994). Unspecified methods may be used to determine arm's length pricing, but only if the result complies with the best method rule under Treas. Reg. § 1.482-1(c). Treas. Reg. § 1.482-3(e)(1).

157 Treas. Reg. § 1.482-1(c) (1994).

158 The four methods are:

(1) Comparable uncontrolled transaction method, which focuses on the *amount charged* in comparable uncontrolled transactions. Treas. Regs. §§ 1.482-4(c)(1) (1994).

(2) Comparable profits method, which evaluates whether the amount charged in a controlled transaction is arm's length based on *objective measures of profitability* derived from uncontrolled taxpayers that engage in similar activities in similar circumstances. Treas. Reg. § 1.482-5(a) (1994).

(3) Profit split method, which evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the *relative value of each controlled taxpayer's contribution* to that combined operating profit or loss. Treas. Reg. § 1.482-6(a) (1994).

(4) Unspecified methods. Treas. Reg. § 1.482-4(d). Unspecified methods may be used to determine arm's length pricing, but only if the result complies with the best method rule under Treas. Reg. § 1.482-1(c). Treas. Reg. 1.482-4(d)(1) (1994).

159 Treas. Regs. §§ 1.482-1(d) (1994); 1.482-4(c)(2)(iii) (1994).

160 Treas. Regs. §§ 1.482-1(g) (1994); 1.482-4(f)(2) (1994).

161 Treas. Reg. § 1.482-1(f)(2)(iii) (1994).

contracts, pricing agreements, and even data from third parties to support their transfer prices.[162] U.S. tax officials are prohibited from disclosing such information and penalties for breach are provided.[163] Writers have suggested that while the taxpayer is now offered some flexibility by which to support his pricing policies, this is balanced by increased reporting and documentation requirements.[164] Nonetheless, assuming the taxpayer meets the rigorous contemporaneous documentation and analysis requirements stipulated in the regulations, the taxpayer will qualify for the "reasonable cause" exception and can avoid later penalties should his choice turn out to be incorrect.[165]

In order to render a multinational company's U.S. tax situation somewhat more certain, and to avoid costly disputes with the U.S. revenue authorities later, the United States has adopted a procedure known as the Advanced Pricing Agreement.[166] This procedure enables a multinational company to negotiate an agreed transfer pricing method with the U.S. revenue authorities, valid for a period of years. There is no authority under either the FEIT or its Regulations, nor the ATC or its Regulations for the PRC revenue authorities to conclude similar agreements with multinational companies doing business in the PRC.

In comparison with the PRC transfer pricing rules, the U.S. rules are even more detailed and precise. In addition, they are onerous and subject the taxpayer to greater record-keeping requirements. In certain cases the U.S. rules depart from the internationally-accepted arm's length standard, while the PRC legislation abides by that standard. The United States has long experience with transfer pricing, and that fact is demonstrated in its legislation and the numerous court decisions.

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162 *See, e.g.*, Treas. Regs. §§ 1.482-1(c)(2)(ii) (1994) (data and assumptions); 1.482-1(d)(3)(ii) (1994) (contractual terms).

163 I.R.C. §§ 7213 (unauthorized disclosure of information); 7214 (offenses by officers and employees of the United States) (1988).

164 *See, e.g.*, George Carlson et al., *The U.S. Final Transfer Pricing Regulations: The More Things Change, the More They Stay the Same*, 9 TAX NOTES INT'L 333, 347 (1994); Steven Hannes, *An Evaluation of IRS's 1993 Transfer Pricing and Related Penalty Proposals: Round Three*, 6 TAX NOTES INT'L 397, 417 (1993).

165 Treas. Reg. § 1.6664-4 (1994).

166 Rev. Proc. 91-22, 1991-1 C.B. 526.

2. *Japan*

In contrast to the PRC and the United States, Japanese tax law deems transactions between related companies to be carried on at arm's length prices, and Japanese tax is charged on that basis.[167] A "foreign related company" refers to one of four situations. Two of these involve direct or indirect control of or by a foreign company, where control is defined as 50% or more of either the number of shares or the amount of capital.[168] The relationship can also be found where such control is exercised over two companies by an individual.[169] Finally, a foreign corporation will be a foreign related company where that company wholly or partly controls or is controlled by a Japanese company that makes "substantial decisions" regarding its business direction.[170] In determining substantiality, Japanese authorities will consider the number of officers who serve both companies; the scope of transactions conducted between the related companies; and the history of capital contributions.[171] Unlike many other countries' transfer pricing definitions, Japan's transfer pricing definition is wide enough to include transactions where an unrelated foreign party has been inserted into the chain, such as a back-to-back transaction with a bank.

