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China's Rising (and the United States' Declining) Influence in Global Tax Governance? Some Observations

This article considers China's rise as a global economic power and the implications for global tax governance, especially in light of the United States' leadership in the international tax system, e.g. the Two-Pillar Solution.

1. Introduction

In the late 1970s, China started to pursue economic reforms and "four modernizations" under the guidance of Deng Xiaoping's thinking – "to get rich is glorious", and that China should "keep a low profile and bide its time" in international relations.[1] In this context, the United States' "normalization with China may have been the most beneficial to world peace and understanding".[2] Since then, China has become the world's largest homogenous digital market and mobile economy, the first or second largest capital importer and exporter, the third largest consumer market, and a critical link in the global value chains of many multinational enterprises (MNEs). Moreover, China recently overtook the United States as the European Union's biggest trading partner.[3]

In 2021, President Xi Jinping stated that:

> We will work to build a new type of international relations and a human community with a shared future, promote high-quality development of the Belt and Road Initiative through joint efforts, and use China's new achievements in development to provide the world with new opportunities.[4]

China also announced that "the United States is not qualified to talk to China in a condescending manner".[5] President Biden regards China to be deadly earnest in trying to displace the United States in terms of global power, and has vowed not to let that happen under his watch.[6] The Biden administration has sought to use "a tax code overhaul to reset the terms of global commerce", and "catalyzed the global tax debate by proposing a worldwide minimum tax of at least 15 percent".[7]Meanwhile, "China stands for safeguarding ... the international order based on international law",[8] but will not follow "what is advocated by a small number of countries as the so-called rule-based international order".[9]

What are the implications of China's rise for the dominance of the United States in global tax governance? Will the signs of "decoupling" or parallel standards in other areas, such as technology (for example, 5G and COVID-19 vaccines) appear in tax policy? Will China go along with the US-catalyzed global minimum tax in the OECD's proposed Pillar Two and US-modified reallocation of residual profits to market jurisdictions under Pillar One?[10] What will be the extent to which US constructive unilateralism or US-centric multilateralism need to contend with China's "true" multilateralism?

This article considers these questions in light of the broader historical and geopolitical context.[11] Section 2.

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1. For the selected works of Deng Xiaoping, *see The Selected Works of Deng Xiaoping Modern Day Contributions to Marxism-Leninism* [hereinafter *Deng's Works*], available at https://dengxiaopingworks.wordpress.com/2013/02/25/carry-out-the-policy-of-opening-to-the-outside-world-and-learn-advanced-science-and-technology-from-other-countries/ (accessed 10 Nov. 2021).
2. *See* The Carter Centre, *40 Years of Friendship from the Personal to the Political: President Carter reflects on our nation's – and his own – relationship with China*, available at www.cartercenter.org/news/features/p/china/president-carter-on-normalizing-relations-with-china.html (accessed 10 Nov. 2021).
3. *See* W. Ma, *The Digital War: How China's Tech Power Shapes the Future of AI, Blockchain and Cyberspace* (Wiley 2021) and UNCTAD, *World Investment Report 2021*, available at https://unctad.org/webflyer/world-investment-report-2021 (accessed 10 Nov. 2021).

Xinhuanet, *Speech by Xi Jinping at a ceremony marking the centenary of the CPC [Chinese Communist Party]*, available at www.xinhuanet.com/english/special/2021-07/01/c_1310038244.htm (accessed 10 Nov. 2021) [hereinafter *Speech by Xi*].

5. Xinhuanet, *Senior Chinese Official tells U.S. to stop interference, avoid confrontation* (19 Mar. 2021), available at www.xinhuanet.com/english/2021-03/19/c_139822014.htm (accessed 10 Nov. 2021).
6. President Joe Biden's speech at a joint session of Congress on 28 April 2021 and M.A. Bloomfield & O.S. Pollock, *Biden Wants Higher Taxes than China's*, Wall St. J., Opinion (4 May 2021), available at www.wsj.com/articles/biden-wants-higher-taxes-than-chinas-11620167575 (accessed 10 Nov. 2021).
7. D.J. Lynch, *Biden set for G-7 boost in bid for all nations to impose minimum global corporate tax*, Washington Post (1 June 2021), available at www.washingtonpost.com/us-policy/2021/05/31/global-minimum-corporate-tax-biden-g7/ (accessed 10 Nov. 2021).
8. Xinhuanet, *supra* n. 5.
9. L. Wei & B. Davis, *China's Message to America: We're an Equal Now*, Wall St. J. (12 Apr. 2021), available at www.wsj.com/articles/america-china-policy-biden-xi-11617896117 (accessed 10 Nov. 2021).
10. For an overview, *see* OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf (accessed 10 Nov. 2021) [hereinafter *Statement on Two-Pillar Solution]*.
11. Owing to space limitations, this article does not discuss the role of European countries in international tax reform. For more discussion on the history of the international tax system, *see* E. Baistrocchi, *The*

provides an overview of the nature, purpose and legal instruments of international taxation and highlights the significance of the China versus United States relationship for global tax governance. Sections 3. to 5. discuss the changing roles of China and the United States in the past 100 years; the United States' role in creating and expanding the international tax system from the 1920s to 1979; China as a norm-taker and the United States as a dominant norm-setter between 1980 and 2007; and China as more of a norm-shaker in the context of "BEPS 1.0" (the 2013-2015 G20/OECD Base Erosion and Profit Shifting (BEPS) Project) and "BEPS 2.0" (i.e. Pillar One and Pillar Two to address the challenges of the digitalization of the economy), while the United States continues to dominate norm-setting. Section 6. speculates on the future by teasing out the areas of convergence and divergence between the two countries. In its conclusions in section 7., the article offers some observations and notes that it is unlikely that decoupling would occur in international taxation, but it remains uncertain how China's role will play out in the next steps of BEPS 2.0 and beyond.

2. From Inter-Nation Taxation to Global Taxation

2.1. Overview: International taxation as a sovereign and fiscal matter

In order to provide the necessary context for subsequent discussions, this section identifies the nature and main issues of international taxation and notes the shift from inter-nation tax relationships to global tax governance.

The power to levy income taxes rests with national (and sometimes sub-national) governments. Through income tax laws, governments raise revenue to finance public expenditures (the "taxing regime") and to promote economic and social activities through tax incentives that are akin to "spending" the tax revenue that would otherwise be collected (the "tax expenditure regime"). As part of fiscal policy, tax policy is a manifestation of a country's fiscal choices, which is, in turn, an expression of a country's cultural, economic and social welfare conditions and choices.[12] Each country has autonomy in deciding how much revenue to collect and/or how much tax expenditure to spend. There is no overarching international law to limit such autonomy.

In addition to the fiscal functions, corporate income tax, which is the focus of this article, also backstops progressive personal income tax to achieve distributive justice. As corporations are the main type of economic entities in many countries and their conduct directly impacts a country's economic, social and environmental conditions, corporate tax policies often seek to regulate or guide corporate behaviour for societal purposes. Accordingly, MNEs can be viewed as "agents" of the state to this extent. How to deal with the income of MNEs lies at the heart of inter-nation tax relations.

2.2. Main issues in inter-nation tax relations

Inter-nation tax issues arise when taxpayers or their transactions cross over the boundaries of national tax systems. The main issues include double taxation, distribution of taxing rights between countries, stateless income and the extent of constraints on national fiscal sovereignty.

Double taxation exists when two tax systems intersect. It can impede cross-border trade and investment by increasing transaction costs for MNEs, thereby reducing the economic welfare of both countries. Countries rely on bilateral tax treaties to coordinate the application of their tax systems without compromising too much of their fiscal and/or tax independence. Even though "models" have been prepared since as early as the 1920s[13] by the League of Nations, bilateral tax treaties are not uniform, reflecting diverse national fiscal interests.[14]

On the matter of taxing rights, however, there is a broad acceptance of the so-called residence and/or source paradigm. Under this paradigm, with regard to MNEs, a country is either a residence country or source country and income is either income from business or income from investment (for example, dividends, interest and royalties). The residence country has exclusive or residual right to tax a resident taxpayer's income derived in the source country, and has the obligation to provide relief from double taxation through an exemption or foreign tax credit method. The source country's taxing right is conditional on the existence of a permanent establishment (PE) in the case of business income, and is limited in the case of investment income. When cross-border flows of income are symmetrical between the two treaty partners, the paradigm works well. In other circumstances, the paradigm favours the residence country. The "revenue losing" source country can be presumed to use the tax treaty as a "tax expenditure" in order to create better trade and investment conditions and stimulate economic development or as part of the overall bargain as to how to divide the revenues.

Stateless income is often the result of tax planning by MNEs that is "inconsequential or non-transformative"[15] in an economic sense, but "sanctioned" or "tolerated" by

International Tax Regime and Global Power Shifts, 40 Va. Tax Rev. 2, p. 219 (2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3744992 (accessed 10 Nov. 2021); R.S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 Va. Tax Rev. 2, p. 313 (2005-06), available at https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1042&context=articles (accessed 10 Nov. 2021); and China International Tax Research Institute, *Accompanying Reform and Open Policy: 40 Year History of Chinese International Taxation* (2018) (in Chinese) [hereinafter *China 40-Year Tax History*].

12. *See* E.D. Kleinbard, *We Are Better than This: How Government Should Spend Our Money* (Oxford U. Press 2015) and J. Scott Wilkie, *The Way We Were? The Way We Must Be? The 'Arm's Length Principle' Sees Itself (for What It Is) in the 'Digital' Mirror*, 47 Intertax 12, p. 1087 (2019).

13. *See* the text of the 1927 Draft Model Convention included in the League of Nations: Committee of Technical Experts on Double Taxation and Tax Evasion: Report Document C. 216.M.85, available at https://www.taxtreatieshistory.org/ (accessed 10 Nov. 2021).

14. J. Scott Wilkie, *David Rosenbloom: A Custodian of the First and Continuing "Real" Model Tax Treaty*, in *Thinker, Teacher, Traveler: Reimagining International Tax – Essays in Honor of H. David Rosenbloom*, chap. 51, pp. 655-74 (G.W. Kofler, R. Mason & A. Rust eds., IBFD 2021), Books IBFD.

