

2005

# Relationship between International Trade Law and National Tax Policy: A Case Study of China

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## Recommended Citation

Li, Jinyan. "Relationship between International Trade Law and National Tax Policy: A Case Study of China." *Bulletin for International Taxation* 59.2 (2005): 77-87.

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# Relationship Between International Trade Law and National Tax Policy: Case Study of China

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The author thanks Aihua (Charlotte) Wu for her comments on the drafts of this article.

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## 1. INTRODUCTION

Traditionally, international trade law as embodied in the General Agreement on Tariffs and Trade (GATT) and subsequently the World Trade Organization (WTO) Agreement directly affects the taxes imposed on goods (such as tariffs and sales taxes), but not the taxes on income.<sup>1</sup> Income taxes are covered by bilateral tax treaties. Tax treaties are negotiated by "tax people" and trade agreements by "trade people". "One of the baffling aspects of international commerce is the wall that separates taxation and trade."<sup>2</sup>

In recent years, it has become clear that the distinction between trade law and tax law is blurring. "The two tracks – tax and trade – have come to the end of their utility."<sup>3</sup> Some even think that "[e]very tax solution causes trade problems, and every trade solution has tax problems".<sup>4</sup> Two recent events also highlight the interaction between trade law and tax law: (a) the decision of the WTO Appellate Body that the US foreign sales corporation (FSC) rules and the FSC Repeal and Extraterritorial Income Exclusion Act violated the WTO principles,<sup>5</sup> and (b) China's commitment to adjust its tax policy in order to gain accession to the WTO.<sup>6</sup>

The international tax literature recently began to address the relationship between trade law and tax law.<sup>7</sup> Some scholars have suggested a WTO-type multilateral agreement on taxes to address the problems that cannot be dealt with in bilateral tax treaties, such as international tax competition;<sup>8</sup> others have examined the tax implications of trade law.<sup>9</sup> This article draws from this literature and uses

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1. Johnson, Jon R., *International Trade Law* (1998), at 274.
2. Rosenbloom, H. David, "Commentary: What's Trade Got To Do With It?", 49 *Tax Law Review* 593 (1994).
3. Field, Tom and Chuck Gnaedinger, "WTO Compliance May Spur Far-Reaching Tax Reform", *Tax Notes International*, 16 December 2002, at 1103, quoting Matthew Slaughter.
4. Id., quoting Homer Moyer.
5. The history of the case is summarized in 3.4. There are numerous reports by the WTO regarding this case; see [www.wto.org/english/tratop\\_e/dispu\\_e/distabase\\_wto\\_members4\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/distabase_wto_members4_e.htm). The most recent report is *United States – Tax Treatment for Foreign Sales Corporations – Recourse by the European Communities to Article 4.10 of the SCM Agreement and Article 22.7 of the DSU*, WT/DS108/26, 25 April 2003 (03-2225), which contains a brief review of the history of the case. For more discussion of this case, see Petersmann, Ernst-Ulrich, "Prevention and Settlement of International Trade Disputes Between the European Union and the United States", 8 *Tulane Journal of International & Comparative Law* 233 (2000); Goulder, Robert, "WTO Rejects US Appeal Regarding FSC Regime", *Tax Notes International*, 6 March 2000, at 1944; Clark, Hunter R., Amy Bogran and Hayley Hanson, "The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?", 10 *Minnesota Journal of Global Trade* 291 (2001); and Minella, Nicholas J., "Motives and Consequences of the FSC Dispute: Recent Salvo in a Long Standing Trade War or Fashioning a Bargaining Chip?", 27 *Brooklyn Journal of International Law* 1065 (2002).
6. For more discussion of China's accession to the WTO and the tax implications, see Wong, Cassie and Jim Chung, "WTO Accession Propels Chinese Tax Reform", *Tax Notes International*, 5 February 2001, at 667; Ip, Joanna, "China's WTO Accession to Change Environment for Taxes", *Tax Notes International*, 13 August 2001, at 790; Li, Jinyan, "WTO and China's Tax Policy", *Tax Notes International*, 29 May 2000, at 2451; and Tsoi, Alan, "A Look at WTO Impact on China's Tax System", *Tax Notes International*, 3 July 2000, at 71.
7. See e.g. Avi-Yonah, Reuven, "Treating Tax Issues Through Trade Regimes", 26 *Brooklyn Journal of International Law* 1683 (2001); Green, Robert M., "Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes", 23 *Yale Journal of International Law* 79 (1998); Clark, Bogran and Hanson, supra note 5; McDaniel, Paul, "The Pursuit of National Tax Policies in a Globalized Environment: Principal Paper: Trade and Taxation", 26 *Brooklyn Journal of International Law* 1621 (2001); Oyola, Jose, "Foreign Sales Corporation Beneficiaries: A Profile", *Tax Notes International*, 11 August 2000, at 157; and Warren, Jr., Alvin, "Income Tax Discrimination Against International Commerce", 54 *Tax Law Review* 131 (2001).
8. See Thuronyi, Victor, "International Tax Cooperation and a Multilateral Treaty", 26 *Brooklyn Journal of International Law* 1641 (2001); Ring, D., "Prospects for a Multilateral Tax Treaty", id. at 1699; Avi-Yonah, Reuven S., "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State", 113 *Harvard Law Review* 1575 (2000), at 1675 ("a multilateral solution [to the issue of tax competition] ... is therefore essential if the fundamental goals of taxation are to be preserved"); and Avi-Yonah, supra note 7.
9. See e.g. Arnold, Brian J. and Neil Harris, "NAFTA and the Taxation of Corporate Investment: A View from Within NAFTA", 49 *Tax Law Review* 529 (1994); and Easson, Alex, *Tax Incentives for Foreign Direct Investment* (2004), at 200-207.

China's accession to the WTO as a case study to discuss the relationship between international trade law and national tax policy.

The article first reviews China's pursuit of joining the international trade system after several decades of economic and political isolation from the West. The article next considers the key aspects of the WTO system – the WTO agreements, the general principles and the dispute settlement procedures – and then discusses the salient aspects of China's tax policy which may conflict with the WTO rules. Finally, the article analyses the tax policy implications of China's accession to the WTO. The main thesis is that, although the WTO rules may override domestic tax policies in certain cases, the extent of the constraints is modest. China remains more or less free to pursue its own tax policies.