Japan follows the OECD guidelines regarding the determination of appropriate transfer prices, and therefore adopts the following methods for determining those prices: (1) comparable uncontrolled price;[172] (2) resale price;[173] (3) cost plus;[174] and (4) any other acceptable methods.[175] In order to police these rules, Japanese taxpayers are required to attach a document to their final tax return each year that contains the name and location of the head or main office of the foreign related person. In addition to the power to compel the submission of books and records from the taxpayer

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167 Sozei Tokubetsu Sochi Hō (Special Taxation Measures Law), art. 66-4 [hereinafter Japanese Special Taxation Measures Law], *translated in* JOHN HUSTON ET AL., JAPANESE INTERNATIONAL TAXATION STML-1 (Vicki L. Beyer trans., 1993).

168 Sozei Tokubetsu Sochi Hō Shikorei (Special Taxation Measures Law Enforcement Order), art. 39-12(1)(i)-(ii), *translated in* JOHN HUSTON ET AL., JAPANESE INTERNATIONAL TAXATION EOSTML-1 (Vicki L. Beyer trans., 1993).

169 *Id.* art. 39-12(1)(ii).

170 *Id.* art. 39-12(1)(iii).

171 *Id.* art. 39-12(1)(iii)(a)-(c).

172 Japanese Special Taxation Measures Law, *supra* note 166, art. 66-4(2)(i)(a).

173 *Id.* art. 66-4(2)(i)(b).

174 *Id.* art. 66-4(2)(i)(c).

175 *Id.* art. 66-4(2)(i)(d).

corporation, the Japanese tax authorities can compel similar information from competing corporations.

In summary, the Japanese transfer pricing rules are detailed, and certainly drafted in favor of the tax authorities. Unlike the PRC rules the Japanese rules contain a deeming provision requiring transactions to be carried on at arm's length prices, rather than granting the tax authorities the right to review transactions in particular cases. Control in the case of stock rights is defined at twice the level of that in the PRC, 50% by vote or value. As in the PRC, the Japanese tax authorities also have broad information-gathering powers.

C. Effect of Tax Treaties on PRC Transfer Pricing Rules

1. Comparison of Transfer Pricing Provisions in the Treaties

The United States and Japan have limited the scope of their domestic transfer pricing legislation in their tax treaties with the PRC, as both of the tax treaties contain a transfer pricing provision.[176] The PRC-Japan transfer pricing provision is one paragraph in length, and provides that parties will be considered associated for the purposes of the treaty if an enterprise participates directly or indirectly in the management, control or capital of an enterprise in the other state, or if such control is exercised through one or more individuals.[177] Where such an association exists between two enterprises, and commercial or financial conditions are imposed between the enterprises which differ from those which would obtain between independent enterprises, then any profits which would have accrued but for those conditions can be included in the profits of the enterprise and taxed accordingly.[178]

The PRC-U.S. tax treaty contains this paragraph, but adds a further paragraph which allows for compensating adjustments in the other state in the event of a transfer pricing adjustment in the host state.[179] Details of the adjustment can be agreed to by the tax authorities in each state. The additional income, which otherwise would be taxed in two states, is thereby only taxed in one.

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176 U.S.-China Tax Treaty, *supra* note 54, art. 8, 23 I.L.M. at 685; China-Japan Tax Treaty, *supra* note 54, art 9, 23 I.L.M. at 127-28.

177 China-Japan Tax Treaty, *supra* note 54, art. 9, 23 I.L.M. at 127-28.

178 *Id.*

179 U.S.-China Tax Treaty, *supra* note 54, art. 8(2), 23 I.L.M. at 685

Both treaties include "Competent Authority" provisions,[180] allowing a taxpayer who feels the treaty has been misapplied to petition the authorities for review. The treaties do not create a specific review process, but instead allow the authority receiving the request to reach a unilateral decision, or else consult the other nation's tax authority for a mutual resolution.[181] Of course, there may be some risk in pursuing a review if it entails disclosure of sensitive information—which is often the case in disputes involving transfer pricing. It is not surprising that few FIE's in China pursue appeals on transfer pricing issues, given the expense and the risk of an ongoing investigation.[182]

2. *Comparison with the PRC Domestic Transfer Pricing Rules*

These tax treaties will prevail in international transfer pricing cases since the UTL provides that where its provisions differ from those of a tax treaty the tax treaty shall apply. Not only does that provide some certainty, but in some cases that provision will allow compensating adjustments in the other state should prices in the first state be adjusted as a result of the transfer pricing proceedings under the tax treaty. However, the tax treaty provisions do not prevent the PRC from using its transfer pricing laws to prevent perceived pricing abuses entirely within the borders of the PRC.

