

# TAXATION IN THE PEOPLE'S REPUBLIC OF CHINA: THE SYSTEM AND ITS FUNCTION

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Taxation is the means by which the government extracts from the private economy the funds necessary for governmental operations and, in the Western economy, a means whereby the government imposes or relaxes pressure on certain aspects of the private economy.<sup>1</sup> One would think then, that China's totalitarian government would have no need for a system of taxation to accomplish either purpose.<sup>2</sup> To an extent, this is a correct assumption. China, as we know it today, can and does accomplish both the revenue-raising and the regulatory function without the necessary resort to annual modifications of its taxation policy. However, with the parting of the bamboo curtain and the invitation to the world, albeit subject to tight restrictions, to invest in China and participate in its economic development, taxation has taken on a new importance.<sup>3</sup> In addition, with the change in direction that has accompanied the ending of the Cultural Revolution and the promulgation of the government's new policy of

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<sup>1</sup> See *Introduction and Summary* in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 1 (H. Aaron & J. Pechman, eds. 1981); J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* 1 (2d ed. 1973).

<sup>2</sup> In fact, China has long had a "complex domestic tax structure." Pomp, Gelatt & Surrey, *The Evolving Tax System of the People's Republic of China*, 16 *TEX. INT'L L.J.* 11, 13 (1981). When the Communists took power, they enacted progressive and differential tax rates to gradually phase out nonessential free enterprise, to redistribute land and wealth, and to control inflation. Reynolds, *Doing Business with the PRC: Tax Considerations*, 14 *INT'L LAW.* 49, 50-51 (1980). Early accounts of China's tax system can be found in CAHO KUO-CHUN, *ECONOMIC PLANNING AND ORGANIZATION IN MAINLAND CHINA: A DOCUMENTARY STUDY, 1949-1957* (1959); A. CHEKHUTOV, *THE TAX SYSTEM IN THE PEOPLE'S REPUBLIC OF CHINA* (U.S. Joint Publications Research Service trans. 1963); A. DONNITHORNE, *THE ECONOMY OF MAINLAND CHINA* (1966); G. ECKLUND, *TAXATION IN COMMUNIST CHINA 1950-1959* (1961); Ting, *Preliminary Notes on Taxation in the People's Republic of China*, 5 *REV. SOCIALIST L.* 347 (1979). For a more in-depth treatment of China's current tax system, see Pomp, Gelatt & Surrey, *supra*; Reynolds, *supra*.

<sup>3</sup> The expansion of trade with the West came about after the Soviet Union diminished its trade with China due to ideological differences. H. HINTON, *THE BEAR AT THE GATE* 8 (1971); W. TUNG, *CHINA AND THE FOREIGN POWERS* 352 n.53 (1970). The normalization of relations between the United States and China, along with the signing of trade agreements, e.g. *The Agreement on Trade Relations*, July 7, 1979, United States-People's Republic of China, T.I.A.S. No. 9630, reprinted in 18 *INT'L LEGAL MATERIALS* 1041 (1979), has resulted in significant amounts of trade between China and our country.

“four modernizations,”<sup>4</sup> there has been a substantial increase in private enterprise within the People’s Republic of China. This too has increased the significance of taxation.

This Article will briefly examine the types of taxes imposed, the significance of the revenue generated thereby and, more importantly, the principle of economic restraint or encouragement accomplished by the policy of taxation. The purpose will be to provide a perspective on taxation in China for the layman.

## I. INCOME TAXES

On September 10, 1980, the Fifth National People’s Congress at its Third Session adopted the Individual Income Tax Law of the People’s Republic of China<sup>5</sup> and the Income Tax Law of the People’s Republic of China Concerning Joint Ventures with Chinese and Foreign Investment.<sup>6</sup> One might surmise that the adoption, for the first time, of a separate income tax “code” would constitute the ultimate “modernization” of a society. It is entirely unlikely, however, that any Chinese citizen will need the help of H & R Block as a result of the enactment of these laws.

The Individual Income Tax Law provides a deduction for the first 800 yuan (approximately \$464) of monthly income.<sup>7</sup> The 1980 per

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<sup>4</sup> This is the popular name for the government’s current “four modernizations” program which emphasizes development in the areas of agriculture, industry, science and technology, and national defense.

