Student Note

Tax Treatment for Foreign Investors Under New Chinese Business Entities Tax Law: The Mixture of American Experience and Special Chinese Characters

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Introduction

In 2006 and 2007, the National People's Congress of China and its Standing Committee adopted two basic laws that bring new opportunities and challenges to foreign investors.[1] The first is the amended Partnership Enterprise Law ("PEL"), which legally allows the business form of Limited

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[1] Michael E. Burke, *People's Republic of China: 2007 Legal Developments in Review*, 20 No.3 Int'l. Q., Art.1, 1-4 (2008).

Partnership ("LP") at a nationwide level in China.[2] The second is the Enterprise Income Tax Law ("EITL"), which unifies the enterprise income tax treatment of both Foreign Investment Enterprises ("FIEs") and Domestic Enterprises ("DEs"), and which terminates some favorable tax policies that were only available to FIEs.[3] Foreign investors can now consider choosing a suitable business form according to the new laws and adopting tax treatment strategies to achieve a better investment return in China.

I. Background

The New Enterprise Income Tax Law ("EITL") terminates almost all favorable tax policies for FIEs and puts them on the same page with DEs.[4] Before the new EITL came into effect, DEs and FIEs were governed by two different tax laws.[5] Although both DEs and FIEs were subject to an Enterprise Income Tax ("EIT") statutory rate of thirty-three percent, FIEs enjoyed many preferences, tax exemption periods, and reduction periods, such that their effective tax rate was generally fifteen percent.[6] The new EITL unifies the EIT rates at twenty-five percent, and the tax law is applicable to both FIEs and DEs.[7] FIEs and DEs also have the same deductions and preferential income tax policies.[8]

The new EITL splits FIEs into three different categories: resident enterprises, non-resident enterprises with establishments in China, and non-resident enterprises without establishments in China.[9] According to the new EITL, the first two categories will pay a twenty-five percent income tax rate for any domestic income and for income which may have arisen outside of China, but which has an effective connection with the establishment.[10] Although the third category has a twenty percent tax rate,[11] the State Council has reduced the withholding tax rate from twenty

[2] Partnership Enterprises Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) (China).
[3] *See* Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) (China).
[4] Qinghua Xu & A. W. Granwell, *The New Chinese Enterprise Income Tax Law: Planning Opportunities and Traps for the Unwary*, 893 PLI Tax 963, 965-966 (2009).
[5] *Id.* at 965.
[6] *Id.*
[7] *Id.* at 966.
[8] *Id.*
[9] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 3 (China).
[10] *Id.*
[11] *Id.*

percent to ten percent.[12] But before the EITL's adoption, the profit earned by a foreign investor from an FIE was completely exempt.[13] Therefore, without special allocation or treatment, the tax burden on foreign investors has increased after the adoption of the EITL.

Moreover, the definition of "establishment" is broad enough to cover almost any substantial facility or site.[14] Generally, foreign investors who have any active management activities in China may transfer non-resident enterprises in category three to category two, which would increase their tax burden significantly. According to the new EITL, foreign investors may have a twenty percent withholding tax rate only for their passive investment income.

In sum, the new EITL increases the tax burden on foreign investors because they must pay more income tax for both ordinary business operations and profit distributions, which reduce their return on investments. On the other hand, the new PEL provides a flexible, limited liability business form for foreign investors. Before the adoption of the new PEL, investors could only establish General Partnerships in China, which require every partner to take unlimited personal liability.[15] Moreover, under the 1997 PEL, only a natural person with full civil capability could be a partner. For example, a legal person, such as a corporation, could not be a partner.[16] In other words, a natural person could not use the limited liability entity to be a partner in order to avoid personal liability. However, after the adoption of the new PEL, a legal person, such as a corporation, can be a partner[17] and can then use the corporation as a general partner to avoid unlimited personal liability. The new PEL also provides wide flexibility to partners for ordinary operations, distribution,

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[12] Notice of the State Council Concerning the Issue of Reducing Income Tax on Income such as Interest of Foreign Enterprises Derived from Inside China, No. 37 (promulgated State Council, Nov. 18, 2000, effective Jan. 1, 2001) (China).

[13] Owen D. Nee, *Business Operations in the People's Republic of China*, Tax Mgmt. Foreign Income (BNA), No. 957 at A-62 (3d. ed. 2010).

[14] Detailed Implementing Regulations of the Enterprise Income Tax Law of the People's Republic of China, No. 512 (promulgated by the State Council, Dec. 6, 2007) (China) [hereinafter EIT Regs.] (stating that establishments include 1) Management, commercial and representative offices; 2) Factories, farms and natural resource development sites; 3) work sites; 4) project sites for construction, installation, assembly, maintenance and development; and 5) other organs or sites that engage in production and operational activities).