## 2. CHINA'S ACCESSION TO THE WTO

China became a member of the WTO on 11 December 2001. It was a celebrated event in China, and a happy result of a five-year long march towards rejoining the world trading community. China was one of the 23 original signatories of the GATT in 1948. At that time, the Communist Party was fighting to overthrow the Nationalist government. In 1949, the Communists won and formed a government in Beijing; the Nationalists fled to Taiwan. While in power, the Nationalist government announced that China would leave the GATT system. The new Beijing government never recognized the decision to withdraw, but it did not notify the GATT Secretariat of its wish to resume its status as a member of the GATT until 1986.<sup>10</sup> After the WTO was created, China applied to become a member in 1995.

From 1949 to 1986, there was little political or economic motivation for China to be part of the GATT system. China's economy was based on central planning. China traded mostly with other socialist countries, and its trade with Western (GATT member) countries was virtually non-existent. The economic reform in China increased its economic relations with Western countries. Rejoining the GATT was considered important to furthering such relations.<sup>11</sup> From 1986 to 1998, China's international trade more than quadrupled in value. In 1998, China was the world's ninth largest exporter and eleventh largest importer,<sup>12</sup> and exports from China accounted for 3.4% of the world's total. China was also one of the world's largest recipients of foreign direct investment.<sup>13</sup>

In order to gain accession to the WTO, China made significant concessions during its negotiations with the WTO. For example, the average tariff (excluding agricultural products) was reduced from 42.7% in 1992 to 15% in 2000. It is to be further reduced to 10% by 2005.<sup>14</sup> Non-tariff measures were reduced from 1,247 in 1992 to fewer than 400 in 1998.<sup>15</sup> China established a timetable to eliminate all non-tariff measures that are inconsistent with the WTO rules.

## 3. THE WORLD TRADE ORGANIZATION

### 3.1. Rules-based system

The WTO, with 147 members and more than 30 applicants for membership (as of July 2004), includes almost all of the world's important trading nations.<sup>16</sup> It was established pursuant to the Marrakesh Agreement of 1994 (WTO Agreement), which concluded the Uruguay Round negotiations.<sup>17</sup> The creation of the WTO completed the unfinished business of establishing an institutional structure for the international trading system.<sup>18</sup> The significance of the WTO cannot be overestimated.<sup>19</sup>

The WTO Agreement is an umbrella agreement. It sets out, in four annexes, a series of agreements,<sup>20</sup> notably the GATT and the General Agreement on Trade in Services (GATS),<sup>21</sup> and understandings which contain the substantive obligations of the member countries. The agreements that may affect domestic tax policy are summarized below.

(a) The General Agreement on Tariffs and Trade 1994 (Annex 1A) incorporated the rules of the GATT 1947. These rules apply principally to customs duties and procedures and, to a lesser extent, to indirect taxes. The objective of the GATT is to liberalize trade among its members through the non-discrimination principle and the reduction of barriers.

(b) The Agreement on Subsidies and Countervailing Measures (SCM Agreement) is one of 12 agreements that

10. A Working Party of the WTO examined China's request to resume its membership in the GATT 1947 and China's application to join the WTO in 1995. See WTO, *Report of the Working Party on the Accession of China*, WT/MIN(01)/31, 10 November 2001 (01-5314), Ministerial Conference, Fourth Session, Doha, 9-13 November 2001.

11. In statements to the Working Party on the Accession of China, China stated that its consistent efforts to resume its status as a member of the GATT and to join the WTO were in line with its objective of reforming the economy to establish a socialist market economy and its basic national policy of opening up to the outside world. *Id.*, Para. 4.

12. *Id.*, Para. 7.

13. United Nations, *World Investment Report* (1999).

14. Feng, Ling, "A Discussion of Several Issues concerning the Reform of China's Tariff System", [1998] *International Taxation in China*, No. 12 at 16 (in Chinese).

15. *Id.*

16. For more information about the WTO, see the WTO's web site: [www.wto.org](http://www.wto.org).

17. The text of this agreement and other WTO agreements is found in 33 *International Legal Materials* 44 (1994) and on the WTO's web site (see note 16, *supra*).

18. The WTO is the third incarnation of an international organization to regulate the international trading system. The original concept, the International Trade Organization, was developed in the original GATT 1947. Throughout the Uruguay Round, the proposed international organization was referred to as the "Multilateral Trade Organization". "Multilateral" was replaced by "World" at the conclusion of the Uruguay Round. See Lowenfeld, Andreas F., "Remedies Along With Rights: Institutional Reform in the New GATT", 88 *American Journal of International Law* 477 (1994), at 478.

19. Johnson, *supra* note 1, at 12.

20. Some important Uruguay Round agreements are included in Annex 1 to the WTO Agreement. They include the GATT 1994, the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the Agreement on Trade-Related Investment Measures (TRIMS), the Agreement on Subsidies and Countervailing Measures, and the Understanding on Rules and Procedures Governing the Settlement of Disputes.

21. See notes 17 and 20, *supra*.

further elaborate on or clarify the GATT 1994. The SCM Agreement expands upon and clarifies the obligations of the member countries with respect to subsidies and creates a comprehensive code regarding the application of countervailing duties (see 3.3.).

(c) The Understanding on Rules and Procedures Governing the Settlement of Disputes, also known as the “Dispute Settlement Understanding” (DSU), sets out the procedures for resolving disputes under the WTO and establishes the Dispute Settlement Body<sup>22</sup> to administer the procedures (see 3.4.).

The WTO’s objective is to establish a rules-based international trading system. Two important rules are the non-discrimination principle and the principle against export subsidies.

### 3.2. National treatment principle

The non-discrimination principle forms the basis of the WTO system. The non-discrimination principle consists of two further principles, the most-favoured-nation (MFN) principle and the national treatment principle. Under the MFN principle, products and services originating in the member countries must be treated alike (e.g. GATT, Art. I). Under the national treatment principle, once import duties have been paid, imported goods and services must be treated no less favourably than domestic products and services (e.g. GATT, Art. III).

The national treatment principle requires that the member countries not impose internal taxes or adopt other measures to protect domestic production (GATT, Arts. III.1 and III.2). The taxes most obviously affected by this principle are indirect taxes, such as excise taxes, the value added tax (VAT), and sales taxes imposed on imported goods. These taxes may not exceed those imposed on similar domestic products or be applied in such a way as to provide protection to domestic production. As discussed below (see 5.2.), the national treatment principle is the principle on which the United States relied in its complaint against China concerning China’s VAT rebate policy for domestically produced semiconductors.

