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United States-People's Republic of China Income Tax Treaty: Opening the Door to Increased Economic Cooperation

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COMMENT

United States-People's Republic of China Income Tax Treaty: Opening the Door to Increased Economic Cooperation

I. Introduction

In the last decade the People's Republic of China (PRC) has witnessed unprecedented levels of economic growth and industrial modernization. This phenomenon is due largely to progressive economic reforms and an increasingly receptive attitude toward working with more developed nations.\(^1\) By October 1986 the PRC had negotiated or concluded income tax treaties with both developed and developing nations to resolve the double taxation problems facing business entities that operate in these countries.\(^2\)

As the PRC's economy has grown so has the United States' interest in commerce between the two nations.\(^3\) Nevertheless, differences between the two countries' legal systems, particularly in the area of taxation, have obstructed closer economic cooperation. In an effort to overcome some of these internal legal obstacles, the United States and the PRC recently concluded a comprehensive tax treaty,\(^4\) Zheng, *The Sino-U.S. Income Tax Treaty and Its Effect on Chinese Taxation of American Economic Interests*, 40 Tax Law. 733, 733-34 (1986). Reform is especially apparent in the PRC's commercial law framework developed over the last few years. In the past four years the PRC has enacted more than 100 statutes concerning foreign economic relations. \(^5\) Recent changes in the PRC's trademark and patent law facilitate foreign investment in the PRC. For a discussion of the current trademark and patent laws of the PRC, see Woods, *Trademark and Patent Law in the People's Republic of China*, 13 N.C.J. Int'l L. & Com. Reg. 473 (1988).

\(^1\) Voyu Shisiguo Qianding Bimian Shuangchong Zhengshui Xieding [China Concluding Treaties of Avoiding Double Taxation With Fourteen Nations], People's Daily, Oct. 23, 1986, at 3. Nations negotiating or concluding tax treaties with the PRC include: France, the Federal Republic of Germany, Sweden, Belgium, Japan, Norway, the United Kingdom, Austria, Australia, Canada, Denmark, Finland, Italy, Malaysia, Singapore, Switzerland, the Netherlands, Romania, Thailand, and Yugoslavia. Several of these treaties contain tax-sparing provisions that entitle taxpayers to a complete exemption from taxes on the foreign income in the home country. \(^6\)

\(^2\) Id.

\(^3\) U.S. exports to the PRC increased from $824 million in 1978 to approximately $3 billion in 1984. U.S. imports from the PRC increased from $357 million to $3.381 billion over the same period. *International Monetary Fund, Director of Trade Statistics Yearbook* 399 (1985). The PRC is the twenty-second largest trading partner of the United States. The United States is the PRC's third largest partner. *Bureau of Public Affairs, U.S. Dept. of State, U.S.-China Relations* 2 (July 1984).
Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (Treaty), which allows residents of these nations to avoid the burden of double taxation.\footnote{Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, United States-People's Republic of China \(\text{U.S.T. } \text{T.I.A.S. No.} \text{reprinted in} \text{I TAX TREATIES (CCH) } 1401-1431 (1986) [hereinafter Agreement for the Avoidance of Double Taxation]. The Articles discussed in this Comment are as follows.}


\begin{itemize}
\item \textit{Taxing Jurisdiction}
\item \textit{Treaty Definitions} — Article 4.
\item \textit{Residence} — Article 4. (\textit{See infra p. 530}).
\item \textit{Permanent Establishment} — Article 5. (\textit{See infra p. 532}).
\item \textit{Substantive Rules of Taxation}
\item \textit{Business Profits} — Article 7. (\textit{See infra p. 533}).
\item \textit{Dividends} — Article 9. (\textit{See infra p. 536}).
\item \textit{Interest} — Article 10. (\textit{See infra p. 536}).
\item \textit{Royalties} — Article 11. (\textit{See infra p. 536}).
\item \textit{Personal Services} — Articles 13 and 14. (\textit{See infra p. 534}).
\item \textit{Directors' Fees} — Article 15. (\textit{See infra p. 535}).
\item \textit{Entertainer and Athlete Exemption} — Article 16. (\textit{See infra p. 535}).
\item \textit{Pensions} — Article 17. (\textit{See infra p. 535}).
\item \textit{Remuneration Other than Pensions} — Article 18. (\textit{See infra p. 535}).
\item \textit{Student and Trainee Exemption} — Article 20. (\textit{See infra p. 535}).
\item \textit{Coordinated Tax Measures}
\item \textit{Tax Credits} — Article 22. (\textit{See infra p. 538}).
\item \textit{Nondiscrimination Provisions} — Article 23. (\textit{See infra p. 539}).
\item \textit{Mutual Agreement Procedure} — Article 24. (\textit{See infra p. 540}).
\item \textit{Exchanges of Information} — Article 25. (\textit{See infra p. 540}).
\end{itemize}
to reduce double taxation of income and tax evasion. The Treaty incorporates coordinated tax measures such as tax credits, nondiscrimination provisions, mutual agreement arrangements, and exchanges of information provisions. The parties to the Treaty also signed an accompanying protocol (1984 Protocol), which contains a "savings clause" and provisions to discourage "treaty shopping." Responding to charges that provisions against treaty shopping were inadequate, both nations negotiated and signed an additional protocol (1986 Protocol) to interpret the anti-treaty shopping provisions of the 1984 Protocol. Subsequently, the Treaty was ratified and entered into force on November 21, 1986 for income derived in taxable years beginning on or after January 1, 1987.

