The United States — People's Republic of China Double Taxation Treaty

by

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INTRODUCTION

On July 24, 1986, the United States Senate ratified a comprehensive agreement for the avoidance of double taxation between the United States and the People's Republic of China [hereinafter the PRC or China]. Ratification of the Treaty marks a significant development in U.S.-China economic relations, yet it also reflects the continuation of several trends in U.S. international taxation policy. Businesses and individuals will need to consider the implications of the Treaty together with the Tax Reform Act of 1986 in planning their activities in China.

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3. In contrast with other U.S. treaty partners, the PRC did not accept the terminology of "treaty" or "convention" for this agreement. Nevertheless, the agreement requires the same ratification process under U.S. law and carries the same legal force as a treaty or convention. U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME (1985); reprinted in 1 TAX TREATIES (CCH) ¶ 1447 (1985) [hereinafter TECHNICAL EXPLANATION]. See also SENATE COMM. ON FOREIGN RELATIONS, REPORT ON THE INCOME TAX AGREEMENT (AND PROTOCOL) WITH THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA, S. EXEC. REPT. No. 7, 99th Cong., 1st Sess. 3 (1985) [hereinafter SENATE REPORT].

Overall, the Treaty is noteworthy in several respects. As the first comprehensive tax agreement between the PRC and the United States,\(^5\) the Treaty demonstrates that the PRC regime for international taxation follows other conventional approaches.\(^6\) The Treaty also promotes trade and investment between the two countries principally by: 1) providing certainty with regard to the tax consequences of transactions, 2) eliminating foreign tax on activities or transactions limited in time or scope, and 3) reducing tax rates on remittances such as dividends, interest, and royalties.\(^7\) These Treaty provisions take on enhanced significance in view of the five-fold increase in trade between the U.S. and PRC\(^8\) and the flow of $400-500 million in U.S. foreign direct investment\(^9\) to China since the 1979 normalization of diplomatic relations. In this connection, conclusion of the Treaty helps U.S. business and commercial interests keep pace with those of China's other major trading partners (Belgium, the Federal Republic of Germany, France, Japan, Norway and the United Kingdom) all of which also recently negotiated tax treaties with China.\(^10\) Finally, the Treaty generally represents a subtle liberalization

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of U.S. international tax policy toward developing countries with its adoption of relatively broader sourcing rules for business profits coupled with its potential allowance for a tax sparing credit if such an allowance is offered to China by tax treaties of other developed countries.

Despite its apparent positive characteristics, the Treaty generated some controversy during the ratification process. Senator Jesse Helms (R.-N.C.) delayed Senate consideration of the Treaty because of its relatively weak anti-treaty shopping provision. In addition, both the Senate Foreign Relations Committee and an American Bar Association subcommittee expressed concern about potential conflicts between the Treaty and the foreign tax credit limitations of the Internal Revenue Code, the concessions accorded the PRC on sourcing rules for business profits and on withholding rates, and the anti-treaty shopping provisions.

In addition, China is reportedly negotiating tax treaties with several other nations, including: Austria, Australia, Canada, Denmark, Finland, Italy, Malaysia, Netherlands, Romania, Singapore, Switzerland, Sweden, Thailand, and Yugoslavia. See Arthur Andersen & Co., China Flash 2 (Feb.-Mar. 1986).

The existence of double taxation treaties between China and “competitor” nations was cited as one of three major arguments in favor of ratification of the Treaty. See 132 Cong. Rec. S9613 (daily ed. July 24, 1986)(statement of Senator Daniel J. Evans, R.-Wash.).

The United States has only recently expanded its double taxation treaty regime with developing countries. Developing nations with which the United States has income tax treaties in force include China, Greece, Jamaica, Korea, Morocco, Pakistan, and the Philippines. In addition, treaties have been signed, but are not in effect for the following developing countries: Argentina, Bangladesh, Barbados, Brazil, Sri Lanka, and Thailand. See List of Tax Conventions, 1 Tax Treaties (CCH) ¶¶ 17, 19 (1986).

12. See infra notes 144-153 and accompanying text.

13. See infra notes 242-246 and accompanying text.


15. Senate Report, supra note 3, at 10-16; American Bar Association Subcommittee on Tax Treaties, Comments on the Proposed Income Tax Treaty and Protocol Between the United
Tax planning in conjunction with the Treaty will depend on an understanding of the present Chinese tax law provisions. This Article, therefore, discusses selected provisions of Chinese tax law in order to illustrate the benefits of and ambiguities inherent in the Treaty. Partially in response to investor criticism, domestic Chinese tax law has undergone numerous changes during the past five years. Most recently, the PRC government promulgated measures to facilitate and promote foreign investment in some businesses.

In most cases, U.S. businesses and individuals engaged in activities in China face four major taxes. First, the Individual Income Tax (IIT) imposes tax at a progressive rate ranging from five to forty-five percent with an 800 yuan monthly deduction for Chinese source income. Second, the Foreign Enterprise Income Tax (FEIT) applies to foreign companies at a progressive rate of twenty to forty percent on net income with a local tax.

16. For a general introduction to Chinese tax law, see the articles cited in supra note 6. For the text of Chinese laws and regulations relating to business, see COMMERCIAL LAWS AND BUSINESS REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 1-2 (V. Sit ed. 1984).

17. For a discussion of the problems facing investors in China, including foreign exchange restrictions, contract interpretation disputes and inflexible bureaucracy, see Burns, Why Investors Are Sour on China, N.Y. Times, June 8, 1986, at F7, col. 1; Sterba, Some Sinologists See Reform Slowing Down After an Active Decade, Wall St. J., Sept. 5, 1986, at 1, col. 1; Gargan, Foreign Investors in China Skeptical, N.Y. Times, Nov. 11, 1986, at 29, col. 4 (national ed.) (stating that foreign investors are not satisfied with the measures promulgated on October 11, 1986 to lower taxes, reduce charges for labor, and provide greater freedom in hiring and firing employees).


Under recent measures to encourage foreign investment, certain "Export Enterprises" whose value of exported products exceeds seventy percent of the total production value during the year pay one-half of the applicable FEIT rate. Foreign Investment Measures, supra note 18, art. 8. Other measures reduce FEIT rates in the SEZs and ETDZs, reduce by one-half the FEIT tax rate for "Technologically Advanced Enterprises," and provide for a refund of FEIT tax paid on certain reinvested portions of profits from an enterprise. Id., arts. 8-10.
surcharge of ten percent. Third, the Joint Venture Income Tax (JVIT)\(^\text{22}\) covers only joint equity ventures between Chinese and foreign entities and applies a tax of thirty percent plus an effective three percent local surcharge. Finally, the Industrial and Commercial Tax (ICT)\(^\text{23}\) represents an amalgam of turn-over taxes and applies to both foreign and domestic taxpayers, including joint ventures. The ICT imposes varying tax rates for over one hundred categories of products and services (e.g., one percent for white cotton and sixty-nine percent for cigarettes). Each of these taxes includes exemptions and provisions for preferential treatment in designated geographic areas, including reductions of tax in the Special Economic Zones (SEZs) and the Economic and Technological Development Zones (ETDZs).\(^\text{24}\)

This Article analyzes the Treaty from a tax policy and tax planning perspective with an emphasis on the concerns of U.S. businesses and individuals considering activities in China. Following an overview of the Treaty's negotiation and structure in Part II, Part III of this Article outlines the application and entitlement issues of the Treaty, the substantive rules for taxation, and the provisions for relief from double taxation. Part IV concludes with a review of the Treaty's implications for U.S. and China tax policy and an outline of tax planning concerns.

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23. The Industrial and Commercial Tax refers to a series of revenue provisions which operate as turn-over taxes. The Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China, Standing Comm. of the Nat'l People's Cong., 101st Meeting (Sept. 11, 1958) [hereinafter ICT], reprinted in CHINA LAWS, supra note 19, at ¶ 31-500. Most recently, ICT rates were adopted for refrigerators (20%), air-conditioners (20%), vacuum cleaners (20%), electronic computers (10%), and video recorders (20%). Notice of the Ministry of Finance Concerning Applicable Rates of Consolidated Industrial and Commercial Tax on Refrigerators and Other Products (Apr. 18, 1986), reprinted in CHINA LAWS, supra note 19, at ¶ 31-605. These taxes represent over seventy-five percent of China's tax revenue. Gelatt & Pomp, supra note 6, at 442.

The ICT should be distinguished from the Industrial and Commercial Business Income Tax (ICIT). Provisional Industrial and Commercial Business Tax Law of the People's Republic of China, as amended, State Council (Jan. 30, 1950) (unofficial translation on file in the office of the International Tax and Business Lawyer). The ICIT imposes a net business income tax ranging from 5.75 percent to 34.50 percent on industrial and commercial enterprises, while the ICT imposes varying tax rates on over one hundred categories of products and services. Id., arts. 1, 10.

II
OVERVIEW OF THE TREATY

Understanding the operation of the Treaty's provisions initially requires a familiarity with the nature of U.S. double tax treaties, the process by which they are negotiated and approved, and the overall structure of the Treaty.

A. U.S. Double Tax Treaty Regime

The U.S.-China Treaty represents the latest development in the evolution of treaties providing relief from double taxation caused by the overlap of the tax regimes of other nations with the worldwide taxing jurisdiction of the United States. Following the initial U.S. comprehensive tax treaties with Sweden and France in 1939, the United States had concluded twenty-one tax treaties by 1963 and currently has in effect income tax treaties with thirty-three countries.

While the tax treaties themselves may reflect as much the exigencies of bargaining as they do a coherent theory of international taxation, the treaties generally address the problems associated with the limited application of foreign tax credit or exemption methods, the uncertainty with regard to the jurisdiction of the source country's domestic tax laws, and the choice to restrict the level of tax on certain items of income. The new treaty between the U.S. and the PRC continues this effort with one of the world's most rapidly developing internal tax structures.

