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The Prospect of New Partnership Taxation in China

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China's new Enterprise Income Tax Law has been showered with attention since its adoption on March 16, 2007, and tax professionals in China are diligently watching the development of regulations that will implement the new law. In contrast, another significant upcoming development in the taxation of business entities has gone widely unnoticed. The newly amended Partnership Enterprise Law (the "Partnership Law"), adopted in the summer of 2006, will come into effect on June 1, 2007. Article 6 of the law states that income of a partnership will, "in accordance with relevant tax regulations issued by the state," be taxed separately to the partners. The "relevant tax regulations," however, do not yet exist. In fact, the Partnership Law is where for the first time the principle that partnerships are not to be taxed at the entity level is stated in statutory form in China. The new Enterprise Income Tax Law (the "EIT Law") has reaffirmed this principle.[1] Thus, a brand new partnership tax regime is supposed to arrive on the scene in just a few weeks.

I. Overview

Why has there been so little discussion of such an apparently important addition to business taxation in China? One part of the answer may be that the partnership form has had relatively limited commercial significance in the country. In the third quarter of 2004, China had 123,043 "privately operated" (i.e. owned or controlled by natural persons) partnerships, as compared to 2,663,158 privately operated limited liability companies (LLCs).[2] More tellingly, the 2004 figure represents the end of several

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[1] The enterprise income tax (EIT) does not apply to partnerships, according to Article 1 of the EIT Law.

[2] *Annual of Development of Mid- and Small-Size Chinese Enterprises* 2004-5. Note that Chinese LLCs are subject to the EIT, and cannot be treated for tax purposes are partnerships, as US LLCs may (by "checking the box") under US federal income tax law. The statutory rate for the domestic EIT has been 33%, which, combined with the 20% statutory rate on dividends, results in a 46% tax on income earned through a corporation. Chinese tax considerations thus do not so far favor choosing the LLC form.

consecutive years of significant decline in the number of partnerships, in contrast to strong growths in the numbers of individual industrial and commercial households (IICHs), single-owner companies, LLCs, and joint stock companies.[3] The explanation for this counterintuitive trend—counterintuitive because of the general rate of Chinese economic expansion—is beyond the scope of this article. But the trend could potentially be reversed by the new Partnership Law, which seems to offer opportunities of pivotal significance for business operations. Most importantly, the Partnership Law introduces, first, the possibility for business entities (limited or unlimited in liability) to become partners of a partnership, and second, the concept of limited partnerships.

The 1997 Partnership Enterprise Law (the "Old Partnership Law") to be replaced on June 1, 2007, allows only natural persons to be partners. If business entities—corporations, LLCs, even IICHs—wanted to form a partnership-like joint venture (where at least one party bears unlimited liability for the venture) with one another, they would have to use a form of *lianying* (joint operation) enterprise recognized by the Civil Law.[4] *Lianying* "partnerships" are subject to entity-level taxation, even though corporate partners may sometimes be exempt from tax on dividends received.[5] In other words, from a tax perspective, there is no difference between *lianying* enterprises that are limited in liability and those that are not. Chinese law also did not seem to recognize partnerships with a mix of individual and entity partners. Finally, foreign individuals and businesses, either by themselves or in conjunction with Chinese partners, cannot participate in partnerships defined under the Old Partnership Law, the Civil Law, and other law generally applicable to partnerships. If they were to form joint ventures in China, it would

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[3] Annual of Industrial, Commercial and Administrative Regulation 2001, 2002, and 2003.
[4] Article 52 of the Civil Law (*Minfatongze*).
[5] *Rules on Certain EIT Policy Issues, Caishuizi* [1994] 009, paragraph 2.

be under the special legal regimes for foreign investments. These regimes have subjected even joint ventures with unlimited liability to entity level taxation.[6]

The non-viability—up until now—of foreign partners in Chinese partnerships is tied to the other fundamental feature of the Old Partnership Law. Giving effect to the unlimited liability of a foreign partner could of course be difficult. Under the Old Partnership Law, however, no partner is allowed limited liability. Only general partnerships are allowed. But the lack of the limited liability concept clearly makes the partnership form disadvantageous for many domestic investors as well. As we will see below, the current rules for taxing domestic (individual) partners of Chinese partnerships are far from favorable. Unlimited liability combined with the lack of any strong tax advantage offers weak inducement to adopt any business form.

Aside from providing for entity partners and for limited liability, the new Partnership Law also makes the partnership form more versatile in other ways. For instance, it recognizes the limited liability partnership, a form that could be adopted by professional service firms (most Chinese accounting firms are now organized as LLCs). It also explicitly allows foreign individuals and entities to join Chinese partnerships.[7] The legal infrastructure for partnerships may also improve. For example, the State Council is currently drafting an implementing regulation for the Partnership Law, which the Old Partnership Law did not have.

