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Wei Cui
Allard School of Law at the University of British Columbia, cui@allard.ubc.ca

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Tax Classification of Foreign Entities in China: The Current State of Play

Wei Cui*
*Associate professor, China University of Political Science and Law, Beijing, China. The author can be contacted at weicuibj@gmail.com.

This article considers recent changes to the classification of foreign entities under Chinese tax law, the implications for China's treaty partners in this regard and the general legal framework within which future changes may occur.

1. Introduction

From an international income tax perspective it is a crucial decision, for a number of reasons, whether to make the tax treatment of foreign entities depend on their organizational characteristics. The application of tax treaties in situations involving partnerships, trusts and other non-corporate entities has been a focus of the OECD[1] and has lead to the need for practitioners to ascertain whether or not the tax laws of other countries treat such entities differently from corporate entities. However, even when the application of tax treaties is not at issue, foreign entity classification may be relevant. For instance, whether or not a country treats a foreign partnership, as opposed to the partners of such a partnership, as the beneficial owner of a particular item of income is relevant to the tax treatment of such income. Similarly, whether or not foreign partnerships are recognized as such can affect the determination of the character, timing and source of income derived in outbound transactions, which, in turn, will impact the application of foreign tax credit (FTC) and controlled foreign company (CFC) rules.

As in many other countries, especially those that have only recently entered into the arena of cross-border investment and introduced domestic income tax systems, China has faltered in confronting the question of the tax classification of foreign entities. By and large, China's tax law does not distinguish between foreign entities, such as publicly traded corporations, which are universally recognized as possessing independent taxpayer status, and entities, such as partnerships and trusts, which are not only often deemed to be "fiscally transparent" in the jurisdiction in which they are formed, but are also increasingly recognized as such by other jurisdictions for the purposes of international taxation. Until recently, Chinese domestic law generally treated foreign entities as having independent taxpayer status regardless of their organizational form. To date, China has not entered into any tax treaties that require China to "look through" a partnership or similar entity to determine the identity and residence of the ultimate investor and apply tax treaty benefits to such an investor.[2] This disinclination to give tax significance to differences in organizational form amongst foreign entities is by no means unusual amongst non-OECD Member countries. However, the consequences of this are becoming more and more notable, given China's status as one of the world's most important investment destinations and as, increasingly, one of the leading exporters of capital.

Because of China's importance in global investment flows, any potential changes in its tax classification of foreign entities is of interest to the international tax community. This article describes some such

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1. OECD, "Report on the Application of the OECD Model Tax Convention to Partnerships" (adopted by the Committee on Fiscal Affairs on 20 January 1999).
2. However, the United States interprets the China-United States tax treaty in such a way that "a U.S. partnership, estate or trust is a resident only to the extent that the income it derives is subject to tax either in the hands of the entity or of its partners or beneficiaries" (Para. 1 of the Commentary on Art. 4 of the US Treasury Department Technical Explanation regarding the China-United States tax treaty).

recent changes, their implications for China's treaty partners, as well as the general legal framework within which future changes may take place. The objective is to provide guidance in an area of Chinese law that often defeats expectations. As will be demonstrated, under Chinese tax law, the classification of domestic and foreign entities may be proceeding along separate tracks, the treatment of foreign entities may differ for inbound and outbound transactions, and, in important ways, certain rules that purport to treat partnerships, etc. as flow-through entities, do not, in fact, do so. Esoteric legal rules, as opposed to common-sense logic, dominate in this area, which not only makes it obscure to "outsiders", but also generates disagreement amongst Chinese tax practitioners. Nonetheless, understanding these rules is becoming increasingly important in structuring cross-border transactions involving Chinese parties.

Section 2. first offers an analysis of the statutory basis for classifying foreign entities under the Enterprise Income Tax Law (EIT Law).[3] This analysis demonstrates that the classification of domestic entities is a legally distinct issue from the classification of foreign entities, and that the decision to recognize foreign transparent entities may be made separately with regard to inbound and outbound transactions. Section 3. briefly surveys developments in domestic entity classification in the last three years. As China's current domestic partnership tax rules do not, in crucial ways, implement flow-through taxation according to international standards and because of the ambiguous tax treatment of other entities that would be natural candidates for flow-through taxation, there is no model for entity classification that could easily be generalized to apply to foreign entities. It is against this background that section 4. describes recent developments in the tax treatment of foreign flow-through entities involved in outbound transactions. In this regard, a close textual analysis of a recent FTC circular implies that Chinese investors in foreign partnerships, trusts, etc. are required to include in their income, on a current basis, amounts received by such entities. This is a wise decision from a domestic tax policy perspective and has substantial implications for Chinese businesses in regard to claiming tax treaty benefits in other countries. Section 5. discusses some of these implications and attempts to draw general conclusions in regard to Chinese tax policy in this area.