B. History of the U.S.-China Tax Treaty

Several unusual circumstances surrounded the conclusion of the U.S.-China Treaty. Negotiations began in September 1982 and occurred over four sessions during 1982-1984. With the conclusion of the U.S.-China Treaty

27. See 1 TAX TREATIES (CCH) ¶ 17 (1986) (including the treaty with China and excluding the treaty with South Africa, which was terminated pursuant to the Anti-Apartheid Act of 1986). See also supra note 11 (list of U.S. tax treaties with developing countries).
28. Vogel, Double Tax Treaties and Their Interpretation, 4 INT'L TAX & BUS. LAW 1, 10 n.26 (1986) (citing 1930 statement of U.S. Secretary of Treasury Mellon).
29. These unilateral methods of relief from double taxation are inadequate because they may not apply to all the activities giving rise to double taxation and the application of unilateral measures may vary from one country to another. Vogel, supra note 28, at 9-10.
32. For a description of how China has developed its system of taxing foreign businesses since 1979, see Gelatt & Pomp, supra note 6, at 422-23.
on April 30, 1984, President Reagan became the first U.S. President to sign a double taxation treaty.\textsuperscript{34} In a change from the usual practice, the parties also signed a protocol \cite[hereinafter the 1984 Protocol] and letters of agreement on the same date.\textsuperscript{35} The three documents, together with a 1986 protocol, form integral parts of the international agreement.\textsuperscript{36}

The constitutional requirement that the Senate give advice and consent to ratify treaties\textsuperscript{37} yielded a "legislative history" useful to understanding the Treaty.\textsuperscript{38} After the President transmitted the Treaty to the Senate on August 10, 1984,\textsuperscript{39} the Treasury Department provided a Technical Explanation as an "official guide" which "reflects policies behind particular provisions as well as understandings reached with respect to the interpretation and application of the Agreement."\textsuperscript{40} In addition, Senate hearings on July 30, 1985 served to draw attention to certain concerns expressed with respect to concessions accorded China in the Treaty, application of the foreign tax credit limitation, and treaty shopping.\textsuperscript{41} On December 11, 1985, the Senate Committee on Foreign Relations recommended that the Senate give its advice and consent to ratification of the Treaty subject to an "understanding" and three "concerns".\textsuperscript{42}

\textsuperscript{34. Treaty; see also Agreement with China for the Avoidance of Double Taxation: Hearing on Treaty Doc. 98-30 before the Senate Comm. on Foreign Relations, 99th Cong., 1st Sess. 17 (July 30, 1985) \cite[hereinafter Senate Hearing] (statement of Ron Pearlman, Assistant Secretary for Tax Policy, U.S. Department of the Treasury).


\textsuperscript{36. TECHNICAL EXPLANATION, \textit{supra} note 3, at 1; SENATE REPORT, \textit{supra} note 3, at 17. \textit{See infra} note 47.

\textsuperscript{37. U.S. Const. art. II, § 2, cl. 2.

\textsuperscript{38. The utility of this "legislative history" in the formal interpretation of a treaty is disputed. \textit{See} Vogel, \textit{supra} note 28, at 36 (these materials cannot assist interpretation under the Vienna Convention on the Law of Treaties); \textit{but see} Estate of Burghardt v. Comm'r, 80 T.C. 205 (1983); Coplin v. United States, 761 F.2d 688 (Fed. Cir. 1985).

\textsuperscript{39. SENATE REPORT, \textit{supra} note 3, at 2. \textit{Also see} Letter of Submittal, \textit{supra} note 7.

\textsuperscript{40. TECHNICAL EXPLANATION, \textit{supra} note 3, at 1. The Treasury Department issued this report on July 30, 1985. \textit{Id.} at 23.

\textsuperscript{41. Senate Hearing, \textit{supra} note 34, at 17-18, 26-27.

\textsuperscript{42. SENATE REPORT, \textit{supra} note 3, at 1, 10; see also 131 CONG. REC. S17, 454-55 (daily ed. Dec. 11, 1985) \cite[submission of Report and Treaty]. The Senate Foreign Relations Committee also received the comments of the major congressional tax-writing committees while considering the Treaty. \textit{See} Letter dated November 13, 1985 from House Ways and Means Chairman Dan Rostenkowski (D.-Ill.) and ranking Republican John J. Duncan (R.-Tenn.) to Senate Foreign Relations Committee Chairman Richard G. Lugar (R.-Ind.) and Senator Daniel J. Evans (R.-Wash.), \textit{reprinted in} 85 TAX NOTES INT'L 4-2-6 (Nov. 27, 1985) \cite[hereinafter Ways and Means Letter]; Letter dated November 1, 1985 from Senate Finance Chairman Bob Packwood (R.-Or.) and ranking Democrat Russell B. Long (D.-Miss.) to Senate Foreign Relations Committee Chairman Richard G. Lugar (R.-Ind.) and Senator Daniel J. Evans (R.-Wash.), \textit{reprinted in} 3 TAX TREATIES (CCH) ¶ 9873 (1985) \cite[hereinafter Senate Finance Letter].
The "concerns" expressed in the Committee report, especially with regard to the anti-treaty shopping provision, coupled with the vigorous opposition of Senator Helms, forced China and the United States back to the negotiating table and resulted in delays in Senate floor action on the Treaty. In an effort to expedite ratification and to assuage Chinese concerns, Treasury Secretary James A. Baker III negotiated and signed an additional protocol [hereinafter the 1986 Protocol] on May 10, 1986, to interpret the anti-treaty shopping provision in the 1984 Protocol. The Senate Foreign Relations Committee approved the 1986 Protocol on June 12, 1986.

Finally, more than two years after signature of the Treaty, the Senate ratified the U.S.-China Treaty by a vote of 96 to 1 with Senator Helms as the lone dissenter.

C. Structure of the Treaty

The U.S.-China Treaty follows the traditional pattern for double taxation treaties. The myriad of provisions in the Treaty can best be organized and understood by the use of a three-part analysis. First, the rules of the Treaty's jurisdiction and definitions appear in Articles 1 through 5. Second, the substantive rules of taxation or "distributive rules" comprise Articles 6 through 21. Third, Article 22 determines the legal consequences and

43. Senate Report, supra note 3, at 1.
44. See supra note 14.
51. Treaty, arts. 6-21 (Income from Real Property, Business Profits, Associated Enterprises, Dividends, Interest, Royalties, Gains, Independent Personal Services, Dependent Personal Services, Directors' Fees, Artists and Athletes, Pensions, Government Pensions, Teachers and Lecturers, Students and Trainees, and Other Income).
solutions in the event of double taxation.\footnote{52} Miscellaneous provisions appear in Articles 23 through 28 and the Protocols.\footnote{53}

This overall structure and the coverage of the provisions closely resemble those adopted in the model tax treaties of the OECD, UN, and the United States.\footnote{54} In this connection, the U.S.-China Treaty is significant for the implicit Chinese recognition of conventional rules of international taxation despite the fact that the PRC did not participate in the drafting of any of the model treaties.\footnote{55}

### III

**Substantive Elements of the Treaty**

#### A. Jurisdiction and Entitlement Issues

Before the Treaty's operative rules of taxation and relief from double taxation are invoked with regard to a particular transaction or event, taxpayers must fulfill the Treaty's jurisdictional requirements. This Part examines the issues of residence, geographic scope, and taxes covered under the Treaty.

1. **Residence and Citizenship**

   Only "residents" of either the United States or the PRC are entitled to the benefits of the Treaty.\footnote{56} Threshold questions arise as to the determination of residence and the treatment of individuals or corporations with dual residence. Article 4 of the Treaty addresses these issues.\footnote{57}

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\footnote{52} Treaty, art. 22 (Relief from Double Taxation).


For a comparison of each article of the model treaties, see K. VAN RAAD, MODEL INCOME TAX TREATIES (1983).

\footnote{55} Schreyer, supra note 6, at 259. Because of this lack of participation, however, the PRC authorities may not feel bound by the OECD Commentary which is often utilized in the interpretation of tax treaties. See REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL (1977) [hereinafter OECD Commentary].

\footnote{56} Treaty, art. 1.

\footnote{57} The following discussion focuses on individual taxpayers and corporations. The Treaty employs the term "company" to include "any body corporate or any entity which is treated as a body corporate for tax purposes." Treaty, art. 3(1)(f). The Treaty defines "person" to include an individual, a company, a partnership, an estate, or a trust. Id., art. 3(1)(e); 1984 Protocol, supra note 35, para. 4. The special dual residence rules (other than the general rule in Article 4(1)) address only the individual and company taxpayers. Treaty, arts. 4(2)-(4).
For most taxpayers, the test for residence is straightforward. In accordance with the UN and OECD Model Treaties,\textsuperscript{58} “resident” of a State means a “person”\textsuperscript{59} liable to tax in that State by reason of “domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.”\textsuperscript{60} However, the United States also imposes tax on its citizens\textsuperscript{61} so that the U.S. Model Treaty and several U.S. tax treaties include citizenship in this definition rather than depending on the other Contracting State to employ it as a “criterion of a similar nature.”\textsuperscript{62} But China, along with other treaty partners,\textsuperscript{63} did not allow treaty coverage to nonresident citizens, apparently based on the belief that these citizens should be covered by a treaty with the third country in which the citizen resides or not be covered at all. In addition, China does not tax on the basis of citizenship.\textsuperscript{64} Therefore, U.S. citizens generally can take advantage of the Treaty’s benefits only as residents or domiciliaries of the United States.\textsuperscript{65} Similarly, Treaty benefits are denied to residents of third countries whose connection is limited to liability to tax on capital or on income from sources in the United States or China.\textsuperscript{66}

