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TAX MANAGEMENT INTERNATIONAL JOURNAL

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Designing Foreign Tax Credit Rules in China: The Case of Foreign Loss Limitations

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INTRODUCTION

Over the last few years, China's large trade surplus against other countries, as well as its high domestic savings rate even relative to its high investment rate, have resulted in a very substantial foreign currency reserve that puts the country in the position of a significant capital exporter. The huge amount of foreign currency assets held by the Chinese government — near $1.9 trillion at the end of 2008 — and a breathtaking series of acquisitions made by Chinese firms overseas are now salient items in international business reporting and public discussion. China's new posture as an exporter of capital has also ushered in a new phase of development in the country's international tax regime; ''outbound'' tax policy — how Chinese corporate and individual residents are taxed on income earned abroad — increasingly attracts the attention of taxpayers and practitioners.

The foreign tax credit (FTC) system stands at the center of this area of law. The Enterprise Income Tax Law (EIT Law) adopted in 2007 inherits most of the FTC provisions from prior law, while also introducing a number of innovations. The most obvious among the innovations is a provision allowing Chinese enterprises to obtain indirect FTC for tax paid by their foreign subsidiaries.[1] While this provision has understandably attracted much attention, and practitioners have been looking forward to more detailed regulations prescribing its workings,[2] it is not as though China had a well-functioning FTC system in place already, and simply needed to add the concept of deemed-tax-paid to that system.[3] Quite the contrary, under prior law, a large number of issues that affected the basic workings of even the direct FTC system were either unresolved, or inadequately resolved. Permitting indirect FTCs will multiply the occasions on which these fundamental issues will arise, as well as the layers of uncertainty they generate.

Some of these prior problems are technical in nature. For example, a crude formula for the foreign tax credit limitation malfunctioned[4] in implementing the per-country limitation when losses were generated by some of the taxpay-

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[1] EIT Law, Art. 24.

[2] *See* the Enterprise Income Tax Law Implementation Regulations (State Council, Decree No. 512, Nov. 28, 2007) (herein referred to as the ''EIT Law IR''), Art. 80 (direct and indirect ownership must exceed 20% for deemed paid credit provision to apply; further regulations to be issued regarding ownership requirements.)

[3] The concept of deemed-tax-paid has long been present in China's income tax treaties.

[4] This crude formula has been inherited by the EIT Law and can be found in Article 78 of the EIT Law IR.

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er's operations. Because regulations issued by the Ministry of Finance (MOF) and State Administration of Taxation (SAT) did not address how such problems were to be dealt with, taxpayers and local tax bureaus had to come up with their own solutions.[5] But other issues in the old FTC system were technical only in appearance; they would be regarded as serious policy issues in countries with advanced income tax systems. Without attempting completeness, one could identify at least the following items as being of policy significance and in need of resolution in the near future:[6]

- **How the source of income is determined.** While the basic EIT regulations contain certain rules on the source of income,[7] they are very incomplete. For example, other than a rule for the transfer of equity investments, there are no rules for sourcing gain (or loss) from the transfer of intangible property, be it non-equity securities, intellectual property, or other rights. The rule for transfers of inventory, which sources income from such transfers to the place where ''transactional activities'' occur,[8] is also badly in need of clarification. These rules directly determine the FTC consequences for Chinese taxpayers entering into the relevant transactions, and therefore could affect the very decisions for entering into them.
- **How expenses (including interest and R&D expenses) are allocated to a taxpayer's activities in different countries.** While some language in the EIT Law and implementing regulations could be read as requiring taxpayers to trace expenses to the particular income generated,[9] it is unclear whether this is seriously implemented. More often, expenses are allocated as recorded on the books, which could lead to mismeasurements of income as well as tax avoidance opportunities.
- **What tax accounting methods should be applied to determine foreign income or loss.** Although the integrity of an income tax system generally requires that the same set of tax accounting rules apply to compute income and loss worldwide, following this principle in China is problematic because of the incompleteness of Chinese tax rules. Domestically, this incompleteness often results, in real practice, in computations of income and loss that are to the taxpayers' disadvantage. If foreign income and loss were also subject to this conservative approach, domestic tax liability on foreign income could end up higher than it should be.
- **Whether the per-country limitation on applying FTCs will have exceptions.** The EIT Law Implementation Regulations state that while the per-country limitation generally applies to claims of FTCs, MOF and SAT may prescribe exceptions.[10] Clearly, the government realizes that the per-country limitation may be too stringent and in conflict with policy goals with respect to outbound investments in some circumstances. What these policy goals are, and how the per-country limitation may be correspondingly relaxed, remain open to discussion.
- **Whether profits and losses from different countries are allowed to offset each other.**