VI. CONCLUSION

Since the publication of its first tax law, PRC tax law has matured rapidly. The Joint Venture Income Tax Law and the Foreign Enterprise Income Tax Law, originally enacted in the 1980s, were replaced with the UTL and its detailed rules (the UTL regulations) in 1991. The following year (1992) saw the enactment of the ATC, and the year after (1993) saw detailed rules for the implementation of the ATC (the ATC Regulations). The first Individual Income Tax Law was enacted in 1980, and replaced by a new Individual Income Tax Law in 1993. Along the way a number of measures and circulars have been issued by the PRC tax authorities to further flesh out the system. Given its similarities with other modern tax

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180 U.S.-China Tax Treaty, *supra* note 54, arts. 24-25, 23 I.L.M. at 698-700; China-Japan Tax Treaty, *supra* note 54, arts. 25-26, 23 I.L.M. at 139-40.

181 *Id.*

182 *See* Yeung, *supra* note 123, at 12.

systems, today the PRC has an income tax system instantly recognizable by tax practitioners.

Although it has many of the characteristics of a developed country's tax system, large areas of uncertainty remain concerning vital PRC tax issues. What is actually connected income pursuant to the withholding tax provision of article 19 of the UTL? What are administrative organizations and business organizations for the purposes of establishing a taxable presence in the PRC? If a business agent in the PRC purchases goods on behalf of an overseas buyer, how is the taxable income of the overseas buyer computed? What does the word "control" include in the context of the PRC transfer pricing rules? Despite the growing complexity of the PRC tax legislation these and other areas of uncertainty remain.

The PRC government has instituted a generous series of tax incentives to encourage economic development in certain locations, and certain kinds of economic development. These incentives are too numerous and lengthy to fully explore here, but it is fair to say that many of them target foreign investors. For example, all enterprises with foreign investment of a productive nature scheduled to operate for a period of not less than ten years are exempted from income tax in the first two profit-making years and allowed a 50% reduction of income tax in the third to fifth years.[183] There are special tax incentives for certain enterprises located in a Special Economic Zone, a Coastal Open Economic Zone, or an Enterprise and Technological Development Zone.[184] Energy, communications, harbor, wharf, and other industries are given special advantages.[185] This list is not exhaustive, but demonstrates the commitment of the PRC bureaucracy to use taxation as a tool of social and economic policy by consciously channeling investments to certain areas. If the PRC simply viewed its tax system as a means to raise revenue, no tax incentives would be offered and either a narrower income tax base or a lower overall income tax rate could be offered. Having chosen the interventionist route, the PRC authorities were thereby encouraged to adopt a broad definition of an establishment or

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183 UTL, *supra* note 1, art. 8. Although natural some mining and petroleum businesses are exempted.

184 For example, the UTL provides for tax rate reductions for certain foreign related businesses amounting to 15% in Special Economic Zones ("SEZs") and Enterprise and Technological Development Zones ("ETDZ"), and 24% in Coastal Open Economic Zones ("COEZs"). UTL, *supra* note 1, art. 7. *See also* UTL Regs., *supra* note 2, arts. 69-70 (defining the location of the SEZs, ETDZs and COEZs).

185 UTL, *supra* note 1, art. 8(2); UTL Regs., *supra* note 2, art. 75 (exempting qualifying enterprises from tax under the UTL for longer periods (five years in most cases) and extending the period of 50% tax reduction (generally for another 5 years)).

place in the PRC, widen the definition of business agent, include all possible PRC source income in the PRC source taxation rules, and adopt far-reaching transfer pricing rules.

It should be borne in mind that the severity of the PRC's domestic tax legislation is, to an extent, moderated by its tax treaties. One can clearly see the conflicting policy goals of the PRC at work in these treaties. On one hand, the PRC wishes to encourage foreign investment, so that an agreement can be reached on tax sparing provisions and reduced withholding tax rates. On the other hand, the PRC attempts to negotiate the U.N. model definition of permanent establishment and the U.N. model other income clause in order to keep its tax base as broad as possible. In addition to those tax treaties examined in this study, the PRC has concluded a number of tax treaties with other countries, and investors would be well-advised to consult the provisions of the relevant treaty.

In conclusion, the PRC's tax law has since its infancy some fifteen years ago, matured very rapidly into a recognizable tax regime. In many ways this tax regime is ahead of itself, having many of the characteristics of a developed tax system, but applying to a lesser developed country in which the taxation administrative and enforcement systems are comparatively immature. The next several years will be interesting ones for those interested in PRC tax law, as more development is certain.