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[6] *Enterprise Income Tax Law for Foreign-Invested and Foreign Enterprises* (to be obsoleted by the new EIT Law on January 1, 2008), Article 1. But see State Council, *Implementations Rules for the Enterprise Income Tax Law for Foreign-Invested and Foreign Enterprises* (State Council Decree No. 85, 1991), Article 7 (participants in "non-legal person" Sino-foreign cooperative joint ventures—ventures that have unlimited liability—may elect to pay EIT in lieu of the venture itself). See also SAT, *Notice Regarding EIT Issues for Foreign Venture Capital Investment Companies, Guoshuifa* [2003] 61 (2003/6/4) (foreign venture capital enterprises with unlimited liability may elect to pay EIT either at the venture or at the participant level.) I thank Lawrence Sussman for pointing out the 2003 SAT notice to me.

[7] The Ministry of Commerce has circulated a draft regulation on "foreign-invested partnerships", which allows foreign individuals and entities to become partners, including general partners.

All this should make the partnership a more attractive business form, provided, of course, that the partnership tax rules are reasonable. Yet as noted earlier, on these rules there has been both governmental and professional reticence. A further explanation that might be offered for this reticence, other than the relative low visibility of the partnership form in China, is the very primitiveness of existing tax law applicable to partnerships. This law is mainly found in one government notice in 2000.[8] As we will see below, many accounting concepts that would facilitate partnership taxation have not yet been introduced. This is in part because the taxation of partners—who must be natural persons under the Old Partnership Law—is a matter of applying the personal income tax (PIT) to them. Partnership taxation is thus constrained by the underdevelopment of the PIT in China. Yet there is another dimension to this. For better or worse, whatever partnership accounting rules that have existed have for the most part not been applied. Instead, Chinese partnerships—like many other small businesses[9]—have mostly been subject to presumptive taxation, where detailed application of accounting concepts is irrelevant.[10] The practicalities of tax administration and planning thus have not demanded the development of better tax rules.

To design partnership tax rules against this background thus represents a real leap in the dark. Yet that is a leap that the Partnership Law has forced the State Administration of Taxation (SAT) to take.

[8] Ministry of Finance and SAT, *Rules on the Application of the Personal Income Tax to Investors in Single-Owner Companies and Partnerships, Caishui* [2000] 91 (hereinafter the "2000 Partnership Tax Rules").
[9] In 2003 a Chinese partnership had on average 3 partners, 14 employees, and RMB433,000 in registered capital. *Annual of Industrial, Commercial and Administrative Regulation 2004*.
[10] Law firms, for example, have generally paid PIT on the basis of revenue and not profits. *See, e.g.* Beijing Local Tax Bureau, *Notice Regarding Changes to the Collection of the Personal Income Tax from Investors in Law Firms, Jingdishuige* [2005] 69 (2005/2/1).

In what follows, I discuss three issues of partnership taxation in the Chinese context: pass-through of the character of income, allocation of income and losses, and contributions to and distributions from the partnership. Anyone with knowledge of partnership taxation—particularly of the American variety—will recognize that these are only some of the many complex issues under this subject. Even for the three issues that I select, most potential technical complexities are skipped over. My purpose here is merely to set out some reference points for evaluating the prospect of partnership taxation in China, whether that body of law is written out over night or develops over many years. In particular, I highlight structural questions such as: To what extent should China's new partnership rules treat a partnership as a mere aggregate of the partners? What are some of the accounting concepts that need to be introduced right away to implement partnership taxation, and which concepts can wait until later? And, is it possible to design sensible partnership tax rules in China without altering the PIT?

Before we delve into these issues, let us first consider to what business entities the new partnership rules could apply. In 2000, the government announced that partnerships formed by natural persons would not be subject to the EIT.[11] These included not only partnerships organized under the Old Partnership Law, but also ones under the State Council *Provisional Rules on Privately-Operated Enterprises*, the *Lawyer's Law* (i.e. law firms), and other law (e.g. the Civil Law) so long as they have unlimited liability.[12] Now, in 2007, while the new Partnership Law asks for tax rules that would govern entities organized under it, the government in fact faces a broader decision, of what businesses constitute partnerships that would be exempt from the EIT (under Article 1 of the EIT

[11] The State Council, *Notice Regarding the Application of the Enterprise Income Tax to Single-Owner Companies and Partnerships, Guofa* [2000] 16 (2000/6/20).
[12] The 2000 Partnership Tax Rules, Article 2.