This article will focus on this last item for two reasons. First, the issue of loss offsets is unfamiliar to many Chinese tax practitioners, and its relation to the FTC is not always understood. Second, corresponding to the unfamiliarity and subtlety of the issue, an important statutory provision in the EIT Law, which prohibits the use of foreign branch losses to offset domestic income, has gone widely unnoticed. In other words, among all the issues of policy significance listed above, a policy decision regarding the last item, limitations on loss offset, has already been made and encoded in the statute, while the importance of the decision is still insufficiently recognized and its merit largely undiscussed. Bringing attention to the issue is thus an urgent, albeit a partially remedial, matter.

However, the extent to which profits and losses from different countries are allowed to mutually offset each other has something in common with all other policy issues (whether or not listed above): its resolution requires an articulation of China's tax policy (or policies) towards the different types of outbound investment.[11] Does the tax regime aim to encourage overseas business ventures? Or is it neutral with respect to whether Chinese taxpayers decide to invest in China or abroad? Or are overseas investments perceived to threaten the domestic tax base, and, therefore, the preservation of fiscal revenue is given high

[5] *See, e.g.,* Beijing State Tax Bureau, Jingguoshui [1998] 063 (instruction to disregard FTC limitation formula when there is a domestic loss).

[6] There are policy issues (e.g., what types of taxes are creditable) that are not always under active consideration even in advanced income tax systems. While what taxes are creditable also awaits clarification under Chinese regulations, it may be argued that it is not really a *live* policy issue.

[7] EIT Law IR, Art. 7.

[8] *Id.*, Clause (1).

[9] *See* EIT Law, Art. 8 (expenses must be related to the earning of (gross) income to be deductible); EIT Law IR, Art. 27 (the relationship between expenses and income must be direct).

[10] EIT Law IR, Art. 78.

[11] Different policies may apply to different types of investments. For example, foreign direct investment (FDI) may be treated differently from foreign portfolio investment.

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priority in designing outbound tax rules? I hope to illustrate, through the particular example of the loss limitation rules, the difference between these policy goals.

In the first section below, I describe the statutory prohibition on the use of foreign losses to offset domestic income, the problem with its purported rationale, its predecessor under prior law, and basic ways to assess the provision. In the second section below, I show that the best argument for the limitation on foreign losses is that it avoids improper results with respect to the FTC mechanisms. However, such results can be avoided through other means, such as a loss recapture or resourcing device, which not only more accurately measures income but also has been practiced elsewhere in China's tax system. Moreover, I argue that there is no good case for other types of limitations on cross-border loss offsets either. In the final section, I discuss why, among aversion, neutrality, and an attitude of encouragement towards outbound investments, China's tax authorities might be expected to exhibit more often the first type of orientation.

EIT LAW ARTICLE 17 AND ITS POSSIBLE EXTENSION

Article 17 of the EIT Law states that when an enterprise computes its tax liability based on the income and losses of all of its operations, the losses of a business unit outside China are not allowed to offset profits of business units within China. No such limitation existed under the previous tax regime for foreign-invested enterprises. Even though, as discussed below, a related limitation was deployed in the regime applicable to domestically funded enterprises, it was laid out only in a ministerial circular and did not have the status of a statutory rule. The appearance in the EIT Law of this limitation on foreign losses is thus striking. Although, in China, there is still no official recording of legislative history in reliance on which legislative intent can be used in legal interpretation, there is an official annotation of the EIT Law published shortly after the Law's adoption. The annotation contains a discussion of Article 17 and justifies the law on the ground that foreign branch losses are easy to manipulate and difficult to verify.[12]

This justification is difficult to accept for a number of reasons. Manipulation of losses should be countered by applying proper accounting rules. Even if, generally, auditing the income and losses of foreign operations is difficult, the degree of difficulty depends on actual circumstances and is not always insuperable. It does not make sense, therefore, to deal with administrative difficulties that arise only in some circumstances by uniformly denying taxpayers the right to the proper measurement of their income whenever foreign branch losses could affect the computation of such income. Moreover, as a matter of general practice, China has not dealt with administrative difficulties by introducing distortions into fundamental tax law. For example, like many countries that have only recently implemented the value added tax (VAT), China has had difficulty combating fraud in tax refund claims on exports. Partly as a result of this, China has long abandoned full zero-rating on exports in practice and offers only partial refunds. However, the basic VAT regulations still provide for the right to zero-rating on exports, subject to exceptions made by the government.[13] Moreover, the adjustment of refund rates has generally been accomplished through temporary regulations. It is hard to believe that manipulation of foreign losses in the income tax context constitutes a problem of a far greater magnitude, requiring a more drastic, statutory solution.

