



DATE DOWNLOADED: Thu Dec 5 14:47:21 2024

SOURCE: Content Downloaded from [HeinOnline](https://heinonline.org/HOL/License)

Citations:

Please note: citations are provided as a general guideline. Users should consult their preferred citation format's style manual for proper citation formatting.

Bluebook 21st ed.

A. J. Easson & Li Jinyan, The Evolution of the Tax System in the People's Republic of China, 23 STAN. J. INT'L L. 399 (Summer 1987).

ALWD 7th ed.

A. J. Easson & Li Jinyan, The Evolution of the Tax System in the People's Republic of China, 23 Stan. J. Int'l L. 399 (1987).

APA 7th ed.

Easson, A. J., & Jinyan, Li. (1987). The evolution of the tax system in the people's republic of china. Stanford Journal of International Law, 23(2), 399-448.

Chicago 17th ed.

A. J. Easson; Li Jinyan, "The Evolution of the Tax System in the People's Republic of China," Stanford Journal of International Law 23, no. 2 (Summer 1987): 399-448

McGill Guide 9th ed.

A. J. Easson & Li Jinyan, "The Evolution of the Tax System in the People's Republic of China" (1987) 23:2 Stan J Int'l L 399.

AGLC 4th ed.

A. J. Easson and Li Jinyan, 'The Evolution of the Tax System in the People's Republic of China' (1987) 23(2) Stanford Journal of International Law 399

MLA 9th ed.

Easson, A. J., and Li Jinyan. "The Evolution of the Tax System in the People's Republic of China." Stanford Journal of International Law, vol. 23, no. 2, Summer 1987, pp. 399-448. HeinOnline.

OSCOLA 4th ed.

A. J. Easson & Li Jinyan, 'The Evolution of the Tax System in the People's Republic of China' (1987) 23 Stan J Int'l L 399

Please note: citations are provided as a general guideline. Users should consult their preferred citation format's style manual for proper citation formatting.

-- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at

<https://heinonline.org/HOL/License>

-- The search text of this PDF is generated from uncorrected OCR text.

-- To obtain permission to use this article beyond the scope of your license, please use:

[Copyright Information](#)

The Evolution of the Tax System in the People's Republic of China

A.J. EASSON*
and LI JINYAN†

It may be some consolation, to those who pay it, that taxation seems to be an indispensable ingredient of civilized society. Of all the great civilizations, China has the longest continuous recorded history, and references to taxes can be found from its earliest records. The Emperor Yu, founder of the Xia Dynasty,¹ is reputed to have instituted a new system of land tenure and taxation, and it is clear from the earliest writings that, even prior to that time, some system of land tax existed. Precise details exist of the "nine-square" system, introduced during the Shang dynasty (16th–11th century B.C.), and of its subsequent modification in the period of the Zhou Dynasty (11th–8th century B.C.). The modern *agriculture tax* does not—or did not until the last two or three years—differ greatly from that introduced in 780 A.D. by the famous tax reformer, Yang Yen, who also imposed a progressive personal income tax. Another present-day tax, the *salt tax*, can be traced back to the Qin Dynasty (221 B.C.–207 B.C.). Ever since then, it has provided one of the most reliable sources of revenue for successive administrations.² Some other taxes—the *livestock tax*, the *slaughter tax*, the *rural market tax* and, of course, *customs duties*—have also been in existence for many years or centuries.

Despite this continuity, the present Chinese tax system is almost entirely the product of the 1980s. The sweeping economic

* A.J. Easson is Professor of Law at Queen's University in Kingston, Canada.

† Ms. Li is affiliated with the University of International Business and Economics in Beijing, China.

¹ c. 2150 B.C., generally considered to be the dawn of China's authentic history. See H. HUANG, *THE LAND TAX IN CHINA* 20–21 (1918).

² G. ECKLUND, *FINANCING THE CHINESE GOVERNMENT BUDGET* 64–65 (1966).

reforms of the post-Mao era have necessitated a fundamental restructuring of the fiscal system. To a considerable extent, modifications to the tax system have mirrored the various shifts and changes in economic and social policy which have occurred in China since the People's Republic was founded in 1949. Thus, the recent reforms provide a clear indication of the direction in which China is now headed. It is in the new taxes that the "responsibility system" and the "open-door policy" find concrete expression. In order to appreciate fully the significance of the recent reforms it is necessary to focus on the state of the Chinese tax system at the beginning of the present decade.³

One of the very first acts of the new Central People's Government following the founding of the People's Republic was to call a National Taxation Conference in Beijing in November 1949. This Conference formulated the twelve articles of the "Principal Rules for Implementation of the National Tax Administration,"⁴ instituting a new unified tax system and designating fourteen categories of taxation. These categories included "salary or remuneration taxes," which were in fact not introduced until 1980,⁵ and "inheritance taxes," which have not been introduced

³ Major works reviewing China's public finance during the first decade after Liberation are A. DONNITHORNE, *CHINA'S ECONOMIC SYSTEM* (1967); A. ECKSTEIN, *CHINA'S ECONOMIC REVOLUTION* (1977); and G. ECKLUND, *supra* note 2. As to taxation specifically, see Reynolds, *Doing Business with the People's Republic of China: Tax Considerations*, 14 INT'L LAW. 49 (1980); Pomp, Gelatt & Surrey, *The Evolving Tax System of the People's Republic of China*, 16 TEX. INT'L L.J. 11 (1981).

⁴ Principal Rules for the Implementation of the National Tax Administration (adopted by the Government Administration Council, Jan. 27, 1950) (in Chinese) [hereinafter Principal Rules]. For an English translation, see COMMERCIAL LAWS AND BUSINESS REGULATIONS IN THE PEOPLE'S REPUBLIC OF CHINA 199 (V. Sit ed. 1984) [hereinafter V. Sit].

⁵ Individual Income Tax Law of the People's Republic of China (adopted by the Third Session of the Fifth National People's Congress, Sept. 10, 1980) [hereinafter IITL]; Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China (approved by the State Council, Dec. 10, 1980, promulgated by the Ministry of Finance, Dec. 14, 1980) [hereinafter IIT Regs.]. For English translations, see CHINA'S FOREIGN ECONOMIC LEGISLATION 75, 85 (1986) [hereinafter CFEL]; 1 LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 114, 118 (1982) [hereinafter LAWS AND REGULATIONS].

Traditionally, personal income taxes have been difficult to collect in China. As noted, a progressive income tax was introduced as early as 780 A.D. and even before that there had been an income tax on merchants, but such taxes tended to be short-lived. The Guomindang government promulgated income tax regulations in 1914 and again in 1921, but it encountered strong opposition and apparently made little attempt at collection. See LI CHUAN SHIH, *CENTRAL AND LOCAL FINANCE IN CHINA* 77, 171 (Studies in History, Economics and Public Law Vol. 99, No. 2, 1968). A further attempt to introduce an income tax was made in 1936, the tax being based on the British schedular system, and special excess income taxes were imposed in 1938 and 1943 to raise reve-

at all.⁶

Initially, the most important taxes were the Industrial and Commercial Taxes (which comprised a business income tax, a turnover tax and a number of other less important taxes, such as a commercial license tax and a street-traders tax), the Agriculture Tax, Customs Duties, and the Salt Tax. Altogether, by May 1950 there were twenty-four different taxes in force.⁷ Despite the Korean war, economic recovery from the years of the anti-Japanese war and the civil war was rapid and tax revenues doubled in two years.

The state sector of the economy also commenced to grow, which led to a simplification of the tax system in 1953. The number of taxes was reduced to fifteen, with a number of specific commodity taxes, such as the Cotton Tax, the Handwoven Cloth Tax and the Medicines Tax either disappearing or being merged into a single Commodity Tax. The Industrial and Commercial Taxes were also simplified and reduced in number. This reform was carried much further in 1958, when the number of taxes was reduced to eleven.⁸ Aside from administrative convenience, the simplification was more apparent than real. The new Consolidated Industrial and Commercial Tax,⁹ which replaced five existing taxes, preserved many of the previous categories and grew in complexity and multiplicity of rates and schedules. The chief effect of the consolidation was to bring together a variety of commodity, excise, sales and turnover taxes,¹⁰ leaving the tax on business income as a separate item—the Industrial and Commercial Income Tax.¹¹ The 1958 reforms also produced a new set of

nue for waging the anti-Japanese war. See GUOJIA SHUIFA GAILUN (Introduction to National Taxation) 184–85 (Wang Kun ed. 1985) [hereinafter Wang].

⁶ An inheritance tax was introduced in 1119 A.D., but abandoned soon afterwards. Li, *supra* note 5, at 153.

⁷ Wang, *supra* note 5, at 58.

⁸ In the following year, the tax on interest income was discontinued, reducing the number to ten. A Rural Market Transactions Tax was introduced in 1962, and the Cultural and Entertainment Tax was discontinued in 1966. See *id.* at 63.

⁹ Consolidated Industrial and Commercial Tax (adopted in principle by the Standing Committee of the National People's Congress, Sept. 11, 1958, and promulgated for trial implementation by the State Council, Sept. 13, 1958).

¹⁰ The new Consolidated Industrial and Commercial Tax most closely resembled the turnover tax employed in the USSR. For a discussion of the Soviet turnover tax, see M. NEWCITY, TAXATION IN THE SOVIET UNION 49–52 (1986). It also possessed some of the features of the German turnover tax in the period prior to the introduction of a value-added tax.

¹¹ This tax had been introduced in 1950, see *supra* note 4, and was not changed by the 1958 reforms. See ZHONGGUO SHUIFA GAILUN (Introduction to Chinese Tax Law)

Agriculture Tax Regulations,¹² the overall effect of which seems to have been a further reduction of the tax burden on agricultural producers. A further reform took place in 1973, when the Consolidated Industrial and Commercial Tax was simplified, taxable categories and rates were revised, and the name "Consolidated" was dropped from the title.

That, essentially, was how the Chinese tax system stood at the beginning of 1980. As one commentator remarked, writing in 1979, "the tax system has not changed in substance, if at all, in the last twenty years."¹³ Superficially, one would have to agree with that assessment: indeed, apart from the discontinuance of a few unimportant taxes and the consolidation of a number of others, the system in 1979 differed very little from that introduced in 1950. What had changed, radically, was the economic system and, with it, the role played by the tax system. In 1950, China's total tax revenue amounted to 4,898 million yuan, and comprised a little over seventy-five percent of the country's total budgetary revenue.¹⁴ Industrial and Commercial Taxes accounted for almost one-half of all tax revenue and the Agriculture Tax for nearly forty percent. During the 1950s, tax revenue increased steadily: by 1952 it had doubled; by 1954 it had trebled; and by the end of 1959 it had risen to over 20 billion yuan, more than four times the 1950 figure. During the same period, however, the Agriculture Tax had increased by less than sixty percent, and had not increased at all after 1954 (when collectivization was more or less completed). By the end of the decade, the Agriculture Tax accounted for only one-eighth of total tax revenue, whereas the Industrial and Commercial Taxes had increased to almost 16 billion yuan and comprised over seventy-five percent of the total tax revenue.

Even more significant was the overall decline in the importance of taxation as a source of national revenue. By the end of 1959, taxes comprised only thirty-seven percent of total budgetary revenue—or just one-half of the 1950 proportion. What had

12–13 (Liu Longheng ed. 1986). For an English translation, see Reynolds, *supra* note 3, at 67.

¹² Agriculture Tax Regulations (adopted by the Standing Committee of the National People's Congress, June 3, 1958) (in Chinese).

¹³ Ting, *Preliminary Notes on Taxation in the People's Republic of China*, reprinted in 1 B.C. THIRD WORLD L.J. 71, 72 (1980).

¹⁴ G. ECKLUND, *supra* note 2, at 20 (for this and following statistics in the text); see also DENG LIQUN, MA HONG & WU HONG, *DANGDAI ZHONGGUO DE JINGJI TIZHI GAIGE* (Current Reform of the Chinese Economic System) 437–67 (1984).

occurred during the intervening period was the socialization and transformation of industry and commerce. "By the end of 1956 virtually no industrial enterprises larger than workshops remained under licit private control."¹⁵ Some two-thirds of Chinese industry was wholly state-owned, and most of the remainder was either under joint state-private ownership or collectively owned.¹⁶ Profits from state enterprises, which in 1952 contributed 4.6 billion yuan to the national budget, accounted for 28.6 billion yuan, or fifty-three percent of total revenue, by the end of 1959. Thereafter, although both tax revenue and state enterprise profits continued to increase, their proportional contributions to the budget changed relatively little.¹⁷

I. ECONOMIC REFORM IN THE POST MAO ERA

At the time of Mao's death, taxation had come to play a comparatively minor role in the national economy. By 1958, the socialist transformation with respect to ownership of the means of production was basically completed, and the internal economic structure had undergone a fundamental change.¹⁸ Subsequently, over a period of almost twenty years, there was a strong tendency to overlook or negate the role of taxation in a socialist economy.¹⁹ As one leading Chinese commentator has observed, "[s]ome comrades went so far as to advocate the integration of taxes and profits, thus abolishing taxes altogether."²⁰

This position regarding the abolition of taxes is not particularly surprising. Virtually all of the tax collected after 1966 was levied either on commodities sold exclusively by state-owned enterprises or on the transactions of those enterprises.²¹ Since

¹⁵ A. DONNITHORNE, *supra* note 3, at 145.

¹⁶ *Id.* During the following decade, even the smallest enterprises came under state ownership or control in the course of the Cultural Revolution.

¹⁷ Tax revenue grew faster during the 1970s. By the end of 1978, tax revenue and state enterprise profits each accounted for about 40% of the total. See A. HO, DEVELOPING THE ECONOMY OF THE PEOPLE'S REPUBLIC OF CHINA 22 (1982).

¹⁸ See Liu Zhicheng, *On the Reform of [the] Industrial and Commercial Taxation System of Our Country*, JINGJI GUANLI (Economic Management), Sept. 15, 1980, at 23-26 (in Chinese) (English translation on file at the Stanford J. Int'l L.).

¹⁹ See Zhan Wu, Gong Qifang & Chen Deyan, *Several Questions on the Reform of the Taxation System*, Renmin Ribao (People's Daily), Mar. 14, 1984, at 5 (in Chinese).

²⁰ Liu, *supra* note 18.

²¹ There are interesting parallels with the tax system of the USSR. In 1983, Soviet transfers of funds from various parts of the public sector—in the form of turnover taxes, accounting for profits, and social insurance contributions—accounted for 91% of total budgetary revenue. M. NEWCITY, *supra* note 10, at 31.

both sale proceeds and profits accrued eventually to the state, the interposing of taxes appeared superfluous.

Policy goals regarding the tax system changed with the launching of the "Four Modernizations" program in December 1978.²² The goal of the new policy was to make China a fully developed nation by the end of the century through four aspects of modernization: agriculture, industry, science and technology, and the military establishment. The focus of the new policy was to be economic and technological progress, rather than cultural and political revolution. The program did not set forth a detailed blueprint for attaining these objectives; rather it expressed a commitment to experimentation. Different methods of resource allocation and distribution would be tried, evaluated and modified in the light of experience. Evident in this approach is the philosophy of Deng Xiaoping—that it does not matter whether the cat is black or white, so long as it catches the mice.