<sup>5</sup> The INDIVIDUAL INCOME TAX LAW OF THE PEOPLE’S REPUBLIC OF CHINA [hereinafter cited as PRC INDIVIDUAL INCOME TAX LAW], translated in FOREIGN BROADCAST INFORMATION SERVICE, Sept. 16, 1980, at L16 [hereinafter cited as FBIS], was passed by the Third Session of the Fifth National People’s Congress. DETAILED RULES AND REGULATIONS FOR THE IMPLEMENTATION OF THE PRC INDIVIDUAL INCOME TAX LAW [hereinafter cited as PRC INDIVIDUAL INCOME TAX REGULATIONS], translated in FBIS, Dec. 19, 1980, at L26, were approved by the State Council on December 10, 1980 and were promulgated by the Ministry of Finance on December 14, 1980. The Ministry of Finance bears the responsibility for interpreting the regulations. *Id.* art. 26.

<sup>6</sup> The INCOME TAX LAW OF THE PEOPLE’S REPUBLIC OF CHINA CONCERNING JOINT VENTURES WITH CHINESE AND FOREIGN INVESTMENT, [hereinafter cited as PRC INCOME TAX LAW CONCERNING JOINT VENTURES], translated in FBIS, Sept. 16, 1980, at L6.

<sup>7</sup> PRC INDIVIDUAL INCOME TAX LAW art. 5, para. 1. For personal service compensation, royalties or rents, the deduction is related to the amount of income, *id.*, and is limited to residents of China. PRC INDIVIDUAL INCOME TAX REGULATIONS art. 11. For single payments in excess of 4,000 yuan (approximately \$2,320), a 20% deduction is allowed. PRC INDIVIDUAL INCOME TAX LAW art. 5, para. 2. To prevent parties from maximizing deductions by having income split into two or more separate payments, the regulations require that “succeeding income from the same item that cannot be obviously divided into separate payments” be combined and counted as one payment if received within the same month. PRC INDIVIDUAL INCOME TAX REGULATIONS art. 12.

capita income for agricultural workers was 170 yuan (\$99) per year, or less than 15 yuan (\$9) per month.<sup>8</sup> Although the city dwellers earned significantly higher incomes, the average salary for factory workers was 30 (\$17) to 50 (\$29) yuan per month. During a visit to China by this writer, and conferences with various officials in several Chinese cities, the highest salary mentioned by any source was that of a law school professor, 200 yuan (\$116) per month. Indeed, the richest city in China is Shanghai where the 1980 per capita income was 76 yuan (\$44) per month.

As one can readily see, the individual income tax law either anticipates a significant change in the structure of the Chinese economy, or was not intended to be applicable to the Chinese citizenry. The latter is true.<sup>9</sup> This is evident because the tax law was adopted simultaneously with the provision for taxation of joint ventures<sup>10</sup> involving foreign investors and was intended to apply to the individual income of foreign nationals residing in China in connection with the establish-

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The deductions are allowed automatically and no other deductions are permitted. Pomp, Gelatt & Surrey, *supra* note 2, at 46. There is, however, a credit for income tax paid to a foreign country on income "earned abroad." *Id.* at 49. On the creditability of taxes paid in China toward American taxes, see notes 51-54 and accompanying text *infra*.

<sup>8</sup> BEIJING REV., Oct. 19, 1981, at 3. According to Du Runsheng, Vice-Minister of the State Agricultural Commission, the average annual income for production teams in the top one-third or productivity, such as the Liuzhuang Production Brigade of Qiliying Commune in Hunan Province, was 587 yuan (approximately \$340) per member, while the average income for members of teams in the bottom one-third of the agricultural economy was only 60 yuan (\$35). A peasant needs an estimated minimum of 120 yuan (\$70) per year to subsist. See *Good Beginning for Reform of Rural Economic System*, BEIJING REV., Nov. 30, 1981, at 15.

<sup>9</sup> It has been reported that only about 20 Chinese citizens, all artists or writers receiving royalties and fees from the sale of their works abroad, are currently subject to the income tax. N.Y. Times, Sept. 3, 1980, § A, at 1, col. 5; Wash. Post, Sept. 3, 1980, § A, at 13, col. 1. Yet the tax can be assumed to reach increasing numbers of Chinese. Pomp, Gelatt & Surrey, *supra* note 2, at 40.