### 3.3. Principle against export subsidies

In general, subsidies become a trade problem when they enable domestic producers to compete unfairly in foreign markets. Export subsidies have caused serious distortions in the world trade in agricultural goods.<sup>23</sup> Art. XVI of the GATT 1994 prohibits export subsidies other than those for primary products and provides for consultations if the subsidization practices of a member country seriously prejudice the interests of another member country.

The SCM Agreement sets out explicit rules on subsidies. Art. 1 defines “subsidy” as a “financial contribution by a government or any public body within the territory of a Member ... [whereby] ... government revenue that is otherwise due is foregone or not collected ... and a benefit is thereby conferred”. Tax reductions, exemptions and

refunds are clearly “subsidies” for purposes of the SCM Agreement.<sup>24</sup>

The SCM Agreement classifies subsidies as prohibited subsidies, actionable subsidies, and non-actionable subsidies:

– Art. 3.1 of the SCM Agreement provides that, with the exception of agricultural products, prohibited subsidies are “(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance ...; (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods”. To be prohibited, a subsidy must be “specific”. Art. 2 of the SCM Agreement provides that a subsidy is specific to an enterprise or a group of enterprises or industries if access to it is limited to certain enterprises or to certain enterprises within a designated geographical region.

– Actionable subsidies are those that cause injury to the domestic industry of another member country, nullify or impair the benefits of the GATT 1994, or cause serious prejudice to the interests of another member country.

– Subsidies are non-actionable if they are given for certain purposes that are recognized as legitimate, such as regional aid, environmental protection, or (within certain limits) the promotion of research and development.

The key word in Art. 3.1 is “contingent”. The Appellate Body interpreted this word in the US FSC case<sup>25</sup> to mean “conditional” or “dependent for its existence on something else”. It stated in Para. 111 of its decision:

In other words, the grant of the subsidy must be conditional or dependent upon export performance. Footnote 4 of the SCM Agreement, attached to Article 3.1(a), describes the relationship of contingency by stating that the grant of a subsidy must be “tied to” export performance. Article 3.1(a) further provides that such export contingency may be the “sole” condition governing the grant of a prohibited subsidy or it may be “one of several other conditions”.

The contingency upon export performance may be in law or in fact. The Appellate Body interpreted “contingency in law” in Para. 112 as follows:

[A] subsidy is contingent “in law” upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. ... For a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis*

22. For more discussion on the Appellate Body, see Bacchus, James, “Around the Table of the Appellate Body of the World Trade Organization”, 35 *Vanderbilt Journal of Transnational Law* 1021 (2002).

23. Johnson, *supra* note 1, at 9.

24. For the Appellate Body’s interpretation of this term, see WTO, Report of the Appellate Body, *United States – Tax Treatment for Foreign Sales Corporations*, WT/DS108/AB/R, 24 February 2000 (00-0675), Para. 15: “In our view, the ‘foregoing’ of revenue ‘otherwise due’ implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, ‘otherwise’. Moreover, the word ‘foregone’ suggests that the government has given up an entitlement to raise revenue that it could ‘otherwise’ have raised.”

25. WTO, Report of the Appellate Body, *United States – Tax Treatment for “Foreign Sales Corporations” – Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108AB/RW, AB-2001-8, 14 January 2002 (02-0152).

*verbis* that the subsidy is available only upon fulfillment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

The standard for determining whether subsidies are in fact contingent upon export performance is met when the facts demonstrate that the granting of a subsidy, without being made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings (SCM Agreement, footnote 4).

Some of China's tax incentives may constitute discriminatory measures or prohibited export subsidies. As a member of the WTO, China is bound by the WTO rules, and it may be challenged by other countries if it violates the rules. The mechanism for settling trade disputes is discussed briefly below.

### 3.4. Dispute settlement process

While the GATT 1994 and other multilateral trade agreements are important for their substantive provisions on international trade, the agreements ultimately rely on the dispute settlement process to regulate compliance.<sup>26</sup> Through the procedures set out in the Dispute Settlement Understanding, countries seek to ensure compliance with the obligations established by the agreements.

The DSU prohibits the member countries from unilaterally determining that obligations under a WTO agreement have been violated or that benefits under the agreement have been nullified or impaired. Only the governments of the member countries have standing under these procedures. Private individuals and organizations have no standing even though their interests may be directly affected by the resolution of the dispute.

According to the DSU, the settlement of a dispute begins with a request for consultations. The usual time limit for consultations is 60 days. If a dispute is not resolved through consultations, the complaining party may request a three-person panel to adjudicate the case. The panel's decision may be appealed by the parties to the WTO Appellate Body, a permanent institution established by the Dispute Settlement Body. The appeal is limited to the issues of law in the panel's report and the legal interpretations developed by the panel.

If a panel or the Appellate Body concludes that a measure is inconsistent with a WTO agreement, it will recommend that the country that lost the case bring the measure into conformity with the agreement, and it may suggest ways for doing so. If the recommendations are not implemented within a reasonable period of time, the Dispute Settlement Body can authorize the suspension of concessions or other obligations to implement its rulings.<sup>27</sup> In some cases, in the event of prolonged non-compliance by the losing/defendant country, the winning/plaintiff country will receive automatic authorization to retaliate by imposing trade sanctions.

These procedures and their operation can be seen from the US FSC case brought by the European Union.<sup>28</sup> FSCs are foreign subsidiaries of US corporations that export US

products to world markets. Qualifying FSC income was effectively exempt from US tax. Most FSCs are based in tax havens so that FSC income is subject to no or low taxation in the FSC's residence country. Approximately 7,000 US companies formed FSCs to take advantage of these and other tax incentives and, by the US Treasury's estimate, the FSC regime helped these companies save more than USD 4 billion a year in taxes.<sup>29</sup>

The European Union followed the procedures required by the DSU and filed a complaint. It claimed that the FSC rules put European businesses at a competitive disadvantage by allowing US exporters to profit from "shell firms set up as offshore paper subsidiaries"<sup>30</sup> in tax havens such as Barbados, Guam and the Virgin Islands.<sup>31</sup> The European Union argued that the tax relief given to FSCs constituted illegal export subsidies. On 8 October 1999, a WTO panel ruled in favour of the European Union and called on the United States to repeal or modify the FSC rules by 1 October 2000.<sup>32</sup> The United States appealed the panel's decision to the Appellate Body; it upheld the panel's decision on 24 February 2000.<sup>33</sup>