A period of almost six years of discussion, experimentation, trial and error ensued, culminating in the announcement, in October 1984, of a detailed program for comprehensive economic reform.²³ This program emphasized the need to "build socialism with Chinese characteristics" by integrating the basic tenets of Marxism with actual conditions in China. In it, taxation is required to play an increasingly important role.

A. *Agriculture—the Responsibility System*

The first stage of the overall transformation of the economy, which had largely been completed by 1984, involved the restructuring of the agricultural system.²⁴ Immediately following the

²² Communiqué of the Third Plenary Session of the Eleventh Central Committee of the Chinese Communist Party, December 1978. The origins of the policy are commonly attributed to a speech delivered by Premier Zhou Enlai before the Fourth National Party Congress in January 1975. For detailed consideration of the program, see Zhou Shulian & Zhang Zhuoyuan, *Changing the Pattern of China's Economy*, in CHINA'S ECONOMIC REFORMS 44-66 (Lin Wei & A. Chao ed. 1982); Zhou Shulian, *The Market Mechanism in a Planned Economy*, in CHINA'S ECONOMIC REFORMS, *supra*, at 94-113; see also A. HO, *supra* note 14.

²³ Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure (adopted the Third Plenary Session, Twelfth Central Committee Session, Oct. 20, 1984). For further comment, see De Wulf, *Economic Reform in China*, FIN. & DEV., Mar. 1985, at 8; Huan Xiang, *On Reform of Chinese Economic Structure*, BEIJING REV. No. 20, May 20, 1985, at 15.

²⁴ For an excellent description, see Yan Ruizhen, *On China's Agricultural Responsibility System*, JINGJI LILUN YU JINGJI GUANLI (Economic Theory and Management), May 28, 1984, at 34-37 (in Chinese) (English translation on file at the Stanford J. Int'l L.).

founding of the People's Republic,²⁵ land reform was implemented on a national scale. Land reform chiefly involved a redistribution of land from the landlord and rich peasant classes to the poor peasants and the landless. Redistribution was followed rapidly by the creation of mutual aid groups and cooperatives; by the end of 1956, ninety-six percent of peasant households had been merged into cooperatives. The tax system promoted this development: a surcharge on the Agriculture Tax encouraged the few remaining individual farmers to join the collective movement.²⁶ Within two years, these new cooperatives, numbering around three-quarters of a million, were merged into 26,400 giant "peoples' communes."²⁷ Later, many of these communes were subdivided and reduced in size. The achievements of the communes were substantial: afforestation and irrigation schemes were undertaken, community projects were initiated and a limited degree of mechanization was achieved. Such achievements would not have been possible on an individual basis. Nevertheless, the pace of rural economic development was not compatible with the demands of national economic growth. The peoples' communes put into effect an excessively uniform and overly centralized system. Such centralization militated against the adoption of diversified production based upon local situations and reduced the enthusiasm of peasants by fostering egalitarianism and the feeling that "the squeaky wheel gets the grease."

As a counter, various arrangements generally described as the "responsibility system" were instituted during the period 1979–1981. Under these arrangements, farm quota outputs are fixed at a group or, more commonly, at a household level, with remuneration linked to planned output. The group or household contracts to grow and sell to the state a specified quantity of produce, to pay certain additional amounts to the production team and to the commune, remaining free to sell or to consume the remainder. The effects of the new policy have been spectacular: agricultural output rose at an average rate of 7.5% per year over the period 1978–1982, as opposed to an annual average of 3% growth from 1952–1978. Increased productivity, however, has not been without its problems. In particular, it has created a

²⁵ For a first-hand account of redistribution in liberated areas prior to the founding of the People's Republic, see W. HINTON, *FANSHEN: A DOCUMENTARY OF REVOLUTION IN A CHINESE VILLAGE* (1966).

²⁶ Ting, *supra* note 13, at 80.

²⁷ A. DONNITHORNE, *supra* note 3, at 46.

large surplus in the rural labour force. To some extent this surplus has been absorbed by a shift from the traditional grain-producing sector to activities such as forestry, animal husbandry, fisheries, cash crops and rural industries. Most significant, from a fiscal point of view, has been the transition from an essentially exchange economy to a cash economy.²⁸

B. *Technology—the Open Door Policy*

The overriding consideration of China's economic and foreign policy since its break with the Soviet Union at the end of the 1950s has been self-reliance. China, with almost a quarter of the world's population, accounts for less than one percent of the world's total trade, and its exports during the period 1952–1978 amounted to only four percent of its gross industrial and agricultural output.²⁹

The "four modernizations" program, however, called for a technological revolution. This goal necessitated the importation of advanced technology and production methods (in particular from Western countries and from Japan), in order to catch up with the economically developed countries. China's exports—raw materials and labor-intensive manufactured goods—would be traded for high technology products and for expertise. More significantly, foreign enterprises would be encouraged to invest in China, to manufacture their products there and to bring with them their advanced technology. Fiscally, this "open door" policy had two major implications. If foreigners were to be encouraged to do business in or with China, there was no reason why they should not contribute to the Chinese economy by paying taxes on their profit. Second, a system designed to tax foreign enterprises should endeavour to promote those activities considered desirable, such as the importation of advanced technology, rather than those regarded as less desirable, such as the production of goods aimed at the Chinese consumer. As a consequence, the first major amendments to the Chinese tax laws since 1950 were those which concerned foreign business and investment in China.³⁰

²⁸ See Huan, *supra* note 23.

²⁹ A. CHAO, *Economic Readjustment and the Open Door Policy*, in CHINA'S ECONOMIC REFORMS, *supra* note 22, at 206.

³⁰ The Joint Venture Income Tax Law and Individual Income Tax Law, both of Dec. 14, 1980 and the Foreign Enterprise Income Tax Law of Dec. 13, 1981. See *infra* text accompanying notes 122–46.

C. *Decentralization of Domestic Industry—"Breaking the Big Pot"*

The third, and most radical, of the reforms involved a complete departure from previous policies which had been directed towards the "socialization" of industry and commerce. As already noted, the Cultural Revolution achieved the elimination of virtually all private enterprise in China. The increases in production since 1949, especially in heavy industry, had been impressive, but there were widespread complaints about lack of incentives to improve either productivity or quality. Since profits were turned over to the state and losses were borne by the state, there was little reward for successful management and no real competition between enterprises.

The reforms have taken a variety of forms. Cooperatives and privately owned businesses have been revived. In some cases, they have taken over the running of the smaller, formerly state-owned, concerns, and in other instances they have started entirely new operations. There has also been experimentation with various other forms of ownership, including enterprises which are jointly owned by the state and by collectives or even by private individuals.³¹

The fiscal reforms have been equally significant. Whereas state-owned enterprises were formally exempt from the tax on business profits,³² experiments were begun in 1978³³ to substitute income tax payments for profit-delivery. This experiment (known as *li gai shui*) proved highly successful, with the growth rates of those enterprises chosen for the experiments averaging three to four times that of the average state enterprise.

The system gave greater control to management over the use of funds and over investment decisions, facilitated the payment of productivity bonuses to workers, and stimulated competition. By reducing reliance on the controlling government ministry, it helped to overcome the problem whereby "everyone eats from the same big pot." The system was rapidly expanded. By the end of 1983, over ninety percent of profitable state enterprises were paying income tax.³⁴ The second stage of this reform was

³¹ See Liu Guogang, *Changes in Ownership Forms: Problems and Possibilities*, BEIJING REV., May 12, 1986, at 17; Chao & Yang, *Reform of the Chinese Enterprise System*, 23 STAN. J. INT'L L. 365 (1987).

³² The Industrial and Commercial Income Tax ceased to apply to the great majority of state-owned enterprises in 1956. See *infra* note 91.

³³ Initially with 100 enterprises in the province of Sichuan. See Wang Haibo, *Greater Power for the Enterprises*, in CHINA'S ECONOMIC REFORMS, *supra* note 22, at 67-93.

³⁴ Yan Zhensheng, *Regarding the Second Step of Substituting Tax Payments for Profit Deliv-*

instituted in September 1984:³⁵ it entails a major revision of the entire pricing system, which in turn will require a comprehensive restructuring of the indirect tax system.³⁶ Experiments with products taxes began around 1980,³⁷ and, pursuant to the 1984 Decision of the Central Committee,³⁸ the former Industrial and Commercial Tax is being replaced by three forms of tax—a products tax, a business turnover tax and a value-added tax. The rebirth of collectively owned and private enterprises has also necessitated the introduction of new taxes on business profits.³⁹

Consequently, the current taxes in China bear little resemblance to those which existed at the beginning of 1980. The methods of payment of the Agriculture Tax have been altered significantly. An entirely new system of taxation has been installed to handle foreign enterprises and investment, including the establishment of *special economic zones* and *economic development zones* with special tax rates and concessions. A generally applicable Individual Income Tax has been introduced for the first time. In addition, commodity and products taxes have been radically revised, state enterprises now pay tax on their profits, and private

ery in State Enterprises, ZHENGFA LUNTAN (Political and Law Forum), Sept. 1985, at 53 (in Chinese); see also He Zhen, *Substituting Tax Payments for Profit Delivery: The Key Step in Accelerating City Economic Reform*, JINGJI GUANLI, Sept. 1984, at 15 (in Chinese); Tao Shengyu, *The Fundamental Content and Policies in the Second Step of Substituting Tax Payment for Profit Delivery*, QIYE GUANLI (Enterprise Management), Oct. 1984, at 16 (in Chinese).

³⁵ Explanation of Substitution of Tax Payment for Profit Delivery in State-Run Enterprises and of Reform of the Industrial and Commercial Taxation System (speech by Finance Minister Wang Bingqian, presented at the Seventh Session of the Sixth Standing Committee of the National People's Congress, Sept. 11, 1984), reprinted in ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO (State Council Bulletin of the People's Republic of China) No. 23, Oct. 10, 1984, at 791-95 [hereinafter State Council Bulletin] (in Chinese) (English translation on file at the Stanford J. Int'l L.). See Du Pingqin, *Step Up the Pace of Overall Tax Reform Using Product Tax as the Main Levy*, JINGJI GUANLI, Jan. 5, 1984, at 25-27 (in Chinese) (English translation on file at the Stanford J. Int'l L.); Dai Yuanchen, *Substituting Tax Payments for Profit Delivery is a Decisive Step in the Economic System Reform*, JINGJI YANJIU (Economic Research), Sept. 20, 1984, at 17 (in Chinese) (English translation on file at the Stanford J. Int'l L.); Tao, *supra* note 34; Yan, *supra* note 34.

³⁶ See Jia Kecheng, *Views on the Relationship between Prices and Tax Revenue*, CAIZHENG YANJIU (Finance Research), Sept. 30, 1985, at 48 (in Chinese) (English translation on file at the Stanford J. Int'l L.); Xie Zhenren, Shen Zhensheng & Shen Fan, *How Collective Enterprises Should Correctly Pay Tax in Accordance with the Law*, ZHONGGUO SHUIWU (China Tax), Mar. 1986, at 36-40, and May 1986, at 40-42 (in Chinese); Siong, *China's Recent Tax Experiments to Revive the Industrial and Commercial Tax System of State Enterprises*, 36 BULL. INT'L FISCAL DOC. 66 (1982); Dai, *supra* note 35; Du, *supra* note 35; Zhan, *supra* note 19.

³⁷ Including the introduction of a value-added tax for certain commodities. See Guo Hongde, WANG WENDING & HAN SHAOCHU, ZENGZHISHUI GAISHUO (Discussion of the Value Added Tax) (1984); Liu, *supra* note 18; Siong, *supra* note 36, at 70.

³⁸ See *supra* note 23.

³⁹ The Collective Enterprise Income Tax and the Private Business Income Tax. See *infra* text accompanying notes 110-21.

and collective enterprises have been revived and are subject to new taxes. Not only has a completely new tax system been created, but taxation has assumed a new importance: whereas in the period 1958–1978 tax revenue accounted for only forty percent of state revenue, by 1985 this proportion had risen to approximately ninety-five percent.⁴⁰ In the ensuing parts of this paper these taxes will be examined in greater detail.

II. TAXES ON INCOME

Historically, income taxes have played a relatively insignificant role in the public finances of China. At various times over the past twelve centuries attempts have been made to levy taxes on income, generally with little success. The Principal Rules, formulated in 1949,⁴¹ anticipated the imposition of a tax on wages and salaries, but no such tax was introduced. In 1980 a general personal income tax was introduced, but the main target for tax was the growing community of foreigners working in China.⁴² The initial post-liberation legislation of 1950 introduced a tax on interest income, which was chiefly payable by former capitalists whose businesses had been transferred to public ownership in return for bonds. This tax was paid until 1959 when it was discontinued and interest rates were correspondingly reduced.⁴³

In addition, the Industrial and Commercial Income Tax was levied on the profits from industrial and commercial pursuits of all units and individuals. The tax included foreign merchants,⁴⁴ but excluded most state-owned enterprises. Finally, the Agriculture Tax can properly be regarded as a tax on income; in one form or another it has been an almost permanent feature of Chinese life for several thousand years.

Some initial comments should be made about income tax in China. First, the law distinguishes the urban and rural sectors;

⁴⁰ See Cong Shuhai, *Analysis of the Establishment of China's Tax System*, CAIJING YANJIU (Finance and Economic Research) No. 5, 1986, at 26 (in Chinese); Renmin Ribao, May 13, 1985, at 1 (in Chinese).

⁴¹ *Supra* note 4.

⁴² It was estimated at the time that no more than 20 Chinese citizens would initially have to pay the tax. N.Y. Times, Sept. 3, 1980, at 1, col. 5. By 1985, it was reported that there were 1,318 households in Shanghai alone paying the tax. Wang Xiaochun, *Why the Shanghai Tax Bureau's 1985 Personal Income Tax Receipts Increased Rapidly*, ZHONGGUO SHUIWU, June 1985, at 15 (in Chinese).

⁴³ G. ECKLUND, *supra* note 2, at 75; A. DONNITHORNE, *supra* note 3, at 378–80.

⁴⁴ Initially there were a number of these, but most had disappeared by 1956. However, one British woollen mill reportedly continued to operate in China until 1959. A. DONNITHORNE, *supra* note 3, at 145.

income from agriculture is not treated in the same way as income from other forms of business activity. Second, the Chinese income tax system is essentially a schedular one. Although some of the taxes are progressive, most income is taxed at a flat rate; there is no general system of aggregation whereby the eventual tax burden of an individual is computed by reference to his or her total income. In particular, a basic distinction is drawn between income from business and income from other sources. Third, different types of business organizations are subject to different rules. Fourth, since September 1986, Chinese resident citizens have been taxed separately from foreigners.

A. *Personal Income Taxes*

When it was introduced in 1980, the Individual Income Tax Law⁴⁵ applied to both foreigners and Chinese citizens. A new tax, the Individual Income Regulatory Tax,⁴⁶ was introduced in September 1986 and, from the beginning of 1987, has applied to Chinese citizens resident in China.

1. *The Individual Income Tax*

As a general rule, residents of China are taxed on world income,⁴⁷ while non-residents are taxed only on income from sources within China.

Residence. For tax purposes, the Chinese concept of residence is unusual:⁴⁸ a distinction is drawn between permanent and temporary residents and, prior to 1986, the tax laws treated citizens and foreigners differently in a number of respects. Now, the

⁴⁵ See *supra* note 5.