2. Statutory Basis for Foreign Entity Classification

The classification of taxable entities is at the very foundation of the EIT Law. Art. 1 of the EIT Law, which defines the range of taxpayers falling within its scope, states that enterprises and other organizations deriving income are taxpayers for purposes of the enterprise income tax. Art. 1(2) states that individual sole proprietor and partnership enterprises are excluded from the scope of the EIT Law. Art. 2 of the Enterprise Income Tax Law Implementation Regulations ("the EIT Law IR")[4] elaborates further by stating that the scope of this exclusion is limited to individual sole proprietor and partnership enterprises organized under Chinese statutes or administrative regulations.[5]

This raises two questions: (1) are there other Chinese legal entities that are excluded from the scope of the EIT Law; and (2) are all foreign entities, regardless of their organizational form, potentially taxpayers under the EIT Law? This article further considers the first question in section 3. In order to answer the second question, it must first be noted that Art. 2 of the EIT Law purports to divide "enterprises" into the following two categories: (1) residents; and (2) non-residents. A resident enterprise is one formed in China pursuant to (Chinese) law or an enterprise formed under the laws of

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3. Enterprise Income Tax Law (National People's Congress, 16 March 2007, effective from 1 January 2008).
4. Enterprise Income Tax Law Implementation Regulations (State Council, 6 December 2007, effective from 1 January 2008).
5. "Individual sole proprietorships" (*geren duzi qiye*), therefore, are a form of business defined and governed by the Law on Individual Proprietorship Enterprises (National People's Congress, 30 August 1999, effective from 1 January 2000). Partnerships, on the other hand, may be formed under several different statutes, of which the Partnership Enterprise Law (National People's Congress, 23 February 1997, effective, as amended, from 27 August 2006) is only one.

another country, but the effective management of which is located in China. A non-resident enterprise is one formed under the laws of another country, the effective management of which is located outside China, but that either has an establishment in China or has Chinese-source income. Notably, this dual categorization omits "enterprises" without effective management or establishment in China or Chinese-source income. In other words, some foreign enterprises may not be resident or non-resident. Art. 2 cannot, therefore, be read as providing a definition of the term "enterprise". Instead, read together with Art. 1 of the EIT Law, it implies that foreign entities without an establishment in China or Chinese-source income would not be taxpayers under the EIT Law.

This result is, in itself, appropriate and unremarkable.[6] However, it impacts the classification of foreign entities. For foreign entities (foreign "enterprises and other organizations")[7] that have either a Chinese establishment or Chinese-source income, Art. 1 of the EIT Law appears to imply that they are, without an exception, taxpayers for purposes of the EIT Law, as they do not fall under the exclusion for domestic law entities. Read this way, Art. 1 does not distinguish between these foreign entities according to their organizational form and precludes the possibility of some such foreign entities being treated as transparent or disregarded for purposes of the EIT Law. There is, therefore, a fundamental asymmetry between the classification of domestic entities and foreign entities that engage in inbound investment into China.

This interpretation accords with current administrative practice. For inbound transactions, foreign partnerships, trusts, etc. investing in China are all treated similarly to foreign corporations and are thus viewed as the parties deriving the income for purposes of both domestic and treaty tax law. As a result, foreign investors investing in China indirectly through such entities cannot claim the benefits of the tax treaties between China and the countries where such investors reside. None of the over 90 tax treaties that China has entered into mitigate this problem for foreign investors. If a UK investor, for example, invests in China through a Cayman partnership, the Cayman partnership would be treated as a non-resident enterprise deriving income from China and, as a result, there would be no Chinese domestic law or specific tax treaty law basis for the UK investor to be recognized as the party deriving income or to claim treaty benefits. When a Chinese investor invests through a Cayman partnership in the United Kingdom, the United Kingdom, on the other hand, recognizes the Chinese partner as the ultimate investor and allows it to claim benefits under the China-United Kingdom tax treaty.

For foreign investors in China, one of the following circumstances may change this state of affairs:

- China's treaty obligations may override the EIT Law provisions.[8] Accordingly, specific treaty provisions may be negotiated that require China to look to the owners of certain foreign entities, for example, partnerships, to determine the applicability of tax treaties.[9]
- Alternatively, China may observe the principle, set out in the Commentary on Art. 1 of the OECD Model Tax Convention ("the OECD Model"), that provides that:

> the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.[10]

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6. However, the SAT issued a widely discussed circular at the end of 2009, which subjects foreign entities with no Chinese establishment or income to the EIT Law. See Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds from Equity Transfers by Non-resident Enterprises (*Guoshuihan* [2009] 698) (SAT, 10 December 2009, retroactively effective from 1 January 2008).
7. The term "organization" is not defined in the EIT Law or in any other Chinese laws.
8. Art. 58 EIT Law.
9. There are, of course, many ways in which this can be accomplished. See, for example, Art. 1(6) of the US Model Income Tax Convention (2006).
10. Para. 6.3 of the Commentary on Art. 1 of the OECD Model.

