Vanderbilt Journal of Transnational Law

Volume 8
Issue 1 *Fall 1974*

Article 6

1974

Recent Developments

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RECENT DEVELOPMENTS

INTERNATIONAL TRADE TAXATION—UNITED STATES TAXATION OF TRADE WITH CHINA: PROBLEMS AND ALTERNATIVES

I. INTRODUCTION

The debacle of the Nationalist regime in China and the subsequent United States trade embargo[1] on the People's Republic of China (China)[2] from 1949 to 1970, resulted in the deletion or obsolescence of United States federal income tax incentives previously applicable to Sino-American trade.[3] The benefits of these tax provisions[4] were transferred, with the Nationalist government, to the Taiwan-based Republic of China (Taiwan).[5] Moreover, foreign trade tax measures enacted during the economic stalemate were largely inapplicable to China,[6] but enhanced existing trade with Taiwan and Hong Kong.[7] Initial United States responses[8] to the

1. The total embargo began in July 1950, following China's entrance into the Korean War, and continued until July 1969, when the Foreign Assets Control Regulations were amended to allow tourists to enter the United States with a limited amount of Chinese goods. For a detailed study of the embargo period see Lee & McCobb, Jr., *United States Trade Embargo On China,* 1949-1970: *Legal Status and Future Prospects,* 4 N.Y.U. J. INT'L L. & POL. 1 (1971) [hereinafter cited as Lee & McCobb].

2. For convenience, the term "China" will be used in referring to the People's Republic of China.

3. The China Trade Act, ch. 346, 42 Stat. 849 (1922), *as amended,* INT. REV. CODE of 1954, §§ 941-43, §§ 901-05 (foreign tax credit). Under the current statute, China Trade Act Corporations do not qualify for the foreign tax credit. Thus, the two provisions are mutually exclusive.

4. The specific benefits of these provisions are discussed in section II.B. *infra.*

5. The United States extended full diplomatic recognition to the Nationalists on Taiwan as the only legitimate government of China, and maintained this policy until 1971, when China was formally recognized by the United States. Taiwan, however, did not officially come within the terms of the China Trade Act until the Internal Revenue Code of 1954 was enacted, although Taiwan had been treated as "China" for United States tax purposes since the Nationalist regime was established there in 1949.

6. INT. REV. CODE of 1954, §§ 991-97 (Domestic International Sales Corporations); INT. REV. CODE of 1954, §§ 951-72 (Controlled Foreign Corporations).

7. Since only four China Trade Act corporations are considered active at the present time, most American companies trading with Taiwan apparently have

current *detente* with China portend increasingly significant bilateral trade relations.[9] Attractive tax provisions presently available to American investors trading with the established Asian market,[10] however, may curtail the vast potential of China trade unless the United States provides tax measures consistent with its policy of diplomatic conciliation and expanding economic intercourse.[11] The divergent economic systems of the two nations, particularly with respect to the generation of internal revenue, complicate the selection of an appropriate format for a tax relief program.[12]

II. HISTORICAL BACKGROUND

A. *United States-China Trade Relations*

Sino-American commerce has never constituted a substantial portion of United States international trade volume.[13] Conversely, American trade historically has been a significant factor in China's foreign trade. United States business grew to dominate the Chinese import-export market in the mid-1930's, a period of relative political stability in China.[14] Japanese occupation of China's coastal provinces prior to World War II interrupted the momentum

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found it easier to use more conventional tax statutes, rather than incorporate under the China Trade Act.

8. *See, e.g.,* Wall Street J., June 11, 1973, at 13, col. 2.

9. *See* Wall Street J., Mar. 16, 1973, at 17, col. 3; May 31, 1973, at 14, col. 4.

10. With the exception of the China Trade Act, Code sections relating to international trade, such as the foreign tax credit and the DISC provisions, are equally applicable to trade with Japan, South Korea, Singapore, Thailand, Phillipines, India, and others.

11. Despite the lack of tax incentives, Sino-American trade has grown much faster than expected. The prospect of United States firms tapping China's offshore petroleum reserves has grown extremely attractive during the current energy crisis. Remarks of Dr. Victor Hoa Li, *Conference Summary: Problems and Prospects of Trade with Eastern Europe and China,* 4 GA. J. INT'L & COMP. L. 20 (1974).