⁴⁶ Provisional Regulations of the Individual Income Regulatory Tax of the People's Republic of China (adopted by the State Council, Sept. 25, 1986) [hereinafter IIRT Regs.]. For English translation, see Li Jinyan, *China: The New Individual Income Regulatory Tax*, 41 BULL. INT'L FISCAL DOC. (forthcoming May 1987). An explanatory note appears in *Zhongguo Fazhibao* (Chinese Legal Gazette), Dec. 12, 1986, at 1.

⁴⁷ A tax credit is given in respect of foreign tax paid. IITL, *supra* note 5, art. 1; IIT Regs., *supra* note 5, art. 16. A special exemption is provided for pensions and other types of income from foreign sources for persons of Chinese origin who return to settle in China after their retirement. Circular of the Ministry of Finance on Certain Questions Concerning Individual Income Tax, June 2, 1982, V. Sit, *supra* note 4, at 222.

⁴⁸ Most of the tax treaties entered into by China contain the usual "tie breaker" provisions and the "183 day" rules. The treaty between the United States and China is an exception; questions of dual residence are to be resolved by the competent authority procedure and no "tie breaker" rules are set forth. Agreement for Avoidance of Double Taxation and Prevention of Tax Evasion, Apr. 30, 1984, United States-People's Republic of China, art. 4, reprinted in 17 INT'L TAX TREATIES OF ALL NATIONS 411 (Ser. B 1985) [hereinafter U.S.-China Treaty]. Articles 13 and 14, dealing with professional and employment income respectively, contain "183 day" rules. *Id.*

Individual Income Tax Law (IITL) essentially applies only to persons who might be termed "resident aliens" and to non-residents. Individuals who are not resident in China or are resident for less than one year⁴⁹ are taxable only in respect of "income gained within China."⁵⁰ Individuals who reside in China for one year or longer are, at least in theory, subject to different treatment.

Within the two classes of individuals a number of further distinctions are made. Individuals who reside in China for a year or more, but for no more than five years, are taxable on foreign-source income only to the extent that it is remitted to China.⁵¹ In practice, however, foreigners working in China for non-Chinese enterprises who do not intend to become permanent residents in China are not taxed on foreign-source income at all.⁵² As already noted, individuals who reside in China for less than a year are taxed only on income gained within China.⁵³ The regulations further provide that remuneration paid by employers outside China for individuals whose continuous residence in China does not exceed ninety days is exempt.⁵⁴ Individuals not resident in China at all are taxed on the total amount of their income ob-

⁴⁹ IITL, *supra* note 5, art. 1. Residence for one year is stated to mean residence for a full 365 days of a tax year. IIT Regs., *supra* note 5, art. 2. No subtraction is made for temporary absence. Technically, it should be possible to be present in China from January 2 in one year until December 30 of the following year without being treated as a resident for the purpose of taxing foreign-source income. In practice, however, any 365 day period—whether or not it spans two tax years—constitutes residence for one year. Gelatt & Pomp, *Tax Aspects of Doing Business in the People's Republic of China*, 22 COLUM. J. TRANSNAT'L L. 421, 430 n.24 (1984).

⁵⁰ IITL, *supra* note 5, art. 1.

⁵¹ IIT Regs., *supra* note 5, art. 3.

⁵² Notice of the Tax Bureau of the Ministry of Finance Regarding Questions About the Exemption from Filing and Payment of Personal Income Tax for Income Earned Outside China by Foreigners Working Inside China, Mar. 7, 1983, in *ZHONGGUO DUIWAI SHUIWU SHOUCE* (China's Foreign Tax Handbook), Book 1, at 17 (1983) [hereinafter *Tax Handbook*] (in Chinese).

⁵³ This includes income from work and personal services performed in China and dividends, royalties and interest from Chinese sources, whether or not the place of payment is in China. IIT Regs., *supra* note 5, art. 5.

⁵⁴ IIT Regs., *supra* note 5, art. 5. Where a tax treaty applies, such remuneration will normally be exempt if the individual is present in China for less than 183 days. See U.S.-China Treaty, *supra* note 48, art. 14. In practice an individual's residence status is normally determined by reference to the type of visa or residence permit held. See Gelatt & Pomp, *supra* note 49, at 427-31; see also Notice of the Tax Bureau of the Ministry of Finance Regarding Questions of the Location for Paying Tax of Foreign Taxpayers Who Work at Several Locations Inside China, and Regarding Questions of Withholding Personal Income Tax of Foreigners at Representative Offices in China, June 2, 1981, in *Tax Handbook*, *supra* note 52, at 69; Notice of the Tax Bureau of the Ministry of Finance Regarding Several Policy and Business Issues of the Personal Income Tax, Feb. 18, 1986, in *ZHONGGUO SHUIWU*, Apr. 1986, at 38-39 (in Chinese).

tained from personal services, royalties and the lease of property in China,⁵⁵ and upon interest and dividends received from Chinese sources.⁵⁶

Taxable Income. Individual Income Tax is levied on the following categories of income:

- (1) wages and salaries;
- (2) compensation for personal services;
- (3) royalties;
- (4) interest, dividends and bonuses;
- (5) income from the lease of property; and
- (6) other kinds of income specified as taxable by the Ministry of Finance⁵⁷

It should be noted that income from business is not included within any of these categories, though what might be termed "professional income" is taxed under this Law.⁵⁸ Each category of income is computed and taxed separately.⁵⁹ A separate return of foreign-source income must be filed yearly.⁶⁰

(1) *Employment Income.* Only income from wages and salaries is taxed at progressive rates. A monthly deduction of 800 yuan⁶¹ is allowed, with the excess taxed at rates which rise from five to

⁵⁵ IIT Regs., *supra* note 5, art. 11. In effect, the tax is a type of withholding tax and is levied on the gross amount.

⁵⁶ IIT Regs., *supra* note 5, arts. 5(2), 5(4).

⁵⁷ IITL, *supra* note 5, art. 2. This English translation is quoted from LAWS AND REGULATIONS, *supra* note 5, at 114.

⁵⁸ "Income from remuneration for personal services" is defined as income of individuals from "designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting, freelance-writing, translating, calligraphy and painting, sculpture, films, drama and opera, music, dancing, acrobatics, ballad singing and comic talk, sports, technical services and other personal services." IIT Regs., *supra* note 5, art. 4(2). Thus, income earned in China by foreign athletes and entertainers is subject to the IITL, unless exempted by virtue of a tax treaty provision, as is commonly the case. See U.S.-China Treaty, *supra* note 48, art. 16. It may sometimes be difficult to determine whether a particular item constitutes remuneration for personal services or income from business, which is taxable under the Foreign Enterprise Income Tax Law. See *infra* note 133. For example, income from medical practice is subject to the IITL, but income from private clinics operated by foreign doctors or dentists presumably would be subject to the FEIT.

⁵⁹ IIT Regs., *supra* note 5, art. 6.

⁶⁰ IITL, *supra* note 5, art. 7.

⁶¹ IITL, *supra* note 5, art. 5(1). 1 yuan = 0.26 dollars U.S., approximately. The basic exemption, therefore, is about 200 dollars a month, which is about eight times the average wage in China. It became apparent that there was a growing number of Chinese citizens with substantial incomes by Chinese standards who were not required to pay tax on account of the relatively high exemption limit. As a consequence, new legislation was introduced in September 1986, setting much lower exemption limits for Chinese citizens. See *infra* notes 79-87 and accompanying text.

forty-five percent,⁶² the top rate being payable on earnings in excess of 12,000 yuan per month. Employment income is stated to include "bonuses and year-end extras," etc.⁶³ The tax is computed on a monthly basis; thus a substantial year-end bonus may be taxed more heavily than the same amount spread over the year.⁶⁴ The monetary equivalent of income paid in kind or in securities is included in income,⁶⁵ so that in principle fringe benefits are taxable. In practice it appears that cash allowances, such as "overseas" or "hardship" allowances, are taxable, but benefits provided in kind by foreign employers, such as accommodation, travel, moving costs and home leave, are not treated as part of employment income.⁶⁶ Other than the basic 800 yuan per month deduction, no provision is made for the deduction of expenses incurred for the purpose of earning employment income.

(2) *Compensation for Personal Services.*⁶⁷ As noted above, of non-business income, only employment income is taxed at progressive rates. For income from compensation for personal services, a deduction is allowed "for expenses" of 800 yuan if the amount received in a single payment is less than 4,000 yuan; for payments of 4,000 yuan or more a deduction of twenty percent is allowed.⁶⁸ The remainder is taxed at a flat rate of twenty percent.⁶⁹ Since business income is generally taxed at progressive

⁶² The rate schedule is as follows:

Monthly income	Tax rate
800 yuan or less	exempt
801-1500 yuan	5%
1501-3000 yuan	10%
3001-6000 yuan	20%
6001-9000 yuan	30%
9001-12,000 yuan	40%
12,001 yuan and above	45%

IITL, *supra* note 5, art. 3 and accompanying schedule.

⁶³ Awards for scientific, technological or cultural achievements are excluded. IIT Regs., *supra* note 5, art. 4(1).

⁶⁴ A special "bonus tax" applies to bonus payments made by state-owned and collective enterprises; the tax is on the enterprise rather than on the individual. *See infra* text accompanying note 109.

⁶⁵ IIT Regs., *supra* note 5, art. 7.

⁶⁶ Ministry of Finance Notices of Oct. 24, 1980, and June 2, 1981. Food allowances are taxed. Ministry of Finance Notice of July 7, 1981. These notices are reproduced in Tax Handbook, *supra* note 52, at 77.

⁶⁷ In the tax treaties entered into by China, income from personal services is taxed only if the individual has a fixed base in China or is present there for 183 days or more in the year. *See, e.g.,* U.S.-China Treaty, *supra* note 48, art. 13.

⁶⁸ IITL, *supra* note 5, art. 5(2).

⁶⁹ *Id.* art. 3(2).

rates,⁷⁰ it is important to distinguish professional income from both employment income and business income. Unfortunately, the legislation gives relatively little guidance.

The deduction system is unusual in that the tax is not imposed on net income or profits. The individual is taxed on gross professional receipts, less the standard deduction, but there is no deduction for the actual cost of earning the income. More striking is the fact that the 800 yuan or twenty percent deduction is applied to each amount received in a single payment; this is taken to mean lump-sum payments or income from completing a single piece of work.⁷¹ Payments of a continuing nature relating to the same item of income, that cannot be divided into separate payments, may be aggregated as to all such payments successively received within a month and counted as a single payment.⁷² Interpreted literally, a doctor or dentist would pay no tax except where a single fee exceeded 800 yuan; whether a lawyer could reduce tax liability by billing separately for completing the various stages of what is essentially the same piece of work is more questionable. In practice, however, the exemption in the case of professional services seems to operate in the same way as the monthly deduction from employment income and "item" is interpreted in the sense of "source."⁷³

(3) *Income from Rents and Royalties.* China taxes rental and royalty income in much the same manner as income from professional services. A tax is levied upon the gross amount received with no deduction for actual expenses; the regulations allow for a standard deduction from each amount received of 800 yuan or twenty percent.⁷⁴ Rents or royalties received by a non-resident are taxable in full without any deduction.⁷⁵

(4) *Interest and Dividends.* Income from interest, dividends and

⁷⁰ The FEIT taxes business income at rates from 20% to 40%, plus an additional local tax of 10%. FEITL, *infra* note 133, art. 3.

⁷¹ IIT Regs., *supra* note 5, art. 12.

⁷² *Id.*

⁷³ For example, all receipts within the month from carrying on a medical practice are aggregated and only one deduction—800 yuan or 20% where the aggregate exceeds 4,000 yuan—is allowed. Ministry of Finance Ruling of Sept. 19, 1981. But if a taxpayer has more than one source—e.g., two professions, or a profession and rental income—a deduction can be claimed for each type. Ministry of Finance Ruling of Oct. 28, 1980. These rulings are reprinted in Tax Handbook, *supra* note 52, at 89, 90.

⁷⁴ IITL, *supra* note 5, art. 5(2); IIT Regs., *supra* note 5, art. 12. The provisions for aggregating amounts received from the same source within the month also apply. There may still be a saving by stipulating for monthly, rather than quarterly or yearly payments.

⁷⁵ IIT Regs., *supra* note 5, art. 11. In effect, there is a 20% withholding tax on the

bonuses is taxed at a flat rate of twenty percent⁷⁶ without deduction.⁷⁷

Exemptions and Reliefs. Certain categories of income are exempted from tax, notably prizes and awards for scientific, technological or cultural achievements, interest on deposits in state banks, welfare benefits, certain pensions or severance pay, and salaries of foreign diplomatic and consular officials.⁷⁸ In addition, tax rates are commonly reduced in the Special Economic Zones and in certain other specially designated areas.

2. Individual Income Regulatory Tax

When it was introduced in 1980, the Individual Income Tax was intended primarily to satisfy the needs of the "open door" policy and was designed mainly to tax foreigners living and working in China. Within a few years, it became apparent that an appreciable number of Chinese citizens were receiving substantial incomes without paying tax. Basic exemption limits, which appeared to be quite reasonable for foreign executives having to live in scarce and expensive apartments or in hotels, were nevertheless many times higher than the average Chinese wage or salary. The large difference between average incomes and the incomes of this newly emerging wealthy class necessitated regulation, and a new tax was introduced in September 1986.⁷⁹

The Individual Income Regulatory Tax (IIRT) applies to Chinese citizens who have a residence in China and obtain personal income.⁸⁰ It differs from the IITL in two important respects: tax rates are more steeply progressive and there is some aggregation of different categories of income.

Taxable Income. The IIRT adds a new category of taxable income, namely "income from contractual and sub-contractual fees."⁸¹ Additionally, the IIRT has two categories of "royalties:"

gross amount. The rate for royalties is commonly reduced by treaty. See, e.g., U.S.-China Treaty, *supra* note 48, art. 11.

⁷⁶ IITL, *supra* note 5, art. 3(2). Again, the rate on payments to nonresidents may be reduced by treaty.

⁷⁷ *Id.* art. 5(3). Dividends and bonuses received from Chinese-foreign joint ventures and from urban and rural cooperative organizations are exempt from tax. IIT Regs., *supra* note 5, art. 5(2). "Bonuses" is used here in the sense of "extra dividends" and is sometimes so translated. E.g., CFEL, *supra* note 5, at 75.

⁷⁸ IITL, *supra* note 5, art. 4.

⁷⁹ IIRT Regs., *supra* note 46. The tax came into force effective Jan. 1, 1987.

⁸⁰ *Id.* art. 2.

⁸¹ IIRT Regs., *supra* note 46, art. 3(ii). These fees are earned by individuals who contract with their work unit to manage the business, or some part of it, and to be re-

1) income from patent rights and from providing non-patented technology; and 2) income from writing and translating.⁸²

Tax Rates. Unlike the IITL, the IIRT provides for a measure of aggregation of the various types of income. The two types of royalty income are taxed at a flat rate of twenty percent, after an "expenses" deduction,⁸³ and dividend and interest income are taxed at twenty percent on the gross amount received. However, employment income, income from contractual fees, remuneration for personal services and "income from the lease of property" are aggregated monthly and are taxed under an elaborate progressive rate schedule.⁸⁴ Tax becomes payable, at a rate of twenty percent, when the individual's income exceeds four times the "basic regional taxable amount,"⁸⁵ and increases to a rate of sixty percent on the excess above eight times that amount. Consequently, the effective rate varies from region to region.⁸⁶ As with the IITL, a number of categories of income are exempted.⁸⁷

B. *Taxes Upon Business Income*

In contrast to the personal income taxes, there are five or, perhaps, six separate taxes (not counting the Agriculture Tax) imposed upon business income, depending on the type of business organization being taxed.⁸⁸

1. *The Industrial and Commercial Income Tax*

Until 1980, the Industrial and Commercial Income Tax

sponsible for the profit or loss thereof. Income exceeding the contract amount is income of the individual. How such income will be classified—either as "individual income" or "private business income"—remains to be seen.