In other words, as a matter of treaty principle, regardless of the specific treaty language, where the other contracting state views certain entities as fiscally transparent and requires its resident owners to include Chinese-source income received by such entities, China may also recognize such residents of the other contracting state as deriving income from China and, therefore, apply the relevant tax treaty to avoid double taxation.[11] However, as China is not an OECD Member country and has not signed any tax treaties that contain language reflecting this approach, it is unrealistic to expect China to adopt this general treaty interpretation.

- As a matter of domestic law interpretation, the Chinese tax authorities could conceivably provide that, with regard to certain foreign entities, payments received by such entities constitute Chinese income "derived by" the owners of such entities. The choice of such entities could be based on China's domestic entity classification system, if and when such a system is developed,[12] or on the laws of the countries where the entities are formed or where the owners of the foreign entities are resident.
- The EIT Law could be amended to recognize different types of foreign entities for inbound transactions.

Clearly, all these possibilities involve substantial changes to the law.

There is a second asymmetry in the classification of foreign entities under the EIT Law. Foreign entities that are not resident or non-resident enterprises fall outside the scope of Art. 1 of the EIT Law. Consequently, their classification is, in contrast to the classification of "non-resident enterprises", open for debate. As such entities are not taxpayers under the EIT Law, their classification is relevant principally in regard to the foreign income of resident enterprises and, in particular, to the operation of both FTC and CFC rules.[13] For instance, if a foreign entity owned by Chinese enterprises is classified as a transparent entity, thereby resulting in the current inclusion by the Chinese owners of income received by the entity, the CFC rules should no longer apply, as there would be no problem of deferral. Significantly, the EIT Law and even the EIT Law IR are entirely neutral regarding the introduction of such a classification into the CFC and FTC rules, with no legislative history to guide interpretation.

Accordingly, under the EIT Law, the classification of foreign entities could follow quite different routes for inbound and outbound transactions.[14] Whether or not this structural asymmetry is intentional, it explains why, despite an impasse in recognizing foreign transparent entities for inbound transactions, China could, as is discussed in 4., allow for the partial recognition of such entities for outbound transactions under recent FTC rules.

3. Tax Classification of Domestic Entities: An Unreliable Model

Since 2007, key legal and commercial developments in China, including the coming into effect of the amended Partnership Enterprise Law (which makes the partnership form available to entity investors, as

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11. This is also the approach taken by the US Treasury Regulations under Sec. 894 of the Internal Revenue Code. See the Treasury Preamble to Temporary Regulations under Sec. 894 (Guidance Regarding Claims for Certain Income Tax Convention Benefits), T.D. 8722 (1997).
12. This would be similar to the approach for determining "beneficial owners" of US-source FDAP income (other than for applying reduced treaty withholding rates) under US federal income tax law (Sec. 1.1441-1(c)(6) of the US Treasury Regulations).
13. The basic rules in these two areas are set out in Arts. 23, 24 and 45 of the EIT Law and Arts. 77-81 and 116-118 of the EIT Law IR.
14. If "entity classification" is used in the narrow sense to mean that an entity's inherent characteristics are sufficient to determine whether or not it is treated as an independent taxpayer (or at least an independent entity), then admittedly China does not currently have such a system of classification for foreign entities. In this article, however, the phrase "entity classification" is used more broadly to mean that the tax treatment of an entity depends on its organizational characteristics.

well as foreign investors), the resulting significant increase in the number of newly created partnerships and keen commercial interest in developing the partnership form for use by private equity investors, have led many to expect that detailed and practical partnership taxation rules will be adopted.[15] This, in turn, has encouraged some practitioners to look for possible new treatments of foreign partnerships. In reality, there has been less progress than anticipated. It was clear in 2007 that partnership income would be taxed in the hands of the partners and the partnership itself would not be subject to income tax, which is, after all, what the statutes say.[16] Since then, the government has provided little more to substantiate the idea that partnerships would be taxed on a flow-through basis.