12. Differences in the underlying assumptions of the respective tax laws may result in an unbearable overall tax burden for individuals and corporations trading between the two nations. *See* note 79, and section III.B.2. *infra.*

13. Lee & McCobb, *supra* note 1, at 2.

14. In 1935 and 1936, approximately 19% of China's total imports came from the United States, and 25% of her exports went to the United States. The Japanese seizure of China's coastal provinces later relegated American trade to secondary status until after World War II. *Id.*

of trade with China, but in the post-war years the United States quickly resumed its leading position, greatly increasing its percentage of the total China market.[15]

Anticipating establishment of communist China on the mainland, Congress passed the Export Control Act of 1949,[16] which abruptly began the official embargo of Sino-United States trade. The severity of the economic restrictions increased with China's involvement in the Korean War,[17] as Congress passed a series of measures threatening withdrawal of American aid to countries trading with the Sino-Soviet bloc.[18] The United States sponsored a United Nations resolution recommending an embargo on shipments of strategic items to China and North Korea.[19] The definition of "China" in the China Trade Act of 1922, a tax provision encouraging trade with China, was amended to delete all Chinese-controlled areas and to include only Taiwan and Hong Kong.[20]

The effectiveness of the United States embargo disintergrated as Chinese trade with noncommunist countries burgeoned during the 1960's. In 1965, two-thirds of an eighteen per cent increase in China's foreign trade[21] was attributable to intercourse with Japan, West Germany, Britain, France, and Italy.[22] Other nonsocialist states such as Canada and Australia successfully explored Chinese

15. After World War II, American exports to China were triple the pre-war volume, and exports also increased to a significant degree, although total trade volume declined gradually as the political situation deteriorated through 1948. *Id.*

16. 63 Stat. 7 (1949), *as amended,* 50 U.S.C. App. §§ 2021-32 (Supp. 1964).

17. Lee & McCobb, *supra* note 1, at 4.

18. Supplemental Appropriations Act of Sept. 27, 1950, ch. 12, § 1303, 64 Stat. 1066 (Cannon Amendment). The Act amended a Marshall Plan fund request putting pressure on United States aid recipients to join the embargo by threatening a cutoff of funds for trading with the Soviet bloc or China. Supplemental Appropriations Act of June 2, 1951, ch. 12, § 1302(a), 65 Stat. 63 (Kem Amendment). The Act provided for a cutoff of American aid to countries exporting arms or armaments to the Soviet bloc or China. Mutual Defense Assistance Control Act of 1951, 22 U.S.C. §§ 1611-13d (1971). The United States halted aid to countries exporting specified "strategic materials" to the Soviet bloc or China.

19. G.A. Res. 500, 5 U.N. GAOR Supp. 20A, at 2, U.N. Doc. A/1775 (1951).

20. INT. REV. CODE OF 1954, § 941.

21. Reghizzi, *Legal Aspects of Trade with China: The Italian Experience,* 9 HARV. J. INT'L L. 88 (1968).

22. China's decision not to let ideology interfere with business was aptly demonstrated by the breadth of her contacts for industrial imports. *Id.*

trade opportunities in the 1960's.[23] China's cordial accomodation of Western nations and the success of United States neighbors in dealing with China contributed to the erosion of the American embargo policy. The first official alteration in the United States position was the relaxation of the Foreign Assets Control Regulations in 1969, which permitted a limited amount of noncommercial Chinese goods to enter the United States.[24] Subsequent developments, including President Nixon's visit to China, have evidenced a continuing American interest in promoting trade with China.[25]

B. *United States Tax Provisions Relating to China*

1. *The China Trade Act.*—The China Trade Act of 1922[26] was intended to stimulate American business activity in China by allowing a tax credit for certain specialized corporations created by federal statute.[27] The original act required that a China Trade Act Corporation[28] be incorporated in the District of Columbia by the Department of Commerce, but contemplated that it would do business principally in China.[29] The credit was determined by dividing the par value of shares held by United States or Chinese citizens residing in China by the total par value of the outstanding shares, multiplied by the corporation's annual net income from sources within China.[30] The amount of the credit was, however, limited by the amount of the "special dividend," *i.e.* that portion of the net income distributed to qualified shareholders residing in

23. Albinski, *Foreign Policy Considerations Affecting Trade with the People's Republic of China: Canadian and Australian Experience*, 5 LAW & POLICY IN INT'L BUS. 805 (1973).