This Comment explains how certain provisions of the U.S.-PRC tax treaty facilitate the United States' dual goals of greater economic cooperation and normalization of political relations with the world's most populous nation. First, this Comment discusses the coverage

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6 Agreement for the Avoidance of Double Taxation, supra note 4, at arts. 22-25.
8 Treaty shopping is the use of a tax treaty by a business entity in a third country to avoid paying taxes in another country. BISCHEL & FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 272-75 (1985). Third country business entities often seek to avoid receiving income in their own country in their own name. The entity routes the income to a holding company, trust, or nominee in a tax haven country in which the United States has a tax treaty. As a result, the entity enjoys the low rates or exemptions from income tax provided by the treaty. Id.
10 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 27. On December 11, 1985, the Senate Committee on Foreign Relations recommended that the Senate give its consent to ratify the Treaty. SENATE REPORT, supra note 7. The Committee based its recommendation on the understanding that Hong Kong would be excluded from the Treaty. The Committee also noted the following concerns: That certain concessions granted not be the starting point for future negotiations with developing countries; that the United States monitor changes in PRC law to ensure the Treaty adequately discouraged treaty shopping; and that the Treaty not restrict the U.S. tax reform process. Id. A full Senate vote was blocked by Senator Jesse Helms (R.-N.C.) who argued that the Treaty lacked adequate anti-treaty shopping provisions. Schmitt, Helms on a New Target: Tax Treaty with China, N.Y. Times, Mar. 17, 1986 at 12, col. 3 (national ed.).
11 See Note, United States Tax Treaty Policy Toward Developing Countries: The China Example, 35 UCLA L. REV. 369, 370-71 (1987) (arguing that economic and political foreign policy objectives motivated and influenced the Treaty negotiation process). In providing for a relatively broad source basis of taxation, the Treaty departs from the U.S. and OECD
of the Treaty, with particular emphasis on the jurisdictional concepts of "residence" and "permanent establishment." Second, the Treaty's substantive provisions for the avoidance of double taxation are examined. Third, this Comment discusses the Treaty's "coordinated tax measures" including provisions for tax credits, nondiscrimination, mutual agreements, and exchanges of information. Finally, the two protocols for the prevention of treaty shopping are explained.

II. The Treaty's Jurisdictional Reach

As in any tax treaty, the initial inquiry in the U.S.-PRC agreement is whether jurisdiction can be asserted over the contracting parties. The two key jurisdictional concepts in the Treaty are "residence" and "permanent establishment."

A. Residence

Taxpayers who qualify as residents of the United States, the PRC, or both are eligible for the Treaty's benefits.12 "Resident" is defined in Article 4 of the Treaty as any person or entity that is liable for tax in a contracting state because of "domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature."13 This definition is taken from the United Nations Model Treaty,14 but does not differ materially from that of the U.S. Model Treaty.15

Dual residency occurs when the taxpayer is considered a resident of both the United States and the PRC under the domestic laws of each.16 According to the 1984 Protocol, the "competent authorities"17 should follow the U.N. Model Treaty tie-breaker rules to de-
termine treatment of a dual-resident individual. Under the Treaty, the taxpayer bears the responsibility of recognizing whether a dual residency problem exists and if so, of bringing the matter to the attention of the competent authorities.

The methods of resolving dual residency differ between individual and corporate taxpayers. Individual taxpayers can resolve dual residency problems without much difficulty. Residence for individual taxpayers is determined according to Article 4 of the U.N. Model Treaty. Under the U.N. Model Treaty, residence is defined as the contracting state where the taxpayer has, in order of priority, a permanent home, a center of vital interests, an habitual abode, or nationality. If none of these factors are determinative, the competent authorities are to resolve questions of residency by mutual agreement.

For dual-resident corporate taxpayers, the Treaty merely provides that the authorities must reach an agreement. No tie-breaking rules apply. If the authorities fail to reach an agreement, the company is not treated as a resident of either contracting state. Thus, whether a dual-resident corporation can enjoy the significantly reduced withholding rate under the Treaty depends entirely on the competent authorities' reaching an agreement. Consistent with

gated to the Commissioner of the Internal Revenue, who has redelegated the authority to the Associate Commissioner (Operations). Senate Report, supra note 7. The PRC competent authority is the Ministry of Finance. Agreement for the Avoidance of Double Taxation, supra note 4, at art. 3, para. 1.