15. Id., at p. 666.

national tax laws. In other words, the "multinational" nature of taxpayers or income is not matched by any "multinational" tax system. Therefore, addressing the stateless income issue requires multilateral efforts, such as BEPS 1.0.

Bilateral tax treaties generally do not encroach on domestic tax expenditure programmes beyond requiring non-discrimination treatment of taxpayers that are resident in the other country. Recent multilateral efforts to address the stateless income issue, by nature, must intersect with the use of tax expenditures, in the form of specific tax preferences or the corporate tax system as a whole (i.e. a tax haven). The shift from inter-nation tax relations to multilateral relations cannot be divorced from national fiscal choices and their underlying economic and other strategic national objectives.

2.3. Shift from international to global tax governance

Evidence of a shift towards global tax governance can be found in the 1998 OECD report "Harmful Tax Competition: An Emerging Global Issue",[16] multilateral efforts in administrative assistance,[17] exchange of information and the Common Reporting Standard (CRS)[18] and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument" or MLI)[19] to implement anti-treaty abuse measures in BEPS 1.0 and BEPS 2.0.

Directionally speaking, the shift is moving from collaboration in the administration and protection of existing tax rights towards agreement on sharing new taxing rights over residual profit (for example, under Pillar One) and curtailing national fiscal choices that are perceived as harmful to the interests of other countries (for example, Pillar Two). It is a paradigm shift that would be difficult in the absence of collaboration between hegemonic powers. In the 1920s, the United Kingdom and the United States could be credited for creating the existing inter-nation tax system. In the 2020s, will China join the United States in creating a global tax system?

16. OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998) [hereinafter *Harmful Tax Competition*].
17. *See*, for example, *Convention between the Member States of the Council of Europe and the Member Countries of the OECD on Mutual Administrative Assistance in Tax Matters* (25 Jan. 1988) (as amended through 2010), Treaties & Models IBFD, also available at www.oecd.org/tax/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm (accessed 10 Nov. 2021) (with 144 jurisdictions participating as of August 2021).
18. OECD, *Automatic Exchange Portal*, available at www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance (accessed 10 Nov. 2021).
19. OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties & Models IBFD [hereinafter *Multilateral Instrument*, or *MLI*], Treaties & Models IBFD, also available at www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (accessed 10 Nov. 2021).

2.4. China and the United States as Great Powers?

The United States has played a pivotal role in shaping international tax norms.[20] China has adopted international tax norms to serve its interests in achieving economic transformation and becoming a global power (*see* section 4.). Although perhaps not quite an "equal" in terms of using technical and legal skills to advance tax policy objectives, China is arguably closer to the United States than any other country in terms of global power.

China and the United States share some common interests in tax policy that are dictated by the economic reality of being the world's largest capital importing and exporting countries. Both use tax policy to advance strategic interests. However, as to the issue of which country is the tax home of residual or stateless income, which is at the heart of the two pillars, the two countries seem to have different ideas. The difference may go deeper than fiscal or economic concerns and into different legal, cultural and other anthropological influences. In order to have a sense of the future, it is helpful to look at the past.

3. 1920 to 1979: The United States as a Norm-Maker

3.1. Foundational ideas and framework

The foundation of the modern international tax system was created a century ago under the auspices of the League of Nations to resolve conflicts of national income tax laws when such conflicts became evident after World War I. China was a member of the League of Nations and was represented on the panel of 1928 Technical Experts, but apparently played no notable role in developing the League's work on taxation. The United States was not a member of the League of Nations, even though President Wilson was instrumental in its establishment. However, US luminaries, such as Edwin R.A. Seligman, T.S. Adams and M.J. Carroll, were instrumental in the work of the League. The United States was invited to attend the final session of the expert meeting that finalized the model treaties in 1928.[21]

The theoretical foundation of international taxation is the doctrine of economic allegiance that is presented in the "1923 Report"[22] by four economists (Bruins, Einaudi, Seligman and Stamp) to the League of Nations. Seligman was the principal author of the 1923 Report, which:

> mediated successfully between the extreme positions taken by the representatives from capital importing countries (Italy and Belgium) and capital exporting countries (the U.K.).[23]

20. Baistrocchi, *supra* n. 11 and R.S. Avi-Yonah, *Constructive Unilateralism: U.S. Leadership and International Taxation*, 42 Intl. Tax J. 17 (2016).
21. *See* S. Jogarajan, *Double Taxation and the League of Nations* p. 103 (Cambridge U. Press 2018).
22. *Report on Double Taxation submitted to the Financial Committee – Economic and Financial Commission Report by the Experts on Double Taxation*, Document E.F.S.73. F.19 (5 Apr. 1923) [hereinafter *1923 Report*].
See Avi-Yonah, *supra* n. 11, at p. 322. Seligman also shaped the development of international taxation through his writings, such as E. Seligman, *Double Taxation and International Fiscal Cooperation* (Macmillan 1928).

Seligman was also the intellectual father of the US international tax system, which had a profound impact on other countries, such as Canada.[24]

The 1923 Report was the starting point for the League's technical experts and provided a framework for their work that led to the publication of the model treaties in 1928.[25] These models had a lasting impact on double tax treaties – for example, the current OECD Model[26] has many features that can be traced to the League's work. Adams, a "founder of the U.S. system of international taxation"[27] and "the main architect of the FTC [foreign tax credit]",[28] played a role in developing the League of Nations' 1928 models as the US representative, especially in respect of the taxation of business profit and double taxation relief.[29]

Carroll was assistant to Adams in 1927 and 1928, but, more importantly, the author of:

> the most important pre-war study of the allocation of income among taxing jurisdictions, as well as a principal mover behind the main limitation on source taxation in the League models, namely the permanent establishment.[30]

Carroll could also be considered to be the promoter of the separate entity approach in applying the arm's length principle (ALP).[31]

The framework created by the League of Nations concerned reconciling divergent tax systems. It reflected the fundamental hegemony for income tax-based systems (notably the United Kingdom and the United States). The comprehensive Canada-United States Income Tax Treaty (1942)[32] was considered to be the "precursor of most modern tax treaties",[33] and the United Kingdom-United States Income Tax Treaty (1945)[34] was the turning point in the development of tax treaties.[35]

The idea of creating a plurilateral tax convention was considered and abandoned by the League in the early 1930s. Even though such a convention was "desirable", it was not recommended because:

> the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to draft a collective convention, unless it were worded in such general terms as to be of no practical value.[36]

3.2. Transfer pricing

US leadership continued after the care-taking function of the international tax regime shifted to the OECD. During the "post-war" and "cold war" periods, "the United States became a beacon, or haven, of free enterprise stability, and foreign investors had substantial incentive to invest in the United States" and US enterprises "found substantial opportunity for investing in active business outside the United States".[37] Unlike European companies that use branches for foreign business operations, US-based MNEs used subsidiaries and practised vertical and horizontal integration.[38] The United States became "a substantial importer of 'portfolio' investment capital" and "a great exporter of 'direct' investment capital".[39] There was a shift towards economic efficiency or neutrality (and, in particular, capital export neutrality, or CEN) and source-based taxation was de-emphasized.[40] Transfer pricing was a significant international tax issue.

The United States introduced transfer pricing regulations in 1968 and 1969 that "were a radical departure from prior practice in a number of respects", including a determinate hierarchy of transfer pricing methods (i.e. comparable uncontrolled price (CUP), resale price and cost-plus methods), ostensibly consistent with the separate accounting approach, but had "no explicit antecedents in the League work".[41] "These new methods, however, created the basis for concentrating the residual profit in a single component of the enterprise at will",[42] while, under the League's work in the 1930s and 1940s on residual profits "would necessarily, if not automatically, be assigned to the 'parent' enterprise, on the theory that those profits were in some sense 'produced' by central corporate management".[43]

The OECD published its first major work on transfer pricing – the 1979 Report, Transfer Pricing and Multinational Enterprises.[44] This report "is largely based on the US

24. C. Campbell & R. Raizanne, *The 1917 Income War Tax Act: Origins and Enactment*, in *Income Tax at 100 Years: Essays and Reflections on the Centennial of the Income War Tax Act* ch. 2 (J. (Jinyan) Li, J. Scott Wilkie & L. Chapman, eds., Can. Tax Fund. 2017).
25. *See* Jogarajan, *supra* n. 21.
26. Most recently, *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.
27. M.J. Graetz & M.M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L. J., p. 1027 (1997), available at https://core.ac.uk/download/pdf/148686157.pdf (accessed 10 Nov. 2021).
28. Avi-Yonah, *supra* n. 11, at p. 318.
29. Graetz & O'Hear, *supra* n. 27, at pp. 1066-1089. Adams attended the final session of 1927 experts meeting and was successful in making several amendments to the draft model convention (*see* Jogarajan, *supra* n. 21, at pp. 103 and 171-181).

Avi-Yonah, *supra* n. 11, at p. 323.

31. R.S. Collier & J.L. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* pp. 29-36 (Oxford U. Press 2017).
32. *Convention between the United States of America and Canada Relating to the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the case of Income Taxes* (4 Mar. 1942), Treaties & Models IBFD.
33. R. Raizenne & C. Campbell, *The Origins and Architecture of the 1942 Canada-United States Income Tax Treaty*, in *Studies in the History of Tax Law* vol. 9, ch. 15 (Hart Publishing 2019).
34. *Convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (16 Apr. 1945), Treaties & Models IBFD.
35. S. Picciotto, *International Business Taxation* (Weidenfeld & Nicolson 1992).

League of Nations Fiscal Committee, Report to the Council on the Work of the Third Session of the Committee C.415.M.171.1931.II.A. *See History of Tax Treaties*, available at www.taxtreatieshistory.org/ (accessed 10 Nov. 2021). The same ideas are found in the report submitted by the General Meeting of Government Experts (document C.562.M.178.1928.II).

37. S.I. Langbein & M.R. Fuss, *The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the "Arm's Length" Standard*, 51 Intl. Law. 2, p. 311 (2018).
38. Id.
39. Id.
40. Avi-Yonah, *supra* n. 11, at p. 324.
41. Langbein & Fuss, *supra* n. 37, at p. 314.
42. Id.
43. Id., at p. 315. Prior to 1968, US MNEs shifted profits by booking transactions in low-tax jurisdictions, such as Switzerland, through the use of base companies.
44. OECD, *Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs* (OECD 1979), Primary Sources IBFD.