24. Lee & McCobb, *supra* note 1, at 10.

25. *See* notes 8, 9 *supra*.

26. The China Trade Act of 1922, ch. 346, 42 Stat. 849 (1922).

27. In the early part of the twentieth century, China's foreign trade was dominated by British, German and Japanese investors, partly because of favorable corporate tax structures in their home countries. The China Trade Act grew out of United States congressional hearings in 1920 investigating the economic barriers to American businessmen in China. Duffy, *Tax Aspects of Trade with the Republic of China and the People's Republic of China*, N.Y.U. 30TH INST. ON FED. TAX 1509-10 (1972).

28. The China Trade Act of 1922, ch. 346, 42 Stat. 849, § 2(c) (1922).

29. Duffy, *supra* note 27, at 1510.

30. The China Trade Act of 1922, ch. 346, 42 Stat. 855, § 264(a) (1922).

China.[31] A 1925 amendment broadened the original restrictions by deleting the residence requirement as to Umited States and Chinese citizens, and eliminating the citizenship requirement for all residents of China.[32] In 1936, the act was amended to include substantially the same operative provisions found in the current Code.[33] The credit was replaced by a "special deduction" in an amount equal to the proportion of taxable income derived from sources within China which the par value of the shares owned by qualified shareholders bears to the total number of shares outstanding.[34] The deduction, like the original credit, is limited by the amount of the special dividend, *i.e.* the total dividends distributed to qualified shareholders. Under section 943, dividends distributed to qualified shareholders residing in Formosa or Hong Kong may be excluded from the gross income of such persons.[35] Issuance of a certificate of incorporation for a China Trade Act Corporation is a matter of broad administrative discretion; the incorporator must satisfy the Secretary of Commerce that the corporation is organized to do business within Formosa or Hong Kong and that it will assist in developing a market for United States exports in those areas.[36] Although approximately 50 corporations are chartered by the Department of Commerce, only four China Trade Act Corpora-

31. The China Trade Act of 1922, ch. 346, 42 Stat. 855, § 264(b) (1922). Under the current Code, § 941(b), the special dividend is the amount, certified by the Secretary of Commerce, distributed to beneficial shareholders resident in Formosa (Taiwan), Hong Kong or the United States.

32. The Revenue Act of 1925, ch. 345, § 263(6), 43 Stat. 997.

33. The Revenue Act of 1936, ch. 829, § 108, 49 Stat. 1019-20.

34. INT. REV. CODE of 1954, § 941(a). In its present form, the China Trade Act provides for two classes of special shareholders: "(1) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (2) individual citizens of the United States wherever resident . . . ." The special dividend is computed as of the last day of the taxable year on the basis of the par value of the corporation's stock as follows:

$$\frac{\$\text{ Amount held by special shareholders}}{\$\text{ Amount of total shares outstanding}} \text{ X Taxable Income} = \text{Amount of Special Dividend}$$

35. B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 375 (1968). China Trade Act Corporation shareholders may thus receive all dividends tax-free if they can establish residence in either Formosa or Hong Kong. The relatively insignificant number of persons affected probably explains the continued existence of § 943.

36. *Id.*

tions are considered currently active.[37]

2. *Foreign Tax Credit.*—Before 1918, income taxes paid to foreign entities by United States taxpayers were generally allowable as deductions against gross income.[38] The Act of 1918[39] sought to minimize the burden of double taxation by introducing a credit for income and profits taxes paid to foreign countries and United States possessions.[40] A series of amendments modified the direct foreign tax credit until 1934, when it was codified in essentially the form found in section 901 of the present Code.[41] In 1942, the credit provision was expanded to provide an indirect credit for proportionate foreign taxes of a second-tier foreign subsidiary.[42] At the

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37. 6 CCH 1974 STAND. FED. TAX REP. ¶ 4377; Duffy, *supra* note 27 at 1512.