18 1984 Protocol, supra note 7, at para. 5.
19 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 24, para. 1.
20 Under the Treaty a "person" includes "an individual, a company, a partnership and any other body of persons." Agreement for the Avoidance of Double Taxation, supra note 4, at art. 3, para. 1. The Treaty defines "company" as "any body corporate or any entity which is treated as a body corporate for tax purposes." Id.
21 1984 Protocol, supra note 7, at para. 5.
22 The United Nations Model Double Taxation Convention provides that:
(a) he shall be deemed to be a resident of the State in which he has made a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
(b) if the State in which he has a center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has a habitual abode;
(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the state of which he is a national;
(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

U.N. Model Double Taxation Convention, supra note 5, at art. 4, para. 2. This rule is virtually identical to the rules of the OECD and U.S. Model Treaties.
25 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 4, para. 2.
24 Id. at art. 4, para 3.
26 Zheng, supra note 1, at 748-49.
the OECD and U.S. Model Treaties, the U.S. Treasury Department states that it will treat an entity incorporated in the United States as a U.S. resident.\textsuperscript{27}

The Treaty incorporates a new rule providing that when a company is a resident of both the United States under the Treaty and of a third country under a separate treaty with the PRC, the company cannot be considered a resident of the United States for purposes of enjoying the benefits under the Treaty.\textsuperscript{28} Rather, the agreement between the PRC and the third country prevails. The motive behind this denial of U.S. residency is to prevent a corporation from treaty shopping by qualifying as a resident under more than one agreement and then claiming benefits under the agreement that provides the more favorable treatment.\textsuperscript{29}

\section*{B. Permanent Establishment}

The concept of permanent establishment further defines the contracting states' jurisdiction to impose taxes under the Treaty. Article 5 of the Treaty defines "permanent establishment" as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."\textsuperscript{30} This definition incorporates aspects of both the U.S. and U.N. Model Treaties and measures the degree of business activity necessary to subject the enterprise to taxation on profits earned inside the taxing country.\textsuperscript{31}

The presence or absence of a permanent establishment determines whether the business profits of a corporate entity residing in one contracting country are taxable in the other country under the Treaty. For business profits to be taxable in the country in which the taxpayer is not a resident, they must be attributable to a permanent establishment in that country.\textsuperscript{32} For example, the business profits of a resident of Country A cannot be taxed by Country B unless the profits are attributable to a permanent establishment in Country B.

The Treaty includes as permanent establishments places of management, branch offices, factories, workshops, and places for the extraction of natural resources.\textsuperscript{33} In addition, some activities consti-

\begin{footnotesize}
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\item[28] Agreement for the Avoidance of Double Taxation, supra note 4, at art. 4, para. 4.
\item[29] Kelly, supra note 15, at 89.
\item[30] Agreement for the Avoidance of Double Taxation, supra note 4, at art. 5, para. 1.
\item[31] Zheng, supra note 1, at 749.
\item[32] Zheng suggests that permanent establishment has broader coverage under PRC tax law. Id. at 750-51. The Treaty, therefore, is a significant limitation on the taxing jurisdiction of the PRC. Id. at 751.
\item[33] Agreement for the Avoidance of Double Taxation, supra note 4, at art. 5. This
\end{itemize}
\end{footnotesize}
tute a permanent establishment if conducted for more than a specified number of months.\textsuperscript{34} Certain agency relationships also may constitute a permanent establishment. While an independent agent does not constitute a permanent establishment unless he acts exclusively on behalf of the enterprise,\textsuperscript{35} a dependent agent with authority to conclude contracts is regarded as a permanent establishment.\textsuperscript{36} The Treaty specifically excludes certain other activities from the definition of permanent establishment. Some of these activities are: Maintaining a fixed place of business solely for storing or displaying goods, purchasing goods or collecting information for the enterprise, and carrying on preparatory or auxiliary activities.\textsuperscript{37}

III. Substantive Rules of Taxation

If the requirements for jurisdiction are satisfied, the substantive rules of the Treaty supersede the laws of the individual contracting state.\textsuperscript{38} In addition to enforcement provisions, the substantive rules cover the various types of income that are categorized as business profits, personal services, and income from certain assets.\textsuperscript{39}

A. Business Profits

Article 7 provides that “business profits” of an entity residing in

\textsuperscript{34} Agreement for the Avoidance of Double Taxation, \textit{supra} note 4, at art. 5. For example, sites used to exploit natural resources and services furnished through employees may be a permanent establishment if these activities exceed six months of a calendar year. \textit{Id.} One commentator suggests that the adoption of the shorter U.N. version, rather than the twelve month period required under the U.S. and OECD Model Treaties, represents a new policy of the United States to assist developing countries by expanding their tax bases. \textit{See Cox, supra} note 5, at 130. The permanent establishment provisions for services necessitate careful tax planning so that they do not aggregate beyond the permanent establishment threshold.