Specifically, in guidance issued in regard to domestic partnerships at the end of 2008,[17] the Ministry of Finance (MOF) and State Administration of Taxation (SAT) essentially reiterated prior partnership tax rules that had been designed for domestic individual taxpayers.[18] In many ways, these rules do not treat partnerships as transparent. For instance, expenses and losses of a partnership are not allocated to the partners but, rather, offset partnership income directly and, if unused, are carried forward for up to five years. This is similar to loss carryover rules for Chinese corporate entities.[19] The character of partnership income also does not generally flow through to the partners and is, in fact, specifically altered in regard to partners that are natural persons. For instance, capital gains on a transfer of property are generally taxed at a 20% flat rate for transferors that are natural persons. However, if a partnership derives such capital gains income and then allocates it to partners that are natural persons, the partners must treat this as trade or business income subject to a progressive rate schedule with a marginal rate of 35%.[20] The same can be said of royalties and certain other passive income.[21] In other words, although partnerships are not independent taxpayers and partners must include and report partnership income on a current basis, the taxation of partnership income does not preserve the character of the income. It has been reported that, in an attempt to attract investment funds, local governments have modified (whether or not with authorization) the MOF and SAT partnership tax rules to deliver more favourable results to fund investors.[22] These local variations are outside the scope of this article. Their pertinence to the topic of foreign entity classification is limited, in any event, as much of the local experimentation is intended to deliver specific tax results in narrow contexts (such as ensuring that dividends and capital gains from private equity investments are taxed at low rates for individual partners), rather than being aimed at developing a general approach to partnership taxation and answering questions such as whether

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15. For discussions of these developments, see, for example, N. Marsh, J. Kadet, C. B. Ye and G. Wang, "Partnerships in China: The New Frontier," *Asian Pacific Tax Bulletin* 4 (2008), p. 296; W. Cui, "Will Partnership Law Be Worth It?", *International Financial Law Review* (September 2008), pp 30-32; and A. Tsoi, A. Zhu and K. Poon, "New Chinese Foreign Partnership Rules Create Tax Uncertainties", *World Tax Daily* (4 December 2009), pp. 231-235.

16. Art. 1 EIT Law and Art. 6 Partnership Enterprise Law.

17. *Caishui* [2008] 159 (SAT and MOF, 23 December 2008, retroactively effective from 1 January 2008) [Notice regarding the Income Taxation of Partners in Partnerships].

18. These previous rules primarily consisted of *Caishui* [2000] 91 (MOF and SAT, 19 September 2000) [Rules on the Application of the Personal Income Tax to Investors in Individual Sole Proprietorships and Partnerships] and *Guoshuihan* [2001] 84 (SAT, 17 January 2001) [Notice regarding Implementing the Rules on the Application of the Personal Income Tax to Investors in Individual Sole Proprietorships and Partnerships]. For an analysis of these rules, see W. Cui, "The Prospect of New Partnership Taxation in China," 46 *Tax Notes International* (2007), p. 625.

19. Art. 5 *Caishui* [2008] 159, supra note 18 and Art. 14 *Caishui* [2000] 91, supra note 19.

20. See, Cui, supra note 18, pp. 627-629.

21. The character of interest and dividends received by a partnership may be preserved when allocated to partners that are natural persons. This was the rule under *Guoshuihan* [2001] 84, supra note 19 and, although that circular was not explicitly renewed by the MOF and SAT, some local tax bureaus have acknowledged its continued validity. See, for example, *Shendishuifa* [2009] 18 (Shenzhen Local Tax Bureau, 12 January 2009) [Forwarding MOF and SAT "Notice regarding the Income Taxation of Partners in Partnerships"].

22. See, for example, Six Tianjin Municipal Departments, "Measures to Promote the Development of Equity Fund in Tianjin", available at www.pe-fund.com/cipef_en/Policies.asp.

partnerships should be viewed for tax purposes more as aggregates of their partners or as entities. As a result, very different understandings of the meaning of "flow-through" taxation exist.

The absence of a generally applicable framework also characterizes current discussions regarding trust taxation, which has also been the subject of substantial commercial interest recently.[23] Trust companies, which act as trustees for most trusts, are typically formed and taxed as corporations in China. Due to the legal characteristics of trusts themselves (with trustors and/or settlors, trustees and beneficiaries) it is unclear whether trusts are entities or merely contractual arrangements.[24] Guidance issued by the MOF and SAT in 2006 on the taxation of loan securitization trusts skirted this issue,[25] stating that income from trust assets is either taxed in the hands of the trustee if not immediately distributed to the beneficiaries, or, if immediately distributed, taxed in the hands of the beneficiaries. This, for some practitioners, should be regarded as "flow-through" taxation, even though trust beneficiaries do not have to include income derived by a trust on a current basis, the character of trust income is not necessarily preserved when taxed in the hands of beneficiaries, and, therefore, the result could equally be characterized as an arrangement based on dividend paid deductions.[26] In any event, the consistency of the 2006 guidance with the EIT Law, which entered into force in 2008, and, consequently, its validity, remains to be examined, and no further guidance for trusts holding other assets has been forthcoming.