⁸² *Id.* at art. 3(v), (vi).

⁸³ 800 yuan, or 20% of the amount received where this exceeds 4,000 yuan. *Id.* at art. 7(i).

⁸⁴ *Id.* art. 5.

⁸⁵ The basic regional taxable amount (BRTA) ranges from 100 to 115 yuan. The starting point for tax is consequently 400 yuan, or 460 yuan in the regions with the highest BRTA.

⁸⁶ The BRTA is determined by reference to wage and price levels in the different regions. It appears to have a built-in incentive to encourage workers to go to the remote regions: tax is heaviest in the capital, Beijing, and least heavy in areas such as Tibet and Xinjiang. The overall effect is that a Chinese citizen will pay the highest rate, 60%, in Beijing, on income in excess of 800 yuan per month. Eight hundred yuan is the level at which a foreigner begins to pay the lowest, 5%, rate under the IITL.

⁸⁷ IIRT Regs., *supra* note 46, art. 9. The categories are essentially the same for both taxes.

⁸⁸ For an excellent description and analysis of the various types of business organizations, see Chao & Yang, *Private Enterprise in China: The Developing Law of Collective Enterprises*, 19 INT'L LAW. 1215 (1985).

(ICIT) was the only tax on business profits. Introduced in 1950 as one of five components of the Industrial and Commercial Tax,⁸⁹ the ICIT taxed the income of all industrial and commercial enterprises operated for profit, including public, private, joint public/private, and cooperative enterprises, except for those governed by other regulations.⁹⁰ In 1958, the other components of the Industrial and Commercial Tax and a number of commodity taxes were consolidated into the Consolidated Industrial and Commercial Tax, leaving the ICIT standing alone. Meanwhile, in 1956 regulations were adopted which exempted most state enterprises from the tax.⁹¹

During the following decade, foreign and privately owned enterprises disappeared almost entirely in China and the number of collectively owned businesses was drastically reduced. Accordingly, the ICIT had lost what little importance it may once have had. From 1976, as the number of privately owned enterprises began to grow again and foreign enterprises were being invited to set up business in China, it made a brief resurgence. In 1980, however, new legislation was adopted to tax joint enterprises with foreign participation, thereby taking these outside the scope of the ICIT. In the following year, foreign-owned enterprises became subject to a separate tax. Between 1983 and 1986, further tax laws were adopted applying to state-owned, collectively owned and privately owned enterprises. In consequence, although the ICIT appears never to have formally been repealed, most types of enterprises are governed by other regulations.⁹²

⁸⁹ Provisional Regulations for the Industrial and Commercial Tax (passed by the Government Administration Council, Jan. 27, 1950). For an English translation, see Reynolds, *supra* note 3, at 67. For discussion of the ICIT, see Castleman, *Taxation in the People's Republic of China: the System and its Function*, 46 ALBANY L. REV. 776 (1982); Jehle, *Taxation in the People's Republic of China*, 39 BULL. INT'L FISCAL DOC. 405, 412 (1985); Gelatt & Pomp, *supra* note 49; Reynolds, *supra* note 3. The other components were a Licence Tax, Street Traders Tax, Temporary Commercial Tax and Turnover Tax. For an historical survey of the tax, see Wang, *supra* note 5, at 185-87.

⁹⁰ Industrial and Commercial Income Tax Law, art. 1. The tax included the profits of foreign-owned enterprises. See Note, *An Introduction to Tax Incentives to Investment in the People's Republic of China*, 2 B.C. THIRD WORLD L.J. 121, 127 (1981).

⁹¹ The ICIT continued to apply to those state enterprises whose activities were not incorporated into the State Economic Plan. See Chao & Yang, *supra* note 88, at 1236 n.92.

⁹² Wholly foreign-owned businesses incorporated under Chinese law, which are permitted under a law adopted on April 12, 1986, see *infra* note 122, and which already numbered 120 by the end of 1985, are not as yet governed by a separate tax law. Renmin Ribao (Haiwai Ban) (overseas edition), Jan. 14, 1986, at 1, col. 2 (in Chinese). Wholly foreign-owned enterprises are mostly established in Special Economic Zones and are accorded special treatment.

2. *The State Enterprise Income Tax*

Despite the recent impressive growth in the number of foreign enterprises, joint ventures and collectively and privately owned enterprises, the Chinese economy remains dominated by state enterprises.⁹³ The growth in the importance of tax revenues—from less than half of the total budgetary revenue a few years ago to the present ninety-five percent—is largely due to the substitution of tax payments for profit delivery by state-owned enterprises (*li gai shui*). Experiments with the taxation of state-owned enterprises began around 1978 and for the most part proved highly successful. As a result, a new system of taxation applicable to all state enterprises was introduced in 1983.⁹⁴

The State Enterprise Income Tax (SEIT) is imposed on the profits of all state-owned enterprises engaged in industry, commerce, transportation and communications, construction and installation, finance and insurance, catering and services, culture, education, public health, supply and marketing of goods, urban utilities and other work.⁹⁵ Those enterprises which keep independent economic accounts are considered to be taxpayers. In the case of a jointly operated enterprise,⁹⁶ the profit sharers are subject to tax if the enterprise's profits are distributed before tax.⁹⁷ The tax is calculated on the basis of profits earned in the fiscal year and is computed according to the state regulations

⁹³ By the end of 1985, there were approximately 833,000 state enterprises, 3,347,000 collective enterprises, and about 17 million people engaged in individually owned enterprises. The number of such enterprises is variously estimated between 5.8 and 11 million. *See* China Daily, Jan. 27, 1986, Oct. 23, 1986; Renmin Ribao, July 11, 1986 (in Chinese). As to foreign participation in the Chinese economy, there were almost 2,000 equity joint ventures, 1,600 representative offices, and over 3,400 contractual joint ventures. China Daily, Oct. 9, 1986, at 1; Renmin Ribao (Hawaii Ban), Jan. 14, 1986, at 1, col. 2 (in Chinese).

⁹⁴ Provisional Regulations of the Ministry of Finance on Financial Matters Following the Replacement of Profit Delivery with Tax Payment in State-Owned Industrial and Communications Enterprises (promulgated Apr. 29, 1983) [hereinafter SEIT Regs.]. For an English translation, see O. NEE, F. CHU & M. MOSER, COMMERCIAL LAWS AND BUSINESS REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 160 (1983).

⁹⁵ SEIT Regs., *supra* note 94, art. 1. Note that agriculture is not included in the list. Supply and marketing cooperatives at the county level and above are, however, considered to be taxable entities. *Id.* art. 2.

⁹⁶ These could be joint state-state, state-collective, state-private or state-foreign.

⁹⁷ SEIT Regs., *supra* note 94, art. 2. For example, a contractual joint venture between a Chinese state-owned enterprise and a foreign enterprise is not treated as a taxable person, and profits are shared before tax. The Chinese partner will be taxed on its share under the SEIT, while the foreign participant will pay the FEIT. The position is different where an equity joint venture is formed; it is a separate legal person and must pay tax under the Joint Venture Income Tax Law before distributing profits.

concerning the financial and accounting system.⁹⁸

State enterprises are divided into three categories for tax purposes.⁹⁹ Large and medium-sized enterprises pay a flat-rate tax of fifty-five percent on their profits. Small enterprises, and supply and marketing cooperatives, pay an eight-grade progressive tax, which rises from seven percent to fifty-five percent.¹⁰⁰ Enterprises engaged in catering and service trades, profit-making guest houses, restaurants and hotels pay a flat-rate tax of fifteen percent.

This distinction also applies to the treatment of after-tax profits. Small state enterprises and supply and marketing cooperatives assume sole responsibility for profits and losses and, after payment of taxes, the state generally makes no further appropriation.¹⁰¹ The after-tax profits of catering and servicing enterprises, guesthouses, hotels and restaurants are the re-

⁹⁸ SEIT Regs., *supra* note 94, art. 3. The tax is calculated on an annual basis, but is paid in advance on a daily, ten-daily or monthly basis. *Id.* arts. 5, 6.

⁹⁹ *Id.* art. 4.

¹⁰⁰ *Id.* art. 4. The schedule is as follows:

<u>annual in-</u> <u>come</u> <u>(RMB)</u>	<u>rate</u>	<u>deduction (RMB)</u>
below 300	7%	0
between 300 and 600	10%	9
600 and 1000	20%	69
1000 and 2500	30%	169
2500 and 10,000	35%	294
10,000 and 30,000	40%	794
30,000 and 80,000	50%	3794
above 80,000	55%	7794

Formula for calculation of progressive rates:

$$(\text{Income} \times \text{rate}) - (\text{deducted sum}) = (\text{tax sum})$$

Small enterprises are defined as those whose fixed assets do not exceed 1.5 million yuan in value and whose profits do not exceed 200,000 yuan annually. In the case of commercial retail enterprises, a small enterprise is one which employs no more than 30 staff and whose annual profits do not exceed 50,000 yuan. *Id.* art. 11.

¹⁰¹ Ministry of Finance Notice of Apr. 12, 1983, on trial methods concerning the substitution of profit delivery for tax payment in State enterprises, arts. 2, 4. For an English translation, see V. Sit, *supra* note 4, at 151. In exceptional cases of excessive profits, certain additional contract fees may be levied. State Council Bulletin, *supra* note 35.

sponsibility of the appropriate government department.¹⁰²

As for the large and medium-sized state enterprises, a number of experimental systems have been tried. Initially, a further part of the profit would be turned over to the state under specially negotiated contractual arrangements. This system has now been superseded by a separate regulatory tax.¹⁰³ This tax addresses the wide disparities in the profitability of different enterprises which may reflect circumstances other than the efficiency of management. The profit margin for a particular product may be large or small, depending upon the fixing of the selling price in relation to the cost of production. To a large extent, the authorities attempt to solve this problem by means of indirect taxation. However, this approach does not address disparities in profitability due to other factors, such as geographical location, availability of natural resources, level of previous capital investment and the condition and age of plant and machinery. Consequently, a tax is levied upon what might be termed "excess profits." The regulatory tax—stated to be temporary only¹⁰⁴—will probably affect no more than a quarter of large and medium-sized state enterprises and is based on 1983 profit margins. It was designed to ensure that subsequent increases in profitability in response to the new incentives are not nullified by the tax. Nevertheless, the tax has received some criticism from Chinese writers. They claim that it retains vestiges of the former profit delivery system and, by penalizing success, is like "beating the fast running cow."¹⁰⁵ Further special taxes have been introduced or proposed which are aimed at eliminating profit disparities brought about by physical conditions. A Resources Tax is now being levied as a form of excess profits tax on the exploitation of crude oil, natural gas and coal;¹⁰⁶ an Oil Burning Tax encourages the use of coal rather than oil by regulating the profits of enterprises benefitting from the use of cheap oil;¹⁰⁷ and a Land Use Tax has been proposed to regulate differential incomes due to

¹⁰² Ministry of Finance Notice of Apr. 12, 1983, *supra* note 101, art. 3. Profits from establishments in the major cities may be used to subsidize outlying and difficult areas.

¹⁰³ The regulatory tax is assessed on each enterprise individually. Its operation is described in State Council Bulletin, *supra* note 35.

¹⁰⁴ See Dai, *supra* note 35; State Council Bulletin, *supra* note 35.

¹⁰⁵ Chen Lanying, *Should Not Undervalue the Historical Function of the Regulatory Tax*, ZHONGGUO SHUIWU, June 1986, at 30 (in Chinese).

¹⁰⁶ The tax was introduced in October 1984. See Guo Hongde & Yang Yimin, *The Status of Implementation of the Resources Tax and Ideas for Perfection*, ZHONGGUO SHUIWU, Apr. 1986, at 13-15 (pt. 1), May 1986, at 11-12 (pt. 2) (in Chinese).

¹⁰⁷ See Dai, *supra* note 35.

geographical location and to promote the economic use of land.¹⁰⁸

Enterprises are not entirely free to dispose of retained profits after payment of the income tax and the other special taxes. A certain proportion must be set aside for capital investment or the creation of reserves, and normally not more than forty percent of retained profits may be applied to workers' welfare funds or bonuses. Further, a special Bonus Tax was introduced in 1984¹⁰⁹ applicable to bonuses paid to employees. The tax is imposed on the enterprise, not on the employee. The bonus *will*, however, form part of the recipient's employment income for purposes of the Individual Income Regulatory Tax. It is levied according to a progressive scale which reaches 300% for bonuses exceeding six months' normal salary.

3. *Collective Enterprise Income Tax*

The tax on the profits of collective enterprises was introduced in 1985.¹¹⁰ Collective enterprises in China take a variety of forms, ranging from small partnerships to large concerns which are incorporated and, in a few cases, have made public stock offerings. The essence of a collective is that it is collectively owned, rather than state-owned, and is "non-governmental;" its production plan is not incorporated directly as part of the State Economic Plan, and it does not remit its profits to the state.¹¹¹

The Collective Enterprise Income Tax (CEIT) treats collectives in a manner similar to the treatment of small state enterprises under the SEIT. Tax is levied upon total income after deduction of expenses, according to an eight-grade progressive

¹⁰⁸ See Wang, *supra* note 5, at 268-71.

¹⁰⁹ Provisional Regulations on Bonus Tax in State Enterprises (promulgated by the State Council, June 28, 1984) *reprinted in* State Council Bulletin No. 16, July 30, 1984, at 550; see Wang, *supra* note 5, at 176.

¹¹⁰ Provisional Regulations on Income Tax of Collective Enterprises (promulgated by the State Council Apr. 11, 1985) [hereinafter CEIT Regs.]. The Collective Enterprise Income Tax (CEIT) applies to all collective enterprises engaged in industry, commerce, service trade, construction and installation, communications and transportation and other fields of work, which have independent accounting systems. For an excellent study of collective enterprises generally, see Chao & Yang, *supra* note 88.

¹¹¹ Chao & Yang, *supra* note 88, at 1217.

scale. The scales are not the same as those for SEIT.¹¹² Generally, a collective will pay less tax than a state-owned enterprise with equivalent profits. The tax is levied annually, and must be prepaid monthly or quarterly.¹¹³ Special reductions or exemptions are given for certain types of enterprises, especially those engaged in activities ancillary to agriculture and village and town collectives established in minority-inhabited areas or remote and border areas.¹¹⁴

It should be noted that it is the enterprise which is the taxable person, rather than the participants themselves. This produces the rather odd result that an enterprise making a profit of 20,000 yuan to be shared among five participants will pay more tax than one with profits of 8,000 yuan shared between two. Salaries paid to employees of the collective normally will be a deductible expense. The salaries are subject to the IIRT if in excess of 400 yuan a month (or the higher basic regional taxable amount). However, profits distributed to the members are taxed only once, at the collective level.

