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AN ANALYSIS OF THE IMPACT OF CHINA'S TAX POLICIES ON SINO-FOREIGN OIL AND GAS VENTURES

I. INTRODUCTION

Since 1978, China has experienced phenomenal economic growth and newly-found tolerance for foreign capitalists.¹ Many opportunities await the adventurous business person. This is especially true for oil and gas enterprises.²

This paper analyzes China's oil and gas industry from the viewpoint of foreign enterprises doing business in China. This comment also examines China's evolving system of taxation with respect to foreign enterprises. In particular, this comment will discuss China's system of financial inspections, recent tax management pronouncements, oil and gas royalty fees, and the Unified Income Tax. Additionally, China's legal system will be examined with an emphasis on the Chinese preference for arbitration over court proceedings.

II. HISTORICAL BACKGROUND

A. Open Door Policy

China's present day policy of welcoming foreign trade is a dramatic change from past philosophy.³ The Qing Dynasty⁴, for the most part, believed foreign relations and trade were not important.⁵ The Communist

1. Andrew Tanzer, *This Time It's For Real*, FORBES, Aug. 2, 1993, at 58. China may be the world's largest economy in the next century. Currently, the entire Chinese economy is growing at a rate of nine percent per year.

2. LAWRENCE LIVERMORE NATIONAL LAB, *NON-OPEC OIL PRODUCTION: THE KEY TO THE FUTURE* (May 1990). Chinese oil production has doubled between 1973-1993. In 1991, Chinese crude oil production reached an all time record high. See *Chinese Crude Oil and Natural Gas Production Up*, OPEC Bulletin, Feb. 1992.

3. See JOHN FAIRBANK, *CHINA: A NEW HISTORY*, 406-25 (1992). See also RANBIR VOHRA, *CHINA'S PATH TO MODERNIZATION: A HISTORICAL REVIEW FROM 1800 TO THE PRESENT*, 23-33 (1987).

4. The Qing Dynasty was established by a group of Manchu tribal leaders. This dynasty ruled a Chinese empire that eventually included Mongolia, Central Asia, and Tibet from 1636-1903.

5. FAIRBANK, *supra* note 3, at 413. China was a self-sufficient, agrarian society. The Chinese had little need or desire for the manufactured goods offered by foreign traders. VOHRA, *supra* note 3, at 26.

regime adopted a policy of autarky except for limited trade within the Soviet bloc.⁶

Not until 1978 when Vice Premier Deng Xiaoping announced a policy of "opening," did China began to take a sincere interest in foreign trade.⁷ This "opening" was intended to provide an infusion of technology and capital into China primarily by means of joint ventures between foreign businesses and the Chinese government.⁸ Since initiating this policy, China has experienced increased economic growth in its coastal cities, a growing market for consumer goods, and a shift from central control and planning toward initiative by local governments.⁹

B. Modern Refòrms

In the 1980s, reformers advocated Zhou Enlai's "Four Modernizations."¹⁰ As a result, many observers believe China is allowing foreigners access to its economy at a faster pace than did Japan, South Korea or Taiwan during their economic development.¹¹ Article 18 of the Chinese Constitution of 1982 states, "[t]he People's Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other economic organizations in accordance with the law of the People's Republic of China."¹² Under the Memorandum of Understanding Concerning Market Access,¹³ China agreed to "publish all laws and regulations pertaining to foreign trade" in an official journal. Any law not published in the official journal is not enforceable against a U.S. business person.¹⁴

As a result of increased participation in the Chinese market-place by foreigners, China's taxation of foreigners continues to rapidly evolve. This is evidenced by several factors: 1) in 1991, two of China's major tax laws dealing with foreigners were repealed and replaced by a single piece of legislation mandating a single tax rate;¹⁵ 2) in 1984, President Reagan and the Chinese government officials signed an agreement to prevent double taxation;¹⁶ and 3) the practice of "financial inspections" was instituted by

6. FAIRBANK, *supra* note 3, at 413.

7. *Id.* at 407-17.

8. *Id.* at 407.

9. *Id.* at 415-16.

10. *Id.* at 404, 407. Premier Enlai announced this plan at the Fourth National People's Congress in January, 1975, shortly before his death. Premier Xioaping, who succeeded Enlai, continued and expanded the policy. This policy called for modernization in the areas of agriculture, industry, science and technology, and defense.

11. Tanzer, *supra* note 1, at 58.

12. XIANFA art. 18 (1982).

13. *Business Operations in the People's Republic of China*, 443-2d [Foreign Income Portfolios] Tax Mgmt. (BNA), at A-2, Apr. 6, 1992, available in WESTLAW, BNA Library, TM-Allport File.

14. *Id.*

15. Tax laws are discussed at length in Section VI of this paper.

16. Agreement for the Avoidance of Double Taxation And The Prevention Of Tax Evasion With Respect To Taxes On Income, Apr. 30, 1984, U.S.-P.R.C., 1988-10 I.R.B. 8.

the government to prevent the exploitation of loopholes in the tax law.¹⁷ It is expected that the Chinese legal system will mature as the economy evolves. However, a foreign business person would do well not to forget that China is still a centrally planned economy even though the flurry of capitalist activity obscures that fact. Much of China's economic growth results from a rapidly growing underground economy whose participants do not report their true income or respect China's individual income tax.¹⁸

C. *China's Oil and Gas Industry*

China is very flexible about production sharing, renegotiating deals and modifying terms so that an oil company can receive a respectable return for their investment.¹⁹ In addition, there is the added security of a strong central government backing these deals. According to Steve Pfeifer, an oil analyst at C.J. Lawrence, Inc., "In China, you still have a very strong central government. You can feel very comfortable that you will be able to go forward with a deal."²⁰