<sup>10</sup> The Chinese adopted a joint venture law in 1979. See Pomp & Surrey, *The Tax Structure of the People's Republic of China*, 20 VA. J. INT'L LAW 1 n. 6 (1979). This was followed in 1980 by the law imposing a tax on income from joint ventures. See note 6 *supra*. The rate of tax imposed on the joint ventures is 30 percent, with a withholding tax of 10 percent on the profits remitted from China by the foreign participant in a joint venture. See Gelatt, *Doing Business with China: The Developing Legal Framework*, CHINA BUS. REV., Nov.-Dec. 1981, at 54. The tax is imposed on the Chinese and foreign investors and is more favorable to foreign investors than the recently enacted income tax on foreign companies doing business in China. See Wren, *China Sets Tax Rates For Foreign Businesses*, N.Y. Times, Dec. 8, 1981, at D1, col. 1. Nonetheless, this new tax on foreign enterprise has been said to "close a major gap in China's taxation of foreign economic activity." Gelatt & Pomp, *What Does China's New Tax Law Mean?*, ASIAN WALL ST. J. WEEKLY, Jan. 4, 1982, at 10. Under the law, foreign companies operating in China are taxed on their corporate profits at rates of 20 to 40 percent. Ching, *China Unveils Foreign Firm Tax Law*, ASIAN WALL ST. J. WEEKLY, Dec. 8, 1981, at 1, col. 3. See also Hudspeth, *The Nature and Protection of Economic Interests in the People's Republic of China*, 46 ALB. L. REV. 691, 697-98 n.28.

ment and operation of such joint ventures.<sup>11</sup> The individual income tax law does treat nonresidents differently from residents in that it exempts nonresidents or those residing in China for less than one year from tax on income gained outside China.<sup>12</sup>

Nonetheless, it is interesting to note that although the Chinese tax code is not as complicated as that of the United States owing to its limited applicability to China's populace, the structure of the individual income tax law has a familiar pattern. A tax is imposed on categories of income similar to those in the Internal Revenue Code;<sup>13</sup> the categories of exempted income are also somewhat similar to those of the I.R.C.<sup>14</sup> As well, the tax schedule for wages and salaries is progressive.<sup>15</sup> The observation is almost inescapable that the similarities to western tax structures and systems is an effort to make those who will be paying those taxes feel comfortable with the seeming familiar-

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<sup>11</sup> Peng, *Report on the Work of the Standing Committee of the National People's Congress of the People's Republic of China* (April 30, 1980). For a discussion of China's Joint Venture Law, see Hudspeth, *supra* note 10, at 727-31.

<sup>12</sup> PRC INDIVIDUAL INCOME TAX LAW art. 1. As well, the regulations exempt an individual who is a resident for not more than 90 days from taxation on compensation paid by his employer outside China for services performed within China. PRC INDIVIDUAL INCOME TAX REGULATIONS art. 5. See Pomp, Gelatt & Surrey, *supra* note 2, at 41 nn. 173-74. In addition, the regulations exempt from taxation income gained outside of China by one who resides in China for one year or more but less than five years. PRC INDIVIDUAL INCOME TAX REGULATIONS art. 3. Unfortunately, residence is not defined except to provide that no subtraction can be made for temporary absence during the tax year. *Id.* art. 2. See Pomp, Gelatt & Surrey, *supra* note 2, at 42 nn. 181-82. A similar problem occurs in defining income gained within China. *Id.* at 42-43.

<sup>13</sup> Wages, salaries, compensation for personal services, royalties, interest, dividends, bonuses and rental income are all subject to the income tax. Pomp, Gelatt & Surrey, *supra* note 2, at 43-45. Taxes on income paid in kind or in marketable securities are based on the asset's fair market value when acquired by the taxpayer. *Id.* at 45. The Ministry of Finance is authorized to classify other types of income as taxable. *Id.*

There are two different rate structures used depending upon the type of income being taxed. Wages and salaries are taxed under a seven bracket progressive schedule with rates ranging from 5 to 45%. PRC INDIVIDUAL INCOME TAX LAW art. 3, para. 1. All other income is subject to tax at a flat rate of 20%. *Id.* para. 2.

<sup>14</sup> Prizes and awards for scientific, technological, or cultural achievements, interest on savings deposits in China's state banks and credit cooperatives, welfare benefits, survivors' pensions, relief payments, insurance indemnities, military severance pay, retirement or severance pay for officials and employees, salaries of diplomatic personnel, income exempted from tax by conventions or agreements to which China is a party, all receive exemptions. PRC INDIVIDUAL INCOME TAX LAW art. 4. Dividends and bonuses derived from joint ventures and from urban and rural cooperatives and dividends from investment by individuals in "construction" (investment) companies in China which do not pay bonuses, provided that the dividends do not exceed interest paid on savings deposits in state banks or credit cooperatives, are exempted by regulation. PRC INDIVIDUAL INCOME TAX REGULATIONS art. 5, para. 2 & art. 9. As well, the Ministry of Finance is empowered to exempt other types of income. PRC INDIVIDUAL INCOME TAX LAW art. 4, para. 9. See also Pomp, Gelatt & Surrey, *supra* note 2, at 45.