In response to the WTO rulings, the US Congress passed the FSC Repeal and Extraterritorial Income Exclusion Act, which was signed into law on 15 November 2000 (Public Law No. 106-519). On 29 January 2002, the Dispute Settlement Body adopted the reports of the panel and the Appellate Body declaring that the FSC Repeal and Extraterritorial Income Exclusion Act violated Arts. 3.1(a) and 4.7 of the SCM Agreement.<sup>34</sup> The EU was authorized

26. For more information on the dispute settlement process, see [www.wto.org/wto/dispute/dsu.htm](http://www.wto.org/wto/dispute/dsu.htm). For comments on the dispute settlement process, see Green, *supra* note 7; Aceves, William J., "Lost Sovereignty? The Implications of the Uruguay Round Agreements", 19 *Fordham International Law Journal* 427 (1995); Dunoff, Jeffrey L., "The WTO's Legitimacy Crisis: Reflections on the Law and Politics of WTO Dispute Resolution", 13 *American Review of International Arbitration* 197 (2002); Petersmann, *supra* note 5; and Schaefer, Matthew, "Sovereignty, Influence, Realpolitik and the World Trade Organization", 25 *Hastings International & Comparative Law Review* 341 (2002).

27. For more discussion of the enforcement mechanism, see Pauwelyn, Joost, "Enforcement and Countermeasures in the WTO: Rules Are Rules – Toward a More Collective Approach", 94 *American Journal of International Law* 335 (2000).

28. For the US FSC case, see note 5, *supra*. European dismay over US tax breaks dates back at least a quarter of a century. In 1972, for example, the European Community charged in a complaint under the GATT 1947 that the US tax laws permitting exporters to defer tax on a portion of their export earnings violated the GATT prohibition on export subsidies. The legislation that created FSCs was "enacted as part of the bilateral settlement in 1981 of [the] GATT complaint filed by the EC against a predecessor U.S. tax provision". Clark, Bogran and Hanson, *supra* note 5, at 292.

29. *Id.*

30. "EU/US: Americans Contest EU Demand for USD 4 Billion Sanctions", *Eur. Rep.*, 2 December 2000, at 2000 (West Law 24320190).

31. See Winestock, Geoff, "EU Aims for Huge Sanctions on the U.S.", *The Wall Street Journal*, 20 November 2000, at A2; and Meller, Paul, "Europeans Seek \$ 4 Billion in Trade Sanctions Against U.S.", *The New York Times*, 18 November 2000, at C1.

32. WTO, *United States – Tax Treatment for "Foreign Sales Corporations" – Report of the Panel*, WT/DS108/R, 8 October 1999, Document No. 99-4118, Para. 7.35.

33. See note 24, *supra*.

34. The Appellate Body held that the FSC Repeal and Extraterritorial Income Exclusion Act constituted a prohibited export subsidy because it granted a tax exemption with respect to products produced in the United States which were intended for use outside the United States (i.e. the tax exemption was contingent in law upon export performance). See note 25, *supra*.

to impose trade sanctions, up to USD 4 billion per year, against the United States, and the US was given until early 2004 to enact new, WTO-compliant, legislation.<sup>35</sup>

US lawmakers were slow to enact new legislation to avert the sanctions. In June 2004, the US Congress approved a bill to replace the "extraterritorial income exclusion" regime with a mix of international tax changes and tax cuts for domestic manufacturers and multinational corporations.<sup>36</sup> In October 2004, the United States finally enacted the American Jobs Creation Act of 2004 which, among other things, repealed the extraterritorial income exclusion regime.

The FSC case is important not only because of its impact on US tax policy but also because of its implications for the relationship between the WTO rules and domestic tax policy. As explained below, certain aspects of China's tax policy can be challenged under the WTO rules.

## 4. CHINA'S TAX POLICY

### 4.1. General tax structure and policy

Tax policy has been an important instrument for the government in implementing a two-pronged reform: opening China up to the outside world and reforming its domestic economic system.<sup>37</sup> A two-track tax system was introduced in the early 1980s: a Western-style tax system for foreign-owned firms and foreign individuals and another system for Chinese-owned firms and Chinese citizens. The two tracks merged over the years in the areas of the individual income tax, VAT, and other indirect taxes (the business tax and the consumption tax). The two-track system, however, still exists with respect to the enterprise income tax: enterprises with foreign investment are subject to the Foreign Enterprise Income Tax (FEIT) Law,<sup>38</sup> and domestic enterprises are subject to the Domestic Enterprise Income Tax (DEIT) Law.<sup>39</sup>

One of China's key tax policy objectives is to be internationally competitive. This has been accomplished by: (a) adopting tax rates that are competitive with those in neighbouring Asian countries;<sup>40</sup> (b) granting various tax incentives to promote investment in designated areas or industries; (c) concluding bilateral tax treaties with trading partners to enable investors from these countries to avoid international double taxation; and (d) adopting international tax norms such as the arm's length principle. Tax incentives are used liberally, despite the absence of empirical research/data showing their effect on foreign direct investment in China.<sup>41</sup>

In terms of revenue, the most important taxes are the indirect taxes. In 2003, of the total tax revenues, indirect taxes accounted for 55%; the enterprise income taxes accounted for about 15% and the individual income tax for about 7%.<sup>42</sup> As to potential conflicts with the WTO principles, VAT and the FEIT are the most important as they contain numerous tax incentives that may contravene the WTO rules.

### 4.2. Value added tax

China's VAT<sup>43</sup> is similar to the VAT in other countries. Owing to the difficulties in adopting a broad-based VAT on the supplies of all goods and services, China's VAT is imposed mainly on goods and selected services (other services are taxed under the business tax). China's VAT also exempts certain goods, including agricultural products and contraceptive medicines.

VAT is imposed on the value added by each taxpayer at the stages of manufacturing, distribution, import and export. This is achieved by charging VAT on the full value of the supplies made by taxpayers, but allowing taxpayers a credit for the taxes paid on the goods used in supplying taxable goods and services. Unlike the consumption-type VAT adopted by many countries, China's VAT is a production-type VAT because the input credit is not available with respect to the cost of acquiring fixed assets, including machinery, transport vehicles, equipment, instruments, appliances with a useful life of more than one year, and goods worth CNY 2,000 or more with a useful life of more than two years. The rationale for denying an input credit with respect to fixed assets is to control the perceived excessive demand for capital investment by enterprises.<sup>44</sup>

The standard VAT rate is 17%. A lower rate of 13% applies to sales and imports of certain necessities (grain and edible oil, running water, hot water, gas, residential coal products, and air conditioning), print publications, and agricultural-related products (feed, chemical fertilizers, pesticides, farm machinery and agricultural plastic film). Exports are taxed at a zero rate.