4. *Private Business Income Tax*

Until recently, privately operated businesses, like collectives, were obligated to pay the Industrial and Commercial Income Tax.¹¹⁵ A new tax, imposed upon privately operated businesses, was introduced in 1986.¹¹⁶ The private business income tax ap-

¹¹² The schedule is as follows:

<u>annual income</u> <u>(RMB)</u>	<u>rate</u>	<u>deduction (RMB)</u>
below 1000	10%	0
between 1000 and 3500		
3500	20%	100
3500 and 10,000	28%	380
10,000 and 25,000	35%	1080
25,000 and 50,000	42%	2830
50,000 and 100,000	48%	5830
100,000 and 200,000		
200,000	53%	10,830
above 200,000	55%	14,830

Formula for calculation of progressive rates:

$$(\text{Income} \times \text{rate}) - (\text{deduction sum}) = (\text{tax sum})$$

¹¹³ CEIT Regs., *supra* note 110, art. 6.

¹¹⁴ CEIT Regs., *supra* note 110, art. 4.

¹¹⁵ See *supra* text accompanying notes 89-92. This tax was excessively complex. Different types of businesses paid tax at different rates; at one time, following the reform of 1958, there was a 21-rate progressive scale. See Wang, *supra* note 5, at 184-87.

¹¹⁶ Interim Regulations on Income Tax of Urban and Rural Individually Operated Industrial and Commercial Businesses (promulgated by the State Council, Jan. 7, 1986) [hereinafter PBIT Regs.].

plies to all entities and legal persons engaged in industry, commerce, service trades, construction and installation trades, as well as individually operated industrial and commercial businesses operating with the approval of the administrative departments of industry and commerce.¹¹⁷ It is levied on net profit, according to a ten-rate progressive scale¹¹⁸ which rises from seven to sixty percent. In addition, a surtax of from ten to forty percent is imposed on taxable income in excess of 50,000 yuan per year.¹¹⁹ Special reductions are accorded to the childless elderly, handicapped, and those providing badly needed services requiring high labour intensity.¹²⁰ Taxpayers are responsible for keeping proper accounts and for filing tax returns; if they are unable to verify the return an estimated assessment is made.¹²¹

5. Joint Venture Income Tax

A foreign enterprise intending to do business in China must choose between establishing a branch operation or forming a subsidiary. Until recently,¹²² the only way it could form a subsidiary was by establishing a joint venture with one or more Chinese

¹¹⁷ *Id.* art. 1. The tax applies both to single individuals who are self-employed and to private businesses operated by households, the rates being the same in either case. The great majority of such business households are rural. See China Daily, Nov. 15, 1986, at 4, col. 1 (Beijing ed.).

¹¹⁸ PBIT Regs., *supra* note 116, art. 3. The schedule is as follows:

<u>annual income (RMB)</u>	<u>rate</u>	<u>deduction (RMB)</u>
below 1000	7%	0
between 1000 and 2000	15%	80
2000 and 4000	25%	280
4000 and 6000	30%	480
6000 and 8000	35%	780
8000 and 12,000	40%	1180
12,000 and 18,000	45%	1780
18,000 and 24,000	50%	2680
24,000 and 30,000	55%	3880
above 30,000	60%	5380

Formula for calculation of progressive rates:

$$(\text{Income} \times \text{rate}) - (\text{deduction sum}) = (\text{tax sum})$$

It should be noted that the top marginal rate, 60%, is the same as under the Individual Income Regulatory Tax (IIRT). However, there are major differences in the scales. The top rate is reached at a much lower annual income under the IIRT, but an individual starts to pay tax sooner under the PBIT Law.

¹¹⁹ *Id.* art. 4.

¹²⁰ *Id.* art. 5.

¹²¹ *Id.* art. 10.

¹²² Wholly foreign-owned corporations may now be formed. Law on Enterprises Operated Exclusively with Foreign Capital, (adopted Apr. 12, 1986). For an English translation, see CHINA TRADE REPORT, August 1986, at 6. The State Council Provisions for the Encouragement of Foreign Investment, promulgated Oct. 11, 1986, expressly

co-venturers. A distinction is commonly drawn between "contractual joint ventures" and "equity joint ventures." In the former, no separate legal entity is created and the relationship between the parties resembles that of a partnership. The contractual joint venture is not regarded as a taxable person; the profits of the venture are divided among the participants in accordance with the contractual stipulation and are taxed in the hands of the participants. Thus, the Chinese participant may pay the State Enterprise Income Tax or Collective Enterprise Income Tax, while the foreign party pays the Foreign Enterprise Income Tax.¹²³ By contrast, an equity joint venture is a separate legal person, incorporated under Chinese law,¹²⁴ and taxed under a separate statute.¹²⁵

The Joint Venture Income Tax (JVIT) is charged on income of Chinese-foreign joint ventures from production, business and other sources, including the income from branches inside and outside China.¹²⁶ Taxable income is defined as "the excess of gross income in a tax year over its deductible costs, expenses and

encourage the formation of wholly foreign-owned enterprises. It is not yet clear, however, how they are to be taxed. See *supra* note 92; see also Note, *supra* note 90, at 136.

¹²³ See *infra* text accompanying notes 133-46.

¹²⁴ Law on Joint Ventures Using Chinese and Foreign Investment (adopted by the State Council, July 1, 1979). For an English translation, see CFEL, *supra* note 5, at 1. See Lussenburg, *Joint Venture Investment in the People's Republic of China: A Continuing Challenge*, 63 CANADIAN B. REV. 545 (1985); Fenwick, *Equity Joint Ventures in the People's Republic of China: an Assessment of the First Five Years*, 40 BUS. LAW. 839 (1985); Nishitaten, *China's Special Economic Zones: Experimental Units for Economic Reform*, 32 INT'L & COMP. L.Q. 175 (1983); Note, *Joint Ventures Law of the People's Republic of China in a Legislated and Negotiated Tax Climate*, 8 SYRACUSE J. INT'L L. & COMM. 227 (1980); Note, *supra* note 90.

¹²⁵ Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investments (adopted Sept. 10, 1980 [hereinafter JVITL]; Detailed Rules and Regulations for the Implementation of the Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment (approved by the State Council Dec. 10, 1980, promulgated by the Ministry of Finance Dec. 14, 1980), 1980 STATE COUNCIL GAZETTE 630 [hereinafter JVIT Regs.]. For an English translation, see CFEL, *supra* note 5, at 36, 45; LAWS AND REGULATIONS, *supra* note 5, at 90, 94. See also Rasmussen & Theroux, *China's New Tax Laws for Joint Ventures and Individuals*, CHINA BUS. REV., Nov.-Dec. 1980, at 36; Note, *Taxation of Joint Ventures in the People's Republic of China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions*, 15 VAND. J. TRANSNAT'L L. 513 (1982); Gelatt & Pomp, *supra* note 49, at 449; Pomp, Gelatt & Surrey, *supra* note 3, at 52.

¹²⁶ JVITL, *supra* note 125, art. 1. As a corporation resident in China, it is taxed on world income. "Production and Business" is defined as "operations in industry, mining, communications and transportation, agriculture, forestry, animal husbandry, fishing, poultry-farming, commerce, tourism, catering, service trades and other lines of business." "Other income" is defined as "income from dividends, extra dividends and interest, and income from the lease or transfer of tangible property, patent rights, proprietary technology, trademark rights, copyrights and other property." JVIT Regs., *supra* note 125, art. 2. Note that income from agriculture is included.

losses.”¹²⁷ Tax is levied at a flat rate of thirty percent, in addition to which a local income tax of ten percent of the assessed tax is payable, bringing the effective rate to thirty-three percent.¹²⁸ For joint ventures established in the Special Economic Zones, or other special development areas, the rate is commonly reduced to fifteen percent, with no additional local income tax. Special rates also apply to joint ventures engaged in the development of petroleum, natural gas and other resources.

In addition to the tax on profits, a further tax of ten percent is levied on profits remitted outside China.¹²⁹ By contrast, when a participant in a joint venture reinvests a share of the profits in China for a period of not less than five years, the participant is eligible for a refund of forty percent of the income tax paid by the joint venture in respect of the reinvested amount.¹³⁰ A participant who withdraws reinvested funds within the five year period must repay the amount refunded.¹³¹

The legislation provides two further important incentives. Newly established joint ventures scheduled to operate for ten years or more may be exempted from the JVIT in the first two profit-making years and allowed a fifty percent reduction in the following three years. Also, joint ventures engaged in certain low-profit operations, in particular farming and forestry, or located in remote or under-developed regions, may be allowed a further reduction for up to ten years.¹³²

¹²⁷ JVITL, *supra* note 125, art. 2. Profits must be computed, and accounts drawn up, in accordance with the Accounting Regulations for Joint Ventures Using Chinese and Foreign Investment, promulgated Mar. 3, 1985. Article 9 of the JVIT Regs. expressly prohibits certain deductions in the computation of profits, notably interest on capital, losses covered by insurance, donations other than those for public welfare and relief purposes, and entertainment expenses in excess of 1% of gross business income. Capital expenditures are not deductible, but depreciation or amortization is permitted, normally on a straight line basis over prescribed periods corresponding to the estimated useful life of the asset in question. See JVIT Regs., *supra* note 125, arts. 10–17.

¹²⁸ JVITL, *supra* note 125, art. 3.

¹²⁹ JVITL, *supra* note 125, art. 4. This is effectively a withholding tax. The 20% tax on dividends under the Individual Income Tax is expressly stated not to apply to dividends of Chinese-foreign joint ventures. IIT Regs., *supra* note 5, art. 5(2). The 10% rate is the same as that prescribed in most of China's tax treaties. See, e.g., U.S.-China Treaty, *supra* note 48, art. 9.

¹³⁰ JVITL, *supra* note 125, art. 6. To qualify, the profits must be invested in the same joint venture, some other joint venture or toward the establishment of a new joint venture in China. Notice of the Tax Bureau of the Ministry of Finance Regarding Questions of Tax Redemption for Reinvestment, June 8, 1981, in Tax Handbook, *supra* note 52, at 16–17.

¹³¹ JVITL, *supra* note 125, art. 6.

¹³² JVITL, *supra* note 125, art. 5. In most of China's tax treaties, these “tax holi-

6. *Foreign Enterprise Income Tax*

A foreign enterprise that carries on business in China through a branch operation or representative office must pay the Foreign Enterprise Income Tax (FEIT) on the income earned by that branch or office.¹³³ For the purposes of the legislation, "foreign enterprise" means a foreign company, enterprise or other economic organization having an establishment in the People's Republic of China engaged in independent business operations or cooperative production or joint business operations with Chinese enterprises.¹³⁴ Foreign enterprises which do not have establishments in China are subject to a flat-rate withholding tax of twenty percent on income from dividends, interest, rentals, royalties and other sources in China, which tax must be withheld by the paying unit.¹³⁵

days" are accorded "tax sparing" treatment. See *infra* notes 163-65 and accompanying text.

¹³³ Income Tax Law of the People's Republic of China Concerning Foreign Enterprises (adopted by the Fourth Session of the Fifth National People's Congress and promulgated Dec. 13, 1981) [hereinafter FEITL]; Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises (approved by the State Council Feb. 17, 1982, promulgated by the Ministry of Finance Feb. 21, 1982) [hereinafter FEIT Regs.]. For English translations see CFEL, *supra* note 5, at 64 (FEITL only); LAWS AND REGULATIONS, *supra* note 5, at 100, 104. See Han, *People's Republic of China's Foreign Enterprises Income Tax Law and Regulations*, 6 HASTINGS INT'L & COMP. L. REV. 689 (1983); Foster & Horsley, *People's Republic of China: The New Foreign Enterprise Income Tax*, TAX PLAN. INT'L REV. No. 6, at 9 (1982).

¹³⁴ FEITL, *supra* note 133, art. 1. It would seem that a foreign individual who carries on business in China may be regarded as an "enterprise" for the purposes of the tax. See Notice of the Tax Bureau of the Ministry of Finance Regarding Questions of the Taxation of Foreign Persons Undertaking Individual Business Inside China, Aug. 2, 1982, in Tax Handbook, *supra* note 52, Book 2, at 4. Since income from business is not taxed under the IITL, but income from personal services is taxed, the distinction between business and profession may be important. It might also be argued that a foreign individual carrying on business should be subject to the PBIT tax, rather than to the FEIT. See *supra* text accompanying notes 116-21.

¹³⁵ FEITL, *supra* note 133, art. 11. Certain types of interest and royalty income are exempted or taxed at reduced rates. Interest on loans to the Chinese government, to the state banks or to the National Offshore Oil Corporation are entirely exempt, and a reduced rate of 10% is charged on interest on loans made between 1983 and 1985 and on income from leasing equipment to Chinese concerns. Provisional Regulations regarding the Reduction and Exemption of Income Tax Relating to Interest Earned by Foreign Businesses in China, issued on Jan. 7, 1983 and extended until 1990 by Notice of the Ministry of Finance regarding the Extension of the Time Limit on the Income Tax Relating to Interest and Rents Earned by Foreign Businesses in China, Jan. 6, 1986, in ZHONGGUO SHUIWU, Feb. 1986, at 33 (in Chinese). Further important exemptions or reliefs apply to income earned in Special Economic Zones and other specially designated areas. See *infra* note 146 and accompanying text. Exemption or reduction may also be given by tax treaty. The tax rate is commonly reduced to 10%. U.S.-China Treaty, *supra* note 48, arts. 9, 10, 11.

A foreign enterprise having an establishment in China is taxed on income earned there at progressive rates, which range from twenty percent on the first 250,000 yuan of taxable income for the year to forty percent on income in excess of 1 million yuan.¹³⁶ A local income tax of an additional ten percent is also levied, bringing the total rate to a maximum of fifty percent.¹³⁷ Consequently, except in the case of small operations, an equity joint venture will pay less tax on its profits than will a branch operation, though there will be an additional tax of ten percent on profits remitted outside the country by the joint venture.

Since liability to the progressive tax depends upon whether an "establishment" exists in China, the scope of this term is of crucial importance. According to the Regulations, "establishments" refer to organizations, places or business agents established in China and engaged in production and business operations, which include management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building, installation, assembly and exploration are operated.¹³⁸ Although the definition appears fairly broad, in practice the Chinese authorities seem to interpret it in much the same sense as the term "permanent establishment," which appears in China's various tax treaties and determines the liability of non-residents to tax on business income. An agent of a foreign enterprise in China constitutes an "establishment" if the agent has authority to enter into contracts binding upon the principal and acts only for that

¹³⁶ FEITL, *supra* note 133, art. 3. The rate schedule is as follows:

<u>annual in-</u> <u>come (yuan)</u>	<u>Rate</u>
below 250000	20%
between 250,001 and 500,000	25%
500,001 and 750,000	30%
750,001 and 1,000,000	35%
above 1,000,000	40%

¹³⁷ *Id.* art. 4. It should be noted that this local rate is not, unlike that under the JVITL, expressed as a percentage of the tax otherwise payable. The local tax authorities may reduce or waive this tax; this is normally done in the Special Economic Zones and other special areas.