\textsuperscript{58} UN Model and OECD Model, supra note 54, art. 4(1).
\textsuperscript{59} Includes individual, company, partnership, estate, or trust. See supra note 57.
\textsuperscript{60} Id.; Treaty, art. 4(1) (adding “place of incorporation” to UN and OECD definitions).
\textsuperscript{61} Treas. Reg. § 1.1-1(b), T.D. 7117, 1971-2 C.B. 5, T.D. 7332, 1975-1 C.B. 204 (“all citizens of the United States, wherever resident”). In this connection, the 1984 Protocol includes the traditional saving clause under which the United States reserves its right to tax its citizens. 1984 Protocol, supra note 35, para. 2. For example, Treaty Article 21 allows taxation of “other income” only in the country of residence. The saving clause exception to this rule means that U.S. citizens who are Chinese residents continue to be subject to taxation in the United States for income received from third countries.
\textsuperscript{64} IIT, supra note 19; D. FOSTER & J. HORSLEY, supra note 6, at A-36.
\textsuperscript{65} This conclusion would change, however, if the Chinese authorities construe citizenship as a “similar” criterion. In addition, Treaty Articles 23 and 22(2) expressly include citizens for purposes of the nondiscrimination and relief from double taxation provisions, respectively. But see 1984 Protocol, supra note 35, para. 2 (saving clause reserving right to tax U.S. citizens); TECHNICAL EXPLANATION, supra note 3, at 2. However, this situation places U.S. citizens in third countries in the hypothetical position of facing triple taxation based on source, residence, and U.S. citizenship.
\textsuperscript{66} The Treaty excludes an express provision on this subject. Compare US and OECD Models, supra note 54, art. 4(1)(a) (including such a provision) and UN Model, supra note 54, art. 4(1) (excluding such a provision). TECHNICAL EXPLANATION, supra note 3, at 4 (stating that “liable to tax” should be interpreted not to include such a person except for tax-exempt entities). For a request for clarification of the Treaty’s position, see ABA Comments, supra note 15.
Dual residence issues can arise in a number of contexts. First, an individual taxpayer may be regarded as a resident under both the domestic law of the PRC and of the United States.\(^6\) Second, a corporation may also fall within the residence definition of both domestic laws.\(^6\) Third, a corporation may be a resident of the United States under the Treaty by virtue of its "place of management, or place of incorporation" and a resident of a third country under the terms of China's other tax treaties.\(^6\)

In all three situations, the Treaty provides that the "competent authorities"\(^7\) will participate in deciding the matter. This arrangement raises tax planning concerns because it contains no safe-harbor test and the competent authorities may be unable to agree.\(^7\) Moreover, the Treaty leaves it to the taxpayer to recognize the dual residence situation and bring the matter before the competent authority in the treaty partner country of which the taxpayer is resident.\(^7\)

For individual taxpayers, more definite rules exist to guide the competent authorities although these rules are not self-executing. The 1984 Protocol\(^7\) states that the competent authorities, in the case of an individual with dual residence, shall employ the rules in Article 4(2) of the UN Model Treaty.\(^7\) These tie-breaking rules look in descending order of priority to the Contracting State where the taxpayer has: a permanent home, a center of vital interests of personal and economic relations, a habitual abode, or nationality status.\(^7\) Accordingly, in most cases, individual taxpayers may resolve dual residence questions relatively easily although there may be problems and delays could arise from the intervention of the competent authorities.

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67. Because the Treaty does not define "resident", taxpayers must look to domestic law of the Contracting States. Treaty, art. 3(2). A nonresident of China or a taxpayer residing in China for less than one year faces taxation for only Chinese source income with an exception for a taxpayer who is a resident for not more than ninety consecutive days. Residents of one year or more pay tax on their worldwide income. IIT, supra note 19, art. 1; Gelatt, supra note 20, at 9 (explaining recent changes). See also Internal Revenue Code of 1986, as amended, § 7701(b) [hereinafter I.R.C.] (definition of resident alien and nonresident alien).

68. In China, a corporation is a resident of China generally if it has, as established, engaged in independent business operations in China or it conducts a joint business operation with Chinese enterprises. FEIT, supra note 21, art. 1. In the United States, a corporation is resident or domestic if created or organized in the United States or under the law of the United States or any State. I.R.C. § 7701(a)(4).

69. Treaty, art. 4(1); see supra note 10 (listing other PRC double tax treaties).

70. For purposes of the Treaty, the competent authorities are the Ministry of Finance or its authorized representative in China and the Secretary of the Treasury or his authorized representative (e.g., the Internal Revenue Service) in the United States. Treaty, art. 3(1)(i).


72. Treaty, art. 24(1).

73. 1984 Protocol, supra note 35, para. 5.

74. UN Model, supra note 54, art. 4(2). These rules are virtually identical to the dual resident "tie-break" rules in the OECD and U.S. Model Treaties.

75. Id. For an amplification of these criteria, see UN Model, supra note 54, art. 2(2) (citing OECD Commentary).
Corporate taxpayers face more uncertainty in dual residence situations. The 1984 Protocol’s tie-breaking rules do not apply in this situation, nor does the Treaty include the broad guidelines of the model treaties. To assist tax planning, the Treasury has stated that, as a matter of policy, the Treasury will treat an entity incorporated in the United States as a U.S. resident. If the competent authorities fail to reach agreement, however, the corporation will not be considered a resident for purposes of enjoying the benefits of the Treaty. Therefore, failure to plan for residence interpretations will lead to the denial of, inter alia, the significantly reduced withholding rates for dividends, interest, and royalties under the Treaty.

Finally, the Treaty contains a new rule for corporations with dual residence in a third country that is a treaty partner of China. Article 4(4) applies where a company is a resident both of the United States under the Treaty and of a third country under a tax treaty between that country and China (e.g., a corporation organized in the United States with its head office in Japan). In this situation, the corporation shall not be considered a resident of the United States for purposes of enjoying the benefits of the Treaty. Therefore, if a U.S. corporation undertakes activities in a third country, which renders it a resident of that third country for purposes of that country’s treaty with China, then the U.S. corporation cannot take advantage of benefits under the U.S.-China Treaty, including the favorable reduced withholding rates under the Treaty. This rule thus poses difficult planning considerations as China’s tax treaty network grows.

2. Geographic Scope

The Treaty limits its application solely to residents of the United States and China. In this connection, China means “all the territory” of China. Observers have expressed concern that the Treaty as constructed may include Hong Kong, so that parties in third countries could evade taxes by establishing Hong Kong corporations that make passive investments in the United States at reduced rates of taxation.

76. 1984 Protocol, supra note 35, para. 5 (applying only to Treaty article 4(2)).
77. UN and OECD Models, supra note 54, art. 4(3) (place of effective management); US Model, supra note 54, art. 4(3) (place where legally organized or created).
78. TECHNICAL EXPLANATION, supra note 3, at 5.
79. Treaty, art. 4(3).
80. See infra Part III.B.2.
82. Current tax treaty partners with China are Belgium, France, the Federal Republic of Germany, Japan, Norway, and the United Kingdom. See supra note 10.
83. Treaty, art. 4(4).
84. Id.
85. Treaty, art. 3(1)(a).
86. See ABA Comments, supra note 15; Senate Hearing, supra note 34, at 26-27; Ways and Means Letter, supra note 42.
As interpreted under present agreements, however, the Treaty does not extend to Hong Kong. Although the Treaty does not expressly exclude Hong Kong, the territorial definition is limited by the phrase "in which the laws relating to Chinese tax are in force." Under the recent agreement with the United Kingdom, China resumes sovereignty over the New Territories and Victoria Island on July 1, 1997. At that time, a new Hong Kong Special Administrative Region under the authority of the Central People's Government of China will continue for fifty years to administer the laws then in force in Hong Kong, including the tax regime. Chinese tax law will, therefore, not be "in force" in Hong Kong during this period and the Treaty will not extend to Hong Kong.

The Senate Foreign Relations Committee based its favorable recommendation of the Treaty in 1985 on the "understanding that Hong Kong is excluded from treaty coverage." Given the form of the Treaty's anti-treaty shopping rule at that time, the Committee felt that treaty shopping possibilities in Hong Kong could be significant. Hong Kong imposes relatively low corporate tax rates (18.5 percent), provides for exemptions from tax for interest paid on Hong Kong bank deposits and dividends received from Hong Kong companies, excludes foreign source income in deriving taxable corporate income, imposes few restrictions on foreign ownership of corporations in Hong Kong, and maintains the convertibility of Hong Kong currency. With the stronger anti-treaty shopping provisions added by the 1986 Protocol, the danger of taxpayers using Hong Kong conduits for passive investments with Treaty benefits in the United States has been reduced even further.

3. Treaty Shopping

It was important to the United States that the Treaty preclude individuals or entities otherwise not entitled to Treaty benefits from establishing enterprises in the PRC solely for the purpose of investing or doing business in

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87. Treaty, art. 3(1)(a).
89. Id., art. 3(8). See also Annex 1 to the Joint Declaration: Elaboration of Basic Policies Regarding Hong Kong, art. V.
90. SENATE REPORT, supra note 3, at 15.
91. Id.
95. See supra note 46. For a discussion of treaty shopping, see infra Part III.A.3.
the United States at reduced Treaty rates. This “treaty shopping” occurs, for
example, when an investor from a non-treaty partner country of the United
States (or from a treaty partner country with less favorable withholding rates)
establishes an entity in the treaty partner country in order to qualify as a
resident entitled to benefits under the treaty. The investor thereby receives,
for example, more favorable tax withholding rates on the dividends payable
on the capital invested by the entity in the United States. Treaty-shopping
became the subject of two protocols to the U.S.-China Treaty executed in

a. 1984 Protocol

The 1984 Protocol of the U.S.-China Treaty contains a provision aimed
at preventing treaty shopping that falls short of provisions contained in the
U.S. Model and other U.S. income tax treaties. It provides that a corpora-
tion will not receive favorable treaty withholding rates on dividends, interest,
and royalties if the competent authorities agree that the corporation is not
entitled because it became a resident of a Treaty partner for the principal
purpose of enjoying these benefits.