Industry experts believe that the opportunities in China exist not only for large international companies, but also for small and medium-sized companies.²¹ According to Dr. Doran, Managing Director of Command Petroleum Holdings NL, "[t]he opportunities which will be available for small companies in this region during the remainder of the 1990s represent something of a unique moment in the history of oil exploration in this part of the world."²²

1. Regions For Potential Development

a. Tarim Basin

China is opening up the Tarim Basin for exploration.²³ It is a remote, undeveloped area, estimated to contain somewhere between 18.4 billion and 50 billion tons of oil and gas.²⁴ The deadline for bids on the Tarim

17. Financial inspections are discussed in Section IV of this paper.

18. Tanzer, *supra* note 1, at 58.

19. Joan Gralla, *China Lures Oil Majors with Stability, Good Terms*, REUTERS, Sept. 2, 1993, available in WESTLAW, Int-News database.

20. *Id.* Contrast the situation in China to the political instability in Russia where, in spite of large, unexplored reserves of oil and gas, companies are being scared off by the ever-changing political scene.

21. Brian Gomez, *Small and Medium-Sized Oil Firms Fill Exploration Breach in Asian Region*, BUSINESS TIMES, Sept. 2, 1993. "There are better opportunities for smaller companies with a critical mass compared with opportunities in the last 10 to 20 years," according to Dr. John Doran, Managing Director of Command Petroleum Holdings NL.

22. *Id.*

23. *Indonesia Petroleum, Simitomo, US Companies to Submit Tender For Oil Exploration in China*, Comline News Service, Sept. 1, 1993, available in WESTLAW, Int-News database. The Tarim Basin is located in Central Asian Xinjiang region of western China.

24. Kim Coghill, *China Wants To Award Tarim Oil Blocks In December*, REUTERS, Sept. 17, 1993, available in WESTLAW, Int-News database. "The most conservative estimate is 11 billion tons but because we have more experience in this area we estimate the basin has at least 18 billion tons," stated Zeng Xingqiu, Vice President of the China National Oil and Gas Exploration and Development

Basin was October 31, 1993.²⁵ Exxon Corp. and Mobil Corp., together with five other international companies, announced their intention to engage in oil exploration in the Tarim Basin. Sixty-eight other companies from seventeen different countries indicated their intent to explore the petroleum reserves in the Tarim Basin.²⁶

To encourage foreign enterprises to bid on the Tarim Basin field, a number of financial incentives have been proposed. First, enterprises will not pay royalty fees until output reaches one million tons per year instead of the present 50,000 per year. Secondly, an enterprise will be given three years in which it may evaluate the deposit of more than five million tons, and is not obliged to begin development.²⁷ Additionally, the period allowed for exploration has already been extended from six years to eight years for Tarim Basin exploration.²⁸

The opening of the Tarim Basin and the proposed financial incentives have all been the work of the China National Petroleum Corporation (CNPC).²⁹ The CNPC is the nationally owned oil company of China and is in effect an arm of the government. Although the Tarim Basin was not opened by legislative decree as it might have been under a democratic system of government, the formal request for bids by CNPC's President Wang Tao is the Chinese equivalent. Wang Tao's request was also a de facto admission by the Chinese government that China needs foreign expertise and investment for its energy industry.³⁰

b. Gulf of Tonkin

China is currently trying to solve a border dispute with Vietnam over the oil-rich Gulf of Tonkin area. Originally, China proposed a "give and take" method of solving the dispute.³¹ This dispute resolution process included several rounds of talks between the two countries.³² Both sides ruled out unilateral military activities in the disputed areas. In addition, the leaders of both countries began an exchange of annual visits.

Unfortunately, recent developments may have jeopardized the dispute resolution process. In mid-August, Vietnamese ships allegedly interfered

Corporation. It is believed that the oil deposits in the Tarim Basin equal approximately 1/3 of Saudi Arabia's provable reserves.

25. Gralla, *supra* note 19.

26. *Indonesia Petroleum*, *supra* note 23.

27. Coghill, *supra* note 24.

28. *Id.*

29. Michael Parrish, *China Faces Dry Hole In Its Bid To Develop Oil*, L. A. TIMES, Feb. 22, 1993, at B3.

30. *Id.*

31. *Border talks with Vietnam "Positive" - Vietnamese President to Visit*, BBC Monitoring Service, Sept. 2, 1993, available in WESTLAW, Int-News database.

32. The Chinese delegation is led by Deputy Foreign Minister Tang Jiaxuan and the Vietnamese delegation is led by Deputy Foreign Minister Vu Khoan.

with a Chinese ship drilling for oil in the area.³³ Vietnam has protested the presence of the Chinese drilling rig, saying that the rig's presence broke their agreement not to take actions that would jeopardize the dispute resolution process.³⁴

China and Vietnam must resolve their territorial dispute soon. If the dispute is not resolved, or if it is resolved in favor of Vietnam, U.S. oil and gas companies may lose a tremendous business opportunity. U.S. business people have been shut out of Vietnam for so long that they are at a competitive disadvantage. Many non-U.S. corporations are firmly established in Vietnam, having developed relationships with the Vietnamese government and Vietnamese businesses. In addition, they are accustomed to Vietnamese business practices. The biggest disadvantage by far appears to be the two decades of distrust that exists between the United States and Vietnam.