¹³⁸ FEIT Regs., *supra* note 133, art. 2.

principal.¹³⁹ A representative office is not considered to be an "establishment" if it confines its activities to marketing, sales promotion and liaison work on behalf of the home office, and if it receives no payment for such work. To the extent that it provides a wider degree of services or receives fees or commissions, the income of the office is taxable.¹⁴⁰

Foreign enterprises with establishments in China are taxed on net income from production, business and other sources.¹⁴¹ Taxable income is computed under the FEIT Regulations in much the same way as that of an equity joint venture.¹⁴² The main problem is determining what income is attributable to the local "establishment." For example, if the foreign enterprise licenses a Chinese enterprise to use a patent or process and receives royalties or rental payments, and also sets up an establishment to provide technical assistance or servicing facilities, the income earned by the establishment is clearly taxable. It is less clear whether the royalties are taxed at the flat rate of twenty percent, or are included in total income and taxed at progressive rates, as "other income" of a foreign enterprise having an establishment in China.¹⁴³ If a foreign enterprise cannot provide accurate vouchers of costs and expenses to correctly compute taxable income, the tax authorities may estimate its profit on the basis of gross business income.¹⁴⁴ Where satisfactory documentation is not available, a representative office is taxed at a flat ten percent of its business proceeds.¹⁴⁵

As in the case of joint ventures, the Chinese provide "tax holidays" to attract foreign investment. Enterprises scheduled to operate for a period of ten years or more in farming, forestry, animal husbandry or other low-profit activities may be exempted from tax in the first profit-making year and allowed a fifty percent reduction in the following two years, with further reductions for

¹³⁹ Han, *supra* note 133, at 694; U.S.-China Treaty, *supra* note 48, art. 5.

¹⁴⁰ Provisional Regulations of the Ministry of Finance of the People's Republic of China on the Levy of Consolidated Industrial and Commercial Tax and Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises (approved by the State Council Apr. 11, 1985, promulgated by the Ministry of Finance May 14, 1985) [hereinafter Provisional Regs.].

¹⁴¹ FEITL, *supra* note 133, art. 2.

¹⁴² See FEIT Regs., *supra* note 133, arts. 9-23. These rules may be modified by treaty. See, e.g., U.S.-China Treaty, *supra* note 48, art. 7.

¹⁴³ Foster & Horsley, *supra* note 133, at 9, 12.

¹⁴⁴ FEIT Regs., *supra* note 133, art. 24. In practice it seems that the foreign enterprise may elect to be taxed on this basis.

¹⁴⁵ Provisional Regs., *supra* note 140, art. 4; see China Daily, Oct. 9, 1986, at 1, col. 1.

an additional period of up to ten years.¹⁴⁶

C. *Agriculture Tax*

Agricultural taxes have existed in China, in one form or another, for at least four thousand years. Whether to classify them as taxes on income is unclear. At some times—for example with the “nine-square” system—the tax resembled the medieval European “tithe” and could be considered to be a tax on production or on income. At other times, the assessment was based upon the value or area of the land itself, more closely approximating a property, or annual wealth, tax. The system in force since 1949 is based upon the estimated yield of the average harvest for the land in question, and might therefore be described as a sort of hybrid property and income tax.¹⁴⁷

Questions of classification apart, the Agriculture Tax is of major importance not only on account of its antiquity but because it affects some eighty percent of the population of the Peoples’ Republic. However, its budgetary importance has gradually diminished over the past three decades; even in predominantly agricultural areas, it has ceased to be a major source of tax revenue.¹⁴⁸

The redistribution of land and the reorganization of the Agriculture Tax was one of the first tasks confronting the new government on coming to power in 1949. The administration of the Agriculture Tax had completely broken down by 1949. The system then introduced provided for tax to be assessed on the basis of the average annual harvest for land of any particular type. The tax was levied on a progressive scale¹⁴⁹ according to the total production of the household owning the land, with a basic exemption for feeding the producing household. By 1958, with the formation of the cooperatives and then the communes, there was

¹⁴⁶ FEITL, *supra* note 133, art. 5. These concessions are also accorded “tax sparing” treatment in China’s tax treaties, other than that with the United States.

¹⁴⁷ In certain respects it also resembles the one-time English “Schedule A” income tax, based upon an estimated rental value of land—a system existing until recently in Hong Kong.

¹⁴⁸ For a detailed study of the application of Agriculture Tax in one particular area—Minhou County, in Fujian Province—see Zheng Jiaju & Ye Shaogun, *Thoughts on Reforming Agricultural Taxes: A Survey of Tax Questions in Minhou County*, NONGYE JINGJI WENTI (Problems of Agricultural Economics), Apr. 23, 1985, at 36–38 (in Chinese). According to their study, in a primarily agricultural county, the Agriculture Tax had accounted for 32% of total tax revenue in 1957, but for only 9% in 1983. *Id.*

¹⁴⁹ Ting, *supra* note 13, at 77. For a description of the tax in practice, see W. HINTON, *supra* note 25, at 593–600.

no longer a need for a progressive tax system, and a new flat-rate system was introduced.¹⁵⁰ This flat-rate system, with some modifications, remains in force today.

As under the previous system, tax is now assessed on the basis of the estimated average annual yield of the land. The assessment usually remains in force for five years. This has the advantage of providing an incentive to increase production; so long as production continues to rise, the actual yield will be greater than the hypothetical yield upon which the assessment is based.¹⁵¹ The tax rate varies from thirteen to nineteen percent in different regions, with the average rate around fifteen percent. Some areas impose an additional local surcharge of up to fifteen percent of the basic tax.¹⁵² The amount of tax is calculated in monetary terms based on the price paid by the state for medium-quality grains when it buys from the producing unit. Until recently, however, the tax was normally paid in kind and was collected twice a year, following the summer and autumn harvests.

The Agriculture Tax has failed to keep pace with crop yield and with rising rural incomes. Since Liberation, despite setbacks such as those during the "three winds" period, 1959–1961, agricultural production has risen steadily. By 1978, total output value stood at 3.63 times that of 1949, and the vital grain output had risen by 270%.¹⁵³ Production rose still more sharply following the introduction of the "responsibility system" in 1978.¹⁵⁴ In contrast, tax assessments rose hardly at all, with the result that an average nominal tax rate of around fifteen percent amounted in reality to a real rate of three percent or less.¹⁵⁵

In the past two or three years, pressure has been mounting for a major reform of the Agriculture Tax in line with the tremen-

¹⁵⁰ Agricultural Tax Regulations of the People's Republic of China, *supra* note 12; see also Recent Development, *People's Republic of China—Personal Income Tax*, 11 GA. J. INT'L & COMP. L. 373 (1981); HE JINMING, JINGJI SHOUCHE (Economics Handbook) 426–51 (1984).

¹⁵¹ See Ting, *supra* note 13, at 77. Also, relief from the tax is given if production falls as a result of natural disaster.

¹⁵² The local surcharge has varied from time to time; some writers quote a maximum rate of 22% or even 25%. See *id.* at 76.

¹⁵³ Zhang Yulin, *Readjustment & Reform in Agriculture*, in CHINA'S ECONOMIC REFORMS, *supra* note 22, at 124.

¹⁵⁴ *Id.*; Huan, *supra* note 23, at 16.

¹⁵⁵ Zheng & Ye, *supra* note 148. In their study of Minhou County, Zheng and Ye estimated that in 1952 tax amounted to 14% of the value of total output. By 1983 this proportion had fallen to 3%. Between 1962 and 1983, the assessment rose by only 3%, whereas actual output rose by 126%. In some communes, output was more than four times the assessed figure.

dous changes which have taken place in rural China since the "four modernizations" movement began. The "responsibility system" has meant that the state has considerably relaxed its control over agriculture. Until recently, the state almost totally monopolized grain supplies; taxes were mostly paid in grain and the remainder of the state's needs were met by quota deliveries at state-fixed prices. This policy has been changed; the state now obtains most of its grain requirements on a contract basis. In the more backward areas, tax continues to be paid mainly in kind, but elsewhere the current policy is cash payment.¹⁵⁶ Farmers, in turn, have greater freedom to determine what shall be grown on the land leased to them. Many have switched from grain production to cash crops which yield higher incomes;¹⁵⁷ stories abound of a new generation of 10,000 yuan a year peasants.¹⁵⁸ The tax system designed for conditions existing twenty or thirty years ago is no longer suitable for modern conditions, and it is likely that, before long, a wholly new system—quite probably an income tax with progressive rates—will replace the present Agriculture Tax.¹⁵⁹

D. *Tax Treaties*

Tax treaties entered into by the People's Republic of China with other countries modify the domestic tax rules with regard to the overseas income of residents in China and the China-source income of foreign individuals and enterprises. Within less than four years, China has concluded tax treaties with most of its major trading partners. Already in force are treaties with France, the Federal Republic of Germany, Japan, Malaysia, Singapore, the United Kingdom, and the United States of America.¹⁶⁰ Treaties with Belgium, Canada, Denmark, Finland, New Zealand, Norway, and Sweden have been concluded but await ratification.

¹⁵⁶ The method of calculating the tax has also been changed to reflect the new procurement policy. It is now set in the "reverse ratio of 3:7;" that is to say, 30% of the price component is the price formerly set for the state monopoly purchase of grain while the remaining 70% is based on the market price for grain surplus to the production quota. Interview conducted by Xinhua News Agency with an official from the Finance Ministry's Agricultural Finance Department (May 24, 1985).

¹⁵⁷ For example, citrus crops yield three and a half times as much income as a double crop of rice. See Zheng and Ye, *supra* note 148.

¹⁵⁸ The stories seem to be somewhat exaggerated. See China Daily, Apr. 16, 1985, at 1 (Beijing ed.).

¹⁵⁹ See China Daily, Oct. 22, 1986, at 2, col. 6.

¹⁶⁰ The U.S.-China Treaty, *supra* note 48, was executed Apr. 30, 1984. See generally Schreyer, *A Guide to the China-U.S. Tax Treaty*, E. ASIAN EXECUTIVE REP., Aug. 1984, at 10. For a general survey of China's treaties, see Jehle, *supra* note 89, at 418-23.

Negotiations are under way with Australia, Austria, Czechoslovakia, Italy, the Netherlands, Romania, Switzerland, Thailand, and Yugoslavia.¹⁶¹

For the most part, China's treaties follow quite closely the OECD Model Treaty,¹⁶² but a number of provisions are based upon the United Nations Model.¹⁶³ Since the present treatment of foreign businesses, investors and individuals working in China is comparatively generous, withholding taxes are low or are waived altogether, and the definition of "establishment" is relatively narrow, the treaties may not, in practice, result in any great tax savings. Of considerable importance to China, however, is the inclusion of a "tax sparing" provision in most of its treaties.¹⁶⁴ This provision ensures that the special incentives and tax holidays China offers in order to attract foreign investment are not nullified by heavier taxation in the investor's country of residence.¹⁶⁵

III. TAXES ON GOODS AND SERVICES

Like most developing countries, and like most socialist countries, China has traditionally relied heavily upon indirect taxes rather than income taxes to provide the revenue needed by the state. As already observed, until the introduction of the tax on state-enterprise profits in 1983, income taxes—other than the Agriculture Tax—were almost insignificant. When first introduced in 1950, the Industrial and Commercial Taxes accounted for approximately half of all tax revenues. By 1959 this proportion had risen to over seventy-five percent of the total and, ten years later, to over eighty percent.¹⁶⁶

¹⁶¹ China Daily, Oct. 24, 1986, at 2, col. 2.

¹⁶² OECD Model Double Taxation Convention on Income and Capital (1977).

¹⁶³ U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980).

¹⁶⁴ There is no such provision in the treaty with the United States. However, the U.S.-China Treaty is accompanied by an exchange of diplomatic notes providing that if at some future date the United States should amend its laws to provide a tax-sparing credit or should grant such a credit to any other country by treaty, the same privilege will be accorded to China.

¹⁶⁵ In some treaties this is done by deeming to have been paid (and consequently qualifying for a foreign tax credit) tax which would have been paid but for a specified exemption: e.g., the treaties with Canada, Japan and the United Kingdom. In others, a higher rate of tax is deemed to have been withheld in respect of dividends, interest and royalties: e.g., the treaties with Belgium, France, Germany and Japan.

¹⁶⁶ Ting, *supra* note 13, at 77; G. ECKLUND, *supra* note 2, at 20; *see also* A. ECKSTEIN,

A. Industrial and Commercial Taxes

The government of the People's Republic of China inherited a chaotic tax system. In the areas liberated prior to 1949, various tax systems operated within different revolutionary bases; in other areas, where the administration had not entirely broken down, the system which had operated under the Guomindang regime remained in force. The new tax system, instituted in 1950, introduced a number of categories of taxes on commodities, goods and commercial services, most of which were based upon taxes which had existed prior to 1949.¹⁶⁷ Most important were the taxes referred to as the Industrial and Commercial Tax (ICT).¹⁶⁸ This tax really comprised five separate taxes, the chief among which was a "turnover tax" or "circulation tax" (*liu tong shui*), apparently modelled upon one in force in the Soviet Union.¹⁶⁹ The other components of the tax consisted of an "income tax" on businesses,¹⁷⁰ a "license tax" on certain commercial enterprises, a "street traders tax," and a "temporary commercial tax." In addition to these five, there were other taxes on commodities and transactions. A "stamp tax" was imposed on documents used in commercial transactions, on transfers of property (other than under land redistribution schemes), and on transportation tickets. A general "commodity tax" (*huo wu shui*) was imposed on manufacturers of a variety of commodities not subject to the turnover tax. Special taxes applied to medicines, cotton and hand-woven cloth.¹⁷¹

This system, with its multiplicity of different taxes and tax rates, was subsequently modified, and to some extent simplified, in three stages. In 1953, the components of the ICT were reduced to three, the commodity tax was expanded to include a number of the special taxes and parts of the stamp tax, and a new "commodity transaction tax" was introduced to replace the spe-

supra note 3, at 184. During the 1950s the yield from these taxes rose by 500%. See Ting, *supra* note 13, at 78.

¹⁶⁷ See G. ECKLUND, *supra* note 2, at 22.

¹⁶⁸ For detailed studies of the evolution of the Industrial and Commercial Tax (ICT), see G. ECKLUND, *supra* note 2, at 65-71; Liu, *supra* note 18; Du, *supra* note 35; Wang, *supra* note 5, at 97; see also *supra* note 89 and accompanying text.

¹⁶⁹ G. ECKLUND, *supra* note 2, at 65; see Ting, *supra* note 13, at 73-74. For a description of the Soviet turnover tax, see M. NEWCITY, *supra* note 10, at 49-52.

¹⁷⁰ See *supra* notes 89-92 and accompanying text.

¹⁷¹ G. ECKLUND, *supra* note 2, at 65-71. The "cotton monopolies sales tax" was introduced in 1951. There were also a number of *local* transaction taxes, some of which—in particular the "livestock transaction tax" and "slaughter tax"—still exist today. See *infra* text accompanying notes 204-12.

cial taxes on cotton and certain categories of products previously covered by the commodity tax.¹⁷²

The reforms of 1958 were more far-reaching.¹⁷³ A new Consolidated Industrial and Commercial Tax (CICT) was promulgated¹⁷⁴ to replace the stamp tax, the commodity tax and the commodity transaction tax and to combine the existing components of the Industrial and Commercial Tax, other than the tax on business income. The new tax took the form of a turnover tax, imposed on supplies of goods and services, similar to the type of tax applied in most Western European countries before the EEC adopted the common system of value-added tax. It also possessed certain elements of an excise tax. The CICT was levied on enterprises and individuals engaged in industrial production, the purchase of agricultural products, the importation of foreign goods, retail trade, transport and communications and service trades. The rules for the imposition of the tax were of some complexity, since the intention was to impose the tax only once during the course of production and again, where appropriate, at the point of retail sale. Nevertheless, the tax clearly had a cumulative effect.