The weakness of this anti-treaty shopping provision became a key criti-
cism of the Treaty. Experts pointed out its deficiencies in comparison to Arti-
 cle 16 of the U.S. Model or other recent U.S. income tax treaties. This
Protocol applies to companies only, while the U.S. Model also covers part-
nerships and trusts. The Protocol denies benefits with regard to dividends, inter-
est, and royalties, while the U.S. Model denies all treaty benefits. The
Protocol provides that the competent authorities may agree to deny benefits,
while the U.S. Model contains self-executing rules. The weaker protocol pro-
vision, if nothing else, would have undermined the U.S. bargaining position in
future negotiations with other income tax treaty partners.

96. For example, the dividend withholding rate in the Treaty is 10 percent. Treaty, art. 9.
Compare I.R.C. § 871 (30 percent withholding) and other U.S. income tax treaties (generally 20
percent withholding).

97. 1984 Protocol, supra note 35, para. 7. Compare US Model, supra note 54, art. 16; Oliva,
Recent Protocols to Tax Treaties Indicate Changes in International Tax Policy, 10 INT'L
TAX J. 427 (1984); U.S.-Sri Lanka Treaty, supra note 62, art. 23. (adopting Article 16 language
for treaty signed in 1985). See also Kooiman, Article 16: The U.S. Attitude to Treaty Shopping,
37 BULL. INT'L FISCAL DOC. 195 (1983) (criticizing the U.S. approach as a departure from interna-
tional practice and as an unnecessary burden); Rolfe & Doupnik, The United States Attempts to
Crack Down on Treaty Shopping, TAX EXEC. 325 (Summer 1986). The OECD and UN Model
Treaties address this situation by limiting the Treaties' favorable rates to the “beneficial owner”
of the obligation or right underlying the dividend, interest, or royalty. UN and OECD Models,
supra note 54, arts. 10, 11, & 12.

98. 1984 Protocol, supra note 35, para. 5.


100. Ways & Means Letter, supra note 42. But the U.S. position on these anti-treaty shop-
ping provisions has changed in a number of treaties since the promulgation of the US Model.
Oliva, supra note 97, at 432.
These comparative weaknesses notwithstanding, the Treasury argued that the 1984 Protocol's structure adequately prevented treaty shopping. First, the recent repeal of the U.S. thirty percent withholding tax on interest paid to foreigners on certain portfolio interest eliminated one incentive for investors to treaty shop. Second, domestic Chinese law contains foreign enterprise registration requirements and foreign exchange controls which discourage the establishment of entities for passive investment. Chinese tax law also imposes relatively high tax rates on foreign enterprises and on dividend or interest payments to foreign individuals. Third, the Treasury indicated in its interpretation of the Treaty that denial of Treaty benefits does not require the agreement of both competent authorities. Finally, U.S. courts have applied principles from domestic tax evasion cases to double taxation treaties even where corporations fall within the protected class of a treaty. While the Senate Committee accepted the 1984 Protocol as adequate under the circumstances, it indicated that subsequent changes in Chinese law would cause the United States to "carefully reexamine" the anti-treaty shopping provision.

b. 1986 Protocol

After submission of the Treaty to the Senate in August 1984, congressional and expert criticism of the Treaty centered on the weaknesses in the
anti-treaty shopping provision.111 Facing an embarrassing delay in the ratification of the Treaty, Treasury Secretary James A. Baker III concluded the 1986 Protocol in Beijing on May 10, 1986. The only objective of this protocol was the “interpretation” of the treaty shopping provision in the 1984 Protocol.112

The sole article in the 1986 Protocol provides three alternative methods for determining eligibility for Treaty benefits. These methods apply to all “persons”1113 other than individuals114 deriving income in a Contracting State. While the methods are substantially identical to the anti-treaty shopping provisions of other treaties, such as the recent income tax treaty between the United States and Denmark,115 they are substantively different in several aspects from those outlined in the U.S. Model Treaty.116

The first alternative method to determine eligibility consists of two tests: an ownership test and a “base erosion” test. The first test requires that ownership of more than fifty percent of the beneficial interest in the entity deriving the income must be by any combination, directly or indirectly, of: individuals who are residents of one of the Contracting States,117 citizens of the United States, publicly traded companies which are residents of one of the Contracting States,118 or one of the Contracting States, its political subdivisions, or local authorities.119

The second test requires that the entity deriving the income must not make substantial deductible payments to residents of third countries. Specifically, where the entity receives reduced taxation at source for dividends, interest, or royalties,120 the entity must not use more than fifty percent of its gross income to make payments to the persons specified in the ownership test.121 These two tests in the first alternative are intended to provide taxpayers a safe harbor and thus facilitate tax planning.122

111. Senate Hearing, supra note 34, at 26-27; Senate Report, supra note 3, at 14; Ways & Means Letter, supra note 42; Senate Finance Letter, supra note 42; ABA Comments, supra note 15.
112. 1986 Protocol, supra note 46.
113. Including corporations, partnerships, estates, and trusts. See supra note 57.
116. US Model, supra note 54, art. 16.
117. For a discussion of the determination of residence under the Treaty, see supra notes 56-84 and accompanying text.
118. For the Protocol’s definition of publicly traded companies, see infra note 124 and accompanying text.
120. Treaty, arts. 9-11. For a discussion of these provisions, see infra Part III.B.2.
121. 1986 Protocol, supra note 46, para. 1(a)(ii). For the persons specified, see supra notes 117-119 and accompanying text.
The second alternative method depends on the entity's status as a publicly traded company. If the entity is a resident company of a Contracting State and its "principal class of shares" is subject to "substantial and regular" trading on a recognized stock exchange, then the entity is entitled to Treaty benefits under this alternative. While the Protocol fails to specify the meaning of "principal class" or "substantial and regular" trading, the Treasury's intent appears to center on the status of the entity as a resident publicly traded company to establish a "sufficient nexus" to justify treaty benefits.

The third alternative method for determining eligibility looks to the legitimacy of the entity's purpose. Under this alternative, an entity is entitled to treaty benefits if the establishment, acquisition, and maintenance of the entity and the conduct of its operations do not have "as a principal purpose the purpose of obtaining benefits" under the Treaty. Before the competent authorities deny Treaty benefits to a resident entity owned by residents of a third country, an argument may thus be made that the entity exists for valid business purposes and that the entity's receipt of benefits is consistent with the Treaty. For example, the Treasury has indicated that the requirements of this alternative would be met where a Chinese company owned by residents of a third country conducts business activities in China and makes investments in the United States which are related or incidental to its Chinese activities, or "if the aggregate tax burden in China equals or exceeds the tax reduction claimed" under the Treaty.

Implementation of the alternative methods of determining eligibility to receive Treaty benefits requires the consultation of the competent authorities. The Treaty benefits cannot be denied without such consultation. Nevertheless, once the competent authorities have consulted on the matter, one Contracting State may deny Treaty benefits to an entity even though the competent authority of the other Contracting State does not agree.

123. See supra notes 59-62, 76-84 and accompanying text.
124. Paragraph 3 of the 1986 Protocol defines "recognized stock exchange" as follows: "(a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; and (b) any national securities exchange approved to be established by the Government of the People's Republic of China or its authorized institution; and (c) any other stock exchange agreed upon by the competent authorities of the Contracting States." 1986 Protocol, supra note 46, para. 3. The PRC has opened stock exchanges in three cities (Beijing, Shanghai, and Shenyang). Stock Market in Beijing, N.Y. Times, Jan. 5, 1987, at 23, col. 6 (national ed.).
125. 1986 Protocol, supra note 46, para. 1(b).
126. TREASURY PROTOCOL EXPLANATION, supra note 47, at 3.
127. 1986 Protocol, supra note 46, para. 2.
128. See infra note 130 and accompanying text.
129. TREASURY PROTOCOL EXPLANATION, supra note 47, at 3. This interpretation also states that the alternative could be met in "other situations." Id.
130. 1986 Protocol, supra note 46, para. 4.
131. TREASURY PROTOCOL EXPLANATION, supra note 47, at 3.
Ratification of the Treaty with the 1986 Protocol clarifies a controversial ambiguity in the previous anti-treaty shopping provision. Under the new Protocol, the United States need not police changes in Chinese tax and foreign investment law to ensure that third party entities do not take advantage of Treaty benefits. The largely self-executing tests in the 1986 Protocol allow business and other entities to undertake activities in the Contracting States with more certainty as to their tax treatment. Finally, the amended anti-treaty shopping provision conforms to recent U.S. international tax policy.

4. Taxes Covered

A third threshold issue in applying the Treaty concerns the taxes covered by the agreement. In the United States, the taxes imposed under the Internal Revenue Code, including the personal holding company tax, the accumulated earnings tax, and the social security tax are covered. Regarding the PRC, the taxes covered include the individual income tax, the joint venture income tax, the foreign enterprise income tax, and the local income tax. Excluded from Treaty coverage are Chinese charges relating to the industrial and commercial tax, the provisional urban real estate tax, and taxes relating to shipping and air transport income. The Treaty also covers any "identical or substantially similar" taxes that are imposed after the date of signature of the Treaty in addition to, or in place of, those taxes referred to above.