38. J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 33.01 (1969).

39. Revenue Act of 1918, ch. 18, § 222, 40 Stat. 1073-74 (1919).

40. The direct advantage of a credit rather than a deduction may be simply illustrated:

Deduction	
Net foreign income before taxes	-$200,000
Less foreign income tax	-$(50,000)
Total	-$150,000
Less U.S. income tax (48%)	-$(72,000)
Net income after taxes	$ 78,000
Credit	
Net foreign income before taxes	-$200,000
U.S. income tax (48%)	-$ 96,000
Foreign tax paid	-$ 50,000
Total taxes paid	-$146,000
Less foreign tax credit	-$(50,000)
Total tax liability	-$ 96,000
Net income after taxes	-$104,000

Before 1921 the extent of the credit was unlimited. Today, foreign tax in excess of the United States rates is lost under the per-country limitation or applied against credit shortages from other countries under the overall limitation. *See* notes 45, 46 *infra*.

41. "Section 901 authorizes the taxpayer who pays foreign income, war profits, or excess profits taxes to a foreign country to take a direct credit against his federal income tax for those taxes paid. . . . (U)nder section 904, there are strict limitation on the amount of credit allowed, but, within the scope of those limitation provisions, the taxpayer is allowed to reduce his federal income tax, dollar for dollar." R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS, § 5.01/3/(1971).

42. Kaplan, *The Limitless Limits of the Foreign Tax Credit*, 45 WASH. L. REV. 347 (1970).

same time, the definition of foreign income tax was broadened to include taxes levied "in lieu of" income taxes,[43] and an option revocable at any time prior to expiration of the statute of limitations, to take either a credit or deduction, was added.[44] Subsequent modifications included a provision for carry-back and carry-forward of excess credit to mitigate the effect of the per-country limitation,[45] an alternative overall limitation,[46] and the "gross-up" method for calculating the credit with respect to dividends from foreign corporations.[47] Later, the benefits of the credit were enhanced for certain Lesser Developed Country Corporations[48] by eliminating the gross-up requirement,[49] and the credit was extended to include dividends from third-tier foreign subsidiaries.[50] The foreign tax credit, however, is not available to China Trade Act Corporations.[51]

3. *Domestic International Sales Corporations.*—The Domestic International Sales Corporation (DISC)[52] provision was designed to remedy the chronic United States trade deficit of recent years. Conceptually, the shareholders of a qualified DISC, rather than the corporation itself, are subject to federal income taxes.[53] The

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43. *Id.*

44. MERTENS, *supra* note 38, § 33.08.

45. INT. REV. CODE of 1954, § 904(d). Corporations operating under the per-country limitation may carry back excess credit for two tax years and, if still not exhausted, may carry it forward up to five years.

46. INT. REV. CODE of 1954, § 904(a)(2). The overall limitation is elective and may be revoked by the taxpayer. Election following an earlier revocation is very difficult, however, and may be done only with the consent of the Commissioner under section 904(b).

47. INT. REV. CODE of 1954, §§ 78, 902. The "gross-up" concept is an attempt to eliminate the disparity of the tax burden borne by a domestic corporation operating through foreign branches as compared to a domestic corporation operating through a foreign subsidiary. The "gross-up" rules do not apply to dividends from Lesser Developed Country Corporations. In practice, however, the "gross-up" requirement is not particularly onerous to corporations with foreign subsidiaries in industrialized countries, because the high effective tax rates in those countries negate the impact of the gross-up rule. RHOADES, *supra* note 42, at § 5.06/7/.

48. INT. REV. CODE of 1954, § 955(c).

49. INT. REV. CODE of 1954, § 902(a)(2).

50. INT. REV. CODE of 1954, § 902(b)(2).

51. INT. REV. CODE of 1954, § 942.

52. INT. REV. CODE of 1954, §§ 991-97.

53. RHOADES, *supra* note 41, at § 4.41.

shareholders are taxed on two types of dividend income from the DISC: actual and deemed distributions. There are several categories of deemed or constructive distributions: 50 per cent of the DISC's annual taxable income is deemed distributed to the shareholders; 100 per cent of all interest income, proceeds of producer's loans and gain on disposition of certain kinds of property are deemed distributions as well.[54] The amount of the deemed distribution for any taxable year may not exceed the current earnings and profits of the DISC.[55] Actual distributions are not taxed to the DISC shareholders until all available deemed distributions have been recognized.[56] Actual distributions are thereafter subject to normal tax rates for corporate distributions. The highly technical requirments for DISC status reflect the narrow purpose of the provision: 95 per cent of gross receipts must be from "qualified export receipts" or 95 per cent of all assets must be "qualified export assets."[57] China Trade Act Corporations are not eligible for DISC status.[58]