[15] Thomas Earl Geu & Yong Wu, *The New PRC Limited Partnership Enterprise Law and the Limited Partnership Law of the United States: A Selective Analytical Comparison*, 25 UCLA Pac. Basin L. J. 133, 139-140 (2007).

[16] Partnership Enterprise Law (promulgated by the Standing Comm. Nat'l People's Cong., Feb. 23, 1997) art. 9 (China); Company Law (promulgated by the Nat'l People's Cong., Dec. 29, 1993, effective Jan. 1, 2006) art. 15 (China).

[17] Partnership Enterprises Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) art. 2 (China).

and liquidation.[18] Partners can allocate operation power, contribution methods, and distribution measures in almost any way they want.[19] Moreover, unlike normal business entities, which must pay EIT for their income, partnerships are not taxed twice. Instead, the Chinese government applies pass-through taxation to partnerships, like the IRS does to partnerships in the United States.[20] The Chinese government only taxes income directly on the partner level.[21] Therefore, foreign investors can use the LP as a vehicle for investment in China to reduce the effect of double taxation and to gain greater flexibility in managing liability issues.

II. Selection of Business Form

From a statutory perspective, FIEs in China have three main forms: equity joint ventures ("EJVs"), cooperative joint ventures ("CJVs"), and wholly foreign-owned enterprises ("WFOEs").[22] An EJV is established pursuant to the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures.[23] An EJV is a limited liability company ("LLC") "established by means of a joint venture contract and Articles of Association entered into between the foreign and Chinese partners, which are subject to the approval of the relevant Chinese governmental authorities."[24] A CJV is established pursuant to the Law of the Peoples' Republic of China on Chinese-Foreign Cooperative Joint Ventures.[25] Although it is not required by statute, a CJV is almost always a Chinese legal person with limited liability.[26] A CJV is based on a cooperative joint venture contract and "Articles of Association entered into between the foreign and Chinese partners," which are subject to "the approval of the relevant Chinese governmental authorities."[27] A WFOE is established pursuant to the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises.[28] A WFOE is not required to

[18] *Id.* at art. 16-19.
[19] *Id.* at art. 26, 64, 69.
[20] *Id.* at art. 6.
[21] Provision of the Ministry of Finance and State Administration of Taxation Concerning Collection of Personal Income Tax on Sole Proprietorship and Investors of Partnership Enterprise, No. 91 (promulgated by the Ministry of Finance and State Administration of Taxation, Sep. 19, 2000) art. 3 (China) [hereinafter Provision of PIT on SP and PE].
[22] Houlu Yang, *Taxing the Capital Gains of Foreign Investments in China*, TAX ANALYSTS TAX NOTES INTERNATIONAL MAGAZINE, Dec. 10, 2007, at 1051.
[23] Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (promulgated by the Nat'l People's Cong., July 1, 1979, revised Apr. 4, 1990 and Mar. 15, 2001) (China).
[24] Nee, *supra* note 13, at A-19.
[25] Law of the Peoples' Republic of China on Chinese-Foreign Cooperative Joint Ventures (promulgated by the Nat'l People's Cong., Apr. 13, 1988, revised Oct. 31, 2000) (China).
[26] Nee, *supra* note 13, at A-19.
[27] *Id.*
[28] Law of the People's Republic of China on Wholly Foreign-Owned Enterprises (promulgated by the Nat'l People's Cong., Apr.12, 1986, revised Oct. 31, 2000) (China).

be a limited liability entity, but it is "established by means of Articles of Association drafted by the foreign investor, subject to the approval of the relevant Chinese governmental authorities."[29] However, from a business and taxation perspective, FIEs can have more forms, including General Partnership ("GP"), LP, LLC and Stock Corporation ("SC"). Every form has its own business and taxation features, advantages, and disadvantages. Foreign investors can choose the most suitable one to form their business.

A. Partnership

Only CJVs and WFOEs can choose the GP or LP forms because EJVs are required to be an LLC or an SC.[30] The main difference between a GP and an LP is that an LP has Limited Partners, who assume liability only to the extent of their investment in the partnership.[31] Another difference is that a Limited Partner cannot actively participate in the operation of the partnership.[32] GPs pose no risk of personal liability because investors can use legal entities with limited liability to be partners.[33] Unlike in the United States, where investors can establish a partnership simply by adopting a Partnership Agreement, foreign investors have to register with the Administration of Industry and Commerce (AIC) to obtain an operation license.[34] LLCs are not difficult to establish as partners because the procedures for registration of a partnership and an LLC are both very simple and similar.[35] Thus, partnerships do not entail much more of a risk than LLCs or SCs in China.