The significance of zero-rating is that the input VAT is creditable even though no output VAT is charged. In principle, where the final product is zero-rated, all the VAT charged at the interim stages in the production chain is effectively refunded. In practice, however, due to fiscal and other concerns, the rates of the export rebate have been reduced many times in China. The current rebate rates are: 17% for selected machinery, equipment and

35. See note 5, *supra*.

36. See Glenn, Heidi, "House-Passed ETI Repeal Bill Sets Stage for Difficult Conference", *Tax Notes International*, 28 June 2004, at 1403.

37. See Li, Jinyan, *Taxation in the People's Republic of China* (New York: Praeger, 1991), Chap. 1.

38. Income Tax Law of the People's Republic of China Concerning Foreign-Investment Enterprises and Foreign Enterprises (FEIT Law), adopted by the National People's Congress on 9 April 1991; Detailed Regulations for the Implementation of the FEIT Law, promulgated by the State Council on 30 June 1991.

39. Interim Regulations of the People's Republic of China on the Enterprise Income Tax, promulgated by the State Council on 14 December 1993.

40. Li, Jinyan, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (2003), at 208-209.

41. *Report of the Working Party on the Accession of China*, *supra* note 10, Annex IA (Information to be provided by China).

42. The data is published on the web site of the State Administration of Taxation (SAT): [www.chinatax.gov.cn/data.jsp](http://www.chinatax.gov.cn/data.jsp).

43. Provisional Regulations of the People's Republic of China on the Value Added Tax (VAT Law), adopted by the State Council on 26 November 1993; Implementing Regulations for the Provisional Regulations of the VAT Law, issued by the Ministry of Finance on 25 December 1993.

44. Yang, Bin, "China's VAT: Difficulties With Further Reform and Proposed Solutions", *Tax Notes International*, 6 November 2000, at 2183.

ships; 13% for selected agricultural products, such as corn flour and frozen duck meat; 8% for selected minerals; and 5% for other mineral products.<sup>45</sup> Therefore, except where the rebate rate is 17%, exporters bear various levels of VAT. This policy is obviously not designed to stimulate, let alone subsidize, exports.<sup>46</sup>

To encourage the domestic production of certain goods, a special VAT rebate applies in certain circumstances. For example, purchasers of domestically produced cotton and steel receive a VAT rebate.<sup>47</sup> Foreign-investment enterprises that purchase Chinese-made equipment to be used in certain preferred investment projects also qualify for the VAT rebate, although, under the normal input credit rules, the VAT paid in respect of equipment is not creditable.<sup>48</sup> Similarly, purchasers of domestically produced integrated circuits (semiconductors) receive a 14% rebate so that the effective VAT rate is 3%.<sup>49</sup> The same VAT rebate policy applies to semiconductors that are designed domestically but made abroad.<sup>50</sup>

### 4.3. Income tax policy

Enterprises in China are subject to the FEIT or the DEIT (see 4.1.). The former tax is levied on enterprises with foreign investment (foreign-investment enterprises or FIEs) and foreign enterprises; the latter is imposed on other (domestic) enterprises.

FIEs are generally enterprises that are registered in China and have foreign investment. They include enterprises jointly owned by Chinese and foreign investors and enterprises that are wholly owned by foreign investors (often Chinese subsidiaries of a multinational enterprise). FIEs are taxed as residents of China and are subject to Chinese tax on their worldwide income. Foreign enterprises are enterprises that are not registered or incorporated in China. They are taxed as non-residents and are subject to the FEIT only on their business and investment income from Chinese sources.<sup>51</sup>

Under the FEIT Law, the combined national and local tax rate is 33%; of this, 30% is the national tax and 3% the local tax. Many tax incentives are granted by the FEIT Law so that the effective tax rate under it is much lower than 33%. The FEIT Law is in contrast to the DEIT Law, which contains fewer tax incentives. The main tax incentives are summarized below.

(a) *Tax holidays.* Under the FEIT Law, a tax holiday is available to new FIEs that are engaged in productive activities. The standard period of the tax holiday is five years, consisting of a tax exemption for two years and a 50% reduction in the tax rate for three years. For certain infrastructure projects, however, the tax holiday is ten years. These tax holidays are not granted on the condition of export performance.

(b) *Incentives for special areas.* There are numerous types of special zones or areas; the earliest and most well known is the special economic zone (SEZ).<sup>52</sup> The tax incentives take the form of rate reductions and longer tax holidays. For example, for enterprises established in an SEZ, the incentives include:

- an income tax rate of 15% for newly established enterprises engaged in production and business operations;
- an income tax rate of 24% for productive enterprises established in the old areas of the cities where SEZs are located;
- an income tax rate of 15% for enterprises that invest in technology-intensive projects, projects that have foreign investment of more than USD 30 million with a long payback period, and projects in sectors encouraged by the state, such as energy and transportation; and
- an income tax exemption for the first year and a 50% tax rate reduction for the second and third years (upon application and subject to the approval of the local tax authorities) for enterprises in the service sectors with foreign investment of more than USD 5 million and a period of operation exceeding ten years.

(c) *Reduced rates for export-oriented enterprises.* An FIE is an export-oriented enterprise if, in any year, the value of

45. For a recent reduction in the export refund rates, see “Ministry of Finance and State Administration of Taxation on Adjusting Export Refund Rates”, *Cai Shui* [2003] No. 222. For earlier rounds of adjustments, see Lam, Calvin and Brendan Kelly, “Strategy Counts for Exporters Depending on VAT Refunds”, *Tax Notes International*, 29 October 2001, at 438.

46. For comments by Chinese scholars, see Chen, Hongwei, “Another Discussion on Export Refund”, [2004] *International Taxation in China*, No. 8 at 18; and Yang, Bin, “An Analysis of the Nature of Economic Globalization and Tax Policy Options”, id. at 8 (both in Chinese).

47. SAT, “Notice on Improving Measures for the Implementation of Import-Replacement of Steel”, *Guo Shui Fa* [1999] No. 68, 16 April 1999; *Cai Shui Zi* [1998] No. 117 (announcing a subsidy to domestic producers that use domestic cotton to manufacture products for export).