\textsuperscript{35} Agreement for the Avoidance of Double Taxation, \textit{supra} note 4, art. 5, para. 6.

\textsuperscript{36} \textit{Id.} at art. 5, para. 5.

\textsuperscript{37} \textit{Id.} at art. 5.


\textsuperscript{39} \textit{Id.} at arts. 7, 9-11, 13, 14.
one contracting state are taxable in the other contracting state only to the extent that the profits are attributable to a permanent establishment in the other state through which the enterprise conducts its business. The Treaty does not define "business profits," but implicitly excludes from the term types of income governed by other provisions of the Treaty. The Treaty provides an arm’s-length standard for determining whether profits are attributable to a permanent establishment. Attributable profits are those that an enterprise might be expected to realize if it were an independent enterprise engaged in similar activities under similar conditions and dealing at arm’s length with the enterprise of which it is a permanent establishment.

PRC tax law does not distinguish between business income from a foreign company conducting business through a locally incorporated subsidiary and income from a foreign company’s subsidiary with a branch office in the PRC. As a result, the Treaty’s standard for attributing business profits is especially helpful to the tax planner. In addition, each contracting state may develop its own formula for attribution so long as it is consistently applied. In computing profits all actual expenses of the permanent establishment may be deducted. Deductions include a reasonable allocation of executive and administrative expenses, regardless of where the expenses are incurred. No deduction, however, is allowed for royalties and interest paid by the permanent establishment to the head office other than as reimbursements for actual costs incurred.

B. Personal Services

Several provisions in the Treaty govern the taxation of income earned through the performance of services. Article 13 permits a contracting state to tax the income of a nonresident who provides

40 Id. at art. 7. This tax is patterned after those found in the U.N. and U.S. Model Treaties. See Zheng, supra note 1, at 751.
41 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 7. Income from certain assets including dividends (art. 9), interest (art. 10), and royalties (art. 11) are not covered by Article 7. Id. at arts. 5, 7.
42 Zheng, supra note 1, at 753.
43 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 7, para. 2.
45 Cox, supra note 5, at 132.
46 Agreement for the Avoidance of Double Taxation, supra note 4, at arts. 6, 7.
47 Id. at art. 7, para. 5. The limitation on reimbursements to the head office of the enterprise represents a concession by the United States to the revenue interests of developing countries. See Cox, supra note 5, at 131.
48 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 7, para. 3.
49 Id.
50 Id. at arts. 13, 14.
"professional services" of an "independent character" only when
that person is present for a period exceeding 183 days of the calen-
dar year or has a fixed base regularly available to him in the nonresi-
dent country for the purposes of performing his services.51 Under
Article 14, the income earned by a nonresident employee also may
be taxed by the contracting state if the employee is present within
the state for more than 183 days, he is employed by a resident em-
ployer, or his compensation was paid by a permanent establishment
of the employer.52 The Treaty provides special taxes and exemp-
tions for directors' fees,53 entertainers and athletes,54 pensions,55
governmental services,56 teachers and researchers,57 and students
and trainees.58

The PRC's individual income tax imposes progressive rates on
income earned by employees ranging from five to forty-five percent
and a flat rate of twenty percent on most other personal services.59
The rate structure remains the same under the Treaty.60 Under PRC
individual income tax law, compensation is exempt from tax if the
foreign employee remains in the PRC fewer than ninety days.61 The
Treaty extends this period to 183 days.62 In addition, the PRC indi-
vidual income tax exemption applies only to income paid by foreign
employers,63 while the Treaty applies to both foreign-sourced and

51 Id. at art. 13, para. 1. Professional services include: Independent scientific, liter-
ary, artistic, educational, or teaching activities; and independent activities of physicians,
lawyers, engineers, architects, dentists, and accountants. Id. As a result, a U.S. doctor
present in the PRC for more than 183 days in a calendar year is subject to PRC tax on
income derived in the PRC during that year. See Cox, supra note 5, at 132.
52 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 14, para. 2.
53 Id. at art. 15.
54 Id. at art. 16, para. 1.
55 Id. at art. 17.
56 Id. at art. 18.
57 Id. at art. 19.
58 Id. at art. 20. Cox suggests that the imposition of taxes or exemptions for several
categories exists for personal services that the PRC seeks either to encourage or discour-
age. Cox, supra note 5, at 133. For example, the Treaty's exemptions for teachers, re-
searchers, students, and trainees illustrate the PRC's interest in the exchange of ideas
through human capital. Id. PRC students and trainees are attracted to the United States
by the relatively advanced technology and facilities. The same attractions, however, do
not exist for U.S. students and trainees in the PRC. U.S. students are primarily interested
in the PRC's culture, language, and history. Note, supra note 11, at 855 n.90. The exemp-
tion under the Treaty for visiting students and trainees is broader than that provided in
the U.S. and OECD Model Treaties. See Senate Report, supra note 7.
59 See Individual Income Tax Law of the People's Republic of China [IITL], Fifth
National People's Cong., 3d sess. (Sept. 10, 1980), reprinted in Longman Group Ltd., The
60 Zheng, supra note 1, at 764. Zheng reaches this conclusion because Articles 13 and
14 fail to impose any limitation on tax rates. Id.
61 See Gelatt & Pomp, supra note 38, at 427.
62 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 13, para. 1.
This aspect of the Treaty offers the taxpayer a distinct advantage over the PRC's domestic
tax law.
63 See Gelatt & Pomp, supra note 38, at 430.
PRC-sourced income.\textsuperscript{64}