Moreover, partnerships provide more flexibility for contributions, operations, and distributions. Contributions can be cash, property, services, and some rights on property, such as land use rights.[36] Partners can manage the partnership themselves, or by someone hired by the partnership;

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[29] *Id.* at art. 8; Nee, *supra* note 13, at A-19.
[30] Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (promulgated by the Nat'l People's Cong., July 1, 1979, revised Apr. 4, 1990 and Mar. 15, 2001) art. 4 (China); Law on Chinese-Foreign Cooperative Joint Ventures, art. 2; Law on Wholly Foreign-Owned Enterprises, art. 8; Provisional Regulations of the Ministry of Foreign Trade and Economic Cooperation on Certain Issues Concerning the Establishment of Companies Limited by Shares with Foreign Investment, No.1 (promulgated by the Ministry of Foreign Trade and Economic Cooperation, Jan. 10, 1995) art. 1(China).
[31] Partnership Enterprises Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) art. 2 (China).
[32] *Id.* at art. 68.
[33] *Id.* at art. 2.
[34] *Id.* at art. 9-10.
[35] Telephone Interview with Xinhua Wu, Officer of Yangpu Breach, Shanghai Administration of Industry and Commerce (Apr. 11, 2011).
[36] Partnership Enterprises Law, art. 16.

however, no management body is required.[37] Partners can make any kind of distribution within their discretion.[38]

The tax treatment of partnerships in China, however, is not as favorable as it is in the United States. In the United States, investors frequently use LPs as vehicles for tax shelters,[39] in which the losses and deductions of the partnership are computed in the same manner as an individual's would be.[40] In other words, investors can use losses and deductions from the partnership to offset other ordinary income to avoid or defer tax payment. However, in China, use of a partnership's losses or deductions to offset other enterprises' income is prohibited.[41] According to the personal income tax system in China, a partnership's losses or deductions cannot be used to offset personal income because losses from business operations cannot be used to offset income of salary, capital gains, rental royalty, or any other kind of income.[42] However, the income from different partnerships can be added together to determine the taxpayer's highest tax bracket.[43] In other words, if the partnerships have profits, the taxpayer should add them together and pay as much tax as possible; but if the partnerships have losses, the losses can only be used to offset new profits from the same partnership.

Additionally, the tax rate for partnerships is also not as good as other enterprises when the business makes significant profits. The top tax bracket for partnerships is thirty-five percent, ten percent higher than the twenty-five percent flat tax rate for other enterprises' income.[44] According to partnership tax rates, if the partnership has two partners and has an annual profit of ¥1,620,000.00 Chinese Renminbi,[45] then the partnership's

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[37] *Id.* at art. 26.
[38] *Id.* at art. 69.
[39] WILLIAM C. DROLLINGER & WILLIAM C. DROLLINGER JR., TAX SHELTERS AND TAX-FEE INCOME FOR EVERYONE 5, (Epic Publications 4th. ed. 1981).
[40] 26 U.S.C. § 703(a) (2012).
[41] Provision of PIT on SP and PE, *supra* note 21, at art. 14 (stating that when a Partner has two or more Partnership Enterprises, the losses or deduction from one enterprise cannot be used to offset the other's income); Notice of the Ministry of Finance and State Administration of Taxation Concerning Issues of Personal Income Tax on Partnership Enterprise, No. 159 (promulgated by the Ministry of Finance and State Administration of Taxation, Dec. 23, 2008) (China), (stating that if a Partner is a legal person or other organization, losses and deductions of the Partnership cannot be used to offset the profits of that legal person or organization).
[42] Law of the People's Republic of China on Individual Income Tax (promulgated by the Standing Comm. National People's Cong., Sept. 10, 1980; effective Jan. 1, 2006) art. 3-6 (China) (stating that a different character of income shall apply to different tax rates and only income from business operations can be deducted by losses or deductions from business operations).
[43] Provision of PIT on SP and PE, *supra* note 21, at art .12.
[44] *Id.* at tax rate list II; Law on Individual Income Tax, art. 3.1.
[45] *See* X-RATES CURRENCY CALCULATOR, http://www.x-rates.com/d/CNY/table.html (last visited Apr. 13, 2011) (showing that, according to recent exchange rates between the US Dollar and the Chinese Renminbi, which is 1:6.53, the profit is approximately $249,000).

tax payment equals other enterprises with the same amount of profit, unless those enterprises distribute profit to their shareholders or other investors. Any more profit would cause partnerships to pay more tax than other enterprises, such as an LLC or SC. The only way to reduce the tax payment is to add more partners and allocate profit equally to achieve a lower tax bracket. However, adding fake partners is illegal and may be punished under the authority of the State Administration of Taxation ("SAT").[46] Even though recent news indicates that the Chinese government will cut off some personal income tax, which may reduce the tax payment of a partnership, a partnership still has to pay more tax when it makes significant profit.[47] Moreover, partners have to pay tax for the partnership's profit for every year.[48] They cannot retain income in the partnership to defer tax payments because of the pass-through method of tax payment.[49]