48. SAT, “Notice on the Trial Measures for the Administration of Tax Refunds to Foreign-Investment Enterprises Purchasing Chinese-Made Equipment”, *Guo Shui Fa* [1999] No. 171, 20 September 1999; Ministry of Finance and SAT, “Circular on Enterprise Income Tax Credit for Purchasing Chinese-Made Equipment by Enterprises with Foreign Investment and Foreign Enterprises”, *Cai Shui Zi* [2000] No. 049, 1 January 2000.

49. As discussed in 5.2., the VAT refund policy was the subject of a WTO complaint filed by the United States against China (see note 55, *infra*). In its complaint, the United States listed the following documents that authorize the preferential tax treatment of domestically produced or designed semiconductors: (1) Notice of the State Council Regarding Issuance of Certain Policies Concerning the Development of the Software Industry and Integrated Circuit Industry, 24 June 2000; (2) Notice of the Ministry of Finance, State Administration of Taxation and General Administration of Customs on Relevant Tax Policy Issues Concerning Encouraging the Development of the Software Industry and the Integrated Circuit Industry, 22 September 2000; (3) Notice of the Ministry of Information Industry Regarding Issuance of Regulations on Certification of Integrated Circuit Design Enterprises and Products, 7 March 2002; (4) Notice of the Ministry of Finance and State Administration of Taxation Regarding Furthering Tax Policies to Encourage the Development of the Software Industry and Integrated Circuit Industry, 10 October 2002; (5) Notice of the Ministry of Finance and State Administration of Taxation Regarding Tax Policies for Imports of Integrated Circuit Products Domestically Designed and Fabricated Abroad, 25 October 2002; and (6) Notice of the State Administration of Taxation Regarding Issuance of the Catalogue of Integrated Circuit Products Enjoying Preferential Tax (First Batch), 23 December 2003.

50. See the documents cited in note 49, *supra*.

51. For an overview of China’s international tax system, see Li, *supra* note 40, Chap. 4; and Chapter on China, in *Taxes and Investment in Asia and the Pacific* (Amsterdam: IBFD Publications, loose-leaf).

52. Other special areas include open coastal economic zones (OCEZs); economic technological development zones (ETDZs); old urban districts of cities where SEZs or ETDZs are located; high-tech and new technology zones (HNTZs); coastal open cities; coastal open areas; capital cities of interior provinces; open cities along the Yangtze River (open areas); Suzhou Industrial Park; open cities and townships in border areas; tourist resort zones (TRZs); bonded areas; and remote/economically underdeveloped areas. For a general discussion of tax incentives, see Easson, *supra* note 9.

its exports constitutes 70% or more of its total output value for that year. This status is determined on an annual basis. In addition to the standard tax holidays, an export-oriented enterprise may, after expiration of the tax holidays, be granted a 50% reduction in the applicable tax rate, resulting in a rate of 15% if no other tax concession is available. For export-oriented enterprises established in an SEZ or ETDZ (economic technological development zone) and for other enterprises that already pay tax at the rate of 15%, the applicable rate is reduced to 10%. There is no time limit – the tax reduction applies as long as the enterprise qualifies as an export-oriented enterprise.

(d) *Reinvestment refund.* A tax refund is available to a foreign investor in an FIE if the investor reinvests the profits derived from the FIE in China for at least five years. The standard refund rate is 40%. A full refund is allowed if the profits are reinvested for establishing or expanding an export-oriented or technologically advanced enterprise.

(e) *Incentives for domestic enterprises.* The tax incentives for domestic enterprises are limited. For example, tax reductions or exemptions may be granted to:

- domestic enterprises that utilize waste gas, waste water and solid waste as major production inputs;
- newly established enterprises in remote regions, poverty-stricken regions or regions with ethnic groups;
- enterprises that derive income from transferring technologies or from related services such as technology consultancy or training;
- enterprises that suffer from disasters such as fire, flood, tornado or earthquake; and
- newly established township enterprises that create a significant number of new jobs (e.g. if the new jobs created in a certain year exceed 60% of the total jobs).

China's current tax system was designed before China became a member of the WTO. China's main policy objectives were to raise revenue and stimulate the economy by encouraging exports and foreign direct investment. Little emphasis was placed on tax equity or neutrality. An examination of these policies in light of the WTO principles reveals various inconsistencies. In its accession negotiations with the WTO member countries, China promised to follow the WTO principles and remove any inconsistent tax measures. As discussed below, the WTO constraints on China's tax policy go beyond mere promises, but to what extent?

## 5. WTO CONSTRAINTS ON CHINA'S TAX POLICY

This part discusses the WTO constraints on China's tax policy. The constraints may be demonstrated by (a) the commitments made by China in its WTO accession negotiations, (b) the change in China's VAT rebate policy to settle a trade dispute with the United States, and (c) possible reform of the export subsidies in anticipation of WTO challenges. This part also explores the extent of these constraints in light of the limitations of the WTO rules and the enforcement mechanism.

### 5.1. China's "promises"

During the accession negotiations, members of the Working Party on China's accession to the WTO expressed concern that certain of China's tax policies were not in conformity with the WTO rules. The *Report of the Working Party on the Accession of China (Report)* noted that certain internal taxes imposed on imports violated the national treatment principle; that the tax subsidies in connection with SEZs and other special economic areas appear to be contingent upon export performance or upon the use of domestic goods and are thus inconsistent with Art. 3.1 of the SCM Agreement (*Report*, Para. 174); and that other tax incentives may also be prohibited export subsidies under Art. 3.1 of the SCM Agreement (*Report*, Para. 166).<sup>53</sup> In response, China confirmed that it would ensure that its tax laws are in full conformity with the WTO rules upon accession to the WTO (*Report*, Paras. 105 and 106).

In preparation of China's accession to the WTO, Chinese tax officials indicated that the tax measures which are inconsistent with the WTO principles would be revised; that the tax measures which are not clearly in violation of the WTO principles may be adjusted at the request of specific WTO members; and that the FEIT and the DEIT would be consolidated to implement the national treatment principle.<sup>54</sup>

### 5.2. The semiconductor case against China

China's commitment to be WTO-compliant was recently tested in a dispute with the United States. On 18 March 2004, the United States filed a complaint with the WTO<sup>55</sup> claiming that China's VAT treatment of integrated circuits (semiconductors) was discriminatory and in breach of the national treatment principle. This was the first complaint against China since China's accession to the WTO. It followed criticism by Democratic presidential candidate Senator John Kerry that President Bush's administration had not done enough to enforce the commitments China made

53. China had provided a list of prohibited subsidies falling within the scope of Art. 3 of the SCM Agreement and a timetable for their elimination; see *Report of the Working Party on the Accession of China*, supra note 10.