Although varying from time to time, the number of tax categories was in excess of one hundred,¹⁷⁵ and tax rates varied from a low rate of 1.5% (for unbleached cotton cloth) to a high of 69% (for Grade A cigarettes). Generally, luxury products—such as tobacco, alcohol, wine and cosmetics—were heavily taxed, while essential clothing and foods were taxed at the lower rates. Industrial products—such as coal, petroleum, metal ores, chemical products, paper and pulp, cement and bricks, timber, and machinery—were taxed at between 5% and 20%. A general rate of 2.5% applied to transport and communications, 3% to retail sales, and between 3% and 7% to service trades.¹⁷⁶

¹⁷² For a description of the 1953 reforms, see G. ECKLUND, *supra* note 2, at 65–67.

¹⁷³ *Id.* at 67–71.

¹⁷⁴ Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China (adopted by the Standing Committee of the National People's Congress Sept. 11, 1958) [hereinafter CICT Regs.]; Detailed Rules and Regulations for the Implementation of the Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China (Draft) (promulgated by the Ministry of Finance Sept. 13, 1958) [hereinafter CICT Rules].

¹⁷⁵ There were 108 items and 141 tax rates, when introduced in 1958. Du, *supra* note 35.

¹⁷⁶ The tax still applies to foreign businesses. See *infra* note 178. Currently, a 5% rate is applied to the *gross* fees received for services performed by foreign agencies and representative offices. See Provisional Regulations for Collection of Consolidated Indus-

A further simplification occurred in 1972: the number of tax categories was reduced to forty-four and the number of separate rates to eighty-two,¹⁷⁷ and the word "consolidated" was dropped from the title.¹⁷⁸

B. Salt Tax

For many centuries the Salt Tax has provided a reliable source of revenue for successive Chinese governments. Despite its essentially regressive character, it was retained as part of the new tax system introduced in 1950¹⁷⁹ and has continued in force since that time.¹⁸⁰ The tax is levied upon salt producers, which are mainly state enterprises, and upon salt marketing agencies. The rates of tax vary considerably from one area of the country to another and depend on the kind of salt and the type of producer.¹⁸¹

C. Customs Duties

Though not of the same antiquity as the Salt Tax, there are records of duties being imposed on foreign boats using Chinese ports and on imported goods as early as the Tang dynasty.¹⁸²

trial and Commercial Tax and Business Income Tax from China-Based Foreign Companies Issued by the Ministry of Finance (passed by the State Council May 11, 1985).

¹⁷⁷ The rates of tax were further revised in 1982. Ministry of Finance Circular, June 10, 1982.

¹⁷⁸ In 1972, little attention was paid to legal formalities. A draft law was approved by the State Council on Mar. 30, 1972, and the new regulations were put into effect without formal promulgation. See Liu, *supra* note 11, at 13-15. These taxes applied only to domestic enterprises for the simple reason that there were no foreign enterprises then operating in the People's Republic. When foreign businesses began to return to China a few years later, the 1972 reforms were not applied to them; rather, the 1958 CICT continued to be applied. In practice, it appears that the Chinese tax officials sometimes apply the 1972 rules and rates to foreign enterprises if this is to the advantage of the taxpayer. See Gelatt & Pomp, *supra* note 49, at 441-43.

¹⁷⁹ The salt tax was in existence at the time of the Qin dynasty (221-207 B.C.), and was probably first introduced during the period of the "warring states." See Wang, *supra* note 5, at 138. A fascinating account of the operation of the salt monopoly and tax during the Ming dynasty is given by R. HUANG, *TAXATION AND GOVERNMENTAL FINANCE IN SIXTEENTH CENTURY MING CHINA* 189-224 (1974). For a discussion of the modern salt tax, see Ting, *supra* note 13, at 81; G. ECKLUND, *supra* note 2, at 64-65.

¹⁸⁰ In the reforms of 1972-1973, the salt tax was in theory merged into the Industrial and Commercial Tax. In practice, it continued to be administered separately. See Guo, Wang & Han, *supra* note 37, at 72. During the 1950s it yielded from 1% to 3% of total tax revenue. Ting, *supra* note 13, at 77. It is proposed to retain the tax as part of the overall reform of the indirect tax system. See *infra* notes 196-97 and accompanying text.

¹⁸¹ Rates range from 50 to 160 yuan per ton; reduced rates or exemptions are given for salt used in farming, fisheries and industry. Originally the tax was paid in grain.

¹⁸² 618-907 A.D. See Wang, *supra* note 5, at 157.

Certain imports, notably tea and horses, were at various times subject to special duties or to state monopolies. In addition, internal customs duties between provinces or regions were also commonly applied. Nevertheless, until the 19th century, China's trade with the outside world was of minor importance and customs duties never constituted a significant part of state revenues. With the Opium War of 1840, imperialist powers both compelled China to open its markets to Western imports and expropriated to themselves the power to impose and collect customs duties.

Given the policy of self-reliance and the small volume of external trade, the relative unimportance of customs duties continued through the first twenty-five years of the People's Republic.¹⁸³ With the initiation of an "open door" policy, however, a new set of regulations has been adopted.¹⁸⁴ The new tariff is designed to promote a more open policy, to facilitate exports¹⁸⁵ and necessary imports,¹⁸⁶ and to protect and promote the development of the national economy. Tariff rates fall into two main categories, a general tariff rate and a reduced rate, the latter applying to imports from countries with which China has concluded trade treaties on reciprocal favorable terms. The value of imported goods is normally calculated on the C.I.F. value. Special reductions or exemptions apply to goods either imported by foreign enterprises and Chinese-foreign joint venture enterprises or imported into the Special Economic Zones.¹⁸⁷

IV. THE REFORM OF INDIRECT TAXATION

In the past two or three years the Industrial and Commercial

¹⁸³ Ting, *supra* note 13, at 78, estimates that customs duties yielded about the same amount of revenue as the salt tax during the 1950s.

¹⁸⁴ Regulations on Import and Export Duties and the Customs Import and Export Tariff (promulgated by the State Council March 10, 1985). These replaced the Regulations of May 10, 1951. In general, the new rates are significantly lower than under the previous tariff. For a detailed examination, see CHINA INTERNATIONAL ECONOMIC CONSULTANTS INC., *THE CHINA INVESTMENT GUIDE* 1984/85, at 425-29.

¹⁸⁵ Export duties now apply to a very limited range of products, the most important of which are probably coal and traditional Chinese medicines.

¹⁸⁶ Those in short supply in China—in particular, fertilizers, pedigree animals, seeds, pharmaceuticals, precision instruments and advanced machinery. Higher rates are imposed on luxury items and on goods which compete with home-made goods which are in need of protection. An additional Import Regulatory Tax was introduced in July 1985, imposing special duties on such items as motor vehicles and motor cycles, color television sets and video recorders, calculators and synthetic fabrics.

¹⁸⁷ See Rules of the General Customs Administration Concerning the Supervision, Control, Taxation and Exemption of Imports and Exports of Chinese-Foreign Joint Ventures (promulgated Apr. 30, 1984).

Tax has been undergoing a complete transformation as part of the second stage of the process of replacing profit delivery with taxation.¹⁸⁸ Indirect taxes have traditionally served a number of purposes in the People's Republic. As in many Western countries, they have been an important source of state revenue, though during the period 1956–1976 this importance was probably exaggerated. By far the greatest part of the Industrial and Commercial Tax was collected from state enterprises, which would eventually account to the state for their profits in any event. Thus the collection of the tax really represented little more than a bank transfer from the enterprise to the tax office at the time that sales receipts were realized.¹⁸⁹ Nevertheless, indirect taxes were simple to administer and ensured a prompt and regular cash flow for the exchequer.¹⁹⁰ This liquidity advantage has become more important with the change from profit delivery to profit taxation.

Additionally, indirect taxes operate as a form of "buffer" between the cost of production and the eventual price paid by the consumer.¹⁹¹ In most tax systems, it is assumed that the burden of indirect tax will be passed forward to the consumer in the form of higher prices. But in China the majority of prices, especially of goods produced and services supplied by state enterprises, are regulated by the state. Consequently, indirect tax has a greater effect upon the level of profit of the enterprise; since it cannot be shifted forward, it is shifted back to the supplier. When enterprise profits accrued to the state, the precise level of tax was relatively unimportant, since the more tax it collected on transactions the less it received in the form of profit delivery. All this, of course, was changed once enterprises became responsible for their own profits or losses and privately owned businesses were allowed to flourish.

It was recognized quite early on¹⁹² that the relationship between taxation and pricing would have to be reexamined, and that any reform in the method of taxing profit would have to take into account the system of taxing goods and services. As has al-

¹⁸⁸ See Ding Xuming & Wang Xinkuan, *Calculation of Taxes Payable by Commercial Enterprises in the Second Phase of Substituting Tax Payment for Profit Delivery*, SHANGYE KUAJJI (Business Accounting), Aug. 10, 1985 (in Chinese); Du, *supra* note 35; Jia, *supra* note 36; Zhan, *supra* note 19.

¹⁸⁹ G. ECKLUND, *supra* note 2, at 69.

¹⁹⁰ See Zhan, *supra* note 19.

¹⁹¹ G. ECKLUND, *supra* note 2, at 29; Siong, *supra* note 36, at 71.

¹⁹² See, e.g., Liu, *supra* note 18.

ready been observed in considering the new State Enterprise Income Tax,¹⁹³ profit levels of different enterprises may be affected by a number of factors, hence the introduction of the Regulatory Tax, the Oil Burning Tax and the Land Use Tax. These special taxes are intended to compensate for the effects of different profitability of enterprises caused by differences in plant and machinery, previous capital investment, and location. The reform of the Industrial and Commercial Tax, in turn, is necessary to regulate the effect upon profits of "irrational" pricing. Pricing policy is also being reformed, but sudden major price changes are being avoided so that, in the meantime, the tax system will have an important economic role to play. Essentially, levels of tax will be established by reference to the fixed price and to the average cost of production, leaving a reasonable margin of profit for the enterprise.¹⁹⁴ Further, by regulating the profitability of particular types of goods and services, the new taxes may operate as economic levers to stimulate the production of those articles which are at present in short supply (such as energy products, light bulbs, newsprint and toilet paper) and to reduce production of those where the supply is excessive due to high profit levels (such as cigarette paper, perfumes, spices, toothpaste and vehicle tires).¹⁹⁵

Under the new indirect tax system,¹⁹⁶ the Industrial and Commercial Tax is replaced by three taxes.¹⁹⁷

Products Tax. This tax is payable by state enterprises, collective enterprises, joint ventures (other than Chinese-foreign joint ventures), private enterprises and all other units and individuals engaged in the production or importation of taxable products. Tax is calculated on the basis of the sale price of the various

¹⁹³ See *supra* text accompanying notes 103-09.

¹⁹⁴ The State Council, approving the second phase of the reform, made it clear that changes in product taxes were not to involve any price change, but must be absorbed by the paying enterprise. State Council Circular on the Approval and Circulation of Finance Ministry Report on the Second Phase of Substitution of Tax Payment for Profit Delivery in State-Run Enterprises, State Council Bulletin No. 23, Oct. 10, 1984, at 796. See also Jia, *supra* note 36.

¹⁹⁵ See Dai, *supra* note 35.

¹⁹⁶ Provisional Rules for the Second Phase of Substitution of Tax Payment for Profit Delivery in State-Run Enterprises and of the Reform of the Industrial and Commercial Tax System (approved by the State Council Sept. 18, 1984); State Council Bulletin, No. 23, Oct. 10, 1984 at 796. The rules became effective on Oct. 1, 1984, but foreign enterprises and Chinese-foreign joint ventures will continue to be taxed under the CICT. See *supra* note 176.

¹⁹⁷ In addition to these three, the Salt Tax will continue to be levied.

items and tax rates vary from three percent to sixty percent.¹⁹⁸

*Value Added Tax.*¹⁹⁹ The introduction of value-added tax (VAT) began on a trial basis in 1979 in a number of regions.²⁰⁰ The reasons for adopting the tax are similar to those given in other countries, notably to avoid the cumulative effects of multi-stage turnover taxes and the distortions characteristic of single-stage taxes imposed at the manufacturer level. The neutrality of VAT became an important factor once enterprises were taxed on their profits and were encouraged to compete with each other. Unlike other countries, however, the Chinese VAT is applied selectively to a limited range of products, notably those where the production structure tends to be complex. There are two kinds of taxable categories: specific items such as bicycles, cars, electric fans, motor boats and sewing machines; and general items such as agricultural machinery, bearings, machinery, mechanical equipment, rolled steel and Western medicines. Tax rates vary from six to sixteen percent, the higher rates applying to the specific categories, and both the "tax-subtractive" and "sales-subtractive" methods of calculation are employed.

Business Turnover Tax. The third element in the new indirect tax system is variously referred to as a "business tax," "circulation tax" or "turnover tax" (*ying ye shui*).²⁰¹ It is payable by units and individuals engaged in commerce, construction and installation, financial and insurance services, publishing, transportation and a number of other trades, and it applies at both the wholesale and retail levels. In contrast to the value-added tax, it is purposely cumulative in effect, providing an incentive to reduce the multiplicity of transactions and the number of links in the production chain.²⁰² Rates of tax range from three percent, on retail sales, construction and installation, entertainment such as cinemas and theatres, public utilities and publishing, to fifteen per-

¹⁹⁸ The lowest rate applies to items such as unbleached cotton cloth, matches and most types of meat. Other foods and clothing are taxed at 5%. Appliances are taxed at a variety of rates—5% for washing machines and radios, 20% for cameras, refrigerators and television sets, 40% for watches. The highest rates apply to liquor (up to 50%) and tobacco (60% on top-quality cigarettes). Product Tax Regulations (Draft), art. 2, app. The tax also applies to industrial commodities and energy products.

¹⁹⁹ See Yan Zengzu, *Discussion of the Administration and Verification of the Value-Added Tax*, ZHONGGUO SHUIWU, May 1986, at 33 (in Chinese); Guo, *supra* note 37; HE, *supra* note 150.

²⁰⁰ For a description of the experiments in Shanghai, see Siong, *supra* note 36, at 71.

²⁰¹ See Dai, *supra* note 35; Du, *supra* note 35; Wang, *supra* note 5, at 138.

²⁰² See Dai, *supra* note 35.

cent on rail transportation.²⁰³

V. LOCAL TAXES

Considering China's size, both in terms of geography and population, its tax system is highly centralized, as is its legal system in general.²⁰⁴ While it is true that tax burdens and rates, especially of the Agriculture Tax, vary considerably from region to region,²⁰⁵ and that special tax inducements are provided to stimulate business or investment in the more remote provinces or minority-nationality areas,²⁰⁶ these variations are centrally ordained. Additionally, local governmental authorities derive their taxing powers from the central government, so that the taxes that they are empowered to levy, and the maximum rates of such taxes, are commonly prescribed by the central government.²⁰⁷

A. *Local Surcharges*

As already mentioned, some central government taxes specifically provide for the imposition of local surcharges, either in the form of an additional tax (as in the case of the Foreign Enterprise Income Tax) or as an additional percentage of the central government tax (as with the Joint Venture Income Tax).