The justification of the limitation on foreign branch losses in terms of administrative difficulties also has problematic implications. If such losses are easily manipulated, should they be disallowed from offsetting foreign income as well? The official annotation undermines its own argument in this regard by stating that a foreign loss may still offset income arising from the same foreign country.[14] This leaves it unclear not only whether loss and income from different foreign countries might mutually offset each other, but also what type of reasoning one is to follow.

Aside from the ''official'' exegesis of Article 17, another approach to its interpretation is to consider its predecessor in a MOF/SAT announcement issued in 1997 (''Circular 116'').[15] That document was issued under the previous enterprise income tax regime for domestically owned firms and did not apply to foreign-invested enterprises (FIEs were subject to no loss limitation with respect to foreign income or losses). The circular stated that, in computing taxable income, losses may offset profits among foreign op-

[12] Shi Yaobin, Sun Ruibiao, and Liu Zhao, *Annotations and a User's Guide to the Enterprise Income Tax Law of the People's Republic of China* (*zhonghuarenmingongheguo qiyesuodeshuifa shiyijishiyongzhinan*) (Law Press: Beijing; first printing Apr. 2007), pp. 81-2: ''Tax administration for foreign branches is relatively difficult; the motive to create artificial losses through manipulation thus easily arises, resulting in encroachment of the domestic tax base.''

[13] *See* Provisional Regulations on the Value Added Tax (as revised pursuant to State Council Order No. 538, Nov. 10, 2008), Art. 2, clause (3).

[14] Shi, Sun, and Liu, *Annotations and a User's Guide*, fn. 12, above, at 82.

[15] MOF/SAT, ''(Revised) Temporary Measures for Computing and Collecting Tax on Foreign Income,'' *Caishuizi* [1997] 116 (11/25/97).

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erations, but there may be no offsetting of losses against profits in either direction across the Chinese border.[16] There are thus some significant differences between the Circular 116 provision and Article 17 of the EIT Law. However, the former points to a set of concerns in light of which Article 17 can be better understood.

We could start by noting that Article 17 does not speak in terms of the source of income and loss. Generally, a foreign branch could have both Chinese- and foreign-source income, as could a domestic branch.[17] Circular 116, by contrast, refers not to foreign or domestic branches but to profit and losses from inside and outside China. It is natural to interpret this more precisely as addressing foreign- or Chinese-*source* income and loss. Understood this way, the Circular 116 provision is a rule of more general application, because it addresses the deductibility of a wider range of foreign losses. For example, under current EIT Law source rules, a loss from the sale of a foreign company's stock should be treated as foreign-source.[18] Whereas Article 17 is silent with respect to this type of loss, Circular 116 would limit its deductibility against domestic income. Moreover, as we will see below, one can argue in favor of such a limitation in terms of the operation of FTC mechanisms, once it is interpreted as addressing foreign-*source* losses.

We should, of course, also note that Circular 116 explicitly prohibits using a domestic-source loss to offset foreign-source income, while permitting the offsetting of loss against income across foreign operations, including across foreign countries.[19] Thus, not only can Article 17 be subsumed under the limitation on foreign-source loss from offsetting domestic income, that limitation itself can be seen in the context of a broader set of limitations. Specifically, there are three distinct limitations:

- Limitation (1): Foreign-source loss cannot offset domestic-source income
- Limitation (2): Domestic-source loss cannot offset foreign-source income
- Limitation (3): Foreign-source loss from one operation (or country) cannot offset foreign-source income from a different operation (or country).[20]

In developing detailed rules regarding the computation of foreign-source income and FTC limitations (which are yet to be issued under the EIT Law), it is not unlikely that the government would consider all three types of limitations.[21] To the extent that the prior law's adoption of both limitations (1) and (2) (in Circular 116) has not been debated and criticized, both limitations may be continued. Although Circular 116 explicitly rejected limitation (3), it clearly could be revived if fear about manipulation of foreign losses is genuine. Moreover, there has been an absence of detailed rules dealing with the consequences of loss offset among foreign operations. As discussed in Section II below, such detailed rules may be perceived by some as too complex in light of the per-country limitation on foreign tax credits, giving another reason for reconsidering limitation (3).

In other words, Article 17 may not be the end of the story in terms of limitations on foreign loss. An understanding and evaluation of Article 17 may require understanding and evaluating its possible extension. Moreover, if, as the next section argues, such extension would be unjustified, its adoption should also be prevented, if possible.