1968 regulations".[45] "The US was strongly in the forefront of campaigning for a single global standard to relieve the pressures of double taxation on US business".[46]

3.3. The Subpart F (controlled foreign corporations) rules

To improve neutrality and the US balance of payments, which had deteriorated rapidly as US-based MNEs expanded their operations abroad, Subpart F was introduced in 1962 to end tax deferral on passive income earned through controlled foreign corporations (CFCs) – the CFC rules. The main architect of the CFC rules was S.S. Surrey:

> Surrey, like Adams before him, emphasized the role of the United States in achieving international cooperation in preventing double nontaxation. His major innovations, Subpart F and the transfer pricing regulations, were copied by other countries and became a new international baseline through the OECD.[47]

4. 1980 to 2007: China as a Norm-Taker and the United States as a Reformer

4.1. Overview: Tax policy serving national interests

During the period 1980-2007, China created an international tax regime by largely borrowing international tax norms and modifying them to suit China's needs, such as attracting foreign investment and exporting Chinese-made products, while the Chinese economy underwent a transformation from a command model to a "socialist market" model. China did not openly challenge any international tax norms.

The United States continued to lead international tax reforms through primarily reforming its domestic rules. These domestic reforms found their way into the OECD's work and other countries' laws.

4.2. China's introduction of the enterprise income tax system

4.2.1. Opening comments

Between 1949-1978, China practised a centrally planned and controlled economy, and had little need for income taxes.[48] Income taxation became necessary when non-state-controlled businesses were allowed to operate under the policies of "getting rich is glorious" and "opening to the world". Foreign investors wanted to know how much tax they had to pay before they could predict how much profit they could make from their Chinese investments.[49] The Individual Income Tax and Chinese-foreign Joint Venture Enterprise Income Tax were introduced in 1980, and the Foreign Enterprise Income Tax was introduced in 1981. The two taxes on enterprises became consolidated into the Foreign Investment Enterprise and Foreign Enterprise Income Tax in 1991. Income taxes were also introduced to apply to domestic enterprises, including state-owned enterprises (SOEs). In 2007, a new and consolidated Enterprise Income Tax (EIT) was introduced.[50]

The national tax administration (now known as the State Taxation Administration, or STA) has quasi-legislative powers, and issued normative rules in response to tax issues arising from rapid development in business structures, national economic development strategies and international tax development. China developed an expansive treaty network with countries that export capital to China as well as countries that receive investment from China.[51]

4.2.2. Transplanting international tax principles

China adopted the residence and/or source tax paradigm. Enterprises established under Chinese laws,[52] such as Chinese-foreign joint ventures or wholly foreign-owned enterprises, were taxable on their worldwide income, while foreign enterprises were taxable on their Chinese-source income. A foreign tax credit mechanism was used to prevent double taxation. Foreign enterprises receiving distributions of profits (or dividends), interest, rent or royalties from China were liable to Chinese withholding taxes.

Transfer pricing rules were first piloted in the Shenzhen Special Economic Zone in 1987, introduced nationwide in 1988 as an administrative rule and codified in 1991.[53] The 1991 legislation authorizes the use of four transfer pricing methods (i.e. CUP, resale price, cost-plus and any other reasonable method).

4.2.3. Tax policy emphasis of attracting foreign investment

During the 1980s, foreign-related enterprise income taxes were not introduced primarily to raise revenue or backstop a progressive personal income tax but, rather, to serve the national strategic interest in attracting foreign direct investment (FDI). Deng Xiaoping made it clear that China's four modernizations need foreign capital, technology and management expertise.[54] A wide range of tax incentives were available to foreign-invested enterprises to encourage FDI in productive activities, special zones, less-developed regions, high and new technology and export-oriented businesses. Withholding taxes were reduced for the

45. Collier & Andrus, *supra* n. 31, at p. 62.
46. Id.
Avi-Yonah, *supra* n. 11, at p. 328.
48. For more history of the Chinese income tax system, *see* J. (Jinyan) Li, *Taxation in the People's Republic of China* (Praeger 1991) and A.J. Easson & J. (Jinyan) Li, *Taxation of Foreign Investment in the People's Republic of China* (Kluwer 1989).
49. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at pp. 5-6.
50. *See* J. (Jinyan) Li, *International Taxation in China: A Contextualized Analysis* (IBFD 2016), Books IBFD.
51. For a list of Chinese tax treaties, *see* State Taxation Administration of the People's Republic of China (STA), *Multilateral Tax Treaties Signed by China*, available at www.chinatax.gov.cn/eng/c101276/c101732/index.html (accessed 10 Nov. 2021).
52. The term "residence" was used for the first time in CN: Enterprise Income Tax Law EITL (*Qi Ye Suo De Shui Fa*) in 2007. Article 3 of the EITL defines this term by reference to place of incorporation and place of effective management (*see* Li, *supra* n. 50, at pp. 77-79.
53. *See* China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at pp. 295-296.
54. Deng Xiaoping, *Carry Out the Policy of Opening to the Outside World and Learn Advanced Science and Technology from Other Countries* (10 Oct. 1978), *Deng's Works*, *supra* n. 1.

transfer of proprietary technology to China.[55] The system was designed to attract foreign capital and technology.

4.3. The US tax reforms and "constructive unilateralism"[56]

4.3.1. The 1986 tax reform

The US 1986 tax reform[57] significantly reduced tax rates and broadened the tax base by cutting loopholes, with the emphasis on making the United States more competitive in attracting investment[58] and US MNEs more competitive globally. The broader context for the reform includes: technological and economic changes that put pressure on US hegemony and the apparent decline of the United States in the 1970s relative to Japan and Europe;[59] budget deficit and increased mobility of capital; and Ronald Regan's election as President on a tax-cutting platform to "make America Great".[60]

The international aspects of the tax reform continued the trend of reducing US-source-based taxation of foreign investors, such as the portfolio interest exemption,[61] which led to a worldwide trend toward zero rate withholding tax on interest paid to foreign portfolio investors in the name of attracting mobile capital.[62] Simultaneously, to enhance the competitiveness of US MNEs, US residence-based taxation was reduced through measures such as narrowing the scope of the Subpart F rules (for example, the banking and insurance exceptions) and extending the "check the box" rules to foreign entities.[63]

To protect the US tax base, a branch profit tax was introduced in 1986 to remove the tax advantage of using branches over subsidiaries in the United States. Earnings stripping limitations on the deductibility of interest were introduced in 1989 to address concerns about foreign debt-financed takeovers of US corporations. Like the earlier Foreign Investment in Real Property Tax Act[64] introduced in 1980, these measures targeted foreign investors in real property and business activities as opposed to portfolio investors. On the outbound investment side, because the foreign tax credit regime allowed US tax to be reduced by foreign taxes paid on foreign income and whether income was foreign-sourced could be "manipulated", nine "baskets" of income were created in 1986 to minimize such manipulation. The passive income basket was broadened to include, generally, dividends, interest, annuities, rents, royalties and gains from the sales of non-inventory assets.[65]

US taxation of income from intangibles became more assertive. For instance, the source rules were revised in 1986 in respect of the sale of personal property (including intangibles) from the previous "passage of title" rule to, in essence, the residence of seller rule – income from the sale of personal property by a US resident is US-source income. As a result, the sale of intangibles of US MNEs is US source. The "super royalty" rule[66] in section 482 of the Internal Revenue Code (IRC) explicitly targets US intangibles, and was enacted in 1986 to prevent royalty-free transfers of intangibles to entities located in tax havens. While the 1968 regulations[67] were designed to bolster US-source taxation,[68] the super royalty rule is more about protecting US residence taxation on the conviction that income from the intangibles of US corporations belongs to the US tax base.

The 1986 Tax Reform gave rise to similar tax reforms in US trading partners, including Australia, Canada and Japan, and various European countries.[69] At the same time, the US international tax rules, such as the check-the-box rules, "led to widespread avoidance of the base company rules by using 'disregarded entities'",[70] and, arguably, enabled US MNEs to avoid taxes in market and production jurisdictions. This can be seen in the EU State aid cases involving Amazon,[71] Apple[72] and Starbucks,[73] and the "stateless income" phenomenon that helped trigger BEPS 1.0.

4.3.2. The 1994 transfer pricing regulations

The super-royalty rule introduced in the 1986 Tax Reform Act is ostensibly inconsistent with the traditional arm's length standard in the 1968 transfer pricing regulations because it is not based on uncontrolled comparables. Such comparables rarely exist, as intangibles are generally unique and their monopoly is protected by law. It took almost eight years for the United States to finalize new transfer pricing regulations.[74]

The 1994 regulations[75] introduced the "comparable profits method" as an alternative method for valuing transfers