Law). These could potentially include not only the partnerships under the 2000 Partnership Tax Rules and the new Partnership Law, but also *lianying* partnerships and unlimited liability Sino-foreign cooperative joint ventures and foreign-owned enterprises, which, as mentioned earlier, were subject to the EIT. In other words, the new partnership tax rules could have a reach well beyond those businesses formed under the Partnership Law.[13]

II. Character of Partnership Items of Income

We first examine the existing rules on the character of partnership income with respect to individual domestic partners. We then look at the case of corporate and foreign partners.[14]

II.1. Individual Partners

Under the 2000 Partnership Tax Rules, the income of a partnership is deemed to be the individual partners' "income from manufacturing and operation" (hereinafter "trade or business income" or TBI), and taxed as if the partners received such income as individual industrial and commercial households (IICHs).[15] A partnership's TBI is to be allocated among the partners in accordance with percentages specified in the partnership agreement, or, if the partnership agreement does not provide for such percentages, on a per capita basis.[16] The TBI of IICHs—which I will call sole proprietor TBI, given the similarity between IICHs and sole proprietors—is a distinct category of income under

[13] What one cannot expect, of course, is for partnership taxation to have the kind of prominence it has in the US due to the fact that even non-partnerships (most importantly, LLCs) can elect to be treated as partnerships for tax purposes.

[14] Unless otherwise noted, I ignore the derivative cases of non-corporate entity partners.

[15] *The 2000 Partnership Tax Rules*, Article 4. Partnership TBI is defined as the sum of various items of partnership income minus costs, expenses, and losses.

[16] *Id*, Article 5.

China's PIT.[17] In effect, under the 2000 Partnership Tax Rules, different types of income received by a partnership—personal service income, rent, royalty, capital gain, etc.—are all converted into a single type of income, sole proprietor TBI, when calculating the partners' PIT liabilities. Two exceptions were subsequently made to this rule: if a partnership receives interest and dividends, such income, when allocated to individual partners, would still be treated as interest and dividends, respectively.[18] But other than these exceptions, the character of items of partnership income does not flow through to, or is not preserved at, the individual partners' level.

This is highly significant because the tax rates applicable to sole proprietor TBI are very different from the rates applicable to most other categories of income under the PIT. In fact, except for the unclear case of non-wage compensation for personal services, [19] they are much higher. Chart I below, for example, compares the statutory tax rates on sole proprietor TBI, on one hand, with the rate on rent, royalties, capital gains, and certain other income received by an individual directly, on the other. The chart shows that, for any individual receiving such latter types of income in an amount in excess of RMB 42,500 a year, the person is better off holding the assets generating such income directly

[17] The eleven different categories of taxable income are listed in Article 2 of the Personal Income Tax Law.
[18] SAT, *Notice Regarding How to Implement the* Rules on the Application of the Personal Income Tax to Single-Owner Companies and Investors in Partnerships, *Guoshuihan* [2001] 84. Interestingly, although interest income is excluded from the calculation of partnership TBI, interest expenses continue to be deductible. If there were no constraints on borrowing and lending, one would be able to use this loophole to convert all sole proprietor TBI into interest income. Inter-business lending, however, is still frowned upon in China.
[19] Non-wage compensation for personal services is also subject to progressive rates under the Chinese PIT, namely at 20% for amount up to RMB 20,000 per payment, 30% for amounts between RMB 20,000 and 50,000 per payment, and 40% for amounts above RMB 50,000 per payment. *Implementation Rules for the Personal Income Tax*, Article 11. However, comparison between it and the rate structure for sole proprietor TBI is less straightforward because a 20% fixed cost deduction is allowed, whereas deductible cost for sole proprietor TBI is variable. Moreover, converting non-wage compensation for services into annual income depends on rules for aggregating payments. See SAT, *Provisions on Certain Issues in the Administration of the PIT*, *Guoshuifa* [1994] 89, Paragraph 9. In any case, compensation received by anyone providing ongoing service to a business is unlikely to be characterized as non-wage compensation for personal service under the PIT.

instead of through a partnership. Or, more precisely, he is better off holding such assets directly as long as the partnership keeps auditable accounts and is not taxed on a presumptive tax basis.[20] (In what follows, the option of presumptive taxation is implicitly left out, as that option would render the design of partnership tax rules a moot exercise.)

[Insert Chart I]

RMB 42,500 per year, of course, is a small amount for individuals pursuing business and going through the trouble of registering a partnership and other paperwork. If the new partnership tax rules preserve the non-pass-through treatment of rent, royalties, capital gains, and other income now subject to the 20% PIT statutory rate, we should see very few partnerships, with individual partners, the main business of which consists in holding assets that generate these types of income.