<sup>15</sup> See note 13 *supra*.

ity of the Chinese tax law.<sup>16</sup>

The joint venture tax, by contrast, is a form of corporate taxation. A joint venture funded by both Chinese and foreign investors is required to be in the form of a limited liability company incorporated in China.<sup>17</sup> The worldwide income of the joint venture Chinese corporation, as derived from "production, business, and other sources,"<sup>18</sup> is taxed in a similar manner to United States corporations with allowances for operating, sales and manufacturing expenses.<sup>19</sup> The Chinese joint venture tax law sets up different ways for computing the taxable income depending upon whether the investment is a service, commercial, or industrial joint venture.<sup>20</sup> Most features of the joint venture tax law seem analogous enough to United States corporate taxation to make the American investor feel at ease.<sup>21</sup>

Taxes which are more likely to be experienced by the Chinese citizenry are the two primary taxes, the consolidated industrial and commercial tax and the agricultural tax. These comprise China's internal system of taxation. There are numerous additional, albeit, minor taxes such as the salt tax,<sup>22</sup> customs duties,<sup>23</sup> the vehicle tax<sup>24</sup> and the urban real estate tax.<sup>25</sup>

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<sup>16</sup> In fact, income tax forms must now be filed, a procedure which will surely remind Americans in China of their homeland. See Pomp, Gelatt & Surrey, *supra* note 2, at 49. For an in-depth discussion of payment and collection procedures, and violations and penalties governing the individual income tax, see *id.* at 49-51.

<sup>17</sup> LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON JOINT VENTURES USING CHINESE AND FOREIGN INVESTMENT art. 1, translated in Reynolds, *supra* note 2, at 45. The Joint Venture Law is discussed more fully in Hudspeth, *supra* note 11, at 727-31.

<sup>18</sup> PRC INCOME TAX LAW CONCERNING JOINT VENTURES art. 1.

<sup>19</sup> See Pomp, Gelatt & Surrey, *supra* note 2, at 56-57.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* For example, the Chinese "cost of sales" is analogous to the concept of "cost of goods sold" which is used in American accounting practice. In the United States, "cost of goods sold" is equivalent to opening inventory plus additions to inventory less closing inventory. While in China, "cost of sales" is equal to initial inventory plus purchases and purchase expenses less purchase returns, allowances and closing inventory. *Id.*

<sup>22</sup> The salt tax, computed on a tonnage basis, varies in amount according to the region. *Id.* at 16 n.13.

<sup>23</sup> Currently the customs duties taxes are not uniformly applied, as certain exemptions are allowed for raw materials or imported goods used in joint ventures. Formerly, the customs duties were used as leverage in bargaining in foreign trade negotiations. *Id.* at 16 n.15.

<sup>24</sup> The vehicle license tax is applied to all vehicles with some cities exempting nonmotorized vehicles and there is apparently no levy at all in rural areas. *Id.* at 15 n.11.

<sup>25</sup> For a discussion of the Urban Real Estate Tax, see notes 47-50 and accompanying text *infra*.

## II. CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX

The primary tax which will fall on private enterprise in the city will be the consolidated industrial and commercial tax<sup>26</sup> which applies to all units or individuals engaged in industrial production, purchasing and resale of farm produce, the importing of foreign goods,<sup>27</sup> retailing, communication, transport and service trades. The tax has been described as "a broad-based turnover tax or . . . a combination of cascading sales and excise taxes."<sup>28</sup> All goods made in China are subject to a production tax<sup>29</sup> imposed during the process of producing the goods.<sup>30</sup> The tax rate ranges from 1.5% on textiles and yarn to 69% on luxury items such as cigarettes.<sup>31</sup> In addition, at the retail level a tax is imposed based on the sale price. For retail sales the rate is 3% of the proceeds received, while for service trades it

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<sup>26</sup> The Consolidated Industrial and Commercial Income Tax Act was adopted in 1958 to simplify and replace four separate taxes—a merchandise circulation or turnover tax, a goods or commodity tax on items not subject to the turnover tax, a business tax on commercial and industrial enterprises which produced goods not subject to the turnover or goods taxes, and a stamp tax on documents used in commercial transactions and property transfers. Pomp, Gelatt & Surrey, *supra* note 2, at 16-18. Apparently, a new industrial and commercial tax was implemented on a trial basis in 1973 which also incorporates the vehicle license tax, the slaughter tax and either the salt tax or the real estate tax. *Id.* at 19 n.23 Although the 1973 revision seems to have left the basic tax structure intact, it has yet to be released to the West. *Id.* Nevertheless, further changes in China's tax system are to be expected. *Id.* at 78; Reynolds, *supra* note 2, at 61-63.