The starting point for any evaluation of the above limitations should be the acknowledgment that all three potentially result in the overstatement of a taxpayer's worldwide income when applied to a particular tax period. They thus potentially increase a taxpayer's liability. Prima facie, each of these limitations violates the so-called principle of horizontal equity: taxpayers with the same income are taxed differently depending on the mix of where their profits and losses are earned. The idea that persons with the same income should be taxed in the same way, no matter where the income is earned, has at least traditionally been offered as a justification for adopting worldwide taxation in the first place.

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[16] *Id.*, ¶2.

[17] *See* EIT Law IR, Article 7, on source of income rules. Presumably, however, the purported concern of Article 17 relates mainly to foreign-source losses, because the *Chinese-source* loss of a foreign branch should not be difficult to verify.

[18] EIT Law IR, Art. 7, clause (3).

[19] In a prior document repealed by Circular 116 (MOF and SAT, *Caishui* [1995] 56), a provision disallowed offsets between "losses and profits of foreign enterprises." It was unclear whether this merely stated the tautology that the tax liabilities of distinct foreign legal entities could not be computed on a combined base, or whether it disallowed loss offsets among foreign (branch) operations of the same taxpayer. This language was removed in Circular 116. Moreover, local tax bureaus have explicitly interpreted Circular 116 as allowing loss offsets across foreign countries. *See* Shandong Provincial Local Tax Bureau, Notice regarding Several Problems in Enterprise Income Tax Administration (*Ludishuifa* [1999]160, Dec. 3, 1999).

[20] In the discussion below, we assume that domestic losses are generally allowed to offset domestic income, subject to specific exceptions, such as the disallowance of deductions related to non-taxable income. This assumption holds under the regulations issued under the EIT Law so far.

[21] Given that limitations on loss offset work to the detriment of taxpayers, it may be questioned whether such further regulatory extension is authorized. The MOF and SAT probably regard Article 20 of the EIT Law as sufficient authorization ("The specific scope and criteria for determining income and deductions and the tax treatment of capital assets in this chapter shall be prescribed by the finance and tax agencies under the State Council.").

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More importantly, the limitations violate standards of efficiency, such as capital export neutrality: foreign income is disadvantaged relative to domestic income if it cannot be offset by domestic loss; risky foreign investments are disadvantaged if losses from such investments cannot offset domestic or other foreign income. The limitations are thus non-neutral with respect to domestic and foreign investments.

Because equity and efficiency considerations go to the heart of any system taxing worldwide income, limitations on loss offset should not be adopted lightly. Nonetheless, at least versions of Limitation (1) seem to have been adopted in countries other than China (e.g., Germany [22] and Australia [23]. Moreover, there is an argument in favor of Limitation (1) (and potentially Limitation (3)) that counters the fundamental equity and efficiency considerations. The argument is that foreign income is primarily subject to foreign (source country) taxation, and the resident country has at best residual taxing power. There is thus a meaningful distinction between the part of the tax base that is domestic from the part that is foreign. To allow foreign loss to offset domestic income would likely encroach on the domestic tax base, and therefore is unacceptable from a revenue perspective. This, of course, is the reason why no country allows unlimited FTCs, and all countries generally limit the FTC to the amount of domestic tax that would be imposed on foreign income.

The key to this argument is how the encroachment on the domestic tax base occurs. As shown in the section below, it is more credible to explain this in terms of how the FTC mechanism works than to allege manipulation of foreign losses. Even for the real problem created by FTC rules, however, there are better solutions than limiting the deductibility of foreign losses. Therefore, the argument does not succeed. Moreover, the argument also fails to justify Limitations (2) and (3). Although special rules may be needed to accommodate any loss offset across borders, the increase in technical complexity is hardly unmanageable.

LOSS LIMITATION VERSUS LOSS RECAPTURE

How unlimited loss offsets could result in encroachment on the domestic tax base has to be understood in connection with FTC rules. We illustrate this through the scenarios depicted in the following charts, in all of which the People's Republic of China (PRC) and foreign tax rates of 25% are assumed.

Chart I depicts a scenario where a PRC taxpayer records in country X a loss of 1000 in Year 1 and profits of 1000 in Year 2. The taxpayer has PRC-source income of 1000 in each of the two years. Chart I assumes that, under X's tax law, X-source loss in Year 1 offsets X-source income in year 2 in determining tax liability in X; therefore, no tax is paid in X for the 1000 of income in Year 2. It further assumes that, if PRC tax rules were to prohibit the offsetting of foreign loss against domestic income, it would allow a carryover of the unused foreign loss from year 1 to year 2. With these assumptions, the chart shows the taxpayer's taxable income and PRC tax liability for years 1 and 2, computed either with or without Limitation (1) discussed in the last section (which prohibits deducting a foreign loss against domestic income).