55. *See* Li, *supra* n. 50.
56. "Constructive unilateralism" is a term used in Avi-Yonah, *supra* n. 20 to describe the US style of influencing international tax reforms.
57. US: Pub. L. No. 99-514, 1231(e)(1), 100 Stat. 2085.
58. J.A. Baker, III, *The Momentum of Tax Reform*, in *Tax Policy in the Twenty-first Century* pp. 1-9 (H. Stein ed., John Wiley & Sons 1988).
59. G.R. Schutte, *The challenge to US hegemony and the "Gilpin Dilemma"*, *Revista Brasileira de Politica International* p. 2 (2021), available at http://dx.doi.org/10.1590/0034-7329202100104 (accessed 10 Nov. 2021).
60. Baker, *supra* n. 58, at p. 3: "It will be one of President Regan's chief legacies that the top tax rate on the world's largest economy dropped from 70 percent to less than half that within a few short years".
61. Introduced in 1984 by US: Internal Revenue Code (IRC), sec. 871(h). Other measures include the safe harbour for passive investors in securities and commodities (*see* sec. 864(b)(2) IRC).
62. Avi-Yonah, *supra* n. 11, at p. 333.
63. Id.
64. US: Foreign Investment in Real Property Tax Act (FIRPTA) of 1980.
65. Avi-Yonah, *supra* n. 11, at p. 333.
66. In the case of the transfer (or the licence) of intangible property, the income in respect of such a transfer or licence must be commensurate with the income attributable to the intangible.
67. US: Treas. Reg. 1.482-2 (1968).
68. Avi-Yonah, *supra* n. 11, at p. 329.
69. B. Brys, S. Mathews & J. Owens, *Tax Reform Trends in OECD Countries* (OECD 2011).
70. Avi-Yonah, *supra* n. 11, at p. 333.
71. *See* the decisions of the Court of Justice of the European Union (ECJ) in LU: ECJ, 12 May 2021, Case T-816/17, *Grand Duchy of Luxembourg, Amazon EU Sàrl and Amazon.com, Inc. v. European Commission* and LU: ECJ, Case T-318/18, *Amazon EU and Amazon.com v. Commission*.
72. IR: ECJ, 15 July 2020, Cases T-778/16 and T-892/16, *Ireland and Others v. Commission*.
73. NL: ECJ, 24 Sept. 2019, Case T-760/15, *Kingdom of the Netherlands and Others v. European Commission* and NL: ECJ, Case T-636/16, *Starbucks and Starbucks Manufacturing Emea v. Commission*.
74. *See* Langbein & Fuss, *supra* n. 37; R.S. Avi-Yonah, *The Rise and Fall of the Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 1, pp. 89 and 147-148 (1995); and Collier & Andrus, *supra* n. 31, at pp. 72-78.
75. US: Treas. Reg. s.1.482 (1994).

of tangible and intangible property. This new method is based on a comparison of the operating profit of the taxpayer with that of independent enterprises with similar types of transactions (or the sector as a whole) under comparable circumstances. It differs from the traditional pricing methods by emphasizing comparison of "profits" as opposed to "price", and, therefore, is more result-oriented and less wedded to rigid transactional pricing comparisons. The 1994 regulations also introduced profit split methods (either comparable profit split or residual profit split), which were still based on a kind of arm's length notion given the comparison with independent profit levels. Under this method, profit will be allocated first to the functions of the parties on the basis of market comparables, with the residual profit allocated to the party who bore the costs of developing the intangibles, whether owned by that party or not. In addition, a "best method rule" was introduced to require the use of the method that leads to the most accurate measure of an arm's length result based on the facts in any particular case. The regulations also introduced tougher penalties and documentation requirements.

The US re-engineering of the transfer pricing regime raised immediate concerns in OECD member countries, and created "a material schism between the approach in the United States and the prevailing OECD thinking on the ALP".[76] There were concerns that the US approach "would unreasonably skew income to the US".[77]

4.3.3. *The 1995 OECD Transfer Pricing Guidelines*

The 1995 OECD Transfer Pricing Guidelines[78] reflected the collective reaction of the OECD member countries to the US approach. These guidelines reiterated the importance of the ALP, but also recognized the reality that the highly integrated operations of MNEs make it difficult to always find a single arm's length price. The OECD borrowed from the US concepts, such as the arm's length range and economic substance. It also adopted the US profit split method and modified the US comparable profit method into the transactional net margin method (TNMM), even though the TNMM was in fact not transaction-based. The OECD emphasized a "transaction-based" application of these methods as opposed to the US approach, which looks at the profit results of the corporation as a whole or industry sector returns. Further, the 1995 OECD Transfer Pricing Guidelines did not go as far as the US super-royalty rule in considering future profits and remain "strongly resistant to the use of hindsight".[79] In anticipation of the increase in transfer pricing disputes, the 1995 OECD Transfer Pricing Guidelines contained detailed materials on ways of resolving such disputes and mention the possibility of advanced pricing arrangements to prevent disputes.

Even though the 1995 OECD Transfer Pricing Guidelines borrowed heavily from the US regulations, the transfer pricing approach started to diverge in the United States and other OECD member countries. The US approach was more result-oriented and maybe considered by some as "more advanced".[80] However, both the OECD and the United States rejected the use of the formulary apportionment method.

4.3.4. *OECD Harmful Tax Competition (1998) and the US role in emerging multilateralism*

In 1998, the OECD published a report entitled "Harmful Tax Competition: An Emerging Global Issue".[81] Unlike the 1995 OECD Transfer Pricing Guidelines, which represented a reaction to the US approach, the later report reflected the initiative of the OECD, especially its member countries in Europe.[82] This initiative was aimed at protecting the tax base of capital exporting countries by targeting preferential tax regimes within OECD member countries as well as tax havens.[83] The United States supported it initially, but altered its position with the change of administration from President Clinton to President Bush. The Bush administration supported only the aspect on transparency and the exchange of information:

> The U.S. had moved from a champion to a revisionist critic of the OECD efforts early in the Bush Administration, and the most influential actors in the OECD and the EU were obliged to adapt as they could.[84]

Nevertheless, the harmful tax competition project signalled a shift from US unilateralism to international cooperation. It also represented a shift in international tax governance away from technical experts to international politics[85] and a shift in the OECD's role from coordinating the prevention of double taxation to reducing tax competition among countries. It may also be the beginning of the decline of US dominance in international taxation.[86]

4.4. China's 2007 tax reform

4.4.1. *Moving closer to international norms*

While the US dominance in international tax reforms may be declining at the turn of the century, China's EIT system moved closer to the existing international norms when the

76. Collier & Andrus, *supra* n. 31, at p. 79.
77. Id., at p. 78.
78. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1995), Primary Sources IBFD.
79. Collier & Andrus, *supra* n. 31, at p. 82.
80. Langbein & Fuss, *supra* n. 37, at p. 331.
81. OECD, *Harmful Tax Competition*, *supra* n. 16.
82. *See* J.H. Mutti, *Foreign Direct Investment and Tax Competition* pp. 87-88 (Inst. Intl. Econ. 2003).
83. Hugh Ault was regarded as the "main theoretician behind this initiative" (*see* Avi-Yonah, *supra* n. 11, at p. 335). Jeffrey Owen was also a key player (*see* A.P. Morriss & L. Moberg, *Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition*, 4 Colum. J. Tax L. 1, pp. 42-56 (2012)).
R.T. Kurdle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, Matthey B. Ridgway Ctr., Working Paper, p. 3 (2005). Kurdle also notes, at p. 23, that Treasury Secretary O'Neill expressed concern that the OECD initiative interfered with US tax policy and constituted a step to harmonize world tax systems.
85. Morriss & Moberg, *supra* n. 83.
86. Kurdle, *supra* n. 84, at p. 42, remarks: "But O'Neill's handling of the OECD's tax competition project typified the Bush administration by placing U.S. interests on a vastly different plane from others' in both words and actions. As such, it made a small but still damaging contribution to the collapse of European confidence in American leadership."

Chinese economy became more connected with the global economy, and more disciplined by market forces. In addition to functioning as a tax expenditure programme, the 2007 EIT became a primary revenue raiser, applying as it did to all forms of enterprises, regardless of ownership.

The 2007 tax reform signals a shift from a system favouring foreign-invested enterprises to one that addresses the international aspects of all types of enterprises. This shift reflects the facts that, among other things, Chinese-owned enterprises had begun to make outbound investment, foreign-invested enterprises were competing with Chinese-owned enterprises on the Chinese market (which, in part, resulted from China's commitment to further open its market to foreign companies on China's accession to the World Trade Organization in 2001), and the existing tax incentives for foreign-invested enterprises became less effective in attracting foreign investment and were open to abuse.[87]

Examples of the internationalization of the EIT include the following: (i) the use of terminology that is more aligned with international tax norms, such as residence, source of income and effectively connected income; (ii) the redesigning of tax incentives to replace "ring-fencing" measures with substantive activity-based measures, which could be in response to the OECD's Harmful Tax Competition initiative; (iii) the introduction of anti-avoidance rules, such as thin capitalization rules, CFC rules, a general anti-avoidance rule and transfer pricing rules that are broadly consistent with the 1995 OECD Transfer Pricing Guidelines.[88]

4.4.2. Protecting China's interest as a source country

The EIT legislation expands the transfer pricing methods to include the TNMM and the profit split method. It also allows the use of reasonable methods if an enterprise does not provide information on its related-party transactions or provides incomplete information. One of the reasonable methods is based on the reasonable proportion of the related party's group profit.

4.4.3. Adopting the worldwide corporate tax system in the name of an international norm

As a growing capital-exporting country, China adopted policies of encouraging "going global". However, instead of adopting the exemption or territorial system, China opted for following the "international common practice"[89] in taxing the worldwide income of residents and preventing double taxation through foreign tax credits. At that time, i.e. in 2007, the United States was one of few OECD member countries with a worldwide tax system.[90]

87. *See* China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11 and Li, *supra* n. 50.
88. *The Enterprise Income Tax Law of the People's Republic of China: Interpretation and Application Guide* pp. 21-30 (Yaobin Shi, Ruibiao Sun & Zhao Liu eds., L. Press 2007).
89. Id., at p. 91.
90. T. Matheson, V. Perry & C. Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries*, International Monetary Fund (IMF) Working Paper, WP/13/2015.

5. 2008 to the Present: China as a Norm-Shaker and the United States as a Leader in Multilateralism

5.1. The global financial crisis as a game changer

The 2008-09 global financial crisis was a game changer in terms of China's rise as a country and "influencer" of international tax policy. While the United States and other OECD member countries struggled to manage the crisis, China began to implement the new EIT system, strengthen the management of international taxation and cooperation, encourage Chinese companies to "go out" and to maintain China's national tax interests through more effective anti-abuse measures.[91] By 2008, China had become the "factory of the world", surpassing the United States in its participation in global manufacturing[92] and a major market for consumer goods. In 2014-15, China became a net exporter of capital.