The comparison of the tax rates on sole proprietor TBI with the rates on wages is even more dramatic. It is well known that the progressive rate structure on wage income in China reaches a high 45% in the top bracket. However, as Chart II demonstrates, the average tax rate on sole proprietor TBI exceeds the average rate on wages in all income brackets until annual income exceeds approximately RMB 1.8 million. In other words, the receipt of partnership profits is a very tax-inefficient way for compensating services provided to a partnership. If the salary of a partner is deductible, any would-be partner who provides personal services to a partnership should structure his compensation as performance-based salary.[21] If, on the other hand, the deduction for the salary of a partner

[20] The 2000 Partnership Tax Rules contain a number of provisions on presumptive taxation of partnerships. The application of these provisions in real life varies widely, often even between two district local tax bureaus in the same city.

[21] For example, he may arrange to receive performance-based wage and no profit share unless such share exceeds RMB 1.7775 million per year.

is disallowed,[22] he must consider the fact that he may be able to receive a higher after-tax income earning wages elsewhere instead.

[Insert Chart II]

In summary, because the current partnership tax rules with respect to individual partners convert many types of income into higher-taxed sole proprietor TBI, they can be said to have an anti-partnership-formation effect, discouraging the pooling of investment assets, intellectual property, and skilled labor in a joint venture.[23] Of course, the effective tax rate is still lower than what it would be forming a corporation and being subject to double taxation.[24] So the partnership form is not without tax advantage vis-à-vis the corporate alternative.

What the new partnership rules could do, of course, is to allow the same pass-through treatment that has been granted interest and dividend income for a wider range of passive income, including rent, royalty, and capital gain.[25] As we will see shortly, there may be other reasons to introduce this pass-through framework for passive income. As to labor income, the problem is not so much that the character of income does not pass through the partnership as it is that the Chinese PIT exacts a high tax cost—though very unevenly and ineffectively administered—for individuals exercising their entrepreneurial

[22] That is the rule under the 2000 Partnership Tax Rules: a partner's salary cannot be deducted in calculating the partnership's TBI (Article 6(1)). This suggests that the Chinese government in fact intended the higher tax rate on sole proprietor TBI and wanted to preclude the conversion of such income to wage income.

[23] In practice, it may not be business formation, but accurate account keeping, that is discouraged.

[24] With the new 25% EIT rate and the 20% PIT rate on dividends, a shareholder is effectively subject to a 40% tax on income earned through a corporation.

[25] More precisely, unless a framework for loss allocation to the partners is put in place for partnerships (see discussion of Section III below), it should be *net* passive income the character of which is passed through to the partners. Otherwise, passive losses would be allowed to offset non-passive sole proprietor TBI. See footnote 18 supra.

skills. Nothing really can be done about this in designing partnership tax rules; the change would have to be made to the PIT itself.

II.2 Corporate and Foreign Partners

Sole proprietor TBI is an income category under the PIT; it has no meaning with respect to corporate partners. For such partners, with the exception of tax-exempt interest and dividend income,[26] the character of income rarely matters. It is quite conceivable, therefore, that in the new partnership rules the SAT would simply preserve the old tax rules for individual partners (i.e. making no attempt to address the problems relating to the non-pass-through of character that we have identified in Section II.1 above), and provide that income allocated to corporations would be taxed under the EIT law.

This choice would be highly problematic, however, when foreign (corporate or non-corporate) partners are taken into account, because the character of income is highly important for treaty purposes. If all partnership distributions are treated as a single type of income—as business profits, for example[27]—then use of the partnership form would have the effect of preempting the favorable treatments of interest, dividend, royalty, and capital gain found in many treaties. This will in all likelihood deter foreign investors' use of the partnership form, and thus undermine a major innovation of the new Partnership Law.

There are thus at least two separate grounds for phasing in a character pass-through framework in partnership taxation in China: removing obstacles for domestic

[26] Dividends received by resident corporations are expected to be exempt from the EIT under the new EIT Law. See Article 26 of the EIT Law.

[27] If, in an odd and unlikely scenario, all partnership distributions are treated as dividends, another type of distortion would result: foreign partners would set up investment vehicles in jurisdictions (e.g. Hong Kong) that have favorable treaty provisions for dividend income, thus undermining the Chinese government's position with respect to taxing other forms of income of foreigners.

individual investors, particularly those who hold investment assets and intellectual property, in joining partnerships, and removing such obstacles for foreign investors.

Development in this direction would imply the adoption of more of an aggregate as opposed to entity view of the partnership. Unfortunately, opportunities for tax avoidance would also immediately arise, as would the specter of complex regulations that would deal with such avoidance. The most basic reason for this consequence is the flexibility that partners have in allocating partnership profits and losses. Under the new Partnership Law, the allocation of income and losses of a partnership should be in accordance with the partnership agreement or, if the agreement fails to adequately specify an allocation, through negotiation among the partners.[28] The only statutory restriction on allocation is that, for any general partnership, the partnership agreement may not stipulate that all profits be allocated to certain partners or that certain partners bear all losses.[29] For a limited partnership, although generally "no limited partnership may allocate all profits to some of the partners", the agreement of a limited partnership may "stipulate otherwise".[30] That is to say, a limited partnership may allocate all profits to certain partners if such a manner of distribution is provided for in the partnership agreement.