4. *Tax Treaties.*—As of December 31, 1973, the United States had ratified 30 tax treaties with foreign states.[59] The existence of a tax treaty generally suspends operation of conflicting Internal Revenue Code sections with respect to transactions between the signa-

54. *Id.*

55. *Id.*

56. INT. REV. CODE of 1954, § 995(b)(1); RHOADES, *supra* note 41 § 4.41.

57. Under section 993(a)(1), "qualified export receipts" are defined as follows: "(A) gross receipts from the sale, exchange, or other disposition of export property, (B) gross receipts from the lease or rental of export property, which is used by the lessee of such property outside the United States, (C) gross receipts for services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation, (D) gross receipts from the sale, exchange, or other disposition of qualified export assets (other than export property), (E) dividends . . . with respect to stock of a related foreign export corporation . . . (F) interest on any obligation which is a qualified export asset, (G) gross receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States, and (H) gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC." "Qualified export assets" of a corporation are defined in section 993(b).

58. INT. REV. CODE of 1954, § 992(d)(6).

59. PRENTICE-HALL, FEDERAL TAX TREATIES AND RELATED MATTERS, ¶ 120,001. Treaties are presently in force with: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Honduras, India, Ireland, Israel,

tory nations.[60] The basic objective of the tax treaty, like the foreign tax credit, is to eliminate double taxation through a system of reciprocal agreements, and thereby facilitate bilateral trade between the contracting states. A secondary purpose is to discourage fiscal evasion by providing for the exchange of information and reciprocal collection procedures.[61] The treaty format has been popular for a number of reasons: (1) existing differences among countries as to the scope of the income tax; (2) problems involving the status of business consultants, teachers, students on stipends, entertainers and other unique occupations; (3) divergent treatment of fees and royalties; (4) differing allowances for overhead deductions in computing taxable income of foreign branches of United States enterprises; (5) United States business operations to which the foreign tax credit does not apply; (6) operations in countries that generate unused foreign tax credit due to tax rates higher than United States rates; and (7) discrimination in the treatment of taxpayers who are nationals of a particular country.[62] Traditionally, United States tax treaties have not produced great benefits for American investors.[63] In recent years, however, the United States, seeking favorable results for investors at home as well as abroad, has utilized the treaty mechanism to implement its political and economic policies. The goals of rapid industrialization for Lesser Developed Countries and stimulation of capital in-flows to key countries have evinced a variety of treaty provisions. In drafting tax treaties with India, Israel, and the United Arab Republic, the "tax sparing credit" was considered but later abandoned.[64]

Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Philippines, Sweden, Switzerland, Thailand, Trinidad and Tobago, Union of Soviet Socialist Republics, United Arab Republic, United Kingdom. A treaty with the Socialist Republic of Romania was signed on December 4, 1973, and submitted to the Senate for ratification on March 28, 1974.

60. INT. REV. CODE of 1954, §§ 894, 7852(d).

61. PRENTICE-HALL, *supra* note 60 § 1001.

62. Statement by Stanley S. Surrey, Assistant Secretary of the Treasury, before the Subcommittee on Tax Conventions of the Senate Committee on Foreign Relations, August 11, 1965. *Id.* ¶ 84,132.

63. Most tax treaties of the United States are with developed countries and define the broad categories of business income, investment income and personal service income. J. CHOMMIE, FEDERAL INCOME TAXATION, § 224 (1968).

64. *See* note 62, *supra*.