China became more open and assertive with regard to its concerns with the existing international tax norms, especially the ALP and residual profits arising from a source country. China also became more active in global tax governance, as illustrated by these words from the Secretary-General of the OECD in 2018:

> On tax policy, China has been a true global player. It has been an active participant in the OECD-G20 Base Erosion and Profit-Shifting (BEPS) Project, initially as a member of the CFA Bureau Plus in the first phase, and now in the Steering Group of the Inclusive Framework on BEPS.[93]

Meanwhile, the United States led a new wave of reforms through introducing, among other things, the Foreign Account Tax Compliance Act (FATCA) in 2010,[94] Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT) in 2017.[95] The FATCA led to the global CRS and domestic law changes in Canada[96] and many other countries. The thinking behind GILTI and BEAT inspired Pillar Two. The 2021 proposed changes to GILTI and to replace BEAT with SHIELD (Stopping Harmful Inversions and Ending Low-tax Developments) also shaped Pillar Two. As part of the budget reconciliation bill, these proposals are expected to be enacted before the end of 2021.

5.2. China as a "norm-shaker"

5.2.1. The ALP and residual profits

China's norm-shaker role is perhaps most evident in the area of transfer pricing. China found it challenging to apply the transfer pricing methods sanctioned in the 1995

91. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at p. 82.
92. Schutte, *supra* n. 59, at p. 7.
Angel Gurría, Secretary-General of the OECD, was in Beijing from 24 to 26 March 2018 to attend the China Development Forum (*see* OECD, *2018 China Development Forum: Session III: China's Fiscal and Tax Reform – A Global Perspective* (OECD 2018), available at www.oecd.org/china/chinas-fiscal-and-tax-reform-global-perspective-march-2018.htm (accessed 10 Nov. 2021)).
94. US: Foreign Account Tax Compliance Act (FATCA), 18 Mar. 2010.
95. US: Pub. L. No. 115-97, 22 Dec. 2017.
96. *See*, for example, CA: Income Tax Act, pt. XVIII and pt. XIX.

OECD Transfer Pricing Guidelines[97] due to a lack of data on uncontrolled comparable transactions. More importantly, the existing methods do not recognize and allocate profit to Chinese subsidiaries regarding location specific advantages (LSAs) in the form of location savings and market premiums (particularly in luxury goods) or intangibles that are developed, enhanced or exploited through activities in China. The existing methods allocate profits to entities that own or control intangibles or risk in terms of creating marketing intangibles and developing technology, but not in connection with the production stage of global value chains (which is located in China). As the Chinese affiliates of foreign MNEs do not legally own or control intangibles or assume risks, they are not allocated any residual profits. That result is not fair.[98] In some cases, "the assets and the people should largely dictate where the group's profits should stay".[99]

To capture residual profits that should "belong to" China because the value creation activities are in that country, China has adopted measures[100] that, in effect, modify the ALP norm. Notable measures include the following six instances: (i) to allow the use of the group approach in transfer pricing analysis; (ii) to incorporate LSAs in conducting comparative analysis and applying TNMM and the profit split method; (iii) to consider internal contracts in light of "the capacity to perform the contract, the actual conduct" and "trustworthiness" of the parties;[101] (iv) to adopt a risk-based approach that places sufficient regard for the facts that "there are sizeable assets located in China" and "the majority of the headcount of" the business group are based in China; (v) to adopt a broader notion of intangibles;[102] and (vi) a contribution analysis may be more suitable than a transactional or profits-based approach so that "remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group".[103]

More generally, to recognize residual profits derived in the source country, "a global formulary approach should be a realistic and appropriate option" in some cases, i.e.:[104]

> Alternatively, the Chinese tax administration may determine the proper return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.[105]

The overall thinking is that profits of entities participating in an MNE's global value chain should be allocated based on the location of the value creation activities. China is more prepared to deviate from the international norm. From the perspective of a developing country, China maintains that such deviations may serve as best practices for other developing countries. The overall stance reflects the taxing interests of a capital-importing country.[106]

Deductions are not permitted on excessive outbound base erosion payments of royalties and service fees. Royalties are considered to be excessive if the intangibles created, enhanced or developed by Chinese affiliates are not taken into account. A commensurate-with-economic-benefits test is adopted as a benchmark – any royalty payment should reflect the economic benefits brought about by the underlying intangibles for the entity.[107] Royalty payments that fail this test will be adjusted for tax deduction purposes, and, if the royalty payments result in no economic benefits, the entire payment is not deductible.[108] This test also applies to intra-group service fees.[109]

5.2.2. *China's active role in BEPS 1.0*

China seized the opportunity of reforming the international tax norms through BEPS 1.0[110] and advocating the value creation principle.[111] This principle's role is most evident in the Final Report on Actions 8-10,[112] which seeks to align transfer pricing outcomes with the value creation of the MNE group as opposed to the contractual terms of the transaction in order to reduce the incentive for MNEs to shift income to "cash boxes" or other centralized entities located in low-tax jurisdictions. To assist the value creation analysis and address the information deficiency challenge facing tax administrations, the Final

97. *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Part D, Country Practices (UN 2013) (UN 2017) and (UN 2021) [hereinafter the *UN Transfer Pricing Manual-China*]. The subsequent citations are to the *UN Transfer Pricing Manual-China* (2021).
98. The term "fair" is used several times in the *UN Transfer Pricing Manual-China* (2021), *supra* n. 97.
99. *UN Transfer Pricing Manual-China* (2021), *supra* n. 97, at sec. 2.23.3.
100. *UN Transfer Pricing Manual-China* (2021), *supra* n. 97, at sec. 2.22.2; STA, [2016] No. 64, Public Notice on Matters Regarding Enhancing the Administration of Advance Pricing Arrangements; STA, [2017] No. 26, Public Notice on Clarifying the Filing Standards of "People's Republic of China Enterprise Annual Reporting Forms for Related-Party Transactions" [hereinafter STA Public Notice [2017] No. 26]; STA, [2017] No. 6, Public Notice on Issuing the Administrative Measures for Special Tax Investigation and Adjustment and Mutual Agreement Procedures [hereinafter STA Public Notice [2017] No. 6].
101. STA Public Notice [2017] No. 6, *supra* n. 100, at art. 15(3).
102. Id., at sec. 2.21. Technology intangibles include technical know-how and business processes that were improved by Chinese entities through "trial and error". Marketing intangibles include global brand names that are "localized" for the unique Chinese market conditions (such as cultural preferences and language). An example is the localization of the shampoo brand "Head and Shoulders" as "Ocean Flying Silk" (*hai fei si* in Chinese pinyin).
103. Id., at sec. 2.23.3.
104. Id. China is the first country that officially supports a global formulary allocation method (*see* Langbein & Fuss, *supra* n. 37, at p. 398).
Id., at sec. 2.23.4.
106. Id.
107. The benefit test is found in STA Public Notice [2017] No. 6, *supra* n. 100, art. 32.
108. Id.
109. STA Public Notice [2017] No. 6, *supra* n. 100, arts. 34 and 35. China's State Administration of Taxation (SAT, now STA) submitted a letter to the UN Working Group on Transfer Pricing Issues setting out China's views on service fees and management fees in April 2014 (*see* C. Turley, D.G. Chamberlain & M. Petriccione, *A New Dawn for the International Tax System: Evolution from past to future and what role will China play?* pp. 302-312 (IBFD 2017), Books IBFD).
110. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at p. 86.
111. The value creation principle was among the numerous proposals made by China during the BEPS 1.0 process (*see* Xiaojing Cui, *A Study on Legal Issues Related to China's Participation in Global Tax Governance* p. 12 (China Social Sci. Press 2021) (in Chinese).
112. OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Action 8-10: Final Report 2015* (OECD 2015), Primary Sources IBFD.

Report on Action 13[113] introduced a minimum standard on country-by-country (CbC) reporting. The 2017 OECD Transfer Pricing Guidelines[114] reflect the changes stated in the Final Report on Actions 8-10. In this sense, one can say that China was, in fact, a norm-shaker in the area of transfer pricing.

China rapidly implemented the main measures in Actions 8-10.[115] It also went further in respect of the contribution-based analysis, the commensurate with economic benefits analysis and the use of global formulary apportionment. Positioning itself as a large developing country, China emphasizes allocating residual profits to production and marketing activities.

5.3. The US transformative reforms

5.3.1. Minimum taxes

While China's influence appeared to be rising, the United States remained a de facto influencer and creator of new norms. The United States was not an enthusiastic participant of BEPS 1.0, but it agreed with the BEPS measures and implemented the minimum standard on CbC reporting. It has not changed its domestic transfer pricing regulations. The effect of BEPS 1.0 is to strengthen anti-abuse rules to protect the tax base of jurisdictions where value creation activities take place. US MNEs were the main targets of BEPS 1.0, and would see more of their profits taxable in source countries and potentially less tax in the United States after claiming foreign tax credits. BEPS 1.0 measures may also encourage US MNEs to locate more economic activities in low-tax jurisdictions to back up the location of profits in such jurisdictions. Off-shoring investment and productive activities and the loss of tax revenues are, therefore, among the significant motivations of the 2017 tax reform.[116]

The 2017 tax reform is the most significant tax reform since 1986. Unlike the 1986 tax reform, however, the 2017 reform brought the US system closer to the international norm by lowering the nominal rate and adopting a participation exemption system. To protect the US tax base regarding residual profits, a new regime was created by way of the GILTI and BEAT rules, which function as minimum taxes.[117]

5.3.2. The intangible (residual) income regime

5.3.2.1. GILTI

The GITLI regime sits between tangible income that is eligible for exemption treatment and passive income that is subject to current taxation under Subpart F at the full US tax rate. It subjects the intangible income of the CFCs of US MNEs (defined as profit exceeding a 20% return on tangible assets) to current US taxation, but at reduced rate,[118] and to provide relief from double taxation through a foreign tax credit regime on a worldwide basis. For foreign MNEs, the BEAT regime functions as a minimum tax on profits derived in the United States through limiting deductions for outbound base-eroding payments, such as royalties and service charges. In effect, the US claims taxing rights over intangible income as a "home" jurisdiction or a market or production jurisdiction, thereby reducing the tax advantages of artificially shifting income to low-tax jurisdictions. Preliminary evidence shows that profit shifting by US MNEs to foreign jurisdictions fell after 2018.[119]

The 2021 changes remove the 10% deduction for tangible income and apply the foreign tax credit on a country-by-country basis instead of a worldwide basis. As such, GILTI becomes a minimum tax not just on intangible income, but all residual profits of US MNEs.[120] All low-taxed foreign income other than Subpart F income can fall within the GILTI regime.