<sup>27</sup> Regulations promulgated for trial implementation by the Ministry of Justice make clear that the tax is only imposed on business conducted within China. Pomp, Gelatt & Surrey, *supra* note 2, at 20. This would include foreign individuals or those conducting business in China and even joint ventures which are also subject to the Joint Venture Income Tax Law. *Id.* at 30. The nature and manner in which the consolidated tax will be applied remains unclear. *Id.* at 31. The tax will probably not be levied on firms which merely export to China since the tax would be borne by the importer. *Id.*

<sup>28</sup> Pomp & Surrey, *supra* note 10, at 14-15. The tax is modeled on the Soviet turnover tax. Reynolds, *supra* note 2, at 56.

<sup>29</sup> The production tax "can be imposed at each stage of production when goods or services are transferred from entity to entity." Pomp & Surrey, *supra* note 10, at 15.

<sup>30</sup> Because the production tax is a turnover tax, based on the number of times a good passes from entity to entity within the chain of production and distribution, there is an inherent advantage for vertically integrated firms. Pomp, Gelatt & Surrey, *supra* note 2, at 24. To reduce this benefit, certain items produced or used by an enterprise in further production or capital construction are taxed. *Id.* This is accomplished "by imputing to the enterprise a constructive sale of the good used in capital construction or in further production." *Id.* at 25. With an enterprise which retails its own product, a tax is imposed on what would have been received if it had been sold to a retailer, as well as the tax on the retail sale. *Id.* Another tax is levied when goods are sent to another enterprise for processing. *Id.* at 25-26.

<sup>31</sup> Tax rates for various products are set out in Reynolds, *supra* note 2, at 58. The Act has "a schedule of more than forty different rates, applicable to more than 100 categories of items." Pomp, Gelatt & Surrey, *supra* note 2, at 18-19. The tax rates are discussed more fully in *id.* at 22-24.

ranges from 3 to 7%. The tax is paid on a tax period basis set for each taxpayer by the tax administration and is paid either to the local branch of the People's Bank of China or directly to the tax administration.<sup>32</sup>

This production tax is used by the Chinese government to encourage or discourage private commercial ventures within the economy.<sup>33</sup> The current trend in China is to encourage private enterprise in order to provide the necessary consumer goods and services which have been unavailable for so long in that country. Numerous such enterprises have sprung up in the past few years. A recent article in the *Beijing Review*<sup>34</sup> describes developments involving this trend in Jiamusi, a city of 520,000 in the northernmost province of Heilongjiang. For example, a collectively run restaurant was exempted<sup>35</sup> from the commercial tax for three years. Particularly surprising was the description of a limited liability company formed with 50 five hundred yuan (\$290) shares. The Xinya Limited Liability Company employs fourteen people and sells a variety of consumer goods including candy, fruit, tea and hardware. Last year's profit, after payment of wages in excess of 50 yuan (\$29) a month to each employee, was 4,600 yuan (\$2,688). Forty percent of this profit was paid out in dividends with the remainder held in the company's accumulation fund. Presumably, this enterprise was subject to the industrial and commercial income tax. This tax is imposed on income earned from business and other sources by all industrial and commercial enterprises in China, including foreign enterprises and joint ventures engaged in production and business. The tax rate consists of 21 grades which range

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<sup>32</sup> Pomp, Gelatt & Surrey, *supra* note 2, at 16-17. For further treatment of payment and collection procedures, as well as violations and penalties, see *id.* at 26-30; Reynolds, *supra* note 2, at 58-59.

<sup>33</sup> The tax rates vary for each type of good or service according to the type of economic activities that the government seeks to promote. Pomp, Gelatt & Surrey, *supra* note 2, at 24. For example, consumer goods which are considered necessities are taxed at lower rates than those which are considered luxuries. *Id.* As well, the level of profit received by enterprises producing a particular product is a factor in setting the appropriate tax rate. *Id.* It is important to note that the tax applies regardless of whether an enterprise is profitable so that it provides "an incentive for a firm to generate enough revenue so that some profit remains after payment of the tax." *Id.* at 20.