In practice, investors usually do not choose partnerships as their business form for several reasons. First, the unfavorable tax treatment for partnerships usually persuades investors to choose an LLC as their business form.[50] Second, a partnership is required to file documentation with the AIC for any modification of the Partnership Agreement or when a partner joins or withdraws.[51] Therefore, partnerships have a similar documentation burden as LLCs.[52] Third, the stability of a partnership is not as good as an LLC, which makes it much harder for partnerships to obtain credit or financing.[53] Fourth, the legal enforcement of a Partnership Agreement is not as predictable as an Article of Incorporation because the judiciary branch has more experience with issues concerning LLCs than it does with issues concerning partnerships.[54] In sum, a partnership is not a thoroughly effective business form in China, and investors cannot use LPs and GPs as vehicles for tax shelters. The tax treatment of an LP and a GP is most favorable for small businesses.

B. Corporation

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[46] Notice of the State Administration of Taxation Concerning Developing the Review for Some Particular Tax Collection, No. 9 (promulgated by the Ministry of Finance and the State Administration of Taxation, Feb. 5, 2009) (China).
[47] Chris Oliver, *China Considers Widescale Income-Tax Cut*, MARKETWATCH, THE WALL STREET JOURNAL, (Apr. 18, 2011 *available at* http://www.marketwatch.com/story/china-considers-widescale-income-tax-cut-2011-04-18).
[48] Provision of PIT on SP and PE, *supra* note 21, at art. 17.
[49] *Id.* art. 5.
[50] Telephone Interview with Xinhua Wu, *supra* note 35.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*

Investors can establish two kinds of corporations in China: an LLC or an SC.[55] Prior to the Temporary Provisions Concerning Issues for Foreign Investors, which allowed for Stock Corporations, foreign investors could only establish an LLC as an EJV, CJV, or WFOE.[56] There are several differences between LLCs and SCs for foreign investors. First, LLCs can only have between one and fifty shareholders, while SCs can have no fewer than two shareholders.[57] Second, unlike LLCs, SCs must establish a Board of Directors,[58] hold shareholders' annual meetings, and follow other statutory procedures.[59] In other words, an LLC's management structure is more flexible. Third, LLCs can distribute profits based on shareholder agreements, but SCs must distribute based on the number of a holder's shares.[60] Fourth, an LLC's shareholders cannot transfer their shares to a third party unless half of the other shareholders consent or the Articles of Incorporation provide otherwise. In contrast, an SC's shareholders can transfer their shares to a third party without the consent of other shareholders.[61] If foreign investors can add provisions to the Articles of Incorporation that authorize the free transfer of shares to third parties, an LLC can then provide more flexibility for management, distribution, and withdrawal.

In the United States, an LLC is treated as a partnership for tax purposes; however, in China, an LLC is treated as a Corporation.[62] In China, an LLC must pay EIT at twenty-five percent of taxable income when it has income or gains, and shareholders must pay personal income tax at twenty percent of the distribution from an LLC.[63] Although the total tax rate of an LLC is forty percent[64] because it can retain income, an LLC may be able to defer more taxes or create more tax shelters than a partnership.

In sum, an LLC can provide significant flexibility to foreign investors and can offer better tax treatment than a partnership, enabling the business to profit more efficiently. Thus, an LLC is the best choice for

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[55] Company Law (promulgated by the Nat'l People's Cong., Dec. 29, 1993, effective Jan. 1, 2006) art. 15 art. 2 (China).

[56] Interim Provisions Concerning Some Issues on the Establishment of Joint Stock Limited Companies with Foreign Investment (promulgated by the Minister of Foreign Trade and Econ. Cooperation, Jan. 10, 1995) art. 1 (China).

[57] Company Law, art. 79.

[58] *Id.* at art. 109.

[59] *Id.* at art. 101.

[60] *Id.* at art. 35, 126.

[61] *Id.* at art. 72, 138.

[62] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 1 (China).

[63] *Id.* at art. 4, 6; Law of the People's Republic of China on Individual Income Tax (promulgated by the Standing Comm. National People's Cong., Sept. 10, 1980; effective Jan. 1, 2006), art. 2, 3.5 (China).

[64] $1\times(1-0.25)\times(1-0.2)=0.6$. Thus the total tax rate equals forty percent.

most foreign investors.

III. Special Treatment for Tax Purposes

Tax treatment is an important factor for investors to consider, as it affects the mobility of capital.[65] Because the adoption of the new EITL terminated some favorable tax policies, foreign investors should take precautions to reduce their tax burden. Some specialized tax treatment is available under the current law.