The permissiveness of the Partnership Law with respect to special allocations—allocations of profits and losses in deviation from the proportions of partnership interests—is at once paradigmatic of the virtues of the partnership form and at the root of complexities in partnership taxation. Even with just the slight modification of the partnership tax rules suggested above, one can imagine partnerships formed for tax-

[28] Partnership Law, Article 33. If no agreement is reached through negotiation, then allocation may be made according to capital contribution or on a per capita basis. Id.
[29] It is unclear whether the impact of this restriction can be blunted simply by allocating a small portion of profits or losses to some partners.
[30] Id., Article 69.

avoidance purposes. For example, consider a foreign investor from a jurisdiction the tax treaty of which with China sets a 10% withholding rate on dividends but zero withholding on capital gain. The foreign investor expecting to receive dividend income from China could swap such income with a domestic corporation which expects to receive the same amount of capital gain, by forming a partnership that holds the relevant shares and capital assets. The partnership agreement could allocate capital gain to the foreign investor and dividends to the domestic corporation. The pre-tax economic consequences to the two partners would be the same as they would be without forming the partnership. But the tax liabilities of both are reduced. Another example in the same spirit would be a successful entrepreneur forming a partnership with a corporation: the individual entrepreneur assigns active income from the partnership—which would be treated as high-taxed sole proprietor TBI on his tax returns—to the corporation, which pays tax on such income at 25%; the corporation assigns income from investments (e.g. rent, royalty, capital gain) to the entrepreneur, taxed at 20%. The proportion of income assignments can be adjusted to reflect each party's tax savings. [31]

The SAT may respond to such transactions in several ways. One is to dramatically curtail the freedom of partnership allocations by prohibiting outright special allocations of items of income that have specific tax characters. Or it may specifically deny the effect of these types of allocation for tax purposes. Or it may apply a general anti-avoidance doctrine to these and other types of tax-avoidance tactics. As we will now see in connection with allocations of profits and losses in general, there are other situations in which the SAT would face the same general challenge: how to prevent a partnership from

[31] The examples would fall under the category of allocations with "shifting tax consequences" under US tax law—a category of allocations lacking "substantial economic effect" and therefore not respected for tax purposes. See Treasury Regulations §1.704-1(b)(2)(iii)(b).

allocating income items in such a way as to reduce overall tax liabilities of the partners, without affecting the economic positions of the partners?

III. Allocation of Income and Losses

A fundamental parameter of partnership taxation in China up until now is that the partners are individual taxpayers, who, under the personal income tax, cannot offset investment or business losses against investment or business gains. In calculating capital gain income for individuals, for example, taxpayers cannot take into account capital losses. In determining business income, the 2000 Partnership Tax Rules requires anyone who owns more than one business—IICHs, partnerships, and single-owner companies—to aggregate all TBI from such businesses before applying progressive rates to such income to arrive at his tax liability.[32] However, the individual who owns more than one business cannot use losses[33] from one business to reduce business income from another, or to reduce any other part of his personal income. Instead, losses of a partnership are carried forward for up to five years.[34] Thus, insofar as its losses are concerned, a partnership is basically treated like a corporation. [35]

One virtue of this policy has been that there are few tax loopholes (in the written law, at least) for partnerships: special partnership allocations are much less useful if losses and gain don't offset. Yet the crucial underlying legal parameter is about to change: business entities—corporations, partnerships, and so on—will soon be forming

[32] The 2000 Partnership Tax Rules, Article 12.
[33] The business losses of a business include both operating and capital losses. This is consistent with the fact, mentioned in Section II above, that operating and capital gain income are treated alike in the calculation of TBI for a partnership.
[34] Id. Article 14. This rule in fact applies equally to sole proprietors and corporations. See SAT, *Personal Income Tax Accounting Rules for IICHs, Guoshuifa* [1997] 43 (hereinafter "IICH PIT Accounting Rules") Article 28; the EIT Law, Article 18.
[35] The government can be reluctant even to allow loss carryforwards. The latter may need to be certified by a third-party professional and approved by the relevant tax bureau each year. See e.g. Beijing Bureau of Finance, Beijing Local Tax Bureau, *Supplemental Rules to Caishui [2000] 91*, *Jingcaishui* [2001] 6.

partnerships, and *they* are allowed to offset losses against gains. Even if partnership losses are still not allowed to flow upstream to its partners, the partners may have their own losses to offset income from the partnership. That's enough to give rise to opportunities of tax avoidance.