<sup>34</sup> Yantai, *Employment Transformation*, *BEIJING REV.*, Nov. 2, 1981, at 25.

<sup>35</sup> Various exemptions from tax are available which can be expanded as tax incentives are deemed desirable. Pomp, Gelatt & Surrey, *supra* note 2, at 20-21. Although the way in which these exemptions are actually used is unclear, they are generally granted to "infant or ailing domestic enterprises" or "to encourage certain types of economic activity." *Id.* at 21. Local tax bureaus, provinces and cities, as well as the central government, have authority to grant exemptions. *Id.* at n.36. It is unclear whether joint ventures would qualify for exemptions. Reynolds, *supra* note 2, at 56.

from 5.75% on the first 300 yuan (\$174) of annual income to 34.5% of annual income over 10,000 yuan (\$5,800), obviously a progressive tax structure.<sup>36</sup> Assuming the Xinya Limited Liability Company had after tax profits of 4,600 yuan (\$2,668), it would have had pretax profits of approximately 5,950 yuan (\$3,451) and paid consolidated industrial and commercial taxes in the amount of 1,350 yuan (\$783).

### III. INDUSTRIAL AND COMMERCIAL INCOME TAX

The Industrial and Commercial Income Tax<sup>37</sup> was originally adopted in 1950 and taxes all industrial and commercial profit-making enterprises from street peddlers to state-owned industries.<sup>38</sup> There is a graduated rate structure which, according to classification of the industry, ranges from 7% to 62%.<sup>39</sup> Certain types of industries, particularly those that are state-owned, are exempted from taxation according to various regulations from the Ministry of Finance.<sup>40</sup>

There is a potential conflict between this tax and the new joint venture tax law. It appears possible that a Chinese branch of a foreign corporation could avoid taxation under the joint venture income tax, but still be taxed under the industrial and commercial income tax.<sup>41</sup> As the joint venture tax rate of basic 30%<sup>42</sup> is more attractive to foreign investors than the industrial and commercial tax rates, foreign businesses may prefer to have a clear understanding of which tax rate schedule will apply to their investments before they make any substantial commitments.<sup>43</sup>

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<sup>36</sup> See Pomp & Surrey, *supra* note 10, at 5-12.

<sup>37</sup> The Provisional Industrial and Commercial Tax Act of the People's Republic of China was approved at the 17th Conference on Government Affairs of the Government Administration Council, January 27, 1950, promulgated by the Government Administration Council, January 31, 1950, revised by the 63rd Conference on Government Affairs of the Government Administration Council, December 15, 1950, and promulgated by the Government Administration Council, December 19, 1950.

<sup>38</sup> See Pomp, Gelatt & Surrey, *supra* note 2, at 32.

<sup>39</sup> *Id.* at 35.

<sup>40</sup> *Id.* at 34-35.

<sup>41</sup> *Id.* at 39-40.

<sup>42</sup> *Id.* at 58.

<sup>43</sup> See Wren, *supra* note 10, at D1, col. 1 (discussing a newly enacted income tax on foreign companies which do business in China).

## IV. AGRICULTURAL TAX

In the agricultural sector of China's economy, the primary tax is the agricultural tax. This tax is imposed on the yield of farm land rather than on the value of the land itself. There is conflicting information (which is true of practically any aspect of Chinese law) on the exact scope of this tax and the method of payment. One source<sup>44</sup> has indicated that it is to be paid in kind, while we were told that it is paid by way of a required sale of a portion of the farm produce to the state with the price fixed by the state. Thus, as the tax increases the price paid to the producing entity by the state decreases. It is known that during periods of extremely low yield, such as would occur following a drought, the tax may be partly or entirely waived by the state. Although the tax varies from province to province and from crop to crop, it is not used as a method for controlling the production of various crops. This type of regulation is accomplished by provincial decree.