A. Tax Advantages under the New EITL

The main purpose of the new EITL is not to eliminate all tax advantages, but to put DEs and FIEs on a level playing field.[66] Thus, the new EITL provides some favorable tax treatment for qualified enterprises.[67] For example, the EIT may be exempted or reduced if an enterprise's income derives from the investment in or operation of projects in agriculture, forestry, animal husbandry, fisheries, state-supported public infrastructure, and qualified projects in environmental protection, water conservancy, and technology transfers.[68] Another important industry receiving favorable tax treatment under the EITL is High/New Technology Enterprises. The EIT rate of High/New Technology Enterprises is fifteen percent.[69] High/New Technology Enterprises' qualification requirements are contained in the EIT regulations.[70]

The new EITL also provides other favorable treatment to encourage new technology development, handicapped employment, and pioneering enterprises.[71] Enterprises that engage in the development of new technology, new products, or new crafts can deduct one hundred and fifty percent of the expense of such development.[72] Enterprises hiring handicapped employees can deduct two hundred percent of compensation to those handicapped employees.[73] Pioneering enterprise investors can deduct seventy percent of the investment cost from the income of such

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[65] George R. Zodrow, *Capital Mobility and Capital Tax Competition*, 63 Nat'l Tax J., 865, 869 (Dec. 2010).
[66] Xiaoyong Zhang, *Eliminating Privileges Enjoyed by Foreign Investors in China: Rationality and Ramifications under a Unified Tax Code*, 12 Deakin L. Rev. 79, 98 (2007).
[67] *Id.*
[68] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 27 (China).
[69] *Id.* at art. 28
[70] EIT Regs., *supra* note 14, at art. 93.
[71] Enterprise Income Tax Law, art. 30-31.
[72] EIT Regs., *supra* note 14, at art. 95.
[73] *Id.* at art. 96.

enterprises two years after the investment.[74] Foreign investors, especially those with the ability to operate high technology development or with experience encouraging such projects, should consider seeking these benefits.

B. Round Trip Investment

Round trip investment is a kind of investment structure generally used to avoid capital gains.[75] Foreign investors establish an offshore holding company as a beneficiary of a bilateral income tax treaty with China or as a tax haven to minimize or avoid Chinese capital gain tax.[76] "Through the round-tripping the offshore holding company is only subject to a withholding tax on the distribution of dividends from the PRC-based operating company."[77] The withholding tax rate is ten percent and can be as low as five percent if the offshore company is incorporated in Hong Kong.[78] This tax rate is much lower than the twenty percent of the personal income tax rate on dividends, or the twenty-five percent EIT rate on non-resident enterprises with an establishment in China.[79] Round trip investment has been used widely, and it is most popular in Hong Kong and the British Virgin Islands. In 2008, foreign direct investment to China amounted to $92,395 million US dollars of which around 44.41 percent and 17.27 percent came from Hong Kong and the British Virgin Islands, respectively.[80]

In the 1990s, the Chinese government became aware of this problem and took various measures to prohibit the use of offshore holding companies involving Chinese companies and assets.[81] Although the main purpose of these measures was to restrict Chinese companies from establishing offshore holding companies to go public abroad, the measures have affected the capital flow of foreign investors.[82] The SAT also has begun to pay more attention to non-resident enterprises' activities in China,

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[74] *Id.* at art. 97.
[75] *Practical Strategies for Global Investments*, BUS. RECORDER, Apr. 21, 2011, *available at* http://www.brecorder.com/component/news/single/626:news.html?id=1180594.
[76] Xu & Granwell, *supra* note 4, at 971.
[77] Shen Wei, *Face Off: Is China a Preferred Regime for International Private Equity Investments? Decoding a "China Myth" from the Chinese Company Law Perspective*, 26 Conn. J. Int'l L. 89, 125 (2010).
[78] Jinji Wei, *Taxing Foreign Enterprises in China,* 52 Tax Notes Intl. 567, 573 (Nov. 17, 2008).
[79] Enterprise Income Tax Law, art. 3; Law of the People's Republic of China on Individual Income Tax (promulgated by the Standing Comm. National People's Cong., Sept. 10, 1980; effective Jan. 1, 2006), art. 3 (China).
[80] Wei, *supra* note 78, at 130.
[81] *Id.* at 134.
[82] Ya Zhang & Shoushuang Li, *China's control on utilisation of offshore vehicles and its implications* 30 Co. Lawyer,113, 113-15 (2009).

which may lead to closer review from the SAT.[83]