For example, two corporate partners may agree to share equally in partnership income. One, however, has a loss carryover that will expire in two years. The two partners may agree to allocate partnership income to the partner with loss carryover until that loss is used up, and then an equal amount of income to the other partner, and to share in partnership income again afterwards. This form of allocation—called "transitory allocations" in the US, and disregarded for US tax purposes because they lack "substantial economic effect"[36]—would preserve the pre-economic positions of the partners while reducing their overall tax liability.

This example suggests that, right away, the new partnership tax rules in China will need to authorize the government to deny special allocations with tax avoidance as its main purpose. But distinguishing such allocations from allocations serving legitimate business purposes is no easy task, and developing a body of law which both rules out abuses and at the same time gives taxpayers flexibility and reliable guidance for pursuing legitimate business goals presents a daunting challenge. It is useful to recall here that although Subchapter K of the US Internal Revenue Code (the "Code") was enacted in 1954, and Section 704(b) already stated at that time that allocations would not be respected if its principal purpose is tax avoidance or evasion, the US Tax Court decided the seminal *Orrisch* case only in 1970.[37] And the current Treasury regulations under

[36] See Treasury Regulations §1.704-1(b)(2)(iii)(c).
[37] *Orrisch v. Commissioner*, 55 T.C. 395(1970).

Section 704(b) were not adopted until 1985, after more than 30 years of experience with partnership taxation.

The challenge for Chinese tax law would be even more daunting, of course, if losses from a partnership are allowed to be currently allocated for tax purposes to its partners instead of being carried forward. While this treatment constitutes a major attraction of the partnership form under US law,[38] and while one might argue that adopting this treatment is necessary for making the partnership form a truly tax-transparent form of doing business, the problems it would usher in would be overwhelming for Chinese tax administration. Not only would sophisticated partnership tax accounting have to be put in place overnight; the tax authorities would also have to introduce passive activity loss rules and at-risk rules similar to Code Sections 465 and 469. It would be quite reasonable for the government to adopt a diffident attitude towards this prospect.

On the other hand, if we assume that the new partnership tax rules will not allow the current allocation of losses, then we can also set aside a number of major technical partnership tax issues as being only of future relevance. For example, the allocation of partnership liabilities becomes a less urgent issue, since a major function of liability allocation is to give partners enough outside basis to absorb depreciation deductions.[39] (However, as will be argued in Section IV below, outside basis accounting *will* need to be introduced into partnership taxation so as to keep track of contributions and distributions.)

[38] The flow-through of losses is an important tax consideration in favor of starting a business venture in a partnership and not a corporation, so that early losses can offset current instead of future income. See Laura and Noël Cunningham, The Logic of Subchapter K (Third Edition) (Thomson/West 2006), p 5.

[39] See discussion in Cunningham, id., pp 15-17. There are others reasons why allocation of liabilities would not be an urgent partnership tax issue in China: business lending itself is heavily restricted, and non-recourse debt seems to be used only in project financing transactions.

Also, if special allocations are limited to income items only, then it is more likely that the government can deal with abusive allocations without examining in detail the partnership's capital accounts. Rules for capital account maintenance may thus be postponed.

Under this scenario of partnership tax development, Chinese partnerships would be formed for their income, not for their losses. And other things being equal, corporations, partnerships, and other entities with business losses would be favored investors—as compared to profitable corporations and to individuals—because their effective tax rate on such partnership income is lower. Note that this will be true even in the absence of abusive special allocations: even if allocations are in proportion to partnership interests, entity partners with business losses would bear a lighter tax burden.

IV. Contribution and Distribution of Property

IV.1. Contribution to a Partnership

The current rules for contribution of non-cash property to a partnership differ for individual and corporate contributors. In the latter case, applicable rules may also be set out in the implementation rules for the new EIT Law.

a. Individual Partners

How to treat the contribution of non-cash assets in the formation of a partnership seems a fundamental issue in partnership taxation. Oddly, the SAT addressed this issue only in 2005. In a short letter,[40] the SAT states: "When an individual contributes, as an investment and after appraisal, non-cash property to an enterprise and receives shares of the enterprise in exchange, the personal income tax shall temporarily not apply to the

[40] SAT, *Reply Regarding the Temporary Exemption from the Personal Income Tax for Appraised Appreciation of Non-Cash Property, Guoshuihan* [2005] 319 (2005/4/13)

gain reflected in any appraised appreciation. When the individual's investment is returned, transferred, or liquidated, the personal income tax shall apply to any income then received by the individual, using the pre-appraisal cost of the (contributed) property as the original cost of the investment."