Chart I

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1000	0	1000	0	0	1000	250
2	1000	0	1000	2000	500	1000	250

As Chart I shows, under either method there is no encroachment on the PRC domestic tax base: over two years, there is net X-source income of zero and PRC-source income of 2000, and the right amount of tax (500) is collected from the domestic income. What the loss limitation does is to defer the loss deduction and therefore accelerate income and tax liability, in deviation from the actual sequence of worldwide income realized by the taxpayer.

Chart II contains the standard illustration of how basic FTC rules could lead to diminution of the domestic tax base in the face of a foreign loss. While keeping the taxpayer's income and loss profile the same, the scenario in Chart II assumes that, under

[22] *See* National Foreign Trade Council, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part Two: Relief of International Double Taxation," p. 260 (with respect to German tax rules, "foreign branch losses are not deductible . . . branch losses can be carried forward for offset against future income of the respective branch. Thus, a benefit for the branch loss, albeit delayed, is ultimately obtained.").

[23] *See* Ault and Arnold, "Comparative Income Taxation: A Structural Analysis" (2d Edition) (*Kluwer Law Int'l* 2004), p. 367.

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country X's law, the loss in Year 1 does not offset the income in Year 2 in determining tax liability in X. There are a number of real-world circumstances where this might occur. The income from Year 2 may not be subject to net-income taxation (e.g., it is portfolio income). Or it could be that the X-source income consists of the repatriation of profit generated by a separate subsidiary (thus, credit for the X tax is claimed on a deemed-paid basis). Or one can imagine that our charts have oversimplified, and the foreign income earned in Year 2 is from a different foreign country, Y, which, of course, would not consider the X-source loss from Year 1.

Chart II

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1000	0	1000	0	0	1000	250
2	1000	250	1000	2000	250 (250 FTC used against 250 liability on foreign income)	1000	250 (excess FTC: 250)

If, for any of these reasons, country X tax is paid in Year 2, and if a FTC is allowed for such tax in China, then over two years only 250 of PRC tax is paid on the 2000 of PRC-source income. This is shown in the "No loss limitation" column of Chart II. The country X loss in Year 1 is genuine and there is no manipulation. However, foreign-source income is effectively overstated over time, and domestic income understated. Consequently, the taxpayer gets to use tax paid to X to shelter PRC-source income from tax. By contrast, Limitation (1) treats the taxpayer as having zero X-source income in Year 2, turning the 250 of X tax paid into excess credits to be carried over into future years. The PRC-source income of 2000 is consequently fully taxed in the PRC.

Chart II, therefore, appears to justify Limitation (1) by its function to protect the PRC tax base. But there is an alternative solution to the problem,[24] as illustrated in the "No loss limitation" column in Chart III. Instead of a limitation on the loss-offset during Year 1, a rule could provide that to the extent foreign loss has offset domestic income in Year 1, subsequent foreign-source income should be recharacterized as domestic-source income for FTC purposes. Thus, in our example, if the 1000 of X-source income in Year 2 is recharacterized as PRC-source income, the 250 of X tax paid would not be creditable and must be carried over, similar to the results under loss limitation. Consequently, the right amount of tax is collected on the 2000 of PRC-source income over two years and the domestic tax base is left intact.

[24] This is the approach adopted in the United States since 1976. *See* U.S. Internal Revenue Code of 1986, §904(f).

Chart III

Year	Country X Income	Country X tax	PRC-source income	No loss limitation but with re-sourcing of foreign income		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1000	0	1000	0	0	1000	250

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2	1000	250	1000	2000	500(excess FTC: 250)	1000	250 (excess FTC: 250)

Comparing the ''No loss limitation'' and ''Limitation (1) applies'' columns of Chart III, one sees that one difference between the loss recapture and the loss limitation approaches is that the latter defers the deduction for the foreign loss to Year 2 and thus accelerates income and tax liability. The latter approach thus gets the timing of income wrong, relative to the former approach. But more importantly, if the taxpayer does not generate foreign-source profit after Year 1, the loss limitation rule would completely fail to recognize this loss for tax purposes. Although the domestic tax base is preserved, it is done at the expense of a serious mismeasurement of the taxpayer's income overall. The recapture approach avoids this problem.