132. See supra notes 104-106, 109 and accompanying text.
133. Conformity with U.S. anti-treaty shopping provisions has not been hailed universally as a positive development. For a summary of the views of the opponents and supporters of the anti-treaty shopping provisions, see Staff of Jt. Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers 146-47 (Jt. Comm. Print 1985). See also Oliva, supra note 97; Kooiman, supra note 97; Rolfe & Doupnik, supra note 97.
134. Treaty, art. 2(1)(b). An exemption to the application of the personal holding company tax and accumulated earnings tax exists for a Chinese company which is "wholly-owned, directly or indirectly, either by one or more individuals who are residents of China (and who are not citizens of the United States) or by the Government of China or any wholly-owned agencies thereof." 1984 Protocol, supra note 35, para. 3.
135. IIT, supra note 19.
136. JVIT, supra note 22.
137. FEIT, supra note 21.
138. The applicable local income tax generally consists of ten percent surcharges. JVIT, supra note 22, art. 3; FEIT supra note 21, art. 4; Treaty, art. 2(1)(a).
139. ICT, supra note 23.
140. Provisional Regulations Governing the Urban Real Estate Tax (Administration Council of the Central People's Government, Aug. 8, 1951) [hereinafter PURETA], reprinted in China Laws, supra note 19, at ¶ 39-500. For a discussion of this tax which applies as a separate tax on foreigners for land and buildings in cities, see Gelatt & Pomp, supra note 6, at 478-79.
141. For treaty coverage of these taxes, see supra note 5; 1984 Protocol, supra note 35, para. 8. Gains, however, are treated by Treaty, art. 12.
142. Treaty, art. 2(2). Such a determination would be made through consultation of the Competent Authorities. Id., art. 24.
B. Substantive Rules of Taxation

Beyond the threshold issues of application and entitlement, the Treaty provides substantive rules of taxation constituting *lex specialis* that operate as a limiting "stencil" over domestic tax law. These Treaty rules can be divided into three categories: income from certain activities, income from certain assets, and income from gains and other income.

1. Income from Certain Activities

a. Business Profits

The U.S.-China Treaty contains the standard model treaty language to the effect that business profits of an enterprise resident in one Contracting State are taxable in the other Contracting State only to the extent that the profits are attributable to a permanent establishment in the other State through which the enterprise conducts its business. An immediate tax planning consideration for U.S. businesses contemplating activities in China thus concerns the limits of a permanent establishment [hereinafter PE].

*Permanent Establishment*. As a general proposition, a PE exists whenever a resident of one Contracting State engages in business through a fixed place of business in the other Contracting State. Treaty Article 5 provides a detailed definition of a PE, which indicates that a PE operates similarly to the establishment concept used in Chinese tax law. In conformity with all three model treaties, a PE under the Treaty includes a fixed place of business, a branch, an office, a factory, a workshop, a place of management, or a place of natural resource extraction. The Treaty explicitly excludes from the PE definition certain activities with a limited scope even if conducted through a fixed place of business. These activities generally include storage or display of goods, maintenance of stock for processing by another enterprise, and preparatory or auxiliary activities.

Certain activities constitute a PE only if conducted within the Contracting State for more than a minimum specified time. For example, the definition of a PE includes a building site, a construction, assembly, or installation project, or the supervisory activities in connection with such a

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144. Treaty, art. 7; US and OECD Models, *supra* note 54, art. 7(1). Compare I.R.C. § 864(b), (c) (1982) (regarding definitions of "trade or business" and "effectively connected income" under U.S. law) with the "permanent establishment" and "attributable" standard under Treaty article 7. Chinese tax law contains a concept similar to the permanent establishment. See infra note 145.
145. See FEIT, *supra* note 21, arts. 1, 3 (applying a progressive tax rate, rather than the more favorable twenty percent flat rate, to foreign enterprises having "establishments" engaged in business operations in China). For a definition of "establishment" under the FEIT, see FEIT Regulations, *supra* note 21, art. 2.
146. Treaty, art. 5(1)-(2). See US, UN, and OECD Models, *supra* note 54, art. 5(1)-(2).
147. Treaty, art. 5(4) (listing the activities in more detail).
project after six months; an installation, drilling rig or ship used for the exploration of natural resources after three months; and the provision of services (not limited to consulting services) through employees if the activities in the country continue for more than six months in any twelve month period.\textsuperscript{148} This rule thus expands the source basis for Chinese taxation by adopting the UN model treaty version of PE under which a PE exists in certain cases after six months as opposed to the twelve months required under the OECD and U.S. models.\textsuperscript{149}

Finally, certain agency relationships may comprise a PE. For example, a dependent agent of a business creates a PE if the agent exercises in the country an authority to conclude contracts for the business, but not if the agent maintains a stock of merchandise for making deliveries.\textsuperscript{150} An independent agent, such as a broker, does not cause the principal business to have a PE unless the agent's activities are in fact exclusively for that enterprise.\textsuperscript{151} Finally, a PE does not exist merely because the enterprise in one Contracting State is controlled by or is a subsidiary of an enterprise in the other State.\textsuperscript{152} These PE rules raise tax policy and planning concerns. As a matter of tax policy, the PE provision in the Treaty reflects the agreement of the United States to assist developing country treaty partners in reducing the revenue sacrifice inherent in the model treaties' rules by providing lower thresholds for PEs.\textsuperscript{153} On the other hand, the Senate Committee responded to these concessions by registering its concern that these provisions not be viewed as a starting point for future negotiations with other developing countries.\textsuperscript{154}

As a matter of tax planning, the PE rule for services\textsuperscript{155} makes it essential that consultants, lawyers, and other service-providers without a fixed place of business nevertheless plan activities carefully so that services by personnel of the same firm on the same or connected projects do not so aggregate as to subject the firm to Chinese tax as a permanent establishment. Tax planners, however, gain more certainty as a result of the Treaty's rules for PEs. Although Chinese tax law employs a similar "establishment" concept, implementation of its terms caused uncertainty.\textsuperscript{156} For example, representative offices carrying on information gathering or liaison activities might fall within the definition of "establishment" for Chinese tax purposes.\textsuperscript{157} Under the

\begin{itemize}
\item \textsuperscript{148} Treaty, art. 5(3).
\item \textsuperscript{149} US, UN, and OECD Models, \textit{supra} note 54, art. 5(3).
\item \textsuperscript{150} Treaty, art. 5(5).
\item \textsuperscript{151} \textit{Id.}, art. 5(6).
\item \textsuperscript{152} \textit{Id.}, art. 5(7).
\item \textsuperscript{153} \textit{Senate Hearing}, \textit{supra} note 34, at 15. \textit{See supra} note 149 (Treaty includes lower six–month threshold for certain activities).
\item \textsuperscript{154} \textit{Senate Report}, \textit{supra} note 3, at 12. The Committee also indicated its belief that all enterprises should face the same PE standards. \textit{Id.} (noting special rules for oil rigs, etc.).
\item \textsuperscript{155} \textit{See supra} note 148 and accompanying text.
\item \textsuperscript{156} \textit{See supra} note 145; Han, \textit{supra} note 6, at 692-93.
\item \textsuperscript{157} Gelatt & Pomp, \textit{supra} note 6, at 464 (stating that, although the term "establishment" might be interpreted under the statute to include such activities, the Chinese tax authorities would be "unlikely" to classify them as such).
\end{itemize}
Treaty, however, this type of activity, if structured properly, falls within the explicit exclusions of the PE definition. In undertaking projects for clients in China, for example, consultants and attorneys may benefit by carefully separating out and identifying the information-gathering and liaison work associated with the client’s project.¹⁵⁸

_Determining Business Profits._ The Treaty provides rules to determine the amount of business profits taxable in the Contracting State in which the PE exists. Although the Treaty does not define “business profits,”¹⁵⁹ the term does not include items of income, such as dividends, interest, and royalties, governed by other provisions of the Treaty.¹⁶⁰ The Treaty employs an arm’s-length test: profits to be attributed to a PE are those which “it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.”¹⁶¹

In computing profits, deductions are allowed for executive and administrative expenses of the PE without regard to where the enterprise incurred such expenses.¹⁶² In another concession to the revenue interests of developing countries, however, the Treaty limits the allowable deductions to reimbursement of actual costs for items such as interest on loans made by an office of the enterprise to the PE or royalties paid by the enterprise.¹⁶³ The determination of business profits is also affected by special rules relating to the deemed profits of specified industries,¹⁶⁴ but the mere purchase by a PE of goods for the enterprise will not render profits attributable to the PE.¹⁶⁵

Once again, the Treaty provides U.S. businesses guidance in tax planning for operations in China. Chinese tax law, for example, does not specify whether income from the sales or manufacturing activities of companies with establishments in China is taxable on a Chinese or worldwide source basis.¹⁶⁶

¹⁵⁸. _See supra_ note 147 and accompanying text (discussing the exclusion for preparatory and auxiliary activities under Treaty Article 5(4)).
¹⁵⁹. _SENATE REPORT, supra_ note 3, at 25.
¹⁶⁰. _See Treaty, arts. 7(7), 9, 10, 11._
¹⁶¹. _Id., art. 7(2)._ 
¹⁶². _Id., art. 7(3)._ The limitation does not apply to transfers among related entities for which arm’s length pricing applies. _Treaty, art. 8._
¹⁶³. _Id., art. 7(3)._ This part of the Treaty borrows from the UN Model, _supra_ note 54, art. 7(3). 
¹⁶⁴. _Treaty, art. 7(4) (regarding the allowance for a deemed profit basis to determine taxable income). China applies such an approach to foreign shipping, airline, and oil drilling industries. _SENATE REPORT, supra_ note 3, at 25. For example, in these industries, Chinese tax law evidently deems the profit attributable to Chinese operations to be ten percent of gross income from these activities. _TECHNICAL EXPLANATION, supra_ note 3, at 8. For an illustration of this calculation, see Hammer, Jack & Ho, _The Important New U.S.-China Treaty: Its Impact on U.S. Firms_, _TAX EXEC._ 53, 58 (Oct. 1984). 
¹⁶⁵. _Treaty, arts. 7(5), 5(4)._ 
¹⁶⁶. _Gelatt & Pomp, supra_ note 6, at 465 (concerning the source rules for FEIT).
Treaty allows U.S. business to calculate potential tax liability with less reliance on the vicissitudes of the developing Chinese tax administration.

b. Personal Services

The Treaty limits the right of the Contracting State to tax the performance of personal services in several ways. With regard to independent personal services including independent scientific, literary, artistic, educational or teaching activities, as well as the independent services of lawyers, physicians, engineers, architects, dentists, and accountants,167 the Contracting State of which the individual is a nonresident may tax the individual in only two cases: 1) where the nonresident's presence amounts to more than 183 days per year, and 2) where the nonresident for the purpose of performing his activities has a fixed base available in the country of nonresidence.168

First, for example, an American lawyer present in the PRC for more than 183 days in a calendar year is subject to Chinese tax on income derived in the PRC during that year.169 Second, an American lawyer with a fixed base regularly available in the PRC is taxable in China for independent services performed in China.170 Dependent personal services involve the wages, salaries or other remuneration of employees. From the standpoint of a U.S. resident, this income is subject to Chinese tax under the Treaty only to the extent of the employment performed in China and only upon the failure of at least one of three conditions: 1) the employee is present in the PRC for less than 183 days in the calendar year, 2) the remuneration is paid by or on behalf of a nonresident employer, and 3) the remuneration is not "borne" by a PE of the employer.171

The Treaty thus generally limits Chinese individual income tax liability to those U.S. service-providers who remain in China more than six months per year. Under Chinese tax law, individuals face varying tax liability depending on whether they are residents or nonresidents, the length of the residency, and the source of the income.172 The Treaty effectively extends tax exemption for individual income tax from 90 days173 to 183 days174 for U.S.