How does the partnership treat the contributed property? The 2000 Partnership Tax Rules state that tax accounting for partnerships should follow tax accounting for IICHs, with certain minor adjustments.[41] A rule that applies to both partnership and IICHs is the valuation of in-kind contribution of assets. The rule says that the both fixed and intangible assets contributed to a business shall be valued (e.g. for purposes of depreciation and exchange) either according to appraisal or according to a value agreed to in the relevant contract/agreement.[42] If we assume that both appraisal and stipulation in an investment agreement values the contributed property near its fair market value, the effect is that the contributed property receives a stepped-up basis if it has unrealized pre-contribution appreciation.

This combination of exchange basis for partnership interests and stepped-up inside basis for contributed assets is of course very favorable to a taxpayer with appreciated property: the taxpayer does not recognize taxable income at the time of contribution, and larger depreciation deductions may be used to offset partnership income (though they may not be allocated to the partners). Another implication of this treatment is that taxpayers would not form a partnership, contribute appreciated property, sell the property, and allocate the resulting gain to partners other than the original contributor—an avoidance maneuver preempted by Code Section 704(c) under US tax law. But

[41] The 2000 Partnership Tax Rules, Article 6.
[42] IICH PIT Accounting Rules, Articles 34(3) and 40(1).

without the need to track Section 704(c) allocations, the need to keep tax capital accounts also goes away—all one needs to do is to keep track of the partners' outside basis. This is good news for keeping partnership tax rules simple.

Lest one thinks that we have finally found a Chinese tax rule favorable to the use of the partnership form, it should be noted that 2005 rule applies to contributions to both partnerships and corporations (and other business entities).

b. Corporate Partners

The story is somewhat different if the contributor to a partnership is a corporation. Recall that while corporations cannot be partners under the Old Partnership Law, they can be investors in *lianying* partnerships or partnership-like foreign invested enterprises.[43] Until now, such enterprises are treated like corporations and subject to the EIT under the dual regimes applicable to domestic and foreign-invested corporations. For our purpose—which is to examine the different approaches that the SAT has taken to the treatment of contributions of property—it's enough to look at the example of a domestic corporation contributing to a *lianying* partnership.

In a 1997 notice,[44] the government stated that if a taxpayer invests in other businesses with non-cash assets, the appraised appreciation of the assets will not be included in (EIT) taxable income. If, however, the investment interest is transferred by or returned to the taxpayer, the difference between money or assets received on such transfer or return and the original cost of the contributed property shall be included in (EIT) taxable income at that point. However, this position was changed by an SAT notice

[43] See text to note 6 supra.
[44] Ministry of Finance and SAT, *Notice Regarding Income Taxation of Appraised Appreciation of Assets of Enterprises, Caishuizi* [1997] 77.

in 2000.[45] That later notice stated that if a corporation contributes non-cash assets used in its operations to another business, the investment transaction shall be treated as having two components: a sale at fair market value of the relevant non-cash asset and an investment of the proceeds of such a sale; gain or loss from such a transaction is therefore recognized.[46] Thus the SAT has taken two opposite positions regarding contributions by corporations to (corporate and non-corporate) businesses, treating a contribution first as a non-recognition, then as a recognition, event with respect to the contributor.

With respect to the inside basis of the contributed property, the general rule has remained the same: the asset is treated for tax purposes as having the appraised value or a value specified in the investment agreement.[47]

What positions should the SAT take in the new partnership rules—and possibly in the implementation rules for the new EIT Law? The current rule applicable to corporate contributors—treating a contribution as a recognition event—of course could have an effect of deterring business formation. The current rule applicable to individual contributors is taxpayer friendly and relatively simple to administer, as was the similar 1997 rule applicable to corporate contributors. An obvious alternative is the approach familiar in US tax law, where contribution is a non-recognition event but the contributed property receives transferred, not stepped-up, basis.[48] While this may be a more consistent approach than the combination of non-recognition and stepped-up basis, the

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[45] SAT, *Notice on Certain Income Tax Issues Regarding Stock Investments by Corporations, Guoshuifa* [2000] 118.
[46] If the income from such a transfer is "relatively large", and recognition would give rise to tax liabilities that the contributing corporation has difficulty to satisfy, then, with the approval of the relevant tax agency, the income can be deferred by being equally allocated to subsequent year income in a period of up to 5 years. Id., Paragraph 3(2).
[47] See Ministry of Finance, *Implementation Measures for the Provisional Rules on the Enterprise Income Tax, Caifazi* [1994] 3, Articles 30(7) and 32(1). See also *Guoshuifa* [2000] 118, supra note 45 (the cost of the non-cash asset contributed may be determined by its appraised value.)
[48] Code Sections 721 and 723.

amount of partnership accounting required to sustain it (e.g. allocation of built-in gain or loss) can be quite challenging. Given that the Chinese tax authorities are unlikely to tackle these complexities soon, perhaps the best scenario—for both taxpayers and the government—is to generalize the non-recognition-with-stepped-up basis approach to all contributions to partnerships.