It may be asked, therefore, why China should not adopt the loss recapture approach, given that it both protects the domestic tax base and more accurately measures worldwide income, thus avoiding the loss limitation's potential to discourage foreign investment.

An answer that cannot be plausibly given is that a recapture mechanism is too complex and alien to the Chinese system. China's tax accounting has already practiced the recapture approach to deal with a problem within the domestic context. Under the tax system before the EIT Law took effect, foreign enterprises and foreign-invested Chinese enterprises (FIEs) received tax preferences depending on the nature of their Chinese operations as well as the locations and timing of such operations. Therefore, a foreign firm's or an FIE's different operations in China could have been subject to different tax rates. Both types of firms were nonetheless allowed to file combined tax returns that aggregated branch profits and losses. This created the possibility that loss from a low-taxed operation would offset income from a high-taxed one. A special rule, therefore, required that if this happened, subsequent income earned by the low-taxed operation would be first recharacterized as income from the high-taxed operation.[25]

The concept of loss recapture is also relevant to assessing the need for imposing Limitations (2) and (3) described in the last section. For example, one argument for Limitation (3), regarding loss offsets among foreign countries, may be the following. Because China adopts the per-country limitation on the claim of FTCs, there is normally residual Chinese tax collectible on income from low-tax countries. Income from high-tax countries, on the other hand, would normally not give rise to residual Chinese taxation. If losses from high-tax countries are allowed to offset income from low-tax countries, China may lose the revenue that it is otherwise entitled to collect from income earned in low-tax countries. Clearly, this concern is similar to the concern about aggregating profits and losses from branches subject to different tax rates, and Chinese law already shows that it can be dealt with by a loss recapture, as opposed to a loss limitation, approach.[26]

It seems hard at first to find *any* justification for Limitation (2), which prohibits the use of domestic losses to reduce foreign income. It fails to display neutrality with respect to domestic and foreign investments (which both fairness and efficiency seem to require), and it does nothing to protect the domestic tax base. But there is a surprising argument for Limitation (2): when the FTC mechanism is taken into account, the limitation sometimes delivers results that are *more favorable* for taxpayers, as well as conceptually more correct. This can be seen in the scenario depicted in Chart IV.

Unlike the previous charts, the Chinese taxpayer here realizes income of 1000 from country X in both Years 1 and 2, but has a domestic loss and income of 1000, respectively, in the two years. The penultimate row contrasts the ''No loss limitation'' approach with the ''Limitation (2) applies'' approach, while the last row contrasts the latter with a ''No limitation but with recapture'' approach. The penultimate row of Chart IV shows that when a domestic loss offsets foreign income, foreign income may be understated and domestic income overstated over time. Under the pure ''No loss limitation'' approach, the taxpayer is treated as having 1000 each of domestic and foreign income over the course of two years, whereas in fact it has zero domestic income and 2000 of foreign income. This could prevent the taxpayer from using foreign tax credits otherwise available: in the scenario depicted, the taxpayer has 250 of excess credits at the end of Year 2. If Limitation (2) applies, by contrast, the mix of domestic and foreign income may be more accurately computed, and the taxpayer can end up paying *less* tax worldwide compared to the pure ''No loss limitation'' approach.

[25] *See* Implementation Rules for the Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises (State Council Order No. 85, 1991), Arts. 91 and 93.

[26] While Circular 116 permitted loss offsets across foreign countries, it did not propose a loss recapture system similar to that used for foreign and foreign-invested enterprises operating in China.

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Chart IV

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (2) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	1000	250	-1000	0	0 (excess FTC: 250)	1000	0 (FTC used: 250. Domestic loss carry-over: 1000)
2	1000	250	1000	2000	250 (FTC used: 250; excess FTC: 250)	1000	0 (FTC used: 250)
2 (alternative with recapture)	1000	250	1000	2000	0 (FTC used: 500, with 250 from Year 1)	1000	0 (FTC used: 250)

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Even in this scenario, however, Limitation (2) is not without problems: if the taxpayer subsequently realizes no domestic income that absorbs the carried-over domestic loss, it would have an unused 1000 of loss carryover, which could be just as bad as the unused FTC under the pure ''No loss limitation'' approach. Now compare both approaches with the ''No limitation but with recapture'' approach in the last row. Under the recapture rule used here, domestic income is recharacterized as foreign income to the extent a domestic loss previously offset foreign income, thus allowing the full crediting of foreign tax paid. The use of this rule allows the accurate measurement, over time, of both the total worldwide income and the proportions of domestic and foreign income within this total. Loss recapture again seems superior to loss limitation.[27]