An interesting aspect of the agricultural economy has been the use of so-called "private plots."<sup>45</sup> When farmland was collectivized in 1955 and 1956, each family was allocated a private plot for the cultivation of agricultural products to supplement the family's subsistence. During brief periods prior to 1978, but consistently since 1978, these plots have served not only to enhance the worker's own family table but have served as a source of privately earned income. The produce, meat and poultry from these private plots has contributed greatly to the availability of foodstuffs in the cities. It is unclear whether a peasant farmer selling pork raised on his private plot is subject to any particular form of taxation other than a license fee to sell his goods at the "free market." It is clear, however, that from time to time the government has discouraged such free market activity. For example, a chief source of organic fertilizer for collective farming operations has been the by-product of pig raising on private plots. In 1956, over 80% of the pigs raised in China were raised on private plots. The same was true of poultry. Consequently, the bulk of organic fertilizer came from these private plots. This fertilizer would be sold to the collective for use in its agricultural operations.

During times in which the government discouraged private enterprise, when the peasant delivered the fertilizer to the collective, the

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<sup>44</sup> See Reynolds, *supra* note 2, at 52 n.15.

<sup>45</sup> The structure of China's agricultural production system is also discussed in Hudspeth, *supra* note 11, at 702-15.

local authorities would undervalue and in some cases not pay for the fertilizer at all; it was considered the peasant's "patriotic duty" to contribute whatever he could to the common good. During periods of government encouragement of such private enterprise, the farmer would be quickly paid a fair price for such deliveries. Thus, the regulation of the price paid for such fertilizer has been a continuing form of economic control similar to taxation.

## V. URBAN REAL ESTATE TAX

Real estate tax in China is levied only in cities and is a local revenue measure.<sup>46</sup> The urban real estate tax is a tax on privately-owned urban housing. There are basically two kinds of housing in China. The cities have thousands of new high-rise apartment buildings.<sup>47</sup> These apartment buildings are either state-owned or are owned by factories for the housing of their workers. The other type of housing is comprised mainly of squalid, tar paper roofed, dirt or concrete floored hovels.

Presumably, the state-owned apartment buildings are not taxed. A Chinese gentleman who was gracious enough to discuss the housing situation with me in Beijing told me that he paid one and a half yuan (\$.87) per month for housing. He said that he owned the house. The urban real estate tax is calculated on an annual basis according to the standard value of the house and the rate is 18% of rental value.<sup>48</sup> If in fact this Chinese gentleman was correct in his assumption that he owned the house, and the one and a half yuan per month figure is correct, the value of that house would be 150 yuan or approximately 87 U.S. dollars. It may be that the gentleman either did not own the house or that the house was not being subjected to the "house tax," but that rather he was paying the "landed estate tax." The landed estate tax is imposed on owner-occupied buildings at a rate of 1.8% of the value of the landed estate.<sup>49</sup> This would be more reasonable since the calculation would yield a value for the landed estate of 1,000 yuan or 580 U.S. dollars.

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<sup>46</sup> Pomp & Surrey, *supra* note 10, at 3 n.8.

<sup>47</sup> High-rise in this context means buildings under five stories since the Chinese believe that taller buildings would require an elevator.

<sup>48</sup> Pomp, Gelatt & Surrey, *supra* note 2, at 14 n.9.

<sup>49</sup> *Id.*

## VI. CREDITABILITY

An important concern for foreign investors in Chinese businesses is the availability of tax credits for taxes paid. The Chinese government, aware of the possibility of double taxation, drafted provisions into the Individual Income Tax Law and the Joint Venture Income Tax Law which gave credits for foreign taxes paid against Chinese taxes.<sup>50</sup> Furthermore, although no tax treaty currently exists between the United States and China, there is interest from both parties in negotiating just such a treaty. This will eliminate the problem of double taxation and any other possible conflicts between the Internal Revenue Code and the Chinese tax law.<sup>51</sup>

Despite the available credits allowable against Chinese taxes, United States investors may still be wary, as there is currently no clear indication from the Department of the Treasury as to the credits which will be allowable against United States taxes for taxes paid to China.<sup>52</sup> The problem lies in the interpretation given by the Internal Revenue Service to the Individual Income Tax Law and the Joint Venture Income Tax Law. If these taxes are interpreted as foreign income taxes or foreign taxes paid in lieu of income taxes, the United States foreign tax credit will apply.<sup>53</sup> Should the expected ruling from the Internal Revenue Service be to the contrary, however, American investors will certainly be discouraged from investing in China, whether the format is as a Chinese branch of a foreign business or as a joint venture.

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<sup>50</sup> *Id.* at 67 n.396.