5.3.2.2. BEAT and SHIELD

The BEAT imposes a minimum tax[121] on "large corporations" (i.e. corporations with average annual gross receipts of at least USD 500 million over the past three tax years) that make deductible payments to their foreign related parties over a threshold (3% of overall deductions). To avoid reducing US tax competitiveness for research and development (R&D), the BEAT rules allow the tax to be reduced by the R&D tax credit.

The SHIELD proposal broadens the minimum tax by covering any financial reporting groups whose global annual revenues are more than USD 500 million and denying deduction for the cost of goods sold to foreign related parties that are subject to a low effective tax rate (ETR). The low ETR is 15% global minimum tax under Pillar Two or the proposed 21% GILTI rate, depending on which is put in place first.

113. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: Final Report 2015* (OECD 2015), Primary Sources IBFD.
114. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), Primary Sources IBFD.
115. STA public announcements, such as those cited in *supra* n. 100, function as laws.
116. US: Congressional Research Service, *Issues in International Corporate Taxation: The 2017 Revision* (P.L. 115-97), updated 13 Oct. 2021, p. 1 available at https://sgp.fas.org/crs/misc/R45186.pdf (accessed 10 Nov. 2021) [hereinafter *CRS Report*].
117. The 2017 tax reform also introduced Foreign Derived Intangible Income (FDII) rules to incentivize MNEs to own intangibles in the United States and "export" the intangibles. FDII rules potentially violate the principles of the World Trade Organization as an export subsidy; see *CRS Report*, *supra* n. 116 at p. 44. The Biden Administration had proposed to repeal FDII. As such, FDII rules are not discussed in this article.
118. Under the 2017 GILTI rules, income of foreign subsidiaries (i.e. CFCs) in excess of a deduction for 10% of tangible assets minus interest costs is taxable to the US parent, but at a reduced rate. Foreign tax credits are allowed for 80% of foreign taxes paid. As a result, a residual US tax is imposed when foreign tax rates are below 13.125% (0.105/0.80) in the initial years and subsequently 16.406% (0.13125/0.80). The GILTI rules do not apply to income of CFCs in countries where the tax rate is 90% or more of the US tax rate (the "high-tax kickout rule").
119. Penn Wharton Budget Model, *Profit Shifting and the Global Minimum Tax* (21 July 2021).
120. For transfer pricing purposes, the concept of "intangibles" was broadened to include goodwill, going concern value and the value of workforce in place.
121. The tax rate was 5% in 2018 and 12.5% for tax years beginning after 2025.

5.4. The US leadership in BEPS 2.0

5.4.1. Pivotal influence

The BEPS 2.0 programme was not initiated by the United States, nor did it represent global efforts to emulate the US approach. Until April 2021, when the United States made significant modifications,[122] the two pillars did not seem to stand on solid ground. Since then, a global political agreement has been reached on the modified pillars, which was evidenced by the endorsement by the G20 leaders on 31 October 2021[123] of the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* released by the OECD/G20 Inclusive Framework on BEPS on 8 October 2021.[124] The US ability to drive the process is evident.

5.4.2. Moulding Pillar Two in the US image

The GILTI regime is treated as co-existent with Pillar Two's Income Inclusion Rule.[125] The BEAT or SHIELD rule is similar to the Undertaxed Payment Rule in Pillar Two. The OECD Blueprint on Pillar Two[126] states that the GILTI regime "draws on elements of the BEPS Action 3 Report" even though the Final Report on Action 3[127] has no measures of this type. There is no doubt, however, that the US rules were the basis for the Pillar Two proposals.[128]

Regardless of the original inspiration for Pillar Two, the United States has played a pivotal role in setting the global minimum rate to be at least 15% and forging global consensus. In fact, the SHIELD regime might just underwrite Pillar Two, as base erosion payments to any low-tax country without Pillar Two would be denied tax deduction in the United States. This position may be similar to the use of US domestic rules to underwrite the FATCA and CRS regimes. Also, a country outside Pillar Two will likely be "persuaded" to join Pillar Two if its taxes, given up through tax expenditures to attract investment from US MNEs, will be shifted to the US Treasury through GILTI.[129]

5.4.3. The "de-Americanization" of Pillar One

The inspiration for Pillar One came from countries that wanted to introduce a digital services tax (DST). Pillar One originally introduced a new nexus and formulary method for allocating residual profits among market jurisdictions, but only for digital and consumer-facing businesses. US MNEs were the primary targets. The United States was not keen on supporting it and advocated for a safe harbour exception that was not well received.

The US Modifications in April 2021 replaced the ring-fencing of digital and consumer-facing businesses scoping with quantitative criteria (for example, total revenue threshold and profit margin threshold) to determine which MNEs are in scope. They also reduced the number of in-scope MNEs by increasing the threshold for global turnovers.[130]

According to US Treasury Yellen, the modified Pillar One "will be largely revenue neutral for the United States since [the US] will be on both the receiving and giving end of the proposed profit reallocations".[131] Pillar One's impact on US MNEs is thus decreased. It could be said, therefore, that the modified Pillar One is de-Americanized by including non-US MNEs in scope and reducing the pillar's fiscal impact on the United States.

5.5. China's earlier ambivalent stance in BEPS 2.0

5.5.1. Different stance from BEPS 1.0

China's attitude towards BEPS 2.0 appears to be different from that in BEPS 1.0. With regard to BEPS 1.0, China was one of the key initiators, took credit for advocating the value creation principle, made numerous submissions to the project and regarded the project as a historic chance for reform to advance the interests of developing countries.[132] In contrast, in BEPS 2.0, it is unclear whether China has made any submissions. Until the statement by Finance Minister Liu on 14 October 2021, it was somewhat unclear about how supportive China was towards the two pillars, especially Pillar Two. Minister Liu stated that China consistently supports multilateral solutions to address tax challenges arising from the digitalized economy, remove unilateral measures and remould the international tax system to be more fair, stable and sustainable, and that China will play an active role under the G20/OECD framework in discussions on specific technical design issues and implementation.[133]

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122. *See* J. Martin, "Leaked copy of US proposal for Pillar One and Two multinational group tax reforms available", https://mnetax.com/leaked-copy-of-us-proposal-on-multinational-group-tax-reforms-available-43379 (accessed 10 Nov.2021) [hereinafter *US Modifications*].
123. G20 Rome Leaders' Declaration, 31 Oct. 2021, para. 32, available at https://www.g20.org/ (accessed 10 Nov. 2021).
124. OECD, *Statement on Two-Pillar Solution*, *supra* n. 10.
125. Id., at p. 5.
126. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint,* OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020).
127. OECD, *Designing Effective Controlled Foreign Company Rules – Action 3: Final Report 2015* (OECD 2015), Primary Sources IBFD [hereinafter *Action 3 Final Report* (2015)], para. 4.2.3., considers income from using intangible property in the context of excess profits and suggests that it can be part of a CFC's income.
128. B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12, sec. 6.2.2. (2019), Journal Articles & Opinion Pieces IBFD.
129. The Ministry of Finance of Estonia explained that Estonian companies could have been in a worse position if Estonia had left the global tax agreement. "This is because of the income inclusion rule, which imposes a top-up tax on a parent entity in respect of the Estonian subsidiary if the income of the subsidiary is not taxed with the effective tax rate of at least 15%." *See Estonia notes reasons to join OECD global tax agreement* (2 Nov. 2021), News IBFD.
130. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020) [hereinafter *Pillar One Blueprint Report*] suggests a threshold of global revenues of EUR 750 million (at paragraph 175), which would scoop in about 2,300 MNEs. The United States increased the threshold to target only the largest 100 MNEs. The IF Statement settles on EUR 20 billion and profitability above 10%.
131. *See* Treasury Secretary Yellen's letter to Mike Crapo on 4 June 2021, available at https://mnetax.com/wp-content/uploads/2021/06/Yellen_letter_to_Crapo_on_OECD_tax_negotiations920-1.pdf (accessed 10 Nov. 2021).
132. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at p. 77.
133. Minister of Finance, Liu, Kun: *Consensus on Two-Pillar Plan Will Effectively Address Tax Challenges Arising from Digitalized Economy* (14 Oct. 2021), available at http://www.gov.cn/xinwen/2021-10/14/

The initial ambivalent stance may have several explanations. China-US relations changed in 2016, when the United States initiated a "trade war" against China and China became more assertive.[134] China apparently took notice of the US 2017 tax reform and introduced a tax incentive to encourage US MNEs to keep their profits in China.[135] More importantly, perhaps, as its outbound investments grow, China has a growing interest in protecting its MNEs, including digital companies and SOEs, from double taxation or additional taxes.[136] Examples of this interest are the creation of the Belt and Road Initiative Tax Administration Cooperation Mechanism (BRITACOM) in 2019,[137] increasing the use of mutual agreement procedures[138] and moving away from the worldwide basis taxation of corporate profit.[139]

There also seems to be a growing sentiment that China is "becoming a significant country in the international landscape of taxation ... ready to shoulder the corresponding international responsibilities".[140] China appears to want to have a voice in global tax governance in terms of taxing rights over residual profit.[141] There is a general theme in Chinese commentaries on BEPS 2.0 regarding the need to better understand the impact of BEPS 2.0 on China and to work out what technical changes are necessary to advance China's interests.[142] China reportedly succeeded in having a clause inserted into Pillar Two that will limit the effect of the global minimum tax on companies that are starting to expand internationally – "because of concerns that its growing domestic companies would be clipped by the measures."[143]

5.5.2. Pillar One: A mixed reaction

Between the two pillars, Pillar One is currently more aligned with China's interests in enhancing the taxing rights of market jurisdictions.[144]China has endeavoured to allocate more profits to China through innovative application of the ALP (*see* section 4.4.). China also considers global formulary apportionment to be a better method in certain circumstances. Pillar One effectively displaces the transfer pricing analysis and allocates 25% of the residual profit under Amount A to market jurisdictions based on sales and deems a safe harbour return (to be determined) to marketing and distribution activities in Amount B. China is expected to gain tax revenue.[145]

On the other hand, China is second only to the United States in terms of hosting large digital companies and MNEs. While 64% of the Amount A profits belong to companies headquartered in the United States, 10% belong to companies headquartered in China, and less than 2.5% belong to Germany, France and Japan.[146] As such, China may be a potential "giver" of tax base when more Chinese MNEs fall within the scope of Pillar One. At the moment, however, very few China-based MNEs under the modified Pillar One would have significant sales outside China and profits exceeding 10%. As such, the amounts of profits subject to reallocation are expected to be small initially.[147] The assurance that no DSTs will be imposed on sales by any Chinese digital companies is also potentially beneficial to China.