54. "Interview with SAT Officials on the Issue of Tax Policy Adjustment and Accession to the WTO", *People's Daily*, 6 April 2000, at 2 (overseas edition, in Chinese). China's accession to the WTO has significant impact on the way the Chinese government conducts its business. In the area of taxation, taxpayers have increased their demand for transparency in tax administration, especially in respect of obtaining up-to-date tax-related information. The SAT announced in May 2002 that it would publish an official gazette with all tax-related laws, regulations, administrative guidelines, tax policies and key speeches. Organizations, enterprises, non-profit organizations, individuals and other interested parties can subscribe to the gazette for an annual cost of CNY 72 (less than USD 10). The SAT has also improved its web site: [www.chinatax.gov.cn](http://www.chinatax.gov.cn). The web site contains: "Information Channel" (news items and important speeches), "Tax Laws and Regulations" (text of major tax laws and regulations), "Statistics" and "About the SAT" (organizational structure, the SAT's functions, and introduction of SAT officials).

55. WTO, *China – Value Added Tax on Integrated Circuits*, circulating the complaint filed by the United States against China; WT/DS309/1, G/L/675, S/L/160, 23 March 2004 (04-1280). See [www.wto.org/english/tratop\\_e/dispu\\_e/distabase\\_wto\\_members1\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/distabase_wto_members1_e.htm). The European Union, Japan, Mexico and Taiwan requested to join the consultations.

when it was admitted to the trade body.<sup>56</sup> In a prepared statement, US Trade Representative Robert B. Zoellick said: “China must live up to its WTO obligations; it cannot impose measures that discriminate against U.S. products. ... The bottom line is that China is discriminating against key U.S. technology products, it’s wrong, and it’s time to pursue a remedy through the WTO.”<sup>57</sup>

The dispute centred on China’s policy of levying a 17% VAT on semiconductors but refunding up to 14% VAT to companies that design and make semiconductor chips in China, while collecting the entire VAT on imported chips. Semiconductors are one of the United States’ leading exports to China. China claimed that the VAT rebate policy had not brought substantial financial benefits to domestic producers and that, in 2003, China imported more than 80% of its semiconductors, most of which were from the United States.<sup>58</sup> Moreover, it was reported that some of the main beneficiaries of the rebate policy were US semiconductor manufacturers that outsource their production to China and US consumers who purchase the Chinese-made products at lower prices.<sup>59</sup>

The two sides entered into consultations in the summer. After four rounds of negotiations, an agreement was reached and a memorandum of understanding was signed in Geneva on 14 July 2004. China agreed to stop certifying new semiconductor products and manufacturers for the VAT refunds and to stop providing the refunds to the current beneficiaries by 1 April 2005. China also promised to terminate the tax refund for semiconductors that are designed locally, produced abroad and then imported into China. In turn, the United States withdrew its complaint to the WTO.

On 31 August 2004, the Ministry of Finance and the State Administration of Taxation jointly issued a circular entitled “Termination of the VAT Refund Policy on the Import of Domestically Designed and Foreign-Produced Semiconductors” (*Cai Guan Shui* [2004] No. 40). According to the circular, as of 1 October 2004, all imported semiconductors would be subject to the standard VAT rate of 17%. This is the first situation where China changed its tax policy in response to a WTO challenge. As noted in the report on China’s accession, other tax policies are susceptible to WTO challenges, especially the policies that may constitute prohibited export subsidies.

### 5.3. Export subsidies

As mentioned above, some members of the Working Party on China’s accession to the WTO considered that some of China’s tax measures probably constitute prohibited export subsidies. The main measures in this group include:

- the VAT rebates on exports;
- the income tax incentives for export-oriented enterprises;
- the income tax incentives in special areas; and
- the general income tax holidays and other incentives.

The VAT rebates on exports are generally not prohibited export subsidies. It is an international practice to apply a zero rate of VAT to exports, thereby resulting in a refund of the VAT paid on business inputs. The theoretical justifi-

cation for export rebates is the destination principle: exports are relieved from VAT in the country of origin (exporting country) and imports are subject to VAT in the country of destination (importing country). Because it is reasonable to assume that goods and services are consumed at the place of destination, VAT is appropriately levied at the VAT rate in the country of destination.<sup>60</sup> VAT export rebates ensure that cross-border trade is free from double taxation under the VAT system. Both the GATT 1947 and the SCM Agreement recognize this and do not consider VAT export rebates as export subsidies so long as the amount of the rebate does not exceed the VAT actually paid on the exported goods (Annex I (Illustrative list of export subsidies) of the SCM Agreement).

China’s VAT export rebate policy deviates from the international norm: the export rebate rates are prescribed by the government and are often different from the nominal VAT rates applicable to business inputs. If the rebate rate is higher than the VAT actually paid, this may violate Art. 3.1 of the SCM Agreement. On the other hand, in most cases, since the rebate rate is lower than the nominal VAT rate, China’s VAT export rebates are not export subsidies.<sup>61</sup>

The tax incentives for export-oriented enterprises are clearly prohibited export subsidies: they involve foregone revenue (i.e. tax reductions), are specific to certain taxpayers (i.e. FIEs), and are “in law” contingent upon export performance (an FIE must export at least 70% of its products to qualify for the tax incentive).

The income tax holidays and the tax incentives for FIEs in special areas pose some analytical problems. Chinese law does not specify “export” as a condition for the incentives. In fact, however, many FIEs export their products to earn foreign currency. China still has exchange controls and its currency is not freely convertible. FIEs must find their own way to balance their foreign currency expenditures and earnings. Exporting products is a necessity for many FIEs. Therefore, the tax holidays and tax reductions that are available to all FIEs, whether or not they export their products, could in effect “subsidize” the exports of FIEs. Because there is no express link between the tax incentives and exports, however, a challenge to these measures as export subsidies is unlikely to succeed. As explained in footnote 4 of the SCM Agreement, “the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision”.

Overall, the WTO principles impose certain constraints on China’s tax policy. As a result of the semiconductor case,

56. “U.S. Launches WTO Complaint against China”, *China Daily*, 19 March 2004.

57. “U.S. Files First WTO Case Against China, Citing Discriminatory Tax Policy on Chips”, 21 *International Trade Reporter*, No. 13 at 532 (25 March 2004).