The conclusions of this section can be summarized as follows:

(1) Despite their apparent violation of equity and efficiency criteria, the three types of loss limitations described above may reflect intelligible concerns about protecting the tax base (Limitations (1) and (3)) or simply preventing incorrect results (Limitation (2)), once the functioning of the FTC mechanism is taken into account;

(2) However, all these concerns could be addressed through a loss recapture system, which more accurately measures income and, therefore, appears more neutral and equitable;

(3) Such a recapture system is not alien to the Chinese tax system;

(4) In light of these conclusions, the enactment of Article 17 of the EIT Law indeed seems unfortunate, and it seems important to prevent its extension, *a la* Circular 116, in future regulations concerning the computation of foreign income and FTC limits.

OUTBOUND TAX POLICY GOALS: NORMATIVE DIMENSIONS

Throughout our discussion in the last two sections, we have taken for granted the goal of correctly measuring income so as not to create tax disadvantages for Chinese firms' foreign investments. The stance of neutrality with respect to choices between foreign and domestic investments is reflected in many of the international aspects of the EIT Law. The general framework of worldwide taxation combined with the FTC, for example, as well as specialized regimes such as that regarding controlled foreign corporations,[28] are generally understood as embodying neutrality norms.[29] On the other hand, questions could be raised: putting aside what the law says, what is China's current tax policy towards outbound investments? And whatever official statements have been made in this regard, what *should* that policy be? After all, neutrality need not be regarded as a goal in itself, let alone the only goal; one could always question whether the stance of neutrality is appropriate in China's actual circumstances.

Consider an easily understood, albeit atheoretical, trichotomy of possible policy effects that outbound tax rules may achieve: (1) encouraging overseas investments; (2) being neutral with respect to such investments; and (3) discouraging such investments. Which of these effects should China aim for? The trichotomy is atheoretical because it only describes the effect of different rules without mentioning their underlying rationale. In theoretical discussions, economists have used different principles of efficiency to justify rules that have effects of either type (1) or type (2).[30] For example, rules that exempt income earned on overseas investments from domestic taxation, which could have the effect of encouraging overseas investments over domestic ones, are associated with the so-called principle of capital import neutrality (CIN).[31] They are justified on the ground of their potential to induce efficient patterns of savings. Alternatively, rules that subject a given taxpayer's income, wherever derived, to the same rate of tax are associated with the principle of capital export neutrality (CEN). They are shown to induce efficient allocations of capital, if certain assumptions are met. These efficiency criteria often cannot be met simultaneously, and economists debate about which criterion it is more reasonable to pursue, given real world circumstances.

Rules with effects of type (3), i.e., those that discourage overseas investments, are normally not justi-

[27] Recapture of domestic losses was enacted in the United States through Internal Revenue Code §904(g), effective in 2007.

[28] *See* EIT Law, Art. 45, and EIT Law IR, Art. 116-8.

[29] *See, e.g.,* U.S. Treasury Department (2000), ''The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study'' (available at *http://www.treas.gov/offices/tax-policy/library/subpartf.pdf*), especially Chapter 3.

[30] For accessible overviews of such discussions, see Shaviro, ''Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?'' 60 *Tax L. Rev*. 155 (2007), and Altshuler, ''Recent Developments in the Debate on Deferral,'' 87 *Tax Notes* 255 (2000).

[31] If home countries all exempted their residents' overseas investment income, income that could be earned from any given investment opportunity would be subject to the same rate of tax — that of the country where that investment was located — regardless of the country in which the investor resided. All sources from which capital can be ''imported,'' therefore, would be put on an equal footing.

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fied on efficiency grounds. Even if investments made overseas instead of at home may reduce the amount of tax revenue collected in the home country, this is generally not regarded as sufficient reason to discourage investments abroad.[32] However, the pursuit of revenue motivates tax agencies, and if, in order to preserve revenue, such agencies adopt rules that effectively discourage foreign investments (whether or not intending such effects), no one should be greatly surprised. Our earlier question could thus be reformulated as: to what extent is the design of outbound tax rules in China determined by the norms of economic efficiency, and to what extent is such design driven instead by the desire to preserve revenue?

The principles of CEN and CIN are known in China and are supposed to have some influence on the design of international income taxation.[33] As mentioned above, neutrality with respect to decisions to invest in China or overseas also informs the overall structure of outbound tax rules. However, as we have seen in connection with Article 17 of the EIT Law (and its predecessor in Circular 116), there are also rules that appear largely driven by the desire to preserve revenue. What explains the choice between these conflicting objectives?