c. Nansha Islands

Also in dispute are the Nansha Islands. This area is believed to contain vast petroleum and mineral deposits. The Nansha Islands are claimed by Brunei, Indonesia, Malaysia, and Taiwan.³⁵

d. East China Sea

The East China Sea is another area that is garnering interest from foreign oil companies. Chevron Overseas Petroleum, Ltd.³⁶ recently signed a seven-year oil and gas exploration contract.³⁷ The contract covers a 700 square-mile area.³⁸ Chevron will receive a share of all oil and gas extracted but will have to pay all of their own expenses.³⁹

Texaco, Inc., in conjunction with Agip Petroli Ltd. of Italy and Maersk Oil China A.S. of Denmark, has also signed a contract to explore in the East China Sea.⁴⁰ The area covered by the contract is about four times the area covered by the Chevron contract.⁴¹ Texaco has estimated that it will spend at least \$100 million in exploration expenses.⁴²

33. *China Says Vietnam Interfered With Oil Drilling*, REUTERS, Sept. 16, 1993, available in WESTLAW, Int-News database.

34. *Vietnam Confirms Oil Rig Protests To China*, REUTERS, Sept. 17, 1993, available in WESTLAW, Int-News database.

35. *Border Talks With Vietnam "Positive"- Vietnamese President To Visit*, *supra* note 31.

36. Chevron Overseas Petroleum, Ltd. is a subsidiary of Chevron Corporation. The Chevron Corporation is a U.S. company.

37. *Chevron Signs Oil Exploration Pact In China*, S. F. EXAMINER, Nov. 1, 1993, at B6.

38. *Id.*

39. *Id.*

40. Joshua Mills, *Chevron To Explore East China Sea*, S. F. CHRONICLE, Nov. 1, 1993, at B2.

41. *Id.*

42. *Id.*

e. Other Areas

In addition to the Tarim Basin, China has announced that it will open up more inland areas to foreign petroleum companies.⁴³ Those areas include Heilongjiang, Hebei, Henan, Inner Mongolia, Xinjiang, and Tianjin.⁴⁴ It is estimated that these areas have a total reserve of 8.2 billion tons of oil and 88 trillion cubic feet of gas.⁴⁵ China also has announced plans to open up the beach and continental shelf of the Bohai Gulf to foreign petroleum companies.⁴⁶

2. Potential Legal Problems

Some novel legal problems arise for foreign-owned business ventures. These problems can be categorized in two classifications: 1) a lack of understanding of the host country's legal system and culture; and 2) financial difficulties. The sections that follow will analyze and provide information about the Chinese legal system and tax legislation.

III. CHINESE LEGAL SYSTEM

China's legal system consists of three parts:⁴⁷ the People's Courts, the Public Security Administration,⁴⁸ and the People's Procuracy.⁴⁹ There are three types of courts: civil, criminal, and economic. Each type of court has three different levels of review similar to courts in the United States. Foreigners are subject to the criminal and civil laws. The economic courts have jurisdiction over business controversies involving foreigners as well as matters such as bribery, workers' safety, and tax evasion.⁵⁰

When a dispute arises between a Chinese firm and a foreign firm, the Chinese prefer to resort first to voluntary, nonbinding mediation.⁵¹ The Chinese refer to this as "friendly negotiation" or "friendly consultation."⁵² It is an informal, unstructured process designed to prevent disagreements from turning into legal problems. If mediation does not resolve the dispute, then, according to Article 8 of the U.S.-China Trade Agreement,⁵³ the parties may resort to arbitration in accordance with the provisions spec-

43. James McGregor, *China To Open Oil Frontier To Foreigners*, WALL ST. J., Feb. 19, 1993, at A13.

44. *Id.*

45. *Id.*

46. *China Opens 12 Oil Areas*, N. Y. TIMES, Feb. 18, 1993, at C4.

47. *Business Operations in the People's Republic of China*, *supra* note 13.

48. The Public Security Administration is a civilian police force.

49. The People's Procuracy is a quasi-judicial institution that approves arrests, investigates crimes, prosecutes criminal cases, and enforces sentences.

50. *Business Operations in the People's Republic of China*, *supra* note 13.

51. *Id.*

52. *Id.*

53. Agreement on Trade Relations, Feb. 1, 1980, U.S.-P.R.C., art. 8, 31 U.S.T. 4659.

ified in their contract or agreement.⁵⁴ The arbitration may be conducted by an arbitration institution in China, the United States, or any other country that both parties agree upon.⁵⁵ Sweden is the country of choice when arbitration is held outside of China.⁵⁶ If arbitration fails, litigation may then be pursued.⁵⁷

The Chinese courts will enforce arbitral awards unless: 1) no written agreement to arbitrate existed; 2) the agreed upon rules of arbitration were not followed; 3) the award exceeded the scope of the agreement; 4) the award is against public policy; or 5) the party against whom the agreement was to be enforced was unable to fully participate in the proceedings.⁵⁸ It is therefore extremely important that all contracts contain very detailed clauses outlining an arbitration procedure in the event that a dispute arises between the parties.⁵⁹

China's taxation system for foreign investors is still in its infancy and evolving along with its economy. New tax pronouncements are being issued with each new problem that evolves. For instance, thirteen new tax management pronouncements were recently issued.⁶⁰ The measures included: implementation of "The Law of the People's Republic of China Concerning Tax Collection Management", reinforcement of invoice management, establishment of a tax judicial system, establishment of a tax court (separate from the economic courts), a tax withholding system, implementation of a two percent increase in the business tax on retail businesses, establishment of an overdue fine system, and strict prohibition of late payments on enterprise taxes and detainment of bank taxes.⁶¹ Tax registration certificates will also be reissued to all taxpayers.⁶²

IV. FINANCIAL INSPECTIONS

Businesses in China must go through a "financial inspection" every year that is similar to an annual audit in the United States except that there is a great deal of government supervision.⁶³ Inspections typically occur

54. The rules governing the arbitration proceeding may be the rules of the arbitration institution selected, the arbitration rules of United Nations Commission on International Trade Law, or other rules of international arbitration if acceptable to all of the parties of the dispute.