It is believed that any interest or dividend payments made by an offshore holding company and/or capital gains derived from the sale of shares in an offshore holding company are free of Chinese tax, but sales proceeds in a share transfer for a purely domestic company in China are deemed to be taxable income and subject to EIT.[84] However, recent cases and regulations have defied this expectation. New regulations authorize the competent tax authority to re-characterize the equity transfer transaction based on the economic substance, subject to review by the SAT, if a foreign investor indirectly disposes of the shares in a Chinese resident enterprise through an arrangement that lacks a reasonable commercial purpose and avoids the EIT liabilities.[85] Such a foreign investor will be required to disclose the equity transaction to the competent tax authority, even though the whole transaction occurs outside of China.[86]

Recent cases also show that the SAT and local tax authorities have applied this rule to some equity transactions. In 2008, a Chinese company in Chongqi, China ("C1") completed a transaction with a Singaporean company ("S1") to purchase all stock of another Singaporean company ("S2"), which was wholly owned by S1. Furthermore, S2 owned 31.6 percent of the shares of another Chinese company ("C2"). Even though the transaction occurred outside of China, the SAT still concluded that this transaction was an indirect equity transferring of a Chinese company because the only property of S2 was the shares of C2, and S2 was a vehicle to avoid the tax of the equity transfer.[87] Under the order of the SAT, C1 withheld the capital gains tax of S1 from its payment.[88]

Another similar case occurred in Jiangsu, China in 2010. The SAT received information that a foreign investor had transferred his wholly-owned Hong Kong holding company to another foreign investor. The only property of the Hong Kong holding company was shares of a domestic company in Jiangsu, China. The SAT concluded that the transaction was an indirect equity transfer of a Chinese company, and that the transferor should pay capital gains tax, even though the transaction occurred outside

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[83] Owen Chan, *China: A Tightening Tax Net for Foreign Investment Enterprises*, 6 TAX POL'Y & CONTROVERSY BRIEFING (2011).
[84] Wei, *supra* note 78, at 125.
[85] Notice on Strengthening Management of Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises, (promulgated by the State Administration of Taxation, Dec. 10, 2009) (China).
[86] *Id.*
[87] *See* Jinji Wei, *Taxing Foreign Companies on Capital Gains in China*, 58 Tax Notes Int'l 323, 326 (2010).
[88] *Id.*

of China and no Chinese party was involved.[89]

However, it is not easy to apply this rule to foreign investors. The circumstances surrounding the two aforementioned cases are unusual. In the first case, when the SAT discovered the transaction, the purchaser, C1, had not paid the purchase price.[90] It was easy for the SAT to obtain the tax payment before C1 paid the purchase price because, if a Chinese company was unwilling to allow the tax payment, the SAT could freeze its bank account until the payment was fully received.[91] In the second case, the seller was a famous multinational corporation doing a significant amount of business in China. If the corporation did not comply with the SAT's decision, the SAT could create problems for the corporation.[92] Therefore, if a foreign investor involves parties that are not Chinese enterprises and the transaction occurs outside of China silently, or even uses an undisclosed agency to complete the transaction, then the SAT could not collect the taxes or stop the transaction.[93] If a holding company's reasonable commercial purpose is readily apparent to the SAT, then the SAT may refrain from applying the re-characterization rule.[94] In sum, round trip investment is an effective way to reduce tax burdens, especially on capital gains, but carries with it some legal risks.

C. Debt Financing

Under the new Chinese tax treatment, an enterprise's interest payments are deductible.[95] Foreign investors can loan money to an enterprise in which it would like to invest instead of providing a direct contribution. However, a loan that "exceeds the stipulated standards" is prohibited.[96] Some particular rules also restrict debt financing from investors. For example, the interest rate cannot exceed the standard loan rate of a financing institution or the interest of the excess amount cannot qualify for a deduction.[97] Additionally, the loan amount cannot exceed half of the investor's contribution amount or the interest of the excess amount

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[89] *See* Xiaowei Liu, *Indirect Equity Transferring May Pierce the Corporation's Veil*, http://www.haitax.com/uchome/space.php?uid=30&do=blog&id=508 (last visited Apr. 20, 2011).
[90] Telephone Interview with Gang Chen, Officer of Dongcheng Breach of Beijing State Administration of Taxation (Apr. 09, 2011).
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] EIT Regs., *supra* note 14, at art. 38.
[96] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 46 (China).
[97] EIT Regs., *supra* note 14, at art. 38.

will not qualify for deduction.[98] Tax authorities also have the power to "make an adjustment whenever a taxpayer has entered into an arrangement with no commercial purpose, which has the effect of reducing taxable revenue or income."[99] Within the restrictions, reasonable debt financing is widely used as a tax shelter.[100]

Moreover, the United States - China Income Tax Treaty limits the income tax burden China can charge on interest that US nationals earn in China to ten percent.[101] US investors have the same tax rate on interest as on dividends income. Debt financing will not increase the tax burden on investors. Despite the many restrictions on debt financing, it is still a good way to achieve deductions more easily.