167. Treaty, art. 13(2).
168. Id., art. 13(1). This provision is subject, of course, to the saving clause under which the United States reserves the right to tax its citizens. 1984 Protocol, supra note 35, para. 2.
169. Treaty, art. 13(1). Compare US Model, supra note 54, art. 14 (broader exemption for independent personal services which excludes 183 day rule); compare I.R.C. §§ 861(a)(3), 864(b), 871(b) (1982) (nonresident alien taxable at regular rates if personal service income effectively connected with trade or business in United States). Chinese tax law imposes liability in similar circumstances after 90 days. See infra note 173.
170. Treaty, art. 13(1). Fixed base is analogous to a PE, but does not include a hotel room unless it is used as an office or work site on a continuing basis. TECHNICAL EXPLANATION, supra note 3, at 14.
172. IIT, supra note 19, art. 1. For a discussion of these rules, see Gelatt and Pomp, supra note 6, at 427-38.
173. IIT Regulations, supra note 19, art. 5(1).
174. Treaty, art. 13(1); see supra notes 168-169 and accompanying text.
service-providers in China. In addition, the Treaty exempts such persons from income tax on both foreign and China source income, whereas Chinese tax law exempts only compensation paid by an employer outside of China. With its rules on independent and dependent services, the Treaty provides a basis for tax planning in an area of Chinese tax law where ambiguities previously raised several problems of interpretation.

In addition, several categories exist for special personal services, which the Treaty seeks either to discourage through imposition of tax or to encourage through tax exemptions in the source country. Director's fees, for example, are taxable in China for a U.S. resident serving as a director of a company resident in China without regard to the director's total absence from the PRC. On the other hand, to encourage the exchange of ideas and the development of human capital, broad exemptions from tax exist for entertainers and athletes; teachers, lecturers, and researchers; and students and trainees.

2. Income from Certain Assets

Passive income from investment-type assets such as dividends, interest, and royalties represents a key ingredient in U.S.-China economic relations. In general, U.S. domestic law taxes such income to foreign corporations or nonresident aliens at a withholding rate of thirty percent, while Chinese tax law usually provides for a maximum withholding rate of twenty percent.

The Treaty contains a reciprocal concession for the reduction of

175. IIT Regulations, supra note 19, art. 5(1).
176. The ninety-day rule and the "residency" rules under the IIT have raised problems of interpretation. Gelatt & Pomp, supra note 6, at 428. For a discussion of recent attempts at clarification by the Chinese government, see Gelatt, supra note 20.
177. Treaty, art. 15.
178. Treaty, art. 16 (total exemption from tax in the host country as long as the activity is part of a special program of cultural exchange agreed to by both governments).
179. Treaty, art. 19 (three year exemption from host country taxation of remuneration for teaching and research activities). ABA Comments, supra note 15 (stating that exemption is "unduly generous").
180. Treaty, art. 20 (limited exemption from taxation in host country of payments for maintenance and study as well as up to $5,000 equivalent for personal services performed).
181. See supra notes 8-9 concerning U.S.-China trade and direct investment figures. In this relationship, China is the net capital importer and faces the largest revenue loss in sacrificing taxation of dividends, interest, and royalties. See supra note 8 (U.S. direct foreign investment figures for the PRC contrasted with the negligible amount of PRC investment in the United States). U.S. DEP'T OF COMMERCE, 8 SURVEY OF CURRENT BUSINESS 64 (1985). In addition, as of December 31, 1983, Chinese financial obligations to U.S. creditors amounted to $317 million compared to $250 million in U.S. liabilities in the PRC. INT'L MONETARY FUND, INT'L FINANCIAL STATISTICS YEARBOOK 223 (1984).

In addition to these assets, the Treaty also covers income from real property by providing that the income may be taxed in the Contracting State where the property is located. Treaty, art. 6(1). The definition includes income from livestock and equipment used in agriculture and forestry. Treaty, art. 6(2).

182. I.R.C. §§ 861, 871 and 881. See also supra note 102 and accompanying text.
183. FEIT, supra note 21, art. 11 (20 percent nationally); JVIT, supra note 22, art. 4 (10 percent nationally); IIT, supra note 19, art. 3(2) (flat rate of 20 percent).
these withholding rates generally to ten percent for residents of the United States and the PRC.

a. **Dividends and Interest**

The Treaty provides for a maximum allowable ten percent tax on gross dividends and interest paid by a resident company if the recipient is a resident of the other Contracting State and is the beneficial owner. While this tax exceeds the rate on direct dividends under the U.S. Model Treaty (five percent), it falls below the U.S. Model's fifteen percent rate for portfolio dividends. Moreover, the ten percent rate matches that applied to dividends and interest by the other tax treaty partners of the PRC. The reduced withholding rate does not apply if the beneficial owner maintains a PE or fixed base in the dividend source country, and the United States agrees not to apply its "second tier" withholding tax. The branch profits tax imposed by the Tax Reform Act of 1986 does not override the Treaty.

A total exemption from tax by the source country applies to interest derived by the government of the Treaty partner, its Central Bank, and any wholly-owned government financial institution in the Contracting State. The

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184. The Senate Committee expressed concern that the reduction in the withholding rate, especially for "direct dividends", not serve as a precedent for future negotiations. Senate Report, supra note 3, at 11-12; Senate Hearing, supra note 34, at 15. But the reduction in the withholding rates also represents a key revenue sacrifice for developing countries. S. Surrey, United Nations Model Convention for Tax Treaties Between Developed and Developing Countries: A Description and Analysis 29-30 (Harvard Int'l Tax Program — IBFD Monograph No. 5 1980).

185. The Treaty definitions for dividends and interest contain conventional terminology. Treaty, arts. 9(3) (dividends), 10(4) (interest).

186. Treaty, arts. 9, 10. The profits of the enterprise remain taxable under Treaty Article 7. The Treasury recognizes, consistent with the OECD Commentary to its model treaty, that the reduced dividend rate will apply "when the beneficial owner is a resident of the other Contracting State, even when the recipient of the dividend may be a nominee for such resident." Technical Explanation, supra note 3, at 10. OECD Commentary, supra note 55, at 92.

187. A direct dividend functions as a dividend payment from a subsidiary company to its parent. U.S. and OECD Models, supra note 54, art. 10(2)(a) (recipient company holding ten percent of the voting stock of the payor company in the US Model, twenty-five percent of capital in the OECD Model).

188. US Model, supra note 54, art. 10(2)(a).

189. Id., art. 10(2)(b). A portfolio dividend is any dividend other than a direct dividend. See supra note 187.


191. Treaty, art. 9(4). In this case, the applicable provisions for PE business profits (Article 7) and independent personal services (Article 13) apply.

192. I.R.C. § 861(a)(2)(B). Under this section, the United States would, absent the Treaty, tax dividends paid by Chinese companies as U.S.-source income where at least 50 percent of the companies' gross income for the preceding three years was effectively connected with a U.S. trade or business. China does not impose "double taxation" on distributions of a foreign corporation's PE or on repatriation of profits from a Chinese branch of a foreign corporation. Technical Explanation, supra note 3, at 10.

193. Tax Reform Act of 1986, supra note 4, § 1241 (adding I.R.C. § 884(e)(2)).
exemption also applies to debt-claims indirectly financed by any of these entities.194 These Treaty exemptions must be compared with several exemptions from Chinese taxation for interest on certain deposits in or loans to Chinese banks.195

b. Royalties

The technology import requirements of developing countries render especially significant the tax treaty provisions relating to intangible property including patents, copyrights, know-how, trademarks, designs, and processes. Royalties, for tax treaty purposes, also include the rental income of industrial, commercial or scientific equipment [hereinafter ICSE].196 As net exporters of such assets, developed countries typically seek a tax exemption at source for royalties and equipment rentals.197 On the other hand, the developing countries argue in favor of preserving this source of tax revenue.198

The U.S.-China Treaty concedes the developing country argument for source basis taxation of royalties of beneficial owner-residents by a Contracting State.199 For most royalties, the source basis taxation is limited to ten percent of the gross amount.200 A royalty is considered to be sourced in a Contracting State if paid by the government or a resident in that State.201 Similar to the Treaty's treatment of interest202 is the Treaty's treatment of a situation in which the taxpayer operates a PE or has a fixed place of business in the other Contracting State, which incurs the liability for payment of the royalty and bears its payment. In that case the royalty is considered to arise in the State where the PE or fixed base is located.203 In the case of ICSE rental, an effective maximum rate of seven per cent applies to the gross

194. Treaty, art. 10(3).
195. FEIT, supra note 21, art. 11. For a discussion of these Chinese exemptions, see Han, supra note 6, at 708-09.
197. The US Model exempts taxation at source of royalties (as modified for U.S. citizens by the saving clause), and treats equipment rental as a form of business profits. US Model, supra note 54, arts. 12(2) and 7(7). The OECD Model includes ICSE rentals within the definition of royalties and requires the exemption of these royalties from source-basis taxation. OECD Model, supra note 54, arts. 12(1) and 12(2). In a 1985 report, the OECD recommended exclusion of ICSE leasing income from "royalties" in tax treaties which subject royalties to taxation at source. OECD COMMITTEE ON FISCAL AFFAIRS, TRENDS IN INTERNATIONAL TAXATION 14 (1985) [hereinafter OECD 1985 REPORT].
198. See UN Model, supra note 54, art. 12(2) (leaving the rate of taxation to bilateral negotiation).
199. Treaty, art. 11(2).
200. Id.
201. Treaty, art. 11(5).
202. Treaty, art. 10(6); see also supra note 191 and accompanying text.
203. Treaty, art. 11(5).
rental, in recognition of the costs associated with leasing capital equipment.