In order to complete the survey of the taxation of non-corporate entities, it should be noted that, before 2008, certain Sino-foreign contractual joint ventures[27] were recognized by law as not being subject to the EIT and, therefore, their income was taxable only at the level of the joint venture partners.[28] However, the legal basis for this partnership-like treatment disappeared once the EIT Law came into effect on 1 January 2008. Strictly speaking, there is no longer any valid legal guidance regarding the tax treatment of many such Sino-foreign contractual joint ventures currently in operation. Some have gone so far as to suggest that such enterprises are no longer exempt from entity-level taxation.[29] However, because other central government ministries have issued announcements in favour of the operation of such joint ventures, market participants appear to assume that it is not the government's intention to adopt radically new and unfavourable tax rules for them.

In summary, even though the taxation of domestic non-corporate entities has become an increasingly urgent topic for Chinese tax policy, the guidance available is both incomplete and difficult to generalize. At most, domestic businesses may be classified as: (1) independent taxpayers, for example, companies and other enterprises subject to the EIT Law; (2) entities that are independent, only the owners of which are subject to tax, for example, individual sole proprietorships and partnerships; or (3) neither

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23. See, for example, KPMG and Reuters, "China's Trust Sector: The Next Chapter" (2010), and Standard Chartered, "China - A Lack of Trust" (14 July 2010).

24. Y. Liu, "An Analysis of SPV Tax Policy for Asset Securitization in China" (in Chinese), *Taxation Research* 6 (April 2007), p. 263.

25. Caishui [2006] 5 (MOF and SAT, 20 February 2006) [Notice Regarding Tax Policy Issues concerning Securitization of Credit Assets]. For a summary, see L. Sussman, L. Jun, and H. Min, "P.R.C. Introduces Tax Framework for Securitization Transactions Involving Trusts," *World Tax Daily* (6 March 2006), 43-1.

26. However, if income is distributed to beneficiaries after it has been subject to tax in the hands of the trustee, the beneficiaries (all of which are corporate taxpayers in the circumstances addressed by the guidance) are treated as receiving "after-tax distributions," which, under the pre-EIT Law regime, were eligible for exemption. This differs from both a partnership tax regime and an entity-level tax with dividend paid deductions.

27. That is, those lacking legal personality. See Art. 50-4 of the Detailed Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (State Council, 30 June 1991, effective from 1 July 1991).

28. Art. 6 of the Detailed Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, which states that non-legal person cooperative joint ventures may be exempt from entity level taxation). There is no similar provision under the EIT Law or EIT Law IR.

29. K. Wang, "Foreign Investors in RMB Funds May Face Double Taxation", 49 *Tax Notes International* (3 March 2008), p. 742.

independent taxpayers nor independent entities, for example, a corporate branch.[30] In terms of this classification, it is not clear whether certain Sino-foreign contractual joint ventures fall under categories (1) or (2) and whether trusts fall under categories (2) or (3). In addition, even for category (2), due to the non-preservation of the character of the income, the prohibition on the allocation of losses to the owners of the entities, as well as numerous other details, flow-through taxation is not complete. Flow-through taxation is available only for businesses in category (3), i.e. branches that are not treated as separate from the entities of which they form a part.

4. Foreign Flow-through Entities and Outbound Transactions

Section 2. of this article suggested that substantial changes to Chinese law may be required before foreign partnerships and other non-corporate entities can be subject to a different, i.e. "look through", treatment from corporate entities for inbound transactions. Section 3. demonstrated that the tax classification of domestic entities and the present treatment of domestic partnerships and trusts do not offer straightforward models for foreign entity classification. Against this background, it is remarkable that China has recently begun to draw distinctions between types of foreign entities in the context of outbound transactions. China taxes its resident enterprises on their worldwide income and allows them to claim FTCs.[31] In guidance issued in December 2009 by the MOF and SAT on FTC issues ("Circular 125"),[32] the tax authorities confirmed, as could be expected, that Chinese enterprises must include the income of foreign branches on a current basis. Circular 125, however, also expands the scope of the current inclusion requirement to foreign entities or persons other than branches, i.e. partnerships and trusts, although the way it does this is less than straightforward.