The tax certainty process may present challenges to China in terms of ceding control over Chinese tax assessment of in-scope MNEs to the multilateral process. In the past, China had been reluctant to adopt international tax arbitration.[148]

content_5642609.htm (accessed 10 Nov. 2021) (in Chinese). *See also* H. Sun, *Two-Pillars Plan will Start a New Chapter in Global Tax Governance* (12 Oct. 2021), available at http://www.chinatax.gov.cn/chinatax/n810219/n810780/c5169614/content.html (accessed 10 Nov. 2021) (in Chinese).

134. *See* R. Christensen & M. Hearson, *The Rise of China and Contestation in Global Tax Governance*, SocArXiv pzvy3, Ctr. Open Sci. (2021).
135. STA, Public Notice on the Matter Regarding the Scope of Temporary Exemption of Dividend Withholding Tax on Non-resident Investors That Reinvest the Dividends in China (29 Oct. 2018).
136. Christensen & Hearson, *supra* n. 134, at pp. 12-13.
137. For a statement on the BRITACOM, *see* BRITACOM, Wuzhen Statement (18-20 Apr. 2019) available at www.britacom.org/zchj/qwfb/202002/t20200228_1098051.html (accessed 10 Nov. 2021). It should be noted that the author of this article is a member of the Advisory Board of BRITACOM, but her views do not in any way represent those of BRITACOM.
138. *See* Cui, *supra* n. 111, at pp. 237-264.
139. CN: Ministry of Finance (MOF) and STA, Notice Regarding Preferential Enterprise Income Tax Policies for the Hainan Free Trade Port, *Caishui* [2020] 31 (23 June 2020).
140. W. Li, *Modernization of China's International Taxation*, Intl. Taxn. China 5, pp. 72-81 (2016) (in Chinese).
141. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at p. 424.
142. *See*, for example, X. Cui & Y. Liu, *OECD Pillar Two: Challenges and Responses*, Intl. Taxn. China 9 (2021), available at https://wemp.app/posts/a1a5dd5b-0130-4391-847c-3ece7372eb4c (accessed 10 Nov. 2021); Y. Jiang & Y. Jiang, *Process, Fatal Points and Responses: An Analysis and Examination of OECD Pillar One (Part 1),* Intl. Taxn. China 12 (2020), available at http://www.cntransferpricing.com/index.php/guojifanbishui/909.html (accessed 10 Nov. 2021); Y. Jiang & Y. Jiang, *Process, Fatal Points and Responses: An Analysis and Examination of OECD Pillar One (Part 2)*, Intl. Taxn. China 1 (2021), available at http://www.cntransferpricing.com/index.php/guojifanbishui/909.html (accessed 10 Nov. 2021); Y. Jiang & Y. Jiang, *Process, Fatal Points and Responses: An Analysis and Examination of OECD Pillar One (Part 3)*, Intl. Taxn. China 2 (2021), available at http://www.cntransferpricing.com/index.php/guojifanbishui/918.html (accessed 10 Nov. 2021); T. Liao, *Globalization and International Tax Reform*, Intl. Taxn. China 8 (2021); Z. Zhang & H. Li, *Digital Economy, Value Creation and Wealth Distribution – A Taxation Perspective*, Intl. Taxn. China 9 (2021); G. Zhu, *We should Study US Tax Policy Reforms and their Impact on Global Tax Systems and Economic Patterns and Come Up with Responding Policy Options in the Post-COVID Era*, a speech at the launch of a report on The Impact of United States Tax Reform on China (5 July 2021), available at https://mp.weixin.qq.com/s/SyQzAAPf_SJZouO9CPWcGQ (accessed 10 Nov. 2021); and X. Zhu & G. Cao, *The Changes and Impact of the Purpose of Two Pillar Framework Agreement*, Intl. Taxn. China 9 (2021) (all in Chinese).
143. *See* "136 nations agree to biggest corporate tax deal in a century", Financial Times, available at https://www.ft.com/content/5dc4e2d5-d7bd-4000-bf94-088f17e21936 (accessed 10 Nov. 2021).
144. Jiang & Jiang, *supra* n. 142.
145. *See*, for example, M.A. Sullivan, *OECD Pillar 1 "Amount A" Shakes Up Worldwide Profit*, Tax Notes F. (24 Feb. 2020), available at https://www.taxnotes.com/featured-analysis/economic-analysis-oecd-pillar-1-amount-shakes-worldwide-profit/2020/02/21/2c6fl (accessed 10 Nov. 2021), and R. Goulder, *The Cost of Change: Pillar 1 Reduced to the Back of a Napkin*, 103 Tax Notes Intl., pp. 111-118 (5 July 2021), available at https://www.taxnotes.com/featured-analysis/cost-change-pillar-1-reduced-back-napkin/2021/07/01/76qdb (accessed 10 Nov. 2021).
146. M. Devereux & M. Simmler, *Who Will Pay Amount A?*, EconPol Policy Br. (July 2021).
147. Zhu & Cao, *supra* n. 142.
148. China has opted out of the arbitration clause in the *MLI*, *supra* n. 19.

5.5.3. Pillar Two: Potentially worrisome?

Pillar Two is more nuanced in terms of its impact on China and appears to be worrisome for some Chinese commentators for several reasons. First, it was perceived to be made by developed countries for developed countries.[149] Pillar Two was originated from a proposal from Germany and France that was likely inspired by the US GILTI and BEAT rules and is consistent with the overall policy objectives of the European Union and the United States. The fact that the G7 reached an agreement first seems to confirm that. The fact that the G7's agreement was touted as a big win for US Treasury Secretary Yellen[150] and the United States did not escape the Chinese attention.[151]

The potential weakening of the effectiveness of Chinese tax incentives is a major concern.[152] For instance, a Chinese affiliate of a US MNE in the qualifying integrated circuit industry may be eligible for a tax holiday,[153] but the "tax room" vacated by China may be occupied by the United States under GILTI or Pillar Two, thereby neutralizing China's tax incentive.[154] Pillar Two may also neutralize the effect of another new Chinese tax incentive to attract MNEs to locate their regional hubs in the Hainan Free Trade Port.[155]

Pillar Two will likely weaken the strategic importance of Hong Kong for China. Hong Kong's low-rate and territorial-based tax regime and treaty network (including the Hong Kong-China Income Tax Agreement (2006)[156] that provides for lower withholding tax rates) make Hong Kong a preferred intermediary jurisdiction for investments into and out of China. China has liberally allowed Chinese MNEs to set up holding companies in Hong Kong to raise capital overseas or make investments, including in Belt and Road jurisdictions. By way of lower withholding taxes on base erosion payments to Hong Kong resident entities, China has encouraged foreign MNEs to use Hong Kong as an intermediary jurisdiction. As such, "the Chinese government should be thought of as invested in Hong Kong's low-tax system",[157] and China's interest would be adversely affected by Pillar Two.

On the other hand, China already has BEAT-like rules through transfer pricing (*see* section 5.2.1.). Pillar Two may present an opportunity for China to reform its international tax system through switching to the exemption system, updating the CFC regime and introducing GILTI- and SHIELD-like rules. In the long run, the growth of China-based MNEs may bring China's interest closer to that of the United States, and make China shift more towards rules that favour capital-exporting countries.

6. The Future?

6.1. Overview

Tax challenges in the digitalizing world economy require multilateral solutions, even though tax laws remain national, as national fiscal interests remain divergent. In the 1920s, the League of Nations considered, but did not adopt, a plurilateral tax convention because of the diversity of national interests (*see* section 3.1.). In the 2020s, through BEPS 1.0 and 2.0, a coalition of countries in the form of the Inclusive Framework seeks to create a multilateral tax convention to bind close to 140 countries, and to draft model rules to be transposed onto national tax laws. While the pivotal role of the United States seems to be consistent from the 1920s to 2020s, China's role has significantly changed.

6.2. US hegemonic multilateralism versus China's "true multilateralism"

Historically, US leadership in international taxation has been one of constructive unilateralism.[158] The Biden administration shows interest in "building multilateral cooperation in international tax" to "bolster American competitiveness".[159] The United States has re-catalysed the BEPS 2.0 process to serve its interests. Thus, there is a shift towards US-centric multilateralism. For lack of a better term, this new American style can be referred to