The Treaty's treatment of royalties will prove most important to taxation of ICSE rental payments and fees for technical know-how. Chinese taxation of royalties paid to foreign parties falls below the Treaty's ten percent withholding rate in many cases. Although a twenty percent flat rate applies generally to royalties, China's tax law provides for ten percent rates in special zones and complete exemption for technology in certain fields. Since the special rates and exemptions apparently do not apply to rental payments, the Treaty provision for ICSE payments assists tax planning in China. The Treaty provision for royalties also raises a tax planning question regarding income from technical assistance. With the incorporation of the new term "technical know-how" into the royalties definition, the Treaty raises the possibility that payments otherwise treated as personal services income may be interpreted as royalties subject to source taxation.

3. Income from Gains and Other Income

The final category of substantive rules of taxation in the Treaty covers gains, including capital gains and ordinary income items, as well as the catch-all "other income".

204. 1984 Protocol, supra note 35, para. 6 (tax imposed on 70 percent of gross amount of ICSE rental royalties).
205. TECHNICAL EXPLANATION, supra note 3, at 12; OECD 1985 REPORT, supra note 197, at 10.
206. FEIT, supra note 21, art. 11.
208. Provisional Regulations of the Ministry of Finance of the People's Republic of China Regarding the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology (Dec. 13, 1982), discussed in Han, supra note 6, at 692 n. 9; Gelatt & Pomp, supra note 6, at 476 n. 268. Article 4 of these regulations exempts taxation of fees for improving, reforming and assisting operation management, training, construction and presentation of technical knowledge, assistance in achieving technical specifications stipulated in contracts, design, technical instructions, technological process design, and quality inspection in data analysis for the transfer of the technology. Han, supra note 6, at 692 n.9.
209. Gelatt & Pomp, supra note 6, at 474-76 (except for special tax treatment for "lease-sale" or "hire-purchase" transactions).
210. Treaty, art. 11(3). The Model Treaties exclude this term from their definitions.
211. For a discussion of the Treaty's treatment of personal services, see Part III.B.1.b. China's other tax treaties contain a similar provision. France-China Treaty, supra note 10, art. 11; Germany-China Treaty, supra note 10, art. 12; UK-China Treaty, supra note 10, arts. 12-13. In the event of questions of treaty interpretation of undefined terms (an analysis known as "qualification"), domestic tax rules are significant as lex fori. Vogel, supra note 28, at 59, 66. In this connection, see FEIT, supra note 21, art. 27 (listing "technical know-how" as a component of "royalties").
Regarding the issue of gains, the PRC and the United States reached a compromise that took into account China's desire for greater source jurisdiction over those gains involving the disposition of corporate shares and the fulfillment of domestic U.S. tax law requirements on the sale of real property under the Foreign Investment in Real Property Tax Act of 1980 [hereinafter FIRPTA]. This compromise makes sense in light of the balance of U.S. enterprises undertaking business in the PRC without the possibility of owning real estate and the strong congressional support for FIRPTA's application despite contrary tax treaty rules. Accordingly, a U.S. resident may be subject to Chinese tax on gains from Chinese sources resulting from the disposition of property. Such property includes: 1) a PE or fixed base in China, 2) business assets of a PE in China, 3) shares representing twenty-five percent or more of a company resident in the PRC, and 4) real property in China. In the absence of a capital gains concept, Chinese law taxes such gains as ordinary income.

From the standpoint of Chinese residents and companies, the Treaty preserves the potential operation of the FIRPTA rules whereby a nonresident alien or foreign corporation is liable for tax on gains from the sale of U.S. real property (including interests in U.S. corporations holding real property) by deeming the gain as effectively connected with a U.S. trade or business. Experts point out an apparent Treaty exception freeing from FIRPTA tax liability the gain from a disposition outside the United States of an interest in a partnership or trust consisting principally of "U.S. real property interests". However, the "official" interpretations of the Treaty hold that Article 12(6) brings this situation under FIRPTA coverage.

"Other income" for Treaty purposes is comprised of "prizes or winnings" and income items not covered by other Treaty articles. This

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212. See infra note 215 and accompanying text.
216. FEIT Regulations, supra note 21, art. 20; JVIT Regulations, supra note 22, art. 15. For Chinese taxation of business profits, see supra notes 161-165 and accompanying text.
217. I.R.C. § 897; Treaty, art. 12(6).
218. ABA Comments, supra note 15; see also I.R.C. § 897(c) ("U.S. real property interests"), § 897(g) (special rule for sales of partnership and trust interests).
219. SENATE REPORT, supra note 3, at 32; TECHNICAL EXPLANATION, supra note 3, at §§ 1435-14.
220. These are the examples provided in the TECHNICAL EXPLANATION, supra note 3, at §§ 1435-18.
221. Treaty, art. 21. In addition to the provisions discussed in this Article, the Treaty includes articles for pensions and government pensions. Treaty, arts. 27, 28.
catch-all provision affirmatively assigns the right to tax such income (including income from third party countries)\textsuperscript{222} to the country of residence in most cases.\textsuperscript{223} However, the Treaty also incorporates a UN Model-inspired rule that allows for source country taxing jurisdiction notwithstanding the general rule, with the result that the double taxation rules of Article 22 apply.\textsuperscript{224} Therefore, a U.S. resident with "other income" sourced in China is subject to Chinese tax on that item with whatever applicable relief the Treaty may provide.

C. Relief from Double Taxation

Application of the Treaty's substantive taxation rules determines whether and to what extent a transaction is taxable by a country. In exceptional cases, double taxation is prevented by a rule with complete legal consequences,\textsuperscript{225} such as business profits in the absence of a PE,\textsuperscript{226} independent personal services in the absence of a fixed base,\textsuperscript{227} and the income of entertainers, teachers, and trainees.\textsuperscript{228} In most cases, however, double taxation arises from the open legal consequences\textsuperscript{229} left by applicable provisions of the Treaty which permit both Contracting States to tax. For example, the income of a PE of a U.S. business in China is taxable by China to the extent that the income is attributable to the PE\textsuperscript{230} and is taxable by the United States as an item of worldwide income.\textsuperscript{231} The rules of double taxation relief address this latter situation.\textsuperscript{232}

1. Foreign Tax Credit (FTC)

Separate tax credit rules operate for the residents of China and those of the United States. With regard to the United States, foreign tax credits for income tax paid to China by or on behalf of a U.S. resident or citizen are

\textsuperscript{222} Treaty, art. 21 ("wherever arising").
\textsuperscript{223} Id. An exception where a PE or fixed base exists and the rules for business profits and independent personal services apply. Treaty, arts. 21(2), 7, 13.
\textsuperscript{224} Treaty, art. 21(3). UN Model, supra note 54, art. 21(3). This provision does not exist in the OECD or U.S. Models and the position of developing countries is that its exclusion is inconsistent with a general policy of source jurisdiction. Surrey, supra note 184, at 48. Experts question the limited protection accorded by this rule. ABA Comments, supra note 15.
\textsuperscript{225} Vogel, supra note 28, at 27 (citing typical treaty language: "shall be taxed only in . . . .").
\textsuperscript{226} Treaty, art. 7(1).
\textsuperscript{227} Treaty, art. 13(1). Also note the time limitation. Id.
\textsuperscript{228} Treaty, arts. 16, 19, 20.
\textsuperscript{229} Vogel, supra note 28, at 27 (citing the typical treaty language: "may be taxed in . . . .").
\textsuperscript{230} Treaty, art. 7(1).
\textsuperscript{231} I.R.C. § 61.
\textsuperscript{232} Treaty, art. 22. The United States provides a unilateral foreign tax credit subject to an overall limitation. I.R.C. §§ 902-904. Many observers have noted the inadequacy of unilateral approaches. Senate Report, supra note 3, at 38; Vogel, supra note 28, at 9-10. The PRC JVIT explicitly provides that treaty provisions shall govern its application with regard to credits, incorporating by reference the foreign tax credit provisions in Treaty Article 22. JVIT, supra note 22, art. 16.
available under Article 22.233 This Treaty provision affirms previous rulings on creditability.234 In addition, a U.S. company owning at least ten percent of the voting stock in a company resident in China from which the U.S. company receives dividends is allowed an FTC for the Chinese income tax paid on the profits from which the dividends are distributed.235 For China’s part, the Treaty provides the benefit of an FTC only for residents of China and only for the U.S. tax payable on U.S. source income under the Treaty.236 Similar to the U.S. provision, the Treaty allows a Chinese tax credit for the U.S. taxes payable on U.S. company profits out of which a resident Chinese company owning ten percent of the U.S. company receives dividends.237

A controversy arose as to whether the Treaty applies to a U.S. “resourcing” rule that prevents U.S. persons from converting U.S. source income into foreign source income in order to inflate the FTC limitation. The Tax Reform Act of 1984 amended the credit limitation rules to disallow U.S. persons from treating as foreign source income interest, dividends, and other items received through a foreign corporation where over ten percent of the foreign corporation’s earning and profits arose in the United States.238 One provision of the Treaty, however, deems the source of income of a resident of one country which may be taxed in the other country to arise in that other country,239 thus potentially preventing operation of the limitation rule. In response to widespread concern that the Treaty overrides domestic tax law,240 the Senate Committee registered its “understanding” that the United States can apply the requisite source rules to enable the operation of its FTC limitation.241