Recent treaties have employed more selective devices such as the investment credit and deferral of tax imposed on gain resulting from the sale of know-how for shares of stock.[65]

5. *Other Code Provisions.*—Certain other Internal Revenue Code sections[66] are tangentially relevant to prospective trade with China but do not present any unique questions in their application. The most significant of these provisions is the 1962 Tax Reform Act (Subpart"F") regarding tax treatment of income and distributions from Controlled Foreign Corporations.[67] The statute is aimed at restricting the deferral of income to United States shareholders of domestic corporations engaged in multicountry operations, primarily in developed nations.[68]

III. PROBLEMS OF SINO-AMERICAN TRADE

A. *Current United States Trade Policy*

The trend toward normalization of diplomatic relations with China has stimulated both governmental and private economic intiatives.[69] Trade volume with China has increased dramatically since President Nixon's visit to China in 1972, with United States exports exceeding imports by a ratio of ten to one.[70] Projections for total 1974 trade volume exceed one billion dollars,[71] yet experts indicate these figures are tempered by a cautious restraint on the part of PRC businessmen.[72] China's involvement in the world community though the United Nations and its increased interest in world trade portend a steady increase in Sino-American commerce.

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65. CHOMMIE, *supra* note 63.

66. INT. REV. CODE of 1954, §§ 906, 911, 482, 367.

67. INT. REV. CODE of 1954, §§ 951-72.

68. It is interesting to note that under § 31 of the 1962 Act, § 7852 (d) does not apply to the Controlled Foreign Corporation statute. *See* note 60, *supra*; CHOMMIE, *supra* note 64, § 223.

69. Albinski, *supra* note 23, at 737; *Conference Summary, supra* note 11, at 3, 25.

70. N.Y. Times, Apr. 3, 1974 § 1, at 3, col. 3.

71. *Id.* Senator Mansfield has introduced a bill which would give most-favored nation status to the PRC.

72. *See generally Conference Summary, supra* note 11, at 30.

B. *Chinese Economic Structure*

1. *China's Trade Policy*.—China's advent to power produced awesome economic transformations in China. The centralized government effectively eliminated private ownership of business and all vestiges of foreign economic control and interest.[73] All Chinese foreign trade is conducted through the government Ministry of Foreign Trade.[74] At least three subordinate governmental units are involved in international commerce: government trade delegations; government foreign trade corporations; and the government "social organization," roughly equivalent to a chamber of commerce.[75] Since 1960, China has realigned its trading patterns toward the noncommunist world in an effort to intensify industrialization by importation rather than primarily through domestic technology. Before 1960, two-thirds of Chinese trade was with communist-bloc nations. Today noncommunist states account for 70 per cent of the total trade volume.[76]

2. *The Chinese Tax Structure*.—Upon assuming power in 1949,[77] the new Chinese Government immediately modified the tax structure of the former Nationalist Government to reflect the desired transition to socialist forms of organization. The tax laws were revised to favor heavy industry and new state-controlled enterprises through tax rate differentials. Privately owned, nonessential production and commerce were thereby discouraged.[78] The tax system applied mildly progressive rates to the net profits of commerce and industry in the early 1950's, but as wealth became equalized throughout the country, both the progressive and discriminatory elements in the tax rates were eliminated.[79] By 1958, China had shifted emphasis from net profits taxes or "profit

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73. G. ECKLUND, FINANCING THE CHINESE GOVERNMENT BUDGET 25 (1966).

74. *See generally* J. COHEN, R. DERNBERGER & J. GARSON, *supra* note 9.

75. By contrast, private companies in the Republic of China (Taiwan) may negotiate with foreign corporations with relative freedom. *See generally* LOH, ALLAN, HISCOCK & ROEBUCK, CREDIT AND SECURITY IN THE REPUBLIC OF CHINA (1973).