149. Research demonstrates that residual profit from intangibles is concentrated in OECD member countries, i.e.: 38.4% in the United States; 12.4% in the Netherlands; 11.2% in Japan; 6% in the United Kingdom; 5% in Switzerland; 4.7% in Germany; 4.6% in France; 2.7% in Sweden; 2.3% in Ireland; 1.9% in Korea (Rep.); and 10.9% in China and all other countries combined. *See* C. Durand & W. Milberg, *Intellectual Monopoly in Global Value Chains*, 27 Rev. Intl. Political Econ. 2, pp. 404-29.
150. *See* J. Stein and A. N. Farzan, *G-7 countries reach agreement on 15 percent minimum global tax rate*, The Washington Post (5 June 2021), available at https://www.washingtonpost.com/us-policy/2021/06/05/g7-tax-us-yellen/ (accessed 10 Nov. 2021).
151. Zhu, *supra* n. 142.
152. Cui, *supra* n. 111 and Zhu & Cao, *supra* n. 142.
153. On 11 December 2020, the MOF, the STA and other agencies jointly issued Bulletin 45 on Enterprise Income Tax Policies regarding the Stimulation of High-quality Development of Integrated circuit and Software Enterprises. This tax incentive is intended to strengthen China's capacity in this sector, following US sanctions that cut off access to American processor chips for Chinese companies, such as Huawei. *See* Associated Press, *China Cut Taxes to Spur Semiconductor Development* (29 Mar. 2021), available at www.usnews.com/news/business/articles/2021-03-29/china-cuts-taxes-to-spur-semiconductor-development (accessed 10 Nov. 2021).
154. It could be said that the effect of Pillar Two is similar to denying granting tax sparing credit in regard to the source country's tax room vacated by tax holidays is occupied by the parent company's residence country that adopts a worldwide system of taxing corporate profits (e.g. the United States). However, the nature and scope of the two measures are fundamentally different because Pillar Two is intended to cover most, if not all, capital exporting countries and is a mandatory annual minimum tax, while the tax sparing credit is relevant only in some countries and only when dividends are repatriated. The author thanks Yansheng Zhu for making this point to her.
155. MOF and STA, Notice Regarding Preference Enterprise Income Tax Policies for the Hainan Free Trade Port, *Caishui* [2020] 31 (23 June 2020). Qualifying enterprises are eligible for the following three tax preferences: (i) a reduced enterprise income tax rate of 15%; (ii) expensing or accelerated deduction of eligible capital expenditure; and (iii) an exemption from Chinese tax for foreign-source income, representing China's shift from a comprehensive regime of taxing foreign income to an exemption regime. Even though the nominal rate is 15%, this tax incentive may be neutralized if the ETR computed under Pillar Two were lower.
156. *Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (21 Aug. 2006), Treaties & Models IBFD.
157. Wei Cui, *What Does China Want from International Tax Reform*, 103 Tax Notes Intl. 2, pp. 141-151 (9 July 2021).
158. *See* Avi-Yonah, *supra* n. 20.
159. US: Department of the Treasury, The Made in America Tax Plan (Apr. 2021).

as "hegemonic multilateralism". Under such multilateralism, international tax reforms will likely fail without the United States. In the case of the fate of BEPS 2.0, given the current political situation in the United States, it is unclear whether the US Congress will ratify the multilateral tax convention to implement Pillar One, even if Congress is to adopt Pillar Two by amending domestic GILTI and SHIELD through a budget reconciliation process that requires a simple majority. If Pillar One cannot be erected in the United States, it is difficult to see why another other country would want to adopt the "two-pillar solution".[160]

Since becoming a norm-shaker, China has relied on multilateral processes, including those of the United Nations, the G20 and the Inclusive Framework to voice its views.[161] As a general approach, President Xi calls for "improving global governance and practicing true multilateralism".[162] Under the BEPS 2.0 process, China has played the role of a good multilateralist. As a "responsible major developing country", China has called for more respect to sovereignty and a globally fair and modern international tax system that fosters growth.[163] China has also desired to have "fair and clear rules ... to allocate profit retrieved from the tax havens".[164] With regard to BEPS 2.0, however, at the time of writing this article (7 November 2021), it is difficult to gauge the meaning of "true multilateralism" and how China will put it into practice.

Will Chinese "true multilateralism" coincide with American-centric multilateralism? Understanding the areas of converging and diverging interests in the two countries may shed some light on the path for the future.

6.3. Convergence in interests

The underlying economic realities may predetermine the tax positions of China and the United States. The economies of the two countries are intertwined. Due to the significant investment in China by US MNEs, what is good for the Chinese economy may also be good for the United States.[165] As major market jurisdictions, both stand to gain new taxing rights under Pillar One, although China would likely gain more in the near future as more US MNEs would be taxable than Chinese ones. What the United States may lose under Pillar One would be more than compensated for by revenue gains under Pillar Two, as US MNEs presumably have more income that is not currently taxed at the minimum rate.

Both countries have recently moved closer to the international tax norm by adopting the territorial system, reflecting the concerns for competitiveness of their MNEs. Meanwhile, both have taken measures to prevent the offshoring of profits. In the area of transfer pricing, both countries have adopted a more substance-over-form approach, a broad notion of intangibles and unconventional ways of capturing residual profits (for example, the super royalty rule in the United States and contribution-based or value-creation methods in China). Both countries' tax treaty practice favours the residence country.[166]

Presumably, it is in both countries' interests to have a coordinated global tax arrangement that can minimize the transaction costs for MNEs while accommodating the fiscal needs of capital-importing countries. It is likely not to be in either country's interest to have different "regional" schemes for taxing MNEs that compete on a global basis.

6.4. Divergence in approach and world view

The general approach to international tax reforms or global tax governance appears to differ between China and the United States. As a hegemonic power and "technical innovator" in taxation, the United States has, until BEPS 2.0, generally practised unilateralism. Other countries have followed the US lead out of their own interests.

As a latecomer, China has been biding its time. It has recently sought to change the existing norms through multilateralism as an advocate for developing countries.[167] China identifies fairness as a key objective for international tax reform. In other words, the Chinese approach is not explicitly about China's own interests, which differs from the "America First" approach. Consequently, China has attempted to "strike a balance between conforming to international conventions while being able to deal with some unique issues ...".[168] China has used multilateral mechanisms, such as BRITACOM, to ostensibly promote "win-win" cooperation.[169]

On the core issue of which country can tax the residual profit of MNEs, China appears to have different views from the United States. By way of GILTI, the United States seems to believe that the residual profit of US MNEs (as well as lowly taxed routine profit) belongs to the United States. China does not have GILTI-like rules, and has not even enforced its CFC rules as rigorously as the transfer pricing rules. It seems to think more like a source country. China emphasizes the contributions by people and assets

160. *See* J. Scott Wilkie, *Critical Questions to Ask About the Next Stage of the Erection of the Pillars – Moving from a Political "Deal" to "Enforceable Law"* Tax Notes Int'l (8 Nov. 2021).
161. Cui, *supra* n. 111. *See also* R.S. Avi-Yonah & H. Xu, *China and the Future of the International Tax Regime*, U. Michigan, L. & Econ. Working Papers. 140 (2017), available at https://repository.law.umich.edu/law_econ_current/140 (accessed 10 Nov. 2021) and Christensen & Hearson, *supra* n. 134.
162. Xinhuanet, *Xi calls for practicing true multilateralism* (22 Sept. 2021), available at www.news.cn/english/2021-09/22/c_1310201342.htm (accessed 10 Nov. 2021).
163. *UN Transfer Pricing Manual-China* (2021), *supra* n. 97, at sec. 2.1.2.
164. Id., at sec. 2.1.3.
165. Schutte, *supra* n. 59, at p. 10, stating that, in 2018, about two thirds of Chinese exports to the United States were organized by foreign companies, most of which are part of US MNE groups. A major exception applies to US digital companies, such as Facebook (or Meta), Google, Twitter, Netflix or Amazon, that are not operating in China.
166. The US treaty policy has been consistently in favour of the residence country, while China initially insisted on more source-country taxing rights and switched to more limitations on source-country taxing rights since becoming a capital-exporter; *see* Turley et al., *supra* n. 109, pp. 725-34.
167. China International Tax Research Institute, *China 40-Year Tax History*, *supra* n. 11, at p. 77.
168. *UN Transfer Pricing Manual-China* (2021), *supra* n. 97, at sec. 2.11.2.
169. BRITACOM aims to reduce tax barriers to investments (mostly by China) in belt & road countries; *see supra* n. 137.

to earning residual profit, as opposed to capital and technology that are embodied by corporate residence. It may prefer to have the residual profit shared by all participating jurisdictions under a global formulary apportionment method on the ground that all constituent members of an MNE group, no matter how they are configured legally, contribute to and share the collective outcome even if their direct contributions are routine.

In terms of technical tax skills, there is a big difference. Even though Chinese tax policymakers have become more sophisticated in understanding the intricate international tax rules and practices and have adapted these rules for China, they have not yet publicly presented specific new tax rules to lead a global discourse or counter US proposals.

The Chinese government enjoys more "flexibility" than the US administration in terms of (i) incorporating international agreement into domestic laws because China does not have the US bipartisanism in law-making; (ii) relying on international tax rules to raise revenue because value-added tax, which does not exist in the United States, is the largest revenue source in China; or (iii) using international tax rules to regulate the behaviour of MNEs because many Chinese MNEs are state-owned.

China is also more guarded about sovereignty. The Century of Humiliation (1839-1949) is often a reminder of China's need to be independent and to avoid falling behind the Western powers.[170] The United States has no similar experience. As such, when Pillar Two effectively treats national corporate tax bases as "fungible"[171] and authorizes the residence country to tax income that is chosen by another country not to tax, fiscal sovereignty can be a real concern for China.

7. Conclusions

This article has attempted to demonstrate that the United States has been the main architect of the current international tax system as it is difficult to find a basic principle that does not have any US influence. China was at the table in 1928 when the League's technical experts finalized the early model tax conventions but has largely been a norm-taker and then norm-shaker. On the battleground for taxing rights over residual profit, which is what BEPS 2.0 is about, the two countries do share some common interests, but also have different approaches and emphases.

In terms of international tax governance, China's influence may be rising, but that does not necessarily mean that the United States' power will decline. However, it does appear that US exceptionalism or US-centric multilateralism needs to contend with China's influence. The trajectory is likely more open confrontation. Until 2013, China had never openly challenged the United States' leadership role.[172] In BEPS 1.0, China and other countries relied on the value creation principle to backstop stronger anti-abuse rules to prevent MNEs (most of which are US-based) from eroding the tax base of source countries. In BEPS 2.0, China may keep a low profile and bide its time. As such, only time can tell how China will put its "true multilateralism" into practice in global tax governance.

170. "After the Opium War of 1840, however, China was gradually reduced to a semi-colonial, semi-feudal society and suffered greater ravages than ever before. The country endured intense humiliation, the people were subjected to great pain, and the Chinese civilization was plunged into darkness. Since that time, national rejuvenation has been the greatest dream of the Chinese people and the Chinese nation." *See Speech by Xi*, *supra* n. 4.

171. J. Scott Wilkie, *Reflecting on the OECD's July 1 "Two-Pillar Plan" Announcement*, Tax Osgoode Hall L. Sch. (9 July 2021), available at https://tax.osgoode.yorku.ca/ (accessed 10 Nov. 2021).

172. Baistrocchi, *supra* n. 11, at p. 245.