As a result, the Treaty benefits individuals who engage in independent services and receive income for their services in the PRC only by extending the exemption period.\textsuperscript{65} For example, a U.S. lawyer is exempt from fees paid by PRC clients in the PRC for 183 days, even though the service and the payment are made in the PRC.\textsuperscript{66} A U.S. lawyer with a "fixed base" in the PRC, however, is taxable in the PRC for independent services performed in the PRC.\textsuperscript{67}

\textit{C. Dividends, Interest, and Royalties}

Another important feature of the Treaty is its treatment of passive income from investment assets like dividends, interest, and royalties. Under PRC tax law passive income from investment assets is subject to differing flat rates of withholding, depending upon the applicable tax.\textsuperscript{68} The U.S. Internal Revenue Code imposes a thirty percent flat rate on the taxpayer.\textsuperscript{69} The resident country of the income recipient also imposes a tax on income received. If the recipient is a resident of the other contracting state and is the beneficial owner of the payments, the Treaty limits the amount that may be withheld by the other contracting state to ten percent of gross dividends and interest paid by a resident company.\textsuperscript{70} The Treaty permits the source country to withhold a certain percentage of tax from the income when it is paid.\textsuperscript{71} While the payer of dividends must be a resident of the withholding country,\textsuperscript{72} interest and royalties are subject to withholding regardless of the payer’s residence when the payer operates

\textsuperscript{64} Agreement for the Avoidance of Double Taxation, supra note 4, at art. 13, para. 1.
\textsuperscript{65} Zheng, supra note 1, at 765.
\textsuperscript{66} See Agreement for the Avoidance of Double Taxation, supra note 4, at art. 13, para. 1.
\textsuperscript{67} See id. According to the Technical Explanation of the Treaty, a "fixed base" is analogous to "permanent establishment," defined in Article 5. A fixed base does not include a hotel room unless the room is used as an office or work site on a continuing basis. Profits attributable to a fixed base are taxed on a net basis using arm's-length principles. Technical Explanation, supra note 27. See Agreement for the Avoidance of Double Taxation, supra note 4, at art. 7.
\textsuperscript{68} The PRC’s Foreign Enterprise Income Tax law provides for a 20% rate of withholding, while the PRC’s Joint Venture Income Tax provides for a 10% rate, and the Individual Income tax rate provides for a 20% rate. Cox, supra note 5, at 133 n.183. For a detailed discussion of PRC taxation of dividends, interest, and royalties, see Zheng, supra note 1, at 758-63
\textsuperscript{70} Agreement for the Avoidance of Double Taxation, supra note 4, at arts. 9, 10. Under Article 22 the withholding tax is credited against the tax imposed by the recipient country. Id. at art. 22, para. 1. The business profits remain taxable under Article 7.
\textsuperscript{71} Zheng, supra note 1, at 756. The withholding rates allowed in the source state on dividends, interest, and royalties are set at 10% of the gross amount. The treatment of these types of income are favorable for the source country and represents another provision favorable to the PRC. Note, supra note 11, at 384-85.
\textsuperscript{72} Agreement for the Avoidance of Double Taxation, supra note 4, at art. 9.
a permanent establishment in the other country.\textsuperscript{73}

For income to constitute a dividend under the Treaty, the income must be paid by a company and be income from a share of equity or similar corporate right.\textsuperscript{74} Article 10 defines “interest” as income from “debt claims of every kind,” including government securities.\textsuperscript{75} The Treaty defines “royalties” broadly as income of any kind received as consideration for the use of, or the right to use, intellectual property, industrial, commercial or scientific equipment, or technical know-how.\textsuperscript{76} PRC tax law, however, only includes the fee derived from intellectual property or industrial, commercial, or scientific equipment as royalties.\textsuperscript{77} Because the Treaty uses the term “technical know-how,”\textsuperscript{78} payments otherwise treated as personal services could be interpreted as royalties under the Treaty.\textsuperscript{79}

The Treaty’s rules with respect to taxation of dividends, interest, and royalties are similar to those in the U.N. Model Treaty.\textsuperscript{80} The source country may withhold dividend and interest income pro-
vided the recipient of the payment is its beneficial owner. In some instances, however, these payments are treated as business profits or income from professional services. For example, payments received by a U.S. enterprise in the PRC with a permanent establishment in the PRC are treated as business profits under Article 7. Likewise, if a U.S. lawyer performs independent services from a fixed base in the PRC and the payments are connected effectively with the fixed base then Article 13 applies.