58. *Id.*

59. “Agreement ends rebates for chip makers”, *China Economic Net*, at [en.ce.cn/Industries/Basic-industries/t20040327\\_546277.shtml](http://en.ce.cn/Industries/Basic-industries/t20040327_546277.shtml) (visited on 17 September 2004).

60. See Doernberg, Richard, et al., *Multijurisdictional Taxation of Electronic Commerce* (2001), Chap. 3.

61. Hu, Xueqin, “Adjusting Export Tax Rebate Policy and Constructing a Neutral Tax Refund System”, [2004] *International Taxation in China*, No. 8 at 14 (in Chinese).

China terminated its VAT rebate policy as requested by the United States. This means that China may not “freely” use the VAT incentives to promote the domestic production of semiconductors. Similar VAT incentives may be withdrawn with or without a WTO complaint.<sup>62</sup> The income tax incentives granted to export-oriented enterprises and other types of FIEs may also be challenged under the WTO rules. Nevertheless, for the reasons explained below, the level of the WTO constraints on China’s tax policy may be very modest.

#### 5.4. Limitations of the WTO constraints

The WTO system, as important as it is in regulating international trade, has limitations in respect of its impact on domestic tax policy. These limitations may be found in the WTO rules, the dispute settlement process and the enforcement mechanism.

The WTO rules are limited in that they do not explicitly apply to tax policies aimed at attracting foreign direct investment. The realm of trade law and the realm of tax policy do not overlap outside the area of tax subsidies.<sup>63</sup> China is perfectly free to determine its tax mix and the structure and rate(s) of each tax. Even in the area of tax subsidies, the WTO principles do not seem to prohibit China from using tax subsidies, especially income tax measures that do not specifically require export as a condition for the subsidies.

The WTO rules are also limited in that they distinguish between VAT/indirect taxes and income taxes. In economic terms, subsidies are fungible: a VAT rebate and an income tax reduction could be designed to produce the same economic benefit to taxpayers.<sup>64</sup> Under the WTO rules, however, VAT export rebates are not prohibited export subsidies, but an income tax refund is. For example, Annex I (Illustrative list of export subsidies) of the SCM Agreement includes:

(h) The exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste).

Therefore, as long as the VAT export rebate does not exceed the VAT levied on business inputs, the rebate is not a prohibited export subsidy. At present, VAT is the most important tax in China. Because the export rebate rates are generally below the nominal VAT rate, China can boost its exports by simply allowing a full VAT rebate for exports without violating the WTO rules.

Even if some of the income tax incentives are potentially prohibited export subsidies, it is questionable whether a country would file a complaint against China. The SCM Agreement sets out the procedural requirements that must

be observed in countervailing duty actions. For example, Art. 11 provides that “an investigation to determine the existence, degree and effect of any alleged subsidy shall be initiated upon a written application by or on behalf of the domestic industry”. The application must include sufficient evidence not only of the existence of a subsidy and, if possible, the amount, but also of the injury to the domestic industry. In a dispute such as that between the European Union and the United States concerning the US FSC regime, the injured party is able to quantify the damage it claims to have suffered and is in a position to take retaliatory action.<sup>65</sup> In the case of the Chinese income tax incentives designed to attract foreign investment, it is difficult to imagine a WTO member country that could quantify the damage resulting from China’s tax policy and be in a position to retaliate against China. The countries that could be injured are probably other developing countries since they compete with China in attracting foreign direct investment. These countries either do not have a sufficiently significant level of trade with China to impose effective trade sanctions against China, or they offer similar tax incentives and are thus not in a position to file a complaint.<sup>66</sup> Developed countries whose investors are attracted to invest in China would probably have difficulty proving an “injury” to a specific domestic industry.<sup>67</sup> Workers in these countries tend to suffer most of the economic “damage” as a result of the disappearance of job opportunities, but as consumers, they benefit from the lower prices of goods imported from China. In any event, trade unions and consumer groups have no standing under the DSU rules.

The enforcement mechanism of WTO decisions has its own limitations. Enforcement of the WTO rules is mainly a bilateral exercise.<sup>68</sup> As such, it depends largely on the internal political and economic situation of the country that must change its laws to comply with the WTO rulings. Prompt enforcement is more likely where the economic stake is high and the political cost is dear (as in the semiconductor case, see 5.2.). According to a study of the WTO cases lost by the United States as a defendant, the impact of the lost cases on domestic policy “is quite minimal”.<sup>69</sup> The US FSC case is the only “punch to the gut” type case: it is more important economically (over USD 4 billion per year) and could potentially trigger significant changes to US tax law. Other cases are merely a “poke in the eye” type or less serious.<sup>70</sup> China is certainly not the United States and may react quite differently to adverse

62. The United States has also taken notice of China’s VAT exemption for fertilizer that is primarily domestically produced. See US Trade Representative, *2003 Report to Congress on China’s WTO Compliance*, 11 December 2003.

63. McDaniel, *supra* note 7, at 1638-1639.

64. Slemrod, Joel, “Free Trade Taxation and Protectionist Taxation”, 2 *International Tax & Public Finance* 471 (1995) (while theoretically it is possible to design tax rules that have the same effect as tariffs, in practice that is difficult to achieve).

65. According to the WTO report cited in note 5, *supra*, the EU is authorized to use countermeasures in the amount of USD 4,043 million, which may take the form of tariffs raised up to 100% on US imports.

66. Easson, *supra* note 9, at 207.

67. *Id.*

68. Pauwelyn, *supra* note 27, at 335.

69. Schaefer, *supra* note 26.

70. *Id.*

WTO decisions. If for various reasons, China chose not to amend its domestic law as requested by the Dispute Settlement Body, China would certainly have the United States as a model.

## 6. CONCLUSION

This article has used China's accession to the WTO to demonstrate the relationship between the WTO rules and domestic tax policy. Following a discussion of the key WTO rules and China's tax policies, the article has identi-

fied some of the potential suspects of WTO violations. The article has also demonstrated that the WTO rules have certain impact on China's tax policy. For example, China has terminated the tax subsidies that discriminate against foreign products, and certain export subsidies are currently under review and will likely be removed in the forthcoming comprehensive tax reform. Overall, however, owing to the limitations in the WTO rules and the dispute settlement process, the impact of WTO membership has been and will continue to be modest. China maintains more or less the same level of control over its tax policies after its accession to the WTO as it did before.