<sup>51</sup> *Id.* at 67 n.397; Reynolds, *supra* note 2, at 65-66. Professor Reynolds lists four potential benefits of a tax treaty between the United States and China:

1. Conflicting or inconsistent IRC sections would be superseded by such a treaty;
2. tax benefits or solutions peculiar to Sino-American trade could be established separately without affecting provisions relating to other countries;
3. alleviation of the need for either the United States or the [People's Republic of China] to alter trade or tax practices in order to do business; and
4. relative ease in implementing a treaty compared to congressional amendment of the Code.

Reynolds, *supra* note 2, at 65-66.

<sup>52</sup> See Pomp, Gelatt & Surrey, *supra* note 2, at 68; Wren, *supra* note 10, at D1, col. 1.

<sup>53</sup> For the rules concerning foreign tax credits, see I.R.C. §§ 901-903. There have been temporary regulations which define "income tax." Temp. Treas. Reg. §§ 4.901-02, 4.903-1 (1980). These regulations classify the foreign tax as an income tax if it is imposed on net income. See Pomp, Gelatt & Surrey, *supra* note 2, at 68. For a discussion of the creditability of taxes paid under the newly-enacted foreign enterprise tax on corporate profits, see Hudspeth, *supra* note 10, at 697-98 n.28.

## VII. SIGNIFICANCE OF TAX REVENUE

According to an excellent article by Professor Paul D. Reynolds,<sup>54</sup> the significance of taxation in the budget of the People's Republic of China has decreased from 75% in 1950 to approximately 36% in 1972.<sup>55</sup> At the same time, the budget has relied more heavily on profits from state enterprises (an increase from 13.3% in 1950 to 60% in 1972). The decrease in reliance on tax revenues, however, does not represent a continuing evolution toward the goal predicted by a Russian economist in 1962 that development of a socialist economy in China would result in the abolition of taxes.<sup>56</sup>

When this prediction was made, taxes as a proportion of the budget of the People's Republic of China had decreased from 75.1% in 1950 to 34.8% in 1960. The percentage has remained fairly constant since that time and there is nothing to indicate (and indeed all indications are to the contrary) that taxes will assume a lesser role in the future. The 1978 budget of the People's Republic of China was estimated by the United States Department of State to be \$72.8 billion.<sup>57</sup> Of that sum \$26.2 billion was raised from taxes imposed on the Chinese people. On a per capita basis, assuming a population of one billion, this results in a direct tax burden of \$26.20 per person. Thus, an average factory-employed couple with one child, having combined income of 80 yuan or \$46 a month would pay \$78.60 a year in direct tax as their part of that annual budget. This represents the imposition of a direct tax burden of approximately 14%.

Taxation in China arises from a different policy basis than does taxation in the United States and other western countries. Taxation in the West is designed to provide the revenue for government operations and functions, at least theoretically, through a payment of one's

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<sup>54</sup> Reynolds, *supra* note 2 at 52.

<sup>55</sup> *Id.*

<sup>56</sup> This economist speculated that:

As a result of the development of a socialist economy [in China] the abolition of taxes has considerable political and economic significance. Only under socialism can the dream of freedom from taxes, so long held by the working people, be realized. This historic measure supplements and accelerates the steady improvement in the life of workers which is based on the powerful surge of production resources. The abolition of taxes is a clear expression of the undisputed superiority of the socialist system and an indicator of the basic advantage of the socialist fiscal system over the capitalist. The experience of socialist countries attests to the necessity and importance of using taxes in socialist construction and to the gradual disappearance of this economic category.

A. CHEKHUTOV, NALAGOVOYA SISTEMA KITAYSKOY NARODNOY RESPUBLIKI (TAX SYSTEM IN THE PEOPLE'S REPUBLIC OF CHINA) (1962).

<sup>57</sup> U.S. DEP'T OF STATE, BACKGROUND NOTES: CHINA (March 1980).

fair share of such governmental costs. On the other hand, taxation in China is used as leverage to promote the currently desired political goals of the government. While this observation might also appear to be true in the United States with the availability of such tax incentives as investment credits, the Internal Revenue Code has much less obvious political flexibility than the Chinese government has with its tax code.

The current political climate in China does not appear to signal any great change in the impact of taxes on the people of China. There is, however, a definite recognition of the potential for revenue by taxing foreign investors; this recognition is tempered by the realization that such taxation could scare off foreign investors unless the taxes are accompanied by the concomitant rewards of profits and tax credits. These kinds of concerns illustrate the new importance of taxation in China so that the underlying policy differences between Western and Chinese tax systems should not cause any significant barriers to foreign investment. Nevertheless, the Chinese tax system is in great flux and it is impossible to predict what changes the future will bring.