IV. Coordinated Tax Measures

To avoid double taxation and tax evasion, the Treaty incorporates coordinated tax measures such as tax credits and nondiscrimination, mutual agreement, and exchange of information provisions. Double taxation arises when each treaty partner asserts jurisdiction to tax the same item of income. The problem occurs because each contracting state has different bases for jurisdiction. Some treaties contain provisions that expressly prevent double taxation. For example, under the Treaty business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment.

A. Tax Credits

Article 22 of the Treaty relieves enterprises from double taxation by requiring a credit against income taxes payable to one treaty partner for income taxes paid to the other treaty partner. Separate credit rules apply to both PRC and U.S. residents. Under the Treaty the United States must give a credit to both U.S. residents and citizens. When a U.S. company owns at least ten percent of the voting interest in a PRC company from which it receives dividends, the United States must give an additional credit for the income tax paid to the PRC by the U.S. company with respect to the profits from which the dividends were paid. The credit to PRC entities extends

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Treaty differs with respect to ownership and withholding percentages. U.S. Model Double Taxation Convention, supra note 5, at arts. 10-12.

Agreement for the Avoidance of Double Taxation, supra note 4, at art. 9, para. 2, art 10, para. 2, art. 11, para. 2.

Id. at art. 9, para. 4, art. 10, para. 5, art. 11, para. 4.

Id. at art. 13.

Bischel & Feinschreiber, supra note 8, at 5-6.

Id.

Agreement for the Avoidance of Double Taxation, supra note 4, at art. 7, para. 1.

Id. at art. 22, para. 2.

Id.

Id. The Internal Revenue Code grants credits for foreign income in any event. See I.R.C. §§ 901-08 (1987). Article 22, therefore, serves to confirm the existing foreign tax credit rules in the Internal Revenue Code. The Senate Committee pointed out that the Treaty might override U.S. tax law allowing a U.S. citizen to convert U.S.-source income to PRC-source income in order to inflate his foreign tax credit. See Cox, supra note 5, at 139.
only to residents, regardless of nationality. The amount of PRC credit is also limited to the amount of income tax payable. The practical effect of this limitation is to preclude carryover of excess credits, which is not allowed by PRC domestic tax law. The Treaty’s tax credit provision is helpful to the tax planner in three ways. First, the Treaty clearly states that the PRC must allow a credit for U.S. income taxes. Second, because the Treaty specifies rules determining sources of income, the Treaty’s tax credit rules are easier to implement than PRC credit rules. Third, the Treaty requires the PRC to extend foreign tax credits for U.S. federal income tax. PRC tax law is silent with respect to whether local and national foreign taxes are creditable.

\[\text{\textit{B. Nondiscrimination Provisions}}\]

In addition to the mandatory tax credit, the Treaty has a nondiscrimination clause that prohibits both the United States and the PRC from taxing residents or permanent establishments in one contracting state either less heavily or more heavily than they are taxed in the other contracting state. The Treaty also states that a contracting state must permit residents to deduct, for purposes of determining taxable profits, interest, royalties, and other disbursements paid to residents of contracting states in the same manner as the state’s own residents. Because Article 23 prohibits more burdensome treatment, the Treaty does not prevent a contracting state from receiving more favorable tax treatment such as the reduced tax rates applied to foreign investors in the PRC Special Economic Zones.

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90 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 22, para. 1.
91 Id.
92 Zheng, supra note 1, at 768.
93 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 22, para. 1.
94 Zheng, supra note 1, at 769.
95 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 2, para. 1.
96 Zheng, supra note 1, at 769.
97 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 23, para. 1.
98 Id.
99 Id. at art. 23, para. 3.
100 Zheng, supra note 1, at 770. PRC taxes for domestic enterprises are typically higher than the 15% rate applied to foreign investors in the PRC Special Economic Zones. Id. PRC domestic enterprises are subject to a progressive income tax ranging from 10% to 55%. The tax differential reflects the PRC’s current economic structure based on socialist
As a result, the Treaty allows U.S. enterprises to take advantage of the preferential tax treatment accorded to foreign enterprises that operate in the PRC Special Economic Zones.