II.2 Distributions and liquidations of partnership interests

Chinese partnership law terminology does not yet clearly distinguish "allocation" (an accounting matter) and "distribution" (involving the transfer of property).[49] The 2000 Partnership Tax Rules appears to recognize that a partnership may retain profits even though such profits are already included in the partners' income.[50] However, there is no system for adjusting outside basis for partnership interests so as to prevent double taxation. For example, suppose that partner Zhou with an initial RMB 10,000 basis in his partnership interest is allocated RMB 2,000 of income, which remains undistributed. Zhou is now entitled to RMB 12,000 of partnership assets upon liquidation. Zhou would need to include the RMB 2,000 in his taxable income during the tax period in which the partnership earns the income. However, if Zhou sells his partnership interest for RMB 12,000, presently there appears to be no legal ground for him to claim that his cost in the partnership interest is RMB 12,000, not RMB 10,000.

In fact the SAT is not unaware of the possibility of double taxing retained profits. With respect to the liquidation of a partnership, the 2000 Partnership Tax Rules provides that income from liquidation should be treated as partnership TBI and taxed to the partners, but income from liquidation does not include retained profits from previous

[49] The same word, "fenpei", is used for both.
[50] The 2000 Partnership Tax Rules, Article 5 (TBI includes both profits distributed and profits retained).

years.[51] There is no corresponding provision, however, on the liquidation of a partnership interest or on the transfer of such an interest. Indeed, there are no published rules on the sale or liquidation of a partnership interest at all.

Presumably, the new partnership tax rules will want to cover these basic grounds. In doing so, one could either look inside a partnership to its assets, and identify such items as undistributed profits, or attribute an outside basis to each partnership interest. The two methods are not equivalent, as the case of contribution of appreciated property shows: the partner's share of inside basis can be higher than his outside basis. When there is such discrepancy, it is the outside basis that matters in cases of transfer or (complete or partial) liquidation. Currently, Chinese tax law does not yet have a concept of outside basis—as adjusted for allocations and distributions.[52] It seems appropriate to introduce such a concept, even if other concepts—tax capital accounts or even capital accounts—could come later.[53]

[51] Id., Article 16.
[52] Neither "original cost of asset" ("caichan yuanzhi") nor "actually contributed capital" ("shijiao ziben") serves all the functions that the concept of outside basis does.
[53] Tong Yingying and Lin Yanhua provided valuable research assistance for this article.

Chart I. Tax rate comparison between (i) sole proprietor TBI and (ii) rent, royalty, capital gain, accidental income, and "other income" under the PIT

Sole proprietor TBI bracket （Annual taxable Income）	Marginal rate	Average rate at top of bracket	PIT statutory rate on income types in the second group
5000	5%	5%	20%
5000-10000	10%	7.5%	20%
10000-30000	20%	15.8%	20%
30000-50000	30%	21.5%	20%

Note: (a) It is assumed that the taxpayer's annual personal allowance of RMB 19,200 is used to offset other taxable income and therefore cannot be used to offset sole proprietor TBI; (b) above RMB 42,500, average rate on sole proprietor TBI exceeds the general 20% rate applicable to income types in the second group.

Chart II. Tax rate comparison between (i) wage income and (ii) sole proprietor TBI.

Annual taxable Income	**Marginal wage income tax rate**	**Average wage income tax rate at top of bracket**	**Marginal sole proprietor TBI income tax rate**	**Average sole proprietor TBI tax rate at top of bracket**
0~5000	5%	5%	5%	5%
5000~6000	5%	5%	10%	5.83%
6000~10000	10%	7%	10%	7.5%
10000~24000	10%	8.75%	20%	14.79%
24000~30000	15%	10%	20%	15.83%
30000~50000	15 %	12%	30%	21.5%
50000~60000	15%	12.5%	35%	23.75%
60000~240000	20%	18.125%	35%	32.1875%
240000~480000	25%	21.5625%	35%	33.59375%
480000~720000	30%	24.375%	35%	34.0625%

720000~960000	35%	27.03125%	35%	34.296875%
960000~1200000	40%	29.625%	35%	34.4375%
1200000~ 1777500	45%	34.62%	35%	34.62%

Note: (a) figures in the first column represents amounts after a personal allowance of RMB 1,600 per month has been subtracted (for both types of income); (b) in order to compare the two income types, wage income is converted into annual figures; (3) the average tax rates for the two types of income are equal at RMB 1,775,500, after which the average rate on wage income is higher.