B. *Local Taxes*

The 1950 Principal Rules provided for the local administration of certain taxes. For the most part, these taxes remain in force as local taxes today. In all, there are now six local taxes.

²⁰³ Banking and insurance are taxed at 5%, as are hotels and restaurants; wholesale supplies are taxed at 10%. Most other types of services are taxed at 3%. Recently, law offices and patent agents have been exempted from the tax. Notice of the Tax Bureau of the Ministry of Finance Regarding the Temporary Exemption of Law Firms and Patent Agencies from the Business Turnover Tax, Jan. 14, 1986, in *ZHONGGUO SHUIWU*, Mar. 1986, at 33 (in Chinese).

²⁰⁴ A further aspect of the post-Mao reforms has been a measure of decentralization away from the centre toward the regional governments. See Barrett, *What's New in China's New Constitution*, 4 *REV. SOCIALIST L.* 305, 327-28 (1983).

²⁰⁵ See HE, *supra* note 150, at 426-29. Another example is the special tax on oil burning. *Id.* at 430.

²⁰⁶ Special support is given to the autonomous regions of Guangxi, Nei Menggu, Ningxia, Xizang (Tibet) and Xinjiang and to the provinces of Guizhou, Qinghai and Yunnan, which have large concentrations of minority peoples.

²⁰⁷ The Principal Rules for Implementation of the National Tax Administration (promulgated Jan. 31, 1950), art. 5, provides that tax legislation which is within the jurisdiction of a county, municipality or province must be submitted to the central authorities for approval. The central government also has the power to grant exemptions from local taxation. See State Council Bulletin, *supra* note 194, which temporarily suspended local taxes on state-owned enterprises.

1. *Livestock Sales Tax*

The Livestock Sales Tax is imposed on trade in cattle, horses, donkeys, mules and camels; it is levied upon the buyer of the animal, normally at a rate of five percent of the price. The tax is payable to the local tax office and accrues to the province, autonomous region²⁰⁸ or municipality directly under central control.²⁰⁹

2. *Market Transaction Tax*

The Market Transaction Tax applies to the private sale by farmers of domestic animals and produce, such as eggs, fruit and meat. It is normally levied at ten percent on the sale price where this exceeds a stipulated amount.

3. *Slaughter Tax*

The Slaughter Tax is levied at the time the animal is slaughtered. The rate is set by the province.

4. *Real Estate Tax*

The Real Estate Tax is imposed in cities, counties and townships and is payable in respect of houses or buildings owned, or land used,²¹⁰ chiefly by proprietors of businesses.²¹¹ It is calculated on the value of the property (at the rate of 1.2%) or on rent received (at a rate of 12%).

5. *Urban Maintenance and Construction Tax*

The Urban Maintenance and Construction Tax is also imposed upon business premises and accrues to the municipality where the property is situated. It is not, however, based on the value of the property but rather on the amount of product tax or business turnover tax paid by the occupant.²¹²

²⁰⁸ In some autonomous regions the tax is not applied. See Interim Regulations on Livestock Sales Tax (adopted by the State Council Dec. 7, 1982), art. 11. For an English translation, see V. Sit, *supra* note 4, at 141.

²⁰⁹ There are three such municipalities: Beijing, Shanghai and Tianjin.

²¹⁰ Land in the cities is owned by the state and in rural areas by collectives or by the state. Constitution of the People's Republic of China (promulgated on Dec. 4, 1982). Citizens may own houses. *Id.* art. 13.

²¹¹ Property owned privately for non-business use is now exempted. Temporary Regulations Governing Real Estate Tax (issued by the State Council Sept. 15, 1986), reprinted in *ZHONGGUO FAZHIBAO*, Sept. 29, 1986, at 2 (in Chinese).

²¹² The rate is generally 7% in cities and 5% in county towns. Provisional Regulations Regarding the Urban Maintenance and Construction Tax (promulgated by the State Council Feb. 8, 1985), reprinted in *ZHONGGUO FAZHIBAO*, Feb. 14, 1985, at 2 (in Chinese). In view of the basis of assessment of the tax, it has been suggested that it

6. *Vehicle and Boat Tax*

The Vehicle and Boat Tax applies to motor vehicles and motor boats of most types and to some types of non-motorized transport. It is within the jurisdiction of the provinces, autonomous regions and municipalities under central control and is normally paid yearly as a form of license fee.

VI. SPECIAL ECONOMIC ZONES

Another reason for the variations in tax burdens and rates from one part of the country to another is the existence of specially designated economic zones or economic development areas. As a part of the "four modernizations" program and the "open door" policy, China began in 1979 to establish special zones in which special tax, labor, and other concessions applied in order to attract foreign capital and technologically advanced industries.²¹³ These concessions include the creation of modern communications infrastructures; easier procedures for establishing businesses and for obtaining the necessary licenses, development permits, visas and residence permits; relaxation of some of the regulations governing labour management and wages; and, of course, reductions in or exemptions from various taxes.

These special areas fall into a number of categories. First, chronologically and in terms of overall economic importance, are the Special Economic Zones (SEZs), of which there are four. Three of these are in the southeastern province of Guangdong—Shantou, Shenzhen and Zhuhai. Shenzhen, adjacent to Hong Kong, is the most important, accounting for almost half of all foreign investment in China. The fourth, Xiamen, is in Fujian province, on the coast facing Taiwan. Tax concessions vary to some extent from one zone to another, and the local tax administrations have discretion in the application of the rules.²¹⁴

might be abolished as a separate tax and replaced with a local surcharge on the product and turnover taxes. See Guo Hongde, *Suggestion for the Principle of Improving Receipts of the Urban Maintenance and Construction Tax*, ZHONGGUO SHUIWU, May 1986, at 16 (in Chinese).

²¹³ See generally Fenwick, *Evaluating China's Special Economic Zones*, 2 INT'L TAX & BUS. LAW. 376 (1984); Klitgaard & Rasmussen, *Preferential Treatment for Foreign Investment in the People's Republic of China: Special Economic Zones and Industrial Development Districts*, 7 HASTINGS INT'L & COMP. L. REV. 377 (1984); Nishitatenno, *supra* note 124; Note, *supra* note 90.

²¹⁴ The basic rules are set forth in the Interim Provisions on the Deduction of and Exemption from Income Tax and Consolidated Industrial and Commercial Tax Relating to Enterprises in the Special Economic Zones and the Fourteen Open Coastal Cities (promulgated by the State Council Nov. 15, 1984), State Council Bulletin, No. 28, 1984,

The rate of income tax on the profits both of foreign establishments, under the Foreign Enterprise Income Tax, and of Sino-foreign joint ventures, under the Joint Venture Income Tax, is normally reduced to fifteen percent, with reduction of or exemption from the additional local surcharge. Tax holidays are commonly given, as provided for under the FEITL and JVITL.²¹⁵ The special ten percent tax on the remittance abroad of dividends by joint ventures is waived and the withholding tax on dividends, interest, royalties and other income under the FEITL is reduced from twenty percent to ten percent or waived entirely.²¹⁶ Rates of the Individual Income Tax are reduced for employees of SEZ enterprises; for other types of income, the Consolidated Industrial and Commercial Tax is waived or reduced on the importation of many categories of goods, and exemptions from local taxes are commonly given at the discretion of the local authorities.²¹⁷

In addition to the SEZs, special status has been accorded to the Industrial Development Districts of Hainan Island, in the extreme south, and Minhang, near Shanghai, and to a number of Economic Development Zones, in which essentially similar tax concessions are granted.²¹⁸ These zones are established in fourteen "open" coastal cities.²¹⁹ More limited privileges are accorded to the so-called "Old Urban Zone Enterprises" which are established within these cities but lie outside the limits of the special zones.

VII. CONCLUSIONS

Despite its long historical antecedents, China's present tax system is primarily the creation of the past seven or eight years. Although further major changes and reforms can certainly be ex-

at 957 [hereinafter Interim Provisions]. For a discussion of these Rules, see China Economic News, Dec. 3, 1984, at 1.

²¹⁵ See *supra* notes 132 and 146 and accompanying text. It should be noted that the granting of these tax holidays is at the discretion of the local tax authorities and is not restricted to special zones or regions. Some local authorities in non-special regions, for example, Beijing, Kunming and Shenyang, have formulated and published general policies.

²¹⁶ Interim Provisions, *supra* note 214, art. 1(i)(4).

²¹⁷ *Id.* art. 1(i)(5).

²¹⁸ See Gelatt, *Interim Provisions Sharpen EDZs' Competitive Edge*, E. ASIAN EXECUTIVE REP., Dec. 1984, at 9. In some respects the tax holidays are more favorable than those in the SEZs.

²¹⁹ Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuaogdao, Shanghai, Tianjin, Wenzhou, Yantai and Zhanjiang. It seems that at least three more "open" cities are planned in the near future.

pected, the basic structure of the system now seems to be complete. Because China is both a developing and socialist country, the criteria which would commonly be applied in assessing a Western capitalist economy may be inappropriate in evaluating China's recent achievements.²²⁰ Nevertheless, such criteria provide a convenient framework within which to work.

A. *Vertical Equity*

Marx and Lenin both called for a heavily progressive income tax in socialist states in order "to ensure that the incidence of taxation falls on those individuals best able to pay."²²¹ Although China's Individual Income Tax could not be described as heavily progressive, the new Individual Income Regulatory Tax has made it much more so for Chinese citizens.²²² Passive investment income is taxed at a flat rate of twenty percent. With the basic deductions permitted, the effective top marginal rate on royalties is a mere sixteen percent and, for "resident aliens," this effective rate applies to professional income and rents. By contrast, the highest marginal rate on employment income is forty-five percent, or sixty percent for Chinese citizens. At first sight, China's system of taxing earned income more heavily than unearned and taxing workers more heavily than the self-employed seems contrary to socialist principles. Such an evaluation, however, is superficial. Employees do not begin to pay tax until their wages or salaries are several times greater than average Chinese monthly earnings. Even under the new IIRT, tax becomes payable only when income exceeds approximately four times average monthly earnings. Employment income would have to exceed seven times the average before the total tax burden equals that of the flat-rate tax on interest and dividends.

For Chinese citizens, the new tax aggregates income from employment, professional services and rents, with the two latter items now being taxed at progressive rates. In addition, business income of individuals, whether operating through private or collectively owned enterprises, is taxed at progressive rates, though technically it is the enterprise which pays the tax. In any event, it could be argued that a progressive income tax is not needed in China for purposes of redistributing income since redistribution has already been achieved by other means. The relatively even

²²⁰ See G. ECKLUND, *supra* note 2, at 94-96.

²²¹ M. NEWCITY, *supra* note 10, at 361.

²²² The tax became effective on January 1, 1987. See IIRT Regs., *supra* note 46.

distribution of income and wealth in China, and the absence (as yet) of any substantial class of "rich" individuals, reduces the need for a steeply progressive income tax.

A further possible cause of vertical inequity is the fact that personal income tax plays, at least for the present, an insignificant role in public finance; heavy reliance is placed upon taxes on goods and services, which are generally considered to be regressive in nature. Taxes on essential items, such as the Salt Tax, clearly are regressive. In general, however, the structure of indirect taxes seems to be mildly progressive, with low rates applying to basic necessities and higher rates to luxuries and to tobacco and alcohol. Further, in an economy where the prices of many commodities are controlled, the conventional view that indirect taxes are necessarily shifted to the consumer is no longer valid. Currently, Chinese officials feel that these taxes operate as taxes on enterprise profits, since they cannot be passed on in the form of higher prices. In the case of state-owned enterprises this may make little difference in the long run; but as competition among different types of enterprise increases in China, it may be legitimate to regard indirect taxes, at least in part, as being imposed upon the profits of private and collectively owned businesses.

B. Horizontal Equity

In terms of horizontal equity, the present system stands up to scrutiny less well. A major reason for this is the essentially schedular nature of income taxation in China, though the new Individual Income Regulatory Tax may be viewed as a step towards the eventual introduction of a comprehensive income tax since it introduces a considerable measure of aggregation of the various sources of income. At present, however, there is a mixture of flat-rate and progressive taxation: an individual with a large salary may pay more tax than another individual with the same total income where that income is derived from dividends or interest, or from a combination of salary and investments. Since different types of income are taxed differently—rents and royalties on the one hand and dividends and interest on the other—distortions are inevitable and opportunities for tax planning and avoidance arise.²²³ Another potential cause of inequity

²²³ Little is known about the Chinese attitude toward tax avoidance. Tax evasion, by contrast, appears to be widespread and a serious problem. See, e.g., *Renmin Ribao*, May 13, 1985 (in Chinese); *China Daily*, Oct. 8, 1986, at 1, col. 3 (Beijing ed.). Nor is it a new problem. Ecklund records a massive campaign against tax evasion in 1955, and notes

is the taxing of certain types of income, notably rents, royalties and professional income, on the basis of gross receipts less a standard deduction, rather than upon actual profit. The adoption of a monthly method of computation may also easily lead to distortions: year-end bonuses are likely to be taxed more heavily than the same amount of wages spread out over the year.

Inequities will arise in the taxation of business income as well. Five different taxes—six if one includes the Agriculture Tax—are imposed on income, depending upon whether the business is foreign-owned, a joint venture, a state enterprise, collectively owned or privately operated. Each type of business pays tax according to its own rules and schedule of rates. Since these different types of business are in competition with each other, there is a risk that differences in tax burdens may cause distortions.²²⁴

Distortions also exist in the indirect tax system, due to the partially cumulative effect of the products tax and business turnover tax. This leads one to wonder whether the value-added tax might eventually be expanded to replace those taxes.

C. *Complexity*

At first glance the Chinese tax system appears to be excessively complex. Where, in many Western countries, there is a single comprehensive income tax, or two taxes (one on individuals and one for corporations), China has eight or nine. Similarly, where other countries manage with two indirect taxes—a sales tax or value-added tax and an excise duty—China has four or five. Nevertheless, these differences are more apparent than real: frequently a country will have a single income tax code, commonly of considerable length, which treats various types of activity and income differently. Western tax codes are at least as complex as the multiplicity of separate tax laws in China. The number of separate taxes, therefore, is not important unless they are administered separately. Nevertheless, the existence of so many categories and rate schedules, both of direct and indirect

that of 2,071 firms audited in Wuhan, 1,760 were found to have evaded tax. G. ECKLUND, *supra* note 2, at 41.

²²⁴ Different tax treatment, of course, may be designed to promote competition and to compensate for other factors which cause distortions. Nevertheless, some consequences may be unintended; for example, a large collective enterprise (in terms of profit) pays more tax than a small one, although when profits are shared among the individual members each receives the same. Similarly, there are significant differences in the rates of tax applicable to contractual fees earned by an individual under the IIRT, and by a private business under the CEIT or PBIT.

taxes, inevitably gives rise to “grey” areas and to uncertainty, which in turn may give rise to disputes between taxpayers and authorities.

In contrast with Western tax codes, Chinese tax legislation is remarkably concise and relatively easy to understand. An Individual Income Tax which, together with the detailed Rules for Implementation, occupies a mere ten pages of text is surely enviable, even if there is little likelihood of its being emulated in Western countries, however much they may extol the merits of “tax simplification.”