The sections in Circular 125 most relevant to the issue of entity classification read as follows:

> Sec. 3(1)
> In the case of a foreign branch establishment that a resident enterprise has formed and invested in and that does not have independent taxpayer status, of the foreign source income that it derives, the taxable income shall be the net amount after the deduction of various reasonable expenses related to foreign income from total foreign income ... The various items of foreign income derived by a foreign branch establishment that is formed by a resident enterprise and that does not have independent taxpayer status should be included as Foreign Taxable Income in the applicable taxable year of the enterprise, regardless of whether such income is remitted to China.
>
> Sec. 13
> For purposes of this Notice, not possessing an "independent taxpayer status" means either not possessing independent legal personality according to the law of the jurisdiction in which the [branch establishment] is formed by an enterprise or not being recognized as a tax resident of a treaty partner under the provisions of a tax treaty. (Author's unofficial translation)

The implications of these apparently cryptic paragraphs are explained in the following comments. First, Sec. 3(1) sets out an explicit requirement for Chinese enterprises to include on a current basis certain types of foreign income, regardless of whether or not the income is remitted. Although this statement is made in a section that is generally concerned with the application of the FTC limitation,[33] the current

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30. Branches (*yingyejigou*) do not separately pay EIT (Art. 50 of the EIT Law).
31. Arts. 3, 23 and 24 EIT Law.
32. SAT, "Notice on Foreign Tax Credit Issues for Enterprise Income Tax" (Caishui [2009] 125, 25 December 2009).
33. The lead paragraph of the section in question refers to the EIT Law IR and states that "An enterprise shall apply the following provisions to determine … the amount of its Foreign Taxable Income, as that term is used in Article 78 of the Implementing Regulations" (author's unofficial translation) (Art. 78 of the EIT Law IR contains the basic formula for China's per country FTC limitation regime).

inclusion requirement should be understood as applying in other contexts. In other words, even if a taxpayer is not claiming an FTC or the FTC limitation does not apply,[34] it would still be necessary to include, on a current basis, income of a "foreign branch establishment". This follows directly from the idea that a taxpayer cannot take into account an item of income in the FTC limitation computation if the income is not treated as having accrued to the taxpayer in the first place.[35] In addition, although the concept of a "foreign branch establishment" should, as discussed in the next paragraph, be understood as a defined term and not equivalent to the common notion of a foreign branch, it is implicit in the EIT Law that at least the income and losses of a foreign branch should, on a current basis, be reflected in a Chinese enterprise's computation of its EIT liability.[36]

Second, "branch establishment" ("*fenzhi jigou*") is not defined in Circular 125 and it is not immediately clear whether or not the term would encompass entities, such as partnerships and trusts. Indeed, no other provision of Circular 125 refers to partnerships and similar entities.[37] However, the phrase "branch establishment" is used throughout Circular 125, together with the phrase "without independent taxpayer status". Therefore, "branch establishment without independent taxpayer status" should be understood as a single term. Further, the elaboration of the meaning of "independent taxpayer status" (in Sec. 13 of Circular 125) implies that "branch establishment" can, indeed, refer to organizations or to what would be characterized as "persons" under tax treaties. Only in regard to "persons" does the question of “residency” under tax treaties arise and partnerships, trusts, etc. are clearly persons.[38] Accordingly, a partnership or trust would be regarded as a "branch establishment without independent taxpayer status" if it satisfies the test for not having "independent taxpayer status".

Third, when applying the criterion for being "without independent taxpayer status", it must be noted that the term "independent legal personality" (*duli faren diwei*) is used in China to denote the feature of having complete limited liability (i.e. limited liability in regard to all owners) Consequently, a Chinese statutory partnership, similar to statutory or even common law partnerships in the United States, could have various powers of a legal person (such as entering into contracts, suing and being sued, and independent ownership of property),[39] but still not be regarded as possessing independent legal personality under Chinese law. When this conception is applied to foreign entities, entities that would be recognized as legal persons under the legal doctrines of the jurisdictions where they were formed, for example, a Delaware limited partnership (Delaware LP), may still be regarded as not possessing "independent legal personality". Under this interpretation, whether the entity has complete limited liability, not whether it has independent "legal personality," must be interpreted under the law of the jurisdiction where it was established pursuant to Sec. 13 of Circular 125. Whilst this is the most obvious interpretation of that section and would limit the number of disputes regarding the application of foreign law, further clarification would certainly be beneficial.