55. Agreement on Trade Relations, *supra* note 53.

56. *Id.*

57. *Id.*

58. *Id.*

59. The arbitration agreement should carefully map out each party's rights and obligations to the arbitration procedure. For example: rules and location of arbitration proceeding; a detailed description of what type of disputes may be arbitrated, or alternatively, a detailed description of dispute that must be litigated instead of taken to arbitration; and an outline of all pre-litigation dispute resolution techniques that must be exhausted before the matter may be taken to court.

60. Chen Xiaohong, *Chinese Tax Administration Issues 13 Measures To Strengthen Enforcement*, 93 TAX NOTES INT'L at 182-89 (Sept. 21, 1993).

61. *Id.*

62. *Id.*

63. *State Council Issues Circular On 1993 Financial Inspection*, REUTERS, Aug. 25, 1993, available in DIALOG, Int-News database.

between August and December of the year under review.⁶⁴ Beginning in 1993, inspections will involve all levels of the government as well as private sector financial professionals.⁶⁵ The work of the private sector accounting and auditing firms will be coordinated and supervised by government officials.⁶⁶

The inspection focuses on all violations of financial and economic laws that occurred during the current year, as well as those during the previous year, but not discovered.⁶⁷ Among the specific violations the state hopes to uncover are whether: taxes were levied; any department has overstepped its authority in granting tax exemptions, such as whether taxes remained uncollected⁶⁸ or rates were reduced; taxes were evaded; and, refunds of export duties were obtained by fraud.⁶⁹

Oil, gas, and petrochemical marketers and suppliers, import and export enterprises, and joint operation enterprises are among the industries specifically targeted by the financial inspections.⁷⁰ Business entities have an opportunity to conduct a careful "self-inspection."⁷¹ Self-inspections must uncover 100 percent of all violations of financial and economic law as well as breaks in "discipline."⁷² There is an important incentive to successfully root out all violations during a self-inspection; any violations discovered and reported due to self-inspection will be dealt with leniently by the government. However, any violations discovered by government agents will be dealt with harshly.⁷³ For instance, "[a]ll areas and departments must choose a few major typical cases and 'expose' them to the public in order to deter those who violate laws and discipline and to educate the broad masses of the people."⁷⁴

However, there has been recent concern that it is the government inspection teams themselves who are corrupt.⁷⁵ Chinese intellectuals and judges have expressed fears that government officials who are charged with fighting corruption are not independent from the government; therefore, those with political connections are immune from such things as financial inspections.⁷⁶ Another charge is that China's "investigation work teams"

64. *Id.*

65. *Id.* Financial, Auditing, Taxation, Commodity Prices and Industry & Commerce Administration departments will be directly involved with the 1993 financial inspections.

66. *Id.*

67. *Id.* The financial and economic laws and regulations are to be used as a "yardstick" to search for not only violations but also a lack of discipline.

68. There will be a selective inspection of tax payments made by privately owned enterprises.

69. *State Council Issues Circular on 1993 Financial Inspections*, *supra* note 63.

70. *Id.*

71. "Self-inspection" in this context is similar to an internal audit in the United States.

72. *State Council Issues Circular On 1993 Financial Inspection*, *supra* note 63.

73. *Id.* At the same time though "the legitimate rights and interests" of the enterprises being inspected must be protected.

74. *Id.*

75. Willy Wo-Lap Lam, *Cadres Led Campaign To Crack Graft*, S. CHINA MORNING POST, Sept. 8, 1993, at 9.

76. *Id.*

are a violation of the principle of separation of party and government.⁷⁷ To combat these problems the Central Commission for Disciplinary Inspection and the Organization Department have been authorized to inspect top level governmental and party units.⁷⁸ The Finance Ministry and the State Planning Commission have been authorized to investigate cadres that have illegally profited from their authority.⁷⁹ These teams must surrender all gifts and other privileges they have garnered from their positions.⁸⁰

However, many argue that these measures still are not enough. A specialist stated that "[w]ithout supervision from non-party elements, it may be difficult for anti-graft teams to tackle culprits who have strong political connections."⁸¹ Some members of the Chinese judiciary want anti-graft operations to be conducted by an independent judiciary committee.⁸²

There are many policy reasons behind the state supervised financial inspections. Some of these reasons are legitimate policy concerns while others are simplistic and unique to an evolving command economy. One concern is that loopholes and "breaks in discipline" will occur due to the chaos created by the switch from a planned economy to a market economy.⁸³ The policy consideration behind using private sector accounting and auditing firms in the inspection is the hope that a foundation will be laid that will facilitate transferring the responsibility for the annual inspections from the state to the private sector.⁸⁴ The government hopes these inspections will promote healthy economic development.⁸⁵ However, China's vision of healthy economic development may not be the same vision held by foreign capitalists. Another stated policy justification behind the inspections is that without them people may "worship money and become selfish, which in turn may easily lead to chaos and the pursuit of economic interests by illegal means."⁸⁶

Foreigners may find the amount of state intervention to be both burdensome and tiresome. Although U.S. firms are accustomed to conducting both internal audits and yearly audits by outside accounting personnel, the Chinese regulations make no exceptions. Chinese, foreign, and joint ventures are all treated alike when it comes to financial inspections. It would be desirable for China to pass regulations that allow foreign companies to institute the same auditing and internal control procedures in their Chinese operations that they would normally follow in their own country. This

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* According to the circular, "Our country is switching from the traditional planned economy to a socialist market economic system." *State Council Issues Circular on 1993 Financial Inspection*, *supra* note 63.