C. Mutual Agreement Procedures

The Treaty obligates authorities in both countries to attempt to resolve by mutual agreement any difficulties or doubts over an interpretation or application of the Treaty. Three provisions are provided through which a taxpayer may seek dispute resolution and Treaty interpretation by the mutual agreement of the competent authorities of each contracting state. In addition, Article 24 provides a legal framework through which the Treaty’s principles are administered. Because Article 24 requires the participation of both contracting states to solve problems, the Treaty serves to increase communication between the two countries. Under Article 24, a taxpayer may present his case to the competent authorities within three years of the initial date of notification of the action that resulted in his being subjected to an inappropriate tax. This requirement is especially significant given U.S. businesses’ lack of familiarity with PRC tax practice and procedure.

D. Exchanges of Information

Article 25 specifically permits the authorities in each contracting state to prevent tax evasion and fraud. Both the United States and the PRC can gain access to financial information concerning the taxpayer’s foreign-sourced income. The Treaty sets broad limits on the information that can be exchanged—anything necessary to carry out the provisions of the Treaty or the domestic laws of the contracting states is accessible. Theoretically, any information concerning residents of third countries is accessible under the Treaty. The Treaty, however, states that neither the PRC nor the United States is ownership. The preferential tax treatment applied to foreign investors in the Special Economic Zones is designed to encourage foreign investment and commercial exchange with developed countries. Id.

100 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 24.
101 Id. at art. 24.
102 Id. at art. 24, para. 1. Under Article 24 a person who considers the actions of either the United States or the PRC not to be in accordance with the Treaty is allowed to present his case to the competent authority of the nation of which he is a resident or a national. If the objection to the tax appears to be justified and if the competent authority is unable to arrive at a solution, the competent authority must resolve the case through consultation with the competent authority of the other contracting state. Any solution must be implemented regardless of domestic law time limitations. Id. at art. 25, para. 2.
103 Id.
104 Zheng, supra note 1, at 770.
105 Agreement for the Avoidance of Double Taxation, supra note 4, at art. 25, para. 1.
106 Id.
107 Id.
obligated under the Treaty to supply to the other state information that normally is privileged or otherwise unavailable under the state's domestic laws. In addition, the contracting parties are not obligated to exchange trade and business secrets.

V. Protocols

Senators opposed to ratification of the Treaty argued that the PRC could be exploited as a tax haven because the Treaty does not adequately discourage treaty shopping. Treaty shopping occurs when business entities of third countries that do not have tax treaties with the United States, or have treaties whose terms are less favorable, establish enterprises in other contracting states solely for the purpose of enjoying the treaty's benefits. The PRC and the United States signed protocols in 1984 and 1986 to prevent treaty shopping.

Under the 1984 Protocol a foreign company may not receive tax benefits for income derived from dividends, interest, and royalties if the competent authorities agree that the taxpayer became a resident solely to enjoy the benefits of the Treaty. The Senate Foreign Relations Committee noted that this provision is much less detailed and considerably less strict than that of the U.S. Model Treaty. Specifically, the Committee criticized the Treaty on four points:

1. under the 1984 Protocol only the Treaty benefits provided may be denied, while the U.S. Model Treaty denies all benefits;
2. the Protocol applies only to foreign companies, while the U.S. Model Treaty applies to all business organizations;
3. the Protocol is dependent on the cooperation of both parties' competent authorities to deny benefits, while the U.S. Model Treaty is self-executing; and
4. the Treaty's standard for denying benefits is largely subjective, while the U.S. version contains several objective tests providing relative certainty as to who will be denied benefits.

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108 Id. Paragraph 2 of Article 25 provides that in no case shall the provisions of paragraph 1 be construed so as to impose on a contracting state the obligation:
(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State.

109 Id.


111 BISCHER & FEINSCHREIBER, supra note 8, at 272-75.

112 1984 Protocol, supra note 7, at para. 7.

113 See U.S. Model Double Taxation Convention, supra note 5, at art. 16.

114 SENATE REPORT, supra note 7, at 36-37.
The U.S. Treasury Department argued that treaty shopping was unlikely to occur because of the PRC's currency and investment controls and limited network of treaties.\textsuperscript{115} The Senate Committee accepted the Treasury's argument, but cautioned that the PRC's currency and investment controls might not continue. According to the Committee, PRC law is changing rapidly, and therefore, the United States should monitor all changes to ensure that the Treaty provides no opportunity for treaty shopping.\textsuperscript{116}

Because ratification by the full Senate was in jeopardy,\textsuperscript{117} the 1986 Protocol was recharacterized as an interpretation of the provisions of the 1984 Protocol.\textsuperscript{118} Like the U.S. Model Treaty, the 1986 Protocol applies to all business entities. The 1986 Protocol, however, has different methods for determining eligibility for treaty benefits.\textsuperscript{119} The first method requires that more than fifty percent of the entity deriving the income be owned by residents of the contracting states and that the entity not make substantial payments to residents of third countries.\textsuperscript{120} The second method for eligibility requires that the entity's "principal class of shares" be subject to "substantial and regular trading on a recognized stock exchange."\textsuperscript{121} The final method is a restatement of the 1984 Protocol standard that required the competent authorities to find a "valid business purpose."\textsuperscript{122} Under each method consultation with the competent authorities is still required. Nevertheless, upon failure to reach a mutual determination one contracting state now can unilaterally deny benefits.\textsuperscript{123}

The 1986 Protocol, therefore, alleviates the concerns expressed by the Senate Foreign Relations Committee. The alternative methods for eligibility are more in line with those of the U.S. Model Treaty and make tax treatment less uncertain. In addition, the United States is no longer required to scrutinize changes in PRC law because the Protocol adequately discourages treaty shopping.