In reflecting on these questions, one inevitably faces the fact that the pursuit of efficiency as recommended by standard economic theory may seem distinctly unpromising in China. Efficiency in international taxation requires minimizing tax-induced distortions to otherwise efficient allocations of resources. However, the allocation of resources in the realm of Chinese outbound investments is subject to serious regulatory distortions, even before the introduction of taxes. The most obvious aspect of this is China's capital control regime. Taxpayers are not free to make foreign investments, and therefore could not freely choose between domestic and foreign investments. Moreover, they are not free to choose between different locations for foreign investments either.[34] It is not clear whether the heavy government approval requirements to which outbound investments are subject bias the choice of such investments in any systematic way, or whether they simply impose uniform transactional (''red tape'') costs. Nonetheless, it is worth remembering that the range of transactions that China's outbound tax policy affects has already been narrowed by other regulatory requirements, and that the transactions in this range may already represent different choices from what the firms would have freely made.

A less obvious obstacle to the pursuit of efficiency objectives in China's outbound tax policy is the fact that most entities that obtain permission to invest overseas are large state-owned enterprises (SOEs),[35] which dominate both foreign direct investment and foreign portfolio investment. There are reasons to think that, as taxpayers, SOEs respond to taxes differently from private firms. This is because, in addition to collecting tax from them, the government also owns the SOEs. It is well known that the government and SOE managers bargain as to how much of SOEs' profits are to be distributed to the government as shareholder.[36] This bargaining tends to carry over to tax administration, too, so that paying tax is sometimes regarded as a way of making distributions.[37] If, then, an SOE manager can ''get credit'' for tax paid — because any tax paid benefits the public fisc just like a dividend distributed — the manager may be less averse to paying taxes than private firms. Conversely, an SOE manager is also more likely to obtain a special tax exemption from the government, because he can argue that less tax paid only increases retained earnings, which belong to the government anyway.

In short, weak corporate governance and protection of the rights of the SOEs' shareholder — the government — may render SOEs' response to taxes quite different from what is standardly assumed in economic theory. In the international context, a sense of skepticism could thus arise: are policy instruments that are neutral for private firms necessarily neutral for SOEs? Do policy instruments that encourage foreign investments for private firms necessarily encourage SOEs' foreign investments?

In light of both China's regulatory restrictions on the range of outbound transactions that can take place, and the special class of taxpayers (i.e., SOEs) that dominate existing outbound transactions, it may be difficult for principles of efficiency to gain wide sympathy among tax policymakers, tax administrators, and even taxpayers themselves. This makes it more

[32] The idea that foreign tax paid on foreign investments constitutes a cost to the home country of the investor is associated with the concept of ''national neutrality.'' The concept has had few advocates. *See* Shaviro, fn. 30 above, for discussion.

[33] *See* SAT Staff, ''Choice of Policy Goals in Taxing the Foreign Income of Chinese Residents,'' *Int'l Tax'n* (*Shewai Shuiwu*), 2006(4), pp. 27-30.

[34] For the most recent proposal for subjecting foreign investment projects to central or provincial government approval requirements, see Ministry of Commerce, Administrative Measures for Overseas Investments (Draft) (*http://hzs.mofcom.gov.cn/aarticle/xxfb/200901/20090105993774.html*), published on Jan. 7, 2009, for public comment.

[35] *See* Morck, Randall, Bernard Yeung, and Minyuan Zhao, ''Perspectives on China's Outward Foreign Direct Investment,'' *J. Int'l Bus. Stud.*, 39(3) (2008), pp. 337-350.

[36] *See* the World Bank, SOE Dividends: How Much and to Whom? (World Bank Policy Note, 2005), available at *www.worldbank.org.cn/english/content/SOE_En_bill.pdf.*

[37] *See* Liu Zuo, ''SOE's Switch from Surrendering Profits to Paying Taxes,'' *Tax'n Res.* (*Shuiwu Yanjiu*) 2004(10), pp. 27-33.

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understandable that the tax authority would often adopt measures that give priority to the protection of revenue. The past and present limitations on loss offset that we examined in the previous sections look wrong in that they deviate from what standard theories recommend. One could harbor well-justified reservations, however, about whether these classic recommendations apply in the Chinese setting.

Future liberalization of Chinese outbound investments may render standard tax policy recommendations more cogent. For example, when Chinese individuals are allowed to invest overseas through approved investment funds, principles of CEN and CIN may be more applicable. In the immediate future, however, general policy towards the export of capital will likely remain hesitant and wavering, headline-grabbing deals notwithstanding. Tax policy will constitute no exception to this general policy ambiguity.

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