84. *State Council Issues Circular on 1993 Financial Inspection*, *supra* note 63.

85. *Id.* This is of particular concern because a well-developed body of law regulating economic activity has not fully evolved.

86. *Id.*

would alleviate two problems: 1) misunderstandings by foreign business people who are not used to a centralized government or Chinese expectations; and 2) high costs incurred by foreign companies for compliance. Misunderstandings could easily arise between foreign capitalists who have no experience with a communist form of government and Chinese government officials who have very rigid expectations based on their government's doctrines. Costs would be reduced because foreign entities would not have to maintain two different auditing procedures: one system for their operations in China, and another for all of their other operations.

V. ROYALTIES

A. *Offshore Royalties*

Any Chinese and foreign enterprises exploiting offshore petroleum resources within the national jurisdiction of China must pay royalty fees to the Chinese government.⁸⁷ These royalty fees are in reality a de facto tax levied on the petroleum industry. Sino-Foreign cooperative ventures must first determine and withhold the appropriate amount of royalty payment.⁸⁸ The royalty payment is then turned over to the National Offshore Oil Corporation which is responsible for forwarding the payment to the state.⁸⁹ All royalty fees must be paid in-kind. A penalty of 1/1000 of the unpaid royalty fee per day will be assessed on the amount in arrears beginning on the first day the payment is overdue.⁹⁰

In addition to forwarding the royalty payments to the National Offshore Oil Corporation, each field operator must provide production data and other related information within 10 days after the close of each quarter.⁹¹ If an operator fails to provide the necessary data, a penalty of Rmb 5,000 may be imposed. A penalty equal to 5 times the amount of the royalty due may be assessed if an operator provides false data.⁹² The following tables and examples illustrate how royalty fees are calculated.

87. *Regulations on Payment of Royalty for the Exploitation of Offshore Petroleum Resources*, art. 2, available in DIALOG, File No. 0470 [hereinafter *Offshore Regulations*].

88. *Id.* art. 6. Royalties are prepaid on a periodic basis with final settlement occurring at the end of the year.

89. *Id.* art. 5.

90. *Id.* art. 8.

91. *Id.* art. 9.

92. *Id.*

TABLE 1
OFFSHORE ROYALTIES FOR OIL PRODUCTION

Annual Gross Production (AGP) (in million tons)	Royalty %
<1	0
1-1.5	4
1.5-2	6
2-3	8
3-4	10
>4	12.5 ⁹³

Example 1: If 1.75 million tons were produced in a year the royalty tax would be calculated as follows: Step 1) No royalty on the first 999,999 tons; four percent royalty on the 500,000 tons that fall in the 1-1.5 AGP category; and six percent royalty on the 250,000 tons that fall in the 1.5-2 AGP category. Step 2) $(.04 \times 500,000) + (.06 \times 250,000) = 20,000 + 15,000$. Step 3) Royalty Fee= 35,000 tons. [The other royalty fees discussed in this section may be calculated using a similar procedure.]

TABLE 2
OFFSHORE ROYALTIES FOR GAS PRODUCTION

Gas Production (in billion cubic meters)	Royalty %
<2	0
2-3.5	1
3.5-5	2
>5	3 ⁹⁴

B. Land Oil Royalties

Chinese and foreign enterprises who are engaged in cooperative exploration of petroleum resources on land within China's territory must also pay royalties.⁹⁵ Different rates exist for land royalties than for offshore royalties.⁹⁶ Otherwise, the same requirements and penalties exist for both land and offshore production. The following tables illustrate how the royalty fees are calculated.

93. *Id.* art. 3.

94. *Id.* art. 4. Royalty fees for both oil and/or natural gas production must be paid in kind.

95. *Provisional Regulations on Payment of Royalty Fees For Mining Areas Used for Sino-Foreign Cooperative Exploitation of Land Oil Resources*, art. 2, available in DIALOG, File No. 0493[hereinafter *Provisional Regulations*]

96. *Cf. id.* art. 3 and *Regulations on Payment of Royalty for the Exploitation of Offshore Petroleum Resources*, *supra* note 87, art. 3.

TABLE 3
ROYALTIES FOR LAND OIL PRODUCTION

Annual Output (in tons)	Royalty %
up to 50,000	0
>50,000-100,000	1
>100,000-150,000	2
>150,000-200,000	3
>200,000-300,000	4
>300,000-500,000	6
>500,000-750,000	8
>750,000-1 million	10
>1 million	12.5 ⁹⁷

TABLE 4
ROYALTIES FOR LAND GAS PRODUCTION

Annual Output (in normal cubic meters)	Royalty %
up to 100 million	0
>100-200 million	1
>200-300 million	2
>300-400 million	3
>400-600 million	4
>600-1 billion	6
>1-1.5 billion	8
>1.5-2 billion	10
>2 billion	12.5 ⁹⁸

The obvious policy justification behind levying royalty fees on foreign enterprises is to generate revenue. However, China may find it advantageous to offer exemptions to foreign energy companies wishing to do business in China. A royalty exemption would be a well-received incentive that would attract more foreign investment.⁹⁹ Further, a royalty exemption would reduce accounting and legal costs to foreign investors. An alternative, although not as attractive to foreigners as exemptions, is for China to reduce the royalty rates that apply to foreign firms doing business in China. However, if one considers that there were many opportunities for China to give tax breaks to the petroleum industry when drafting the Unified Income Tax Law, royalty rate reduction is not likely. In addition, the petroleum industry was summarily shut out from "tax holidays" and other

97. *Provisional Regulations on Payment of Royalty Fees For Mining Areas Used for Sino-Foreign Cooperative Exploitation of Land Oil Resources*, *supra* note 95, art 3; *Regulations on Payment of Royalty for the Exploitation of Offshore Petroleum Resources*, *supra* note 87, art 3.