76. Lee & McCobb, *supra* note 1, at 2.

77. ECKUND, *supra* note 73, at 13.

78. Huang, *Reflections on Law and the Economy in the People's Republic of China*, 14 HARV. J. INT'L L. 293 (1973).

79. ECKLUND, *supra* note 73 at 24-25.

remittances" to the commodity tax,[80] an excise based upon a specified percentage of the wholesale price of the commodity. The commodity tax and profit remittance constitute a two-tiered system of taxation, but the long-term goal contemplates an increasingly significant role for the commodity tax.[81]

China has never imposed a tax upon individual income but relied instead upon various forms of indirect taxation such as sales and "consumption" taxes, municipal taxes and assorted fees and licenses.[82] In rural areas, the individual household or, more commonly, the farm cooperative, is the taxable entity. The rate is applied to the "set yield" of the land, as determined by the government, rather than the actual annual harvest.[83] The overall effect of the Chinese tax system tends to discourage individual initiative or maximization of resources. Accordingly, the profit remittance law provides for a "bonus fund," a percentage of net profit retained by the business enterprise, to be used in awarding individual performance and excellence.[84] In general, the centralized administration of government revenues allows China to concentrate its efforts in areas of emphasis, such as industrialization, and to guide more easily the flow of capital throughout the economy.[85]

IV. Approaches to Taxation of China Trade

A. *The China Trade Act*

In its present form the China Trade Act does not apply to trade with China.[86] Revision of section 941 of the Act by Congress to include China would effect several dubious results. First, no other relevant tax benefits, such as the foreign tax credit or the DISC provisions, would be available.[87] Secondly, extension of China Trade Act benefits to China would clearly prejudice the economic position of the Republic of China in Taiwan, whose economy has prospered by increased exports to the United States in the past

80. *Id.*
81. *Id.* at 26.
82. *See id.* at 25-77.
83. *Id.* at 44.
84. *Id.* at 80-83.
85. *Id.* at 119-21.
86. *See* note 5, *supra.*
87. *See* notes 3, 59 *supra.*

twenty years. Moreover, the United States recognition of China in the United Nations has already created political problems for the Taiwan Government; an additional affront would seem difficult to justify in view of the healthy alliance which has existed since World War II.

The salient question for congressional consideration is whether extension of China Trade Act benenfits to China is the proper vehicle for achieving favorable trade relations with China. Several factors suggest favoring a proposal for conferring China Trade Act benefits upon China: (1) the possibilities for abuse of such benefits are low, as evidenced by the extremely small number of China Trade Act Corporations currently active; (2) the original China Trade Act was intended to promote trade with the geographical area now controlled by China; and (3) in 1969, Congress had a clear opportunity to repeal the China Trade Act as a useless relic, but did not do so. On the other hand, Congress may feel reluctant to offer wide-ranging benefits, even to a few corporations, when the possibility of extensive future trade exists. While the foreign trade volume of Taiwan is effectively limited by its resources and manpower, the potential of China for international trade is largely untapped. Moreover, the policies that originally justified the China Trade Act are no longer extant; the United States is no longer struggling with colonial powers for a share of the world market. Conversely, the United States is undergoing a mild xenophobic backlash in the face of heavy foreign investment in American business by Japanese and Arab entrepreneurs, often utilizing capital earned in transactions with American investors. Although restoration of China Trade Act benefits to China may appear attractive from a legislative point of view, the prospect of foregoing potentially substantial revenues will probably prevent realization of such a proposal as Chinese industrial technology improves.

B. *Foreign Tax Credit*

No taxes imposed by China are known to qualify for the foreign tax credit.[88] Section 903, however states that the credit may apply to a tax paid "in lieu of" income and other qualifying taxes. A

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88. Duffy, *supra* note 27, at 1509.

favorable ruling by the Commissioner, or a definitive congressional amendment, could bring some Chinese taxes within the ambit of this section. A second possible incentive could be effected under section 955(c)(3): an Executive Order eliminating the exclusion of Sino-Soviet bloc countries from qualification as Lesser Developed Countries, thereby eliminating the "gross-up" requirement of section 902(a)(2).[89] An advantage of applying the foreign tax credit, rather than the China Trade Act, to transactions with China is that the stated goal of promoting trade with China is achieved without giving the Chinese a clear and discriminatory advantage over the Lesser Developed Countries. The credit allowance for previously nonqualifying taxes, however, would establish dangerous precedent for the Internal Revenue Service and might effectively overrule many earlier decisions with respect to the taxes of other nations. The domino effect of such an action will likely prevent amendment of the foreign tax credit sections to accomodate trade with China. Moreover, the practical administration of any tax credit system, given the underlying philosophical differences in the Chinese tax structure, would be both financially burdensome and unreasonably difficult for the United States.