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34. Sec. 10 of Circular 125, for example, provides for simplified approaches to claiming FTCs without requiring taxpayers to apply the FTC limitation formula of Art. 78 of the EIT Law IR.
35. Earlier drafts of the FTC regulation that was finally issued in the form of Circular 125 contained language requiring the current inclusion of income of "foreign branch entities" as a general matter, and not only in the context of an FTC limitation computation. The rather terse Circular 125 omits this part of the draft rules.
36. See, for example, Art. 17 of the EIT Law, which prohibits Chinese taxpayers from offsetting the losses of a foreign operating branch against domestic profit.
37. In the most recently issued *Gonggao* [2010] 1 (SAT, 2 July 2010) [Operating Guides for Enterprises concerning Foreign Income Tax Credits], "foreign branch establishments without independent taxpayer status" is said to "especially include company branches, representative offices, administrative offices, liaison offices, and business establishments and sites from which services are provided and which are deemed to give rise to enterprise income tax liabilities by the countries (regions) where the service is performed" (author's unofficial translation). This list is presumably not exhaustive. In some of the earlier drafts of the FTC regulation, the term "branch establishment" was explained as also including contractual projects.
38. Commentary on Art. 1 of the OECD Model.
39. A. Bromberg and L. Ribstein, *Bromberg and Ribstein on Partnership,* (Aspen Publishers, looseleaf), § 1.03 Partnership as a Legal Entity.

Fourth, the disjunctive criterion for being "without independent taxpayer status", either not having "independent legal personality" or not qualifying as a treaty resident, is at once innovative and potentially problematic. As treaty residency is determined generally under the law of the country of the person claiming treaty benefits,[40] the second prong of the disjunctive test essentially leaves the question of whether or not a branch establishment is "without independent taxpayer status" to the tax law of the relevant treaty partner country (if any). For instance, a Delaware limited liability company (Delaware LLC) that elects to be treated as a partnership for US federal income tax purposes would be treated as "without independent taxpayer status". Whilst this is arguably the right result,[41] it is not clear that this is the result intended by Circular 125. Further, there are other cases, for example, a Delaware LP that has elected to be taxed as a corporation for US federal income tax purposes, in respect of which the disjunctive criterion cannot easily be applied.[42]

Finally, as Circular 125 applies the "independent taxpayer status" test only in the context of determining when a Chinese enterprise should, on a current basis, include income received by a foreign "branch establishment", it does not have classification implications for all foreign entities. Not only does it not create a new rule for inbound transactions, even for outbound transactions, it does not address all relevant foreign entities. For instance, the classification of a foreign partnership that is only indirectly owned by a Chinese enterprise, for example, through a foreign corporation, would still not be clear. How to treat such entities in the context of indirect FTC rules is still open for debate.[43]

Overall, Circular 125 sets out, in a circumscribed fashion, the position that foreign partnerships, trusts and similar entities may be treated differently from other foreign entities, in that their Chinese enterprise owners have to include, on a current basis, income received by the relevant entity regardless of an actual distribution. The government has good reasons for adopting this position. For instance, the current income inclusion requirement pre-empts deferral of income on the part of Chinese taxpayers by parking income in offshore partnerships, trusts, etc, and it does so, automatically, without resorting to the various tests in the CFC rules.[44] In addition, the requirement may result in more coherent FTC rules. Specifically, it would prevent taxpayers from claiming creditable foreign taxes that are disproportionate to their foreign income. "Looking through" foreign partnerships, etc. would also generally allow for a more consistent and accurate determination of the source and character of foreign income. For instance, if the Chinese partner of a non-Chinese partnership is subject to tax on partnership income derived from a foreign country, whether or not the tax is creditable depends on whether, in calculating the foreign tax, any applicable treaty provision has been correctly taken into account.[45] This determination requires considering the character of the income received, for example, whether or not it is interest, royalties, a

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40. Commentary on Art. 1 of the OECD Model.

41. As the Delaware LLC is not treated in the United States (the jurisdiction of the entity's formation) as a separate taxpayer, and the LLC's owners would be treated under US law as the relevant taxpayers in regard to income received by the LLC, the owners should be subject to the current inclusion requirement so that income and FTCs arise in the same period.

42. The Delaware LP lacks "independent legal personality", as the general partner bears unlimited liability, but could qualify as a treaty resident. It possesses independent taxpayer status under US tax law and under China's general FTC rules taxes paid by such an entity would not be treated as paid by the Chinese enterprise owner (Art. 77 EIT Law) and would be creditable only through the indirect FTC mechanisms. As a result, the current inclusion of the income of the Delaware LP may not be matched by FTCs.

43. As indirect FTCs are generally claimed only when distributions are made to the home country taxpayer, the distinction between transparent and non-transparent entities may be less important for indirectly owned entities because there would be no mismatch between distribution and inclusion in income.

44. The Chinese CFC rules require a resident enterprise to include the income of a foreign enterprise, on a current basis, only if the foreign enterprise is established in a low-tax jurisdiction, is controlled by Chinese residents and fails to distribute all of its profits for reasons other than reasonable operational needs (Art. 45 of the EIT Law).

45. Sec. 4(2) Circular 125.

capital gain, etc. Similarly, in applying the per country approach to the FTC limitation, it is necessary to determine the source of the foreign income. "Looking through" foreign partnerships, etc. is more likely to produce the right results in making such a determination.