98. *Provisional Regulations on Payment of Royalty Fees For Mining Areas Used for Sino-Foreign Cooperative Exploitation of Land Oil Resources*, *supra* note 95, art. 3.

99. China has repeatedly stressed that one of the policy considerations behind "opening" is to increase the flow of foreign capital into China.

such tax relief. The Unified Income Tax will be discussed in detail in the following section.

VI. UNIFIED INCOME TAX

A. Overview

"The Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises" (Unified Income Tax) became effective on July 1, 1991.¹⁰⁰ This law specifically repealed and replaced the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment,¹⁰¹ as well as the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises.¹⁰² The Unified Income Tax applies to income gained from production and business operations¹⁰³ with foreign investment located in China as well as other income¹⁰⁴ derived from sources in China.¹⁰⁵ However, enterprises that establish their headquarters in China must pay tax on their income from all sources, whether inside or outside of China.¹⁰⁶

Unlike previous tax schemes,¹⁰⁷ the Unified Income Tax imposes a flat tax rate of thirty percent.¹⁰⁸ In addition, there is a local flat income tax of three percent.¹⁰⁹ If an enterprise does not have an establishment or site in China but derives income from sources within China, a tax of twenty percent will be imposed.¹¹⁰ All accounting vouchers, books and statements must be written in Chinese. The enterprise may maintain the accounting records in both Chinese and a second language if they wish.¹¹¹

100. *Business Operations in the People's Republic of China Working Papers, Worksheet 17A: The Income Tax Law of the People's Republic of China Concerning Enterprises With Foreign Investment and Foreign Enterprises*, 443-2d [Foreign Income Portfolios] Tax Mgmt. (BNA), art. 5, Apr. 6, 1992, available in WESTLAW, BNA Library, Tm-Allport File [hereinafter *Income Tax Law*].

101. *Id.* art. 30.

102. *Id.*

103. *Id.* arts. 2, 3. The corresponding regulations specifically define income from "exploration and development operations" as falling under the phrase "income gained from production and business operations". Furthermore, Article 3 of the Regulations includes in its definition of "establishments or sites" sites for the extraction of natural resources.

104. *Id.* art. 2. Article 2 of the Regulations define "other income" as "profits (dividends), interest, rents, income from the transfer of property, income from the provision or transfer of patent rights, proprietary technology, trademark rights, copyright and other non-business operations income.

105. *Id.* art. 1.

106. *Id.* art. 4.

107. Gerald A. Wunsch & Dingfa Liu, *Recent Chinese Tax Legislation Affecting Foreign Investment In China*, 2 IND. INT'L & COMP. L. REV. 415 (Spring 1992). In the past, foreign companies were subject to a progressive income tax falling between 30% and 50%.

108. *Income Tax Law*, *supra* note 100, art. 5.

109. *Id.*

110. *Id.* art. 17.

111. *Business Operations in the People's Republic of China Working Papers, Worksheet 17B: Regulations For The Implementation Of The Income Tax Law of The People's Republic of China*, 443-2d [Foreign Income Portfolios] Tax Mgmt. (BNA), art. 100, Apr. 6, 1992, available in WESTLAW, BNA Library, Tm-Allport File [hereinafter *Regulations*].

All taxes must be paid in Renminbi.¹¹² An enterprise that receives taxable income in foreign currency must convert it into Renminbi. For quarterly tax prepayments, the exchange rate in effect on the last day of that quarter should be used. For the end of the year settlement, the exchange rate in effect on the last day of the tax year should be used on only the portion of foreign exchange income on which tax is still left to be paid.¹¹³

B. *Calculating the Unified Income Tax*

1. Taxable Income

Taxable income is determined using the accrual method¹¹⁴. It is calculated by deducting costs, expenses and losses from gross revenues¹¹⁵ received for the tax year.¹¹⁶

If an enterprise receives a payment in kind, the enterprise is deemed to have earned revenue.¹¹⁷ The amount of revenue is equal to the price at which the products are resold to a third party or the market price.¹¹⁸ Enterprises engaged in cooperative exploitation of petroleum resources are deemed to have earned revenue when they receive their share of crude oil.¹¹⁹ The amount of revenue is determined by reference to a price list that reflects international market prices of crude oil.¹²⁰

2. Expenses

The regulations for the Unified Income Tax are very detailed about what may or may not be considered as expenses. Among the more interesting provisions are those that concern nondeductible items, entertainment expenses, wages and welfare benefit expenses, and petroleum exploration expenses.¹²¹

The regulations provide, among other items, that income tax payments, overdue tax surcharges and fines, and royalty payments may not be counted as costs, expenses or losses when calculating taxable income.¹²² However, Article 28 of the regulations states that "[e]nterprises or sites set up in China by foreign enterprises may deduct as expenses the income tax

112. *Income Tax Law*, *supra* note 100, art. 21.

113. *Regulations*, *supra* note 111, art. 15.

114. *Id.* art. 11.

115. *Income Tax Law*, *supra* note 100, art. 4.