233. Treaty, art. 22(2)(a). For the taxes covered, see supra notes 135-138. As the credit is allowed “in accordance with the provisions of [U.S.] law,” the credit limitations apply. I.R.C. § 904.
235. Treaty, art. 22(2)(b).
236. Treaty, art. 22(1)(a). A limitation holds the amount of the credit to not more than the amount of Chinese tax payable. Id. Chinese tax law allows for credits against the JVIT, but application to the FEIT is not clear. JVIT Regulations, supra note 22, art. 32; Han, supra note 6, at 711 (concerning FEIT).
237. Treaty, art. 22(1)(b).
239. Treaty, art. 22(3).
240. Ways & Means Letter, supra note 42; Senate Finance Letter, supra note 42; Senate Hearing, supra note 34, at 24-5. But the Chinese evidently believed that this matter should be resolved through further negotiation. Letter, dated October 29, 1985, from James P. Fuller to Steven Lainoff, International Tax Counsel, U.S. Treasury Department, reprinted in 85 TAX NOTES INT’L 40-8 (1985) (citing concerns of Lin Rong Sheng, Deputy Director of China’s General Taxation Bureau).
241. This interpretation is achieved by reading the § 904(g) limit as part of the application of the credit “in accordance with the laws of the United States.” Treaty, art. 22(2). SENATE REPORT, supra note 3, at 10. This is the only “understanding” or “reservation” registered by the Senate Committee. Id.
2. Tax Sparing Credit (TSC)

Of the existing tax treaties with the PRC, the U.S.-China Treaty stands out as the only agreement to exclude any form of Tax Sparing Credit [hereinafter TSC].242 The TSC operates in the case of a "less developed country" [hereinafter LDC] tax holiday or investment incentive program with the effect that the developed country allows the taxpayer a credit for the full amount of LDC tax that would have been imposed on the LDC source income in the absence of such holidays or programs.243

The United States has followed a firm policy against TSCs since the early 1960s.244 Nevertheless, the U.S.-China Treaty contains an unprecedented agreement to incorporate a TSC in the Treaty should the United States amend its laws to provide for a TSC or agree to a TSC in a treaty with another country.245 While this step may cause difficulties in future U.S. treaty negotiations with other developing countries,246 it was undoubtedly the compromise required to bring the Treaty to a conclusion.

D. Other Treaty Provisions

Miscellaneous provisions in the Treaty cover items of special concern. The nondiscrimination clause generally prevents taxation of residents in one country in less favorable or more burdensome ways than similarly situated nationals of the other country.247 In addition, other provisions apply to the mutual agreement procedure (relating to dispute resolution and consultations),248 exchange of information,249 diplomatic and consular privileges,250

242. UK-China Treaty, supra note 10, arts. 7, 10, 11, 12; France-China Treaty, supra note 10, arts. 9, 10, 11; Germany-China Treaty, supra note 10, arts. 10, 11, 12; Belgium-China Treaty, supra note 10, arts. 9, 10, 12; Japan-China Treaty, supra note 10, arts. 7, 10, 11, 12.


244. Id. at 99. Criticism included: the undesirability of providing an exemption for foreign investment while earnings in the United States remained taxable; the resulting encouragement of competition among cash-poor LDCs to reduce revenues; the incentive for rapid repatriation of income rather than reinvestment; and the windfalls created for earnings on existing investment. Patrick, U.S. Tax Treaties with Developing Countries, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 312 (R. Hellawell ed. 1980).


246. But see U.S.-Sri Lanka Treaty, supra note 62 (in this treaty which was concluded with a developing country after the China treaty, the United States did not even promise to discuss a future tax sparing credit).

247. Treaty, art. 23(1). In this connection, the Senate Committee indicated the possibility that the U.S. Congress may override this Treaty article (see supra note 214) to take into account proposed tax reform measures on branch-level taxation. The Tax Reform Act of 1986, however, provides that the branch-level tax does not override treaties. See supra note 193.

IV
CONCLUSION

The U.S.-China Treaty represents a significant development in several areas. The Treaty is an important addition to China’s growing network of international agreements and testifies to China’s conformity to conventional taxation approaches. Also, the United States, with its acceptance of the Treaty, indicated its willingness to subtly change its international tax policy to address the concerns of a developing country. In addition, the Treaty assists tax planners in assessing U.S. business activities in China.

First, the Treaty testifies to China’s willingness to work within the framework of international taxation developed by western countries. Since the 1970s, the People’s Republic of China has accepted limitations on its sovereignty in international agreements and adopted the central international law principle of *pacta sunt servanda*. In the field of taxation, China has entered into treaties with six major western nations since 1983 and has agreed to abide by the terms of the agreements for at least five years. Moreover, internal Chinese tax law provides for self-executing treaty arrangements so that taxpayers may seek recourse in Chinese courts. This acceptance of the conventional double tax treaty regime is compatible with China’s modernization plans and facilitates the burgeoning U.S.-China economic relationship. Nevertheless, China’s absence from the formulation and negotiations of the model treaty regime and its lack of clear precedents under domestic law suggest that interpretative problems under the Treaty may lead to renegotiations between the two governments.

249. *Id.*, art. 25.
250. *Id.*, art. 26.
251. *Id.*, art. 27.
252. *Id.*, art. 28.
253. See Schreyer, *supra* note 6, at 259; Gelatt & Pomp, *supra* note 6, at 503; *see also supra* notes 54-55 and accompanying text.
255. See *supra* note 10.
256. See, e.g., Treaty, art. 28; *see also supra* note 252 and accompanying text.
259. *Supra* note 55 and accompanying text.
260. See, e.g., *supra* notes 106, 166.
261. For example, one Chinese official has already expressed dismay over the resourcing rule issue under the foreign tax credit limitation. Letter, *supra* note 240.
Second, the U.S.-China Treaty represents a liberalization of some aspects of U.S. international tax policy toward the Third World. The provisions of the Treaty indicate U.S. concessions to "less developed country" concerns, including broader source rules for taxation of permanent establishments,\textsuperscript{262} limited deductions on computing the business profits of permanent establishments,\textsuperscript{263} broad tax exemptions for entertainers, athletes, teachers, lecturers, researchers, students and trainees,\textsuperscript{264} reduced maximum withholding rates on dividends and interest,\textsuperscript{265} and enhanced source basis taxation of royalties and other income.\textsuperscript{266} In addition, the United States agreed to accord China most favored nation status regarding tax sparing credits.\textsuperscript{267} Treaties signed subsequent to the U.S.-China Treaty indicate, however, that these concessions may have resulted more from China's political and economic importance to the United States than from a fundamental shift in U.S. policy.\textsuperscript{268}

The tax planning concerns under the Treaty result from new rules and certain vague formulations. First, close attention is required regarding the third country dual residence of corporations which stand to lose Treaty benefits.\textsuperscript{269} Second, in the absence of careful planning, persons or corporations with activities in China that face dual residence questions may have to wait for long consultations by the competent authorities.\textsuperscript{270} Third, U.S. businesses would benefit by structuring work to avoid the shortened tax exempt source period of the PE rules relating to building sites, construction, assembly, and oil drilling rigs,\textsuperscript{271} and service providers should take care not to inadvertently subject themselves to taxation on personal services in concert with others in their firms.\textsuperscript{272} Fourth, the inclusion of technical know-how in the royalties definition provides an alternative taxing mechanism for what might otherwise be characterized as personal services.\textsuperscript{273} Fifth, as with every treaty to which the United States is a party, a tax reform statute passed by Congress after the date of the Treaty (e.g., concerning the sourcing rules under the foreign tax credit or the applicability of the branch level tax) controls over the Treaty terms if such purpose on the part of Congress has been clearly expressed.\textsuperscript{274}

Finally, and perhaps most importantly, the Treaty provides the tax planner added certainty in dealing with the rapidly developing Chinese tax law.

\textsuperscript{262} See supra note 149 and accompanying text.
\textsuperscript{263} See supra note 163 and accompanying text.
\textsuperscript{264} Supra notes 178-180.
\textsuperscript{265} See supra notes 186-189 and accompanying text.
\textsuperscript{266} See supra notes 199, 224 and accompanying text.
\textsuperscript{267} See supra notes 242-246 and accompanying text; Schreyer, supra note 6, at 263.
\textsuperscript{268} See U.S.-Sri Lanka Treaty, supra note 62, discussed supra note 246.
\textsuperscript{269} See supra notes 79-80 and accompanying text.
\textsuperscript{270} See supra notes 71-72, 78-79 and accompanying text.
\textsuperscript{271} See supra notes 148-149 and accompanying text.
\textsuperscript{272} See supra note 148 and accompanying text.
\textsuperscript{273} See supra notes 210-211 and accompanying text.
\textsuperscript{274} Whitney v. Robertson, 124 U.S. 190, 8 S.Ct. 456, 31 L.Ed. 386 (1888); Cook v. United States, 288 U.S. 102, 120, 53 S.Ct. 305, 311, 77 L.Ed. 641 (1933).
Where ambiguities exist in China’s law, the Treaty contains helpful definitions and rules. The Treaty is far from a panacea for investor concerns, and China may need to consider further steps to encourage foreign investment. Nevertheless, the new U.S.-China Treaty cannot help but promote mutually beneficial economic relations between the United States and China.

275. See supra notes 156-158 (definition of “establishment” under FEIT); 166 (source basis for taxing sales and manufacturing activities of companies with establishments in China); 173-176 (tax liability of nonresidents in China for limited time); 209 (taxation of ICSE rental payments).
276. See supra note 17.
277. See supra note 18.