VI. Conclusion

The Treaty represents a commitment on the part of the PRC and the United States to increase economic cooperation. This commitment is especially apparent in the Treaty's coordinated tax measures such as tax credits, nondiscrimination provisions, mutual

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\textsuperscript{115} See Technical Explanation, supra note 27. For a discussion of laws eliminating the incentive to treaty shop, see Cox, supra note 5, at 125.
\textsuperscript{116} Senate Report, supra note 7, at 37.
\textsuperscript{117} Id. at 14.
\textsuperscript{118} See 1986 Protocol, supra note 9.
\textsuperscript{119} See U.S. Model Double Taxation Convention, supra note 5, at art. 16.
\textsuperscript{120} 1986 Protocol, supra note 9, at para. 1.
\textsuperscript{121} Id. This method has been interpreted to require that the entity be a resident and a publicly traded company. Cox, supra note 5, at 127.
\textsuperscript{122} 1986 Protocol, supra note 9, at para. 2.
\textsuperscript{123} Id. at para. 4.
agreement arrangements, and exchanges of information provisions that call for long term cooperation between the PRC and the United States. While the Treaty limits both countries' authority to tax various types of income, the Treaty clarifies the taxation of businesses maintaining permanent establishments in the PRC. Under the Treaty the PRC may tax the world-wide profits of a U.S. company's subsidiary incorporated in the PRC. But when a branch office of a U.S. company is located in the PRC, only the business profits attributable to the permanent establishment are taxable.

By clarifying the taxing jurisdictions of the United States and the PRC, the Treaty provides a sense of certainty necessary for tax planning by U.S. enterprises. The benefits of the Treaty to U.S. companies, however, are diminished by the Treaty's lack of a tax-sparing mechanism to preclude a contracting state from taxing its own businesses on income taxed by the other contracting state. As a result, companies in developed countries with income tax treaties containing tax-sparing provisions have an economic advantage over U.S. businesses with permanent establishments in the PRC. Even without a tax-sparing provision, the Treaty facilitates commercial exchanges between the PRC and the United States and attracts U.S. capital and technology to assist further PRC economic development and modernization. Adoption of the Treaty signals an effort by the United States and the PRC to coordinate transnational tax measures in order to increase economic cooperation by providing stability and predictability in a relatively new arena for U.S. enterprises. In addition, the Treaty further opens the door for the United States to gain closer political and economic ties with one

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124 PRC tax law is ambiguous and constantly changing in this area. See Zheng, supra note 1, at 773.
125 Kelly, supra note 15, at 124.
126 See Comment, The Effects of Tax-Sparing on United States Business in China, 21 U.S.F. L. Rev. 393, 411 (1987). The 1986 Protocol, however, incorporates a tax-sparing credit if U.S. law is amended or a tax-sparing credit is employed in treaties with other countries. Id. The Foreign Relations Committee Report suggests that the United States incorporated this provision both to minimize interference with incentives offered by the PRC and to remain consistent with U.S. tax policy with other developing nations. This additional agreement goes beyond existing agreements between the United States and other developing countries. Senate Report, supra note 7. The absence of a tax-sparing provision is considered the PRC's most substantial concession. Note, supra note 11, at 388.
127 The Treaty lowers tax rates and eliminates double taxation. See Agreement for the Avoidance of Double Taxation, supra note 4, at art. 22, para. 1.
128 The PRC and the United States must uphold the Treaty for at least five years. Id. at art. 28.
129 U.S. investment in the PRC has developed only during the last several years. U.S. trade with the PRC the year before the signing of the Treaty represented less than 3% of the total U.S. trade with Asian nations. U.S. Bureau of The Census, Statistical Abstract of the United States: 1987, at 794-95 (1987).
of the next economic world powers.\textsuperscript{130}

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\textsuperscript{130} See Kelly, \textit{supra} note 15, at 104 (pointing out that the adoption of the Treaty indicates the United States' recognition of the PRC's status as a unique developing country); Note, \textit{supra} note 11, at 384 (arguing that the Treaty illustrates that the United States is willing to make economic concessions to the PRC to facilitate better political relations). The politicization of the U.S.-PRC agreement is not in accord with U.S. policy to avoid favoritism in international economic agreements. Note, \textit{supra} note 11, at 391-92.

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