116. *Regulations*, *supra* note 111, art. 8. The tax year runs from January 1 to December 31 according to the Gregorian Calendar system. The Gregorian Calendar is used in the United States. The Chinese, however, do not use it. An enterprise may, with permission of the local tax authorities, use a fiscal year system. Under special circumstances an enterprise may, with permission, use a tax year that is shorter than 12 months.

117. *Id.* art. 12.

118. *Id.*

119. *Id.*

120. *Id.*

121. Other expenses discussed by the Regulations include interest on loans, foreign exchange gains and losses, and bad debt.

122. *Regulations*, *supra* note 111, art. 19.

paid abroad on profits (dividends), interest, rents and royalties earned outside China and actually connected with such establishments or sites."¹²³

The Unified Income Tax regulations allow certain entertainment expenses to be deducted from taxable income. These expenses must relate to the business and be evidenced by records or vouchers.¹²⁴ If the enterprise's net annual sales total 15 million yuan or less, entertainment expenses may not exceed .5 percent of the net sales.¹²⁵ If net annual sales exceed 15 million yuan, the expenses may not exceed .3 percent of the excess portion of net sales.¹²⁶ If gross annual revenue is five million yuan or less, the expenses may not exceed .1 percent of the gross revenue.¹²⁷ If gross annual revenue exceeds five million yuan, entertainment expenses may not exceed .5 percent of the excess portion of gross revenue.¹²⁸

Fringe benefits paid to employees may be listed as an expense. However, local tax authorities must grant permission to claim these expenses. In order to grant permission, the tax authorities must examine the pay scale and other documents that evidence the fringe benefits.¹²⁹ This is perhaps more interference than many foreign business people will feel comfortable allowing. In the United States, most companies carefully guard salary information. In many instances an employee is not allowed to know what salary a fellow employee in the same office is earning. However, the Chinese officials insist that they be allowed to examine all pay scales. This is reminiscent of communist ideology.

Reasonable exploration expenses may be amortized for a period of not less than one year against the revenue from oil and gas fields that have already begun commercial operations.¹³⁰ If a foreign company discontinues operations in China due to a lack of discovery of a productive field but later enters into a new contract for cooperative exploitation of petroleum resources within ten years of the termination, the enterprise may amortize exploration expenses from the previously terminated contract against the production revenue of the new contract area.¹³¹

3. Fixed Assets

Fixed assets are valued on the basis of their original cost.¹³² Unless the enterprise submits an application to the local tax authorities and thereby receives special permission to use another depreciation method, the

123. *Id.* art. 28.

124. *Id.* art. 22.

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* art. 24.

130. *Id.* art. 48.

131. *Id.*

132. *Id.* art. 31. Original cost of purchased assets is defined as the purchase price plus freight, installation costs, and other costs incurred before the assets were placed in service. The original costs of fixed assets created by the enterprises is equal to the actual expenditure during manufacture or construction.

straight line method of depreciation must be used.¹³³ Oil and gas enterprises may treat all investments made at the development stage as capital expenditures. Each field constitutes one unit. Depreciation is calculated beginning with the month following the month the field begins commercial production.¹³⁴ The depreciation of fixed assets used to exploit petroleum resources may be calculated over a period of not less than six years.¹³⁵

C. Fines

If an enterprise fails to pay the Unified Income Tax, a fine of .2 percent of the overdue tax will be imposed.¹³⁶ If an enterprise fails to turn over its financial and accounting records, a fine of not more than 5,000 yuan may be imposed.¹³⁷ If an order by the tax authorities is ignored, a fine of not more than 10,000 yuan will be imposed.¹³⁸ If an enterprise fails to withhold tax payments or withholds an insufficient amount, a fine of not more than 100 percent of the tax that should have been withheld may be imposed.¹³⁹ A fine of not more than five times the amount of tax not paid will be assessed for situations where tax evasion has taken place.¹⁴⁰

An enterprise may appeal the levying of a fine. However, before filing for a reconsideration decision, the enterprise must pay the disputed tax.¹⁴¹ If the enterprise prevails at the reconsideration decision, any unnecessarily paid tax is refunded.¹⁴² If a reconsideration decision is made that is unsatisfactory to the enterprise, the matter may be further pursued in the People's Court.¹⁴³ If the enterprise does not apply for a reconsideration decision or pursue a lawsuit, the tax authorities may apply to the People's Court for compulsory enforcement.¹⁴⁴

D. Special Economic Zones

The Unified Income Tax provides for reduced tax rates in certain circumstances. In general, Article 7 of the Unified Income Tax allows foreign enterprises with establishments or sites in special economic zones to be taxed at a rate lower than thirty-three percent.¹⁴⁵ Paragraph 1 of Article 7 allows production-oriented enterprises established in the economic and technological development zones, firms with foreign investment established

133. *Id.* art. 34.

134. *Id.* art. 32.

135. *Id.* art. 36.

136. *Income Tax Law*, *supra* note 100, art. 22. There appears to be an inconsistency between Article 22 and Article 24. Article 24 states that "[i]f a withholding agent fails to turn over withheld tax payments . . . the tax authorities shall . . . impose a fine of not more than 5,000 yuan." *Id.* art. 24.

137. *Regulations*, *supra* note 100, art. 106.

138. *Id.* art. 23.

139. *Id.* art. 24.

140. *Id.* art. 25.

141. *Income Tax Law*, *supra* note 100, art. 23.

142. *Id.* art. 98.

143. *Id.* art. 26.