Circular 125 is not completely clear as to whether or not the "flow through" approach should apply to a "foreign branch establishment without independent taxpayer status". The circular requires taxpayers to apply the rules of "the Enterprise Income Tax Law and its Implementation Regulations, tax treaties, and of this Notice" in computing foreign income, foreign creditable taxes and FTC limitations.[46] However, as current income inclusion may be required of both partners (with regard to partnership income) and corporations with branches (with regard to branch income), it is not clear whether it is more appropriate for a foreign partnership to apply accounting principles for partnerships or accounting principles for branches. As noted in 3., the current Chinese partnership taxation rules fail to preserve the character of the income. The imposition of this defective partnership tax regime on foreign partnerships in computing the foreign income of a Chinese enterprise would decidedly be unhelpful. The better approach would be to apply the same accounting treatment, i.e. branch tax accounting, which does not contain character-distorting provisions, to all "foreign branch establishments without independent taxpayer status."

5. Implications for Other Countries and General Conclusions

The differentiation in Circular 125 between certain foreign non-corporate entities (under the heading of "foreign branch establishments without independent taxpayer status") and foreign corporate entities not only has significant consequences for the operation of China's domestic tax law, but also affects the application of tax treaties by other countries. Some of the countries where Chinese enterprises invest, for example, Japan, appear to allow benefits to be claimed under its tax treaties with China when offshore partnerships are interposed between the Chinese investors and the source of income and in the absence of specific treaty provisions that require them to do so. This treatment is often granted on the basis of the domestic classification of foreign partnerships, for example, provisions that treat partnerships as lacking legal personality and/or as transparent for tax purposes. Some other countries do not view all partnerships as transparent, but follow the approach recommended in the Commentary on Art. 1 of the OECD Model and, as source countries:

> take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.[47]

Finally, the United States takes the view that, for example, if a Chinese enterprise invests in the United States via a Cayman partnership, for the Chinese investor to access the benefits of the China-United States tax treaty, it is not sufficient that US tax law treats the Cayman partnership as transparent and the Chinese partner as the beneficial owner of the income received by the partnership. Instead, *Chinese* tax law must treat the Cayman partnership as fiscally transparent.[48]

Circular 125 significantly enhances the ability of Chinese enterprises to claim the benefits of income tax treaties with the latter two types of countries, which look to Chinese tax law to determine whether treaty provisions could apply to income received through a partnership or similar entity. Before Circular 125, Chinese law did not require Chinese residents to include in income, on a current basis, amounts received by foreign partnerships in which they own interests. Circular 125 introduces this requirement. Even

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46. Sec. 2 Circular 125.
47. Para. 6.3 of the Commentary on Art. 1 of the OECD Model and Australian Tax Office Commentary on the Convention between Australia and New Zealand for the Avoidance of Double Taxation (2009) (commentary on Art. 1(2), "fiscally transparent persons").
48. Sec. 1.894-1(d) US Treasury Regulations.

though there may be additional specific technical requirements imposed by some countries that must be satisfied before treaty benefits can be granted,[49] there is now a presumption for these countries that, as China does tax such foreign income of its residents, the treaty mechanisms for preventing double taxation should be triggered.

Readers hardly need to be reminded, however, that, as discussed in 2., China itself (like many other non-OECD countries) does not take this view regarding its treaty obligations. China's hesitation to recognize, under its domestic law, differences between types of foreign entities for inbound transactions is presumably justified on the following grounds. First, classifying foreign entities requires the analysis of foreign laws, which can be a difficult exercise. Second, it is administratively complex to verify claims by the nominal recipients of income that they are not the "real" recipients of the relevant income, especially as such claims are more likely to be made when disclosing the "real" recipient brings tax benefits. Third, if foreign partnerships and partnership-like entities are to be recognized, special tax rules may have to be designed for them. However, proper tax rules for partnership-like entities may be intrinsically complex. This level of complexity is unsuited to the current state of development of China's income tax laws, and should be postponed to the indefinite future.

These rationales are understandable. The question is perhaps the extent to which, and how soon, China should start considering the ability of Chinese enterprises to claim the benefits of Chinese tax treaties in their overseas investments, especially in relation to countries that take seriously the avoidance of double taxation through tax treaties. As such investments grow, so might China's awareness of the need to reconsider its tax treaty policies, in the spirit of reciprocity.

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49. For instance, the requirement under US federal income tax law is for the laws of the resident country of the treaty benefit claimant to treat the foreign partnership or other non-corporate entity as "fiscally transparent" with regard to the relevant item of income, in the sense that such laws "require the interest holder in the entity … to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity" (Sec. 1.894-1(d)(3)(ii) US Treasury Regulations).