C. *Domestic International Sales Corporations*

As a remedy for the United States balance of trade deficit, the DISC has already achieved widespread usage. The principal advantage to the corporate taxpayer is that DISC profits are free from current taxation and may sometimes be reinvested tax-free.[90] The DISC statute may be particularly useful with respect to China trade because the tax structure of the foreign country does not directly affect operation of the DISC provisions; a qualifying corporation may take advantage of DISC status without regard to the inconsistencies of foreign tax laws. However, the limited purpose of the DISC statute reflects a limited benefit: the provision relates only to export sales. The American businessman is encouraged to sell to, but not to buy from, foreign merchants. It seems likely that China would expect reciprocity from the American market as

89. *See* note 48, *supra*.

90. Feinschreiber, *DISC: A New Export Tax Incentive*, FINANCIAL EXECUTIVE 66 (April 1972).

United States exporters reap profits from sales to China. The DISC election, therefore, seems best suited as a tool to be used in conjunction with other tax incentives, excluding the China Trade Act, rather than as an independent and sole alternative.

D. *Tax Treaties*

The treaty format is particularly well-suited to dealing with tax recognition problems between two nations. While initial United States tax treaties were largely confined to agreements with industrialized, ideologically compatible nations, recent pacts have evidenced an awareness of the need for cooperation beyond the Western bloc. For example, the United States has recently concluded tax treaties with the Soviet Union[91] and the Socialist Republic of Romania.[92] Due to certain structural similarities between the economies of China and the Soviet Union, it is useful to examine briefly the highlights of the United States-Soviet treaty for possible application to China trade. The agreement applies hereinafter to present and future taxation of income under the laws of both signatory nations.[93] Income exempt from taxation in one country is to be exempt in the other.[94] Business income derived by a resident of one country is exempt from taxation by the other country unless such income is attributable to a place of business established in the country seeking to impose the tax. Interest on debt connected with the financing of trade between the two countries, derived from sources in one country by a resident of the other, is generally exempt.[95] There are reciprocal exemptions for rental, royalty and realty income; government salaries; and compensation for personal services.[96] Each signatory, of course, remains free to tax its own citizens under its tax laws, but residents of one state are both discouraged from taking advantage of, and protected from inequities of, the foreign tax structure.[97]

91. PRENTICE-HALL, *supra* note 59.

92. Tax Treaty with the Union of Soviet Socialist Republics, Sept. 19, 1973, *as cited in* PRENTICE-HALL, *supra* note 59, art. I.

93. *Id.*, art. III.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*, art. X.

Adoption of a similar tax treaty with China would present several distinct advantages. First, the treaty would supersede most conflicting Internal Revenue Code sections, such as the foreign tax credit, and allow for resolution of problems on an intergovernmental level rather than in the courts of either nation. Secondly, specific tax benefits applicable only to Sino-American commerce could be included without establishing troubling precedents in United States tax law. Thirdly, a tax convention would not directly interfere with existing incentives for trade with other nations, such as the China Trade Act. Fourthly, the agreement would allow each country to continue present trade patterns without the necessity of adjusting to the economic philosophy or structure of the other country. Lastly, a treaty would lend a greater degree of certainty to trade relations between the two nations than would reliance on complex, frequently amended tax statutes.

V. Conclusion

Among the existing alternatives, the tax treaty format is the most flexible and efficient mechanism for correlating American foreign policy and tax patterns with respect to China. Attractive tax incentives may be bilaterally negotiated without unduly sacrificing relations with other countries or valuable precedents in the United States tax law. A treaty would provide a single consistent body of rules governing taxation of Sino-American trade, rather than a resort to administrative or judicial interpretation of foreign law. Moreover, Code provisions, which now afford advantages to American investors, such as the DISC sections, need not be abandoned under the treaty. Neither the China Trade Act nor the foreign tax credit is readily adaptable to current United States policy. However, major changes in political orientation or economic assumptions on the part of either nation may point to innovations not presently acceptable nor apparently feasible. In the present political climate, however, a carefully drafted tax treaty will afford the greatest certainty and reciprocal benefits, while preserving goodwill in other areas of the world.

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