144. *Id.*

145. *Id.* art. 7.

in the special economic zones, and foreign enterprises with sites in the special economic zones engaged in production or business operations to be taxed at a reduced rate of fifteen percent. Paragraph 2 of Article 7 allows production-oriented enterprises established in the open coastal economic zones and in old urban districts to be taxed at a reduced rate of 24 percent.¹⁴⁶ However, enterprises engaged in the exploitation of petroleum and natural gas do not qualify as production-oriented enterprises for the purposes of Paragraphs 1 and 2 of Article 7.¹⁴⁷

In special economic zones established in old urban districts, open coastal economic zones, and economic and technological development zones, foreign enterprises engaged in energy construction projects will be taxed at the reduced tax rate of fifteen-percent instead of thirty-three percent.¹⁴⁸ The regulations define special economic zones as the areas in Shenzhen, Zhuhai, Shantou, Xiamen and Hainan where special economic zones have been established.¹⁴⁹ Open Coastal Economic Zones are defined as "municipalities, counties, and districts of coastal port cities" where open coastal economic zones have been established.¹⁵⁰

E. Tax Holidays

Article 8 of the Unified Income Tax allows production-oriented enterprises with contracts to operate in China for ten years or more to be exempt from the Unified Income Tax for the first two profit-making years. Furthermore, these enterprises will be allowed to reduce their income tax by fifty percent during each of the third, fourth, and fifth profit-making years.¹⁵¹ Unfortunately, enterprises engaged in the exploitation of petroleum, natural gas, and rare and precious metals are not eligible for these "tax holidays".¹⁵² This is a flat denial of "tax holiday" relief to these industries and there is no way around the prohibition. These enterprises must look elsewhere for tax relief.

Productive projects such as those involving energy are only eligible for income tax exemptions or reductions allowed under provisions promulgated before the Unified Income Tax was enacted.¹⁵³ For example, enterprises established in the Pudong New Area of Shanghai that are committed to energy construction projects (such as power stations) for 15 years or more may be exempt from income taxes for the first five profit-making years. For the sixth through tenth profit-making years, the enterprise is eligible for a 50 percent reduction in the income tax.¹⁵⁴ Joint Equity Ventures established in the National High-Technology and New-Technology

146. *Id.*

147. *Regulations, supra* note 111, art. 72.

148. *Income Tax Law, supra* note 100, art. 7.

149. *Regulations, supra* note 111, art. 69.

150. *Id.* art. 70.

151. *Income Tax Law, supra* note 100, art. 8.

152. *Id.*

153. *Id.*

154. *Regulations, supra* note 111, art. 75.

Industrial Development Zones may be exempt from income tax for the first two profit-making years if they are committed to China for 10 years or more.¹⁵⁵

Enterprises which reinvest their share of profits into their business enterprise in China may be eligible for a refund of forty percent of the Unified Income Tax paid.¹⁵⁶ The enterprise which receives the reinvestment of profits must be committed to operating in China for at least five years.¹⁵⁷ If the amount reinvested is withdrawn within five years, the investing enterprise must repay the amount of income tax that was originally refunded.¹⁵⁸

F. Policy Considerations

The Unified Income Tax is more advantageous for foreign investors than the previous taxation laws that employed multiple tax rates. A single tax rate applied across the board allows an enterprise greater flexibility in choosing a business form. There is no difference in tax rates among different legal forms unless the enterprise has an annual income of 250,000 Rmb or less.¹⁵⁹

There are two main policy considerations behind the Unified Income Tax.¹⁶⁰ First, China wants to encourage foreign investment.¹⁶¹ This is evident by the policy of "opening" begun in the late 1970s and the reform movement of the 1980s. Second, China's taxation of foreign investments needed to be reworked for several reasons: 1) prior tax legislation was done in a piecemeal fashion; 2) China's foreign investment taxation scheme was higher than other countries in the Asian Rim; and 3) The tax rate structure was a confusing array of multiple rates.¹⁶²

Unfortunately, tax breaks in special and open coastal economic zones, as well as tax holidays, are primarily aimed at infrastructure projects such as wharf, highway, and power plant construction.¹⁶³ Oil and gas exploitation projects are specifically denied these tax breaks.¹⁶⁴ One of the simplest and least painful ways China could increase the inward flow of foreign capital would be to expand the types of enterprises eligible to receive tax breaks. Considering China's large deposits of natural resources which have not been exploited and the considerable amount of capital that international petroleum companies could inject into the Chinese economy, China

155. *Id.* art. 75(6).

156. *Id.* art. 10.

157. *Id.*

158. *Id.*

159. Wunsch & Liu, *supra* note 107.

160. *Id.* at 420.

161. *Id.*

162. *Id.* at 421.

163. *Regulations*, *supra* note 111, art. 75.

164. *Id.* See also *Income Tax Law*, *supra* note 100, arts. 7-8.

could benefit substantially by offering further tax benefits to the oil and gas industry.¹⁶⁵

VII. CONCLUSION

The opportunities for foreign investors are great in China. The Chinese population, which constitutes about twenty percent of the world's population,¹⁶⁶ is hungry for western-style conveniences. Their government's policies of "opening" and the Four Modernizations conspire to insure that China will continue to be an expanding marketplace into the next century. China's land mass, rich natural resources, and strong central government make China a haven for adventurous international oil and gas companies. Undoubtedly, the Chinese government will continue to welcome foreign investment through joint ventures, financial assistance, and tax code refinements.

Joy K. Williams

165. Lena H. Sun, *China Eyes Oil Field in Xinjiang; Beijing Hopes to Tap Vast Desert Resources*, WASH. POST, Oct. 9, 1990, at A18.

166. Chris Yeung, *Economic Blueprint Planned to Aid Growth*, SOUTH CHINA MORNING POST, Oct. 26, 1993, at 11.