D. Using Partnerships as a Vehicle of Property Transactions

Because a partnership is generally not attractive to investors, the restrictions and monitoring of partnerships are much less stringent than for LLCs and other enterprises.[102] For example, the SAT does not issue anti-avoidance rules for partnerships such as it does for other enterprises. While "disguised sales" are permitted in China, these transactions are subject to special rules in the United States.[103]

Investors can use partnerships to avoid income tax on property transfers. Ordinarily, if the seller directly sells its property to the buyer, the seller has to pay taxes on the gain from this transaction, which are calculated based on the difference between the selling price and the tax basis.[104] The tax basis is the cost of the property minus the total depreciation.[105] For example, if the selling price was the fair market value of $1,000,000, and the cost of the property was also $1,000,000, then the amount of depreciation would be $500,000. The gain of this transaction should be $1,000,000 minus $500,000 to total $500,000, and the tax payment of this transaction would therefore be twenty-five percent of $500,000, to total $125,000.

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[98] Notice of the State Administration of Taxation on the Issuance of the Provisional Measure of Deduction No. 84 [Guoshuifa] (2000) (China) [hereinafter Provisional Measure].
[99] Nee, *supra* note 13, at A-82.
[100] Telephone Interview with Weida Feng, Chief Accountant of Zhejiang Heshun Plastic Product Co., Ltd. (Apr. 07, 2011).
[101] Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, with Protocol and Exchange of Notes, U.S.-China, art. 10, Apr. 30, 1984, T.I.A.S. 12065.
[102] Telephone Interview with Gang Chen, *supra* note 90.
[103] 26 U.S.C. § 707 (2012).
[104] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 16 (China).
[105] EIT Regs., *supra* note 14, at art. 58-59.

However, if the investors use a partnership to avoid the tax, they will only have to pay the registration fee of the partnership, which is less than ¥400 Chinese Renminbi.[106] Partners can contribute cash, property, or other rights to the Partnership, and then can either negotiate among themselves or obtain a third-party evaluation to determine the value of the contributed property.[107]

To complete the "disguised sale," the seller should contribute the property and the buyer should contribute cash with equal value to the property. The seller should then assign a third, indifferent party as a partner to maintain the partnership after the transaction. Without the third party, the partnership would have to dissolve after the transaction, when the buyer leaves the partnership.[108] It is not desirable for a partnership to have a very short period of time between establishment and dissolution because the short duration may evoke suspicion from tax authorities.[109] After both parties respectively contribute the cash and the property, the buyer can withdraw from the partnership with the property, and the seller will retain the money.[110] Because the money comes from contribution and not from operations, it is not defined as income; thus, the seller will not have to pay tax on the property transfer.

LLCs cannot use disguised sales, unlike partnerships. First, when one LLC contributes its property to another LLC, the transfer is treated as a property sale between LLCs at fair market value, and thereby gains will be recognized.[111] Second, the SAT has also adopted rules that are similar to the IRS's reportable transaction regulations[112] to prevent related parties' unreasonable transactions.[113]

Overall, by establishing a partnership and not an LLC, a seller can avoid income tax and the buyer can likely buy the property at a lower price.

E. Real Estate Investment

Real estate investment is a popular tax-deferring measure in the United States,[114] and foreign investors in China can operate similar investments. Foreign investors can purchase real estate property and use

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[106] Telephone Interview with Xinhua Wu, *supra* note 35.
[107] Partnership Enterprises Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) art. 16 (China).
[108] *Id.* at art. 85.
[109] Telephone Interview with Gang Chen, *supra* note 90.
[110] Partnership Enterprises Law, art 52. (stating that a departing Partner shall receive his Partnership interest and that the interest can by paid as cash or property).
[111] EIT Regs., *supra* note 14, at art. 25.
[112] Jeffrey H. Paravano & Melinda L. Reynolds, *Tax shelters (Portfolio 798)*, A:21-22 (2003).
[113] Provisional Measure, *supra* note 98, at art. 9-12.
[114] DROLLINGER & DROLLINGER JR., *supra* note 39.

the depreciation to offset income, and then sell the property to achieve gains. Real estate investment is most effective where the enterprise has enough income to be offset. For example, suppose A is an LLC and has a taxable income of $10,000,000 every year. After purchasing $200,000,000 in real estate property in the first year, A will have $10,000,000 in depreciation every year.[115] After full depreciation, A sells the real estate property and recognizes gain and income in the twenty-first year. Assuming the interest rate is five percent, the future value of tax payment without real estate investment in the twenty-first year will be approximately $89,298,000, while the future value of tax payment with a real estate investment in the twenty-first year will be $52,500,000. This demonstrates how real estate investment can save an investor $36,798,000 over twenty years.

However, real estate is not a liquid enterprise, and real estate investors assume large price fluctuation risks. Contributing a large amount for real estate investment may lead to cash flow problems. Moreover, the Chinese government is attempting to collect property taxes, which will increase the burden for investors.[116] In addition, the Chinese government has some restrictions on real estate investment market access.[117]

It is inconvenient to operate a large range of real estate investments because of the heavier restrictions for foreign investors. But real estate can nonetheless have some contributions on overall tax deferring.

IV. Other Issues of Tax Treatment

In addition to selecting the most suitable business form and considering special tax treatment, foreign investors should also consider other issues of tax treatment. First, foreign investors should consider that tax regulation is modified frequently. The taxation statutes usually have only general principles,[118] while the detailed Regulations from the State Council or even Circulars from the SAT contain more critical information to the interpretation of the laws.[119] One purpose of this approach is to enable policymakers to retain the ability to alter regulations to deal with dynamic economic situations.[120] In 2009, the SAT issued more than six hundred Circulars and some of them are critical to foreign investors. Investment circumstances may change dramatically with new

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[115] EIT Regs., *supra* note 14, at art. 60.
[116] *China to Speed up Reform of Resource, Property Taxes,* CHINA DAILY, Apr. 21, 2011.
[117] *China's Tightening Measures Hurt Foreign Investors: Experts*, THE CHINA POST, Feb. 28, 2011.
[118] Nolan C. Sharkey, *China's New Enterprise Income Tax Law: Continuity and Changes*, 30 U. New S. Wales L. J. 833, 833 (2007).
[119] *Id.*
[120] *Id.* at 834.

interpretations of laws or new implementing rules. Therefore, foreign investors should pay attention to these materials, even before they are issued.

Second, because Chinese tax law is not very transparent and changes rapidly, no one can interpret it perfectly.[121] Even large Multinational Corporations may not be able to avoid tax problems.[122] Developing a relationship with local tax authorities and their officers is an effective way to reduce the legal risk of tax deferment and to avoid investigation.[123] In this way, foreign investors may be able to access unpublished information, or even operate though local tax authorities to lobby the central government to establish more favorable policies.[124]

Third, foreign investors should acknowledge that the Chinese government has begun to impose more taxes on FIEs in order to treat them as equitably as DEs.[125] China has more than three trillion dollars in foreign exchange reserves.[126] Thus, China is not as hungry for foreign investment as it was several decades ago. Future favorable tax treatment will mostly focus on high technology industries, such as new energy, and normal FIEs will face more competition in the future.[127] To continue taking advantage of favorable tax treatments, foreign investors should consider investing in high technology businesses.

Fourth, foreign investors may even benefit from increased tax payments. Local governments will usually provide more benefits to profitable enterprises in order to keep these major sources of revenue in their territory.[128] Local governments may provide more projects, financing, or policy advantages to the major taxpayers.[129] Therefore, foreign investors should find a balance between their interests in tax reduction and other policy advantages.

Conclusion

[121] Telephone Interview with Weida Feng, *supra* note 101.
[122] Liang Chen, *Google is Under Investigation of Huge Amount Tax Evasion,* http://tech.163.com/07/1122/10/3TT94HPM000915BF.html (accessed Apr. 10, 2011).
[123] James C. Chapman & Wanli Xu, *The Road to China: Ten Key Lessons for Doing Business in China,* 28, Licensing J. 8 (2008).
[124] Telephone Interview with Weida Feng, *supra* note 100; Telephone Interview with Gang Chen, *supra* note 90.
[125] Jurien Groot, *China Imposes Additional Tax on Foreign Enterprise, Invested Enterprises and Individuals*, NEWSFLASH CHINA, Dec. 23, 2010.
[126] *China's Foreign Exchange Reserves Over 3 Trillion,* NEWSTIME, http://www.newstime.co.za/Business/Chinas_Foreign_Exchange_Reserves_Over_3_Trillion/24131/ (accessed Apr 18, 2011).
[127] Enterprise Income Tax Law (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 28 (China).
[128] Telephone Interview with Weida Feng, *supra* note 100.
[129] *Id.*

China is the second-largest economy in the world.[130] Economic development in China is still growing rapidly and there are many opportunities to invest in China. However, China has begun to treat DEs and FIEs more equally, and thus has begun to impose more taxes on FIEs. Tax treatment is becoming increasingly important for foreign investors. The more effective the tax treatment is, the more probable the foreign investor will succeed in China.

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[130] David Barboza, *China Passes Japan as Second-Largest Economy*, N.Y. TIMES, Aug. 15, 2010, at B1.