

Challenges and Countermeasures of China's Digital Economy Tax System under the Double Pillar Model

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Abstract

The rapid development of digital economy has brought unprecedented changes to Global Tax Governance in a century. Economic digitalization has not only changed the business model of multinational enterprises, but also put forward urgent requirements for the improvement of China's tax system. In order to deal with the problems of tax base erosion and profit transfer brought about by economic digitalization to the international tax system, the organization for economic cooperation and development (OECD) released the "two pillar" framework, striving to provide relatively consistent institutional reference for the international tax system reform in the field of digital economy, so as to deal with the tax problems of digital economy and maintain the international tax order. It is of far-reaching significance to study the challenges brought by the digital economy to the determination of jurisdiction, tax base and tax collection and management methods of the traditional tax system. It is helpful to prevent the erosion of China's tax base, promote tax fairness, and build an inclusive tax governance system by reforming the recognition principle of permanent institutions, improving the legal system of digital tax, and strengthening the tax collection and management in the field of digital services.

Keywords

Double Pillar; Digital Economy; International Tax Rules.

1. The Background and Significance of the Two Pillar Scheme

1.1. Background of the Two Pillar Scheme

With the development of information technology, the Internet has been penetrating into all fields of social development. According to the 2020 white paper on the global digital economy issued by the China Institute of information and communications, in 2020, the scale of the global digital economy reached US \$32.6 trillion, with a year-on-year nominal growth of 3.0% and accounting for 43.7% of GDP. The digital economy has objectively accelerated the pace of innovation and reform of traditional tax collection and management methods, and has brought new challenges to the traditional international tax system. Enterprises use digital technology to provide products and services and highly rely on intangible assets to transfer their income and profits to low tax countries and regions, This has a serious impact on the connection degree rule based on "permanent establishment" and the profit distribution rule based on the principle of independent transaction.

In order to deal with the problem of tax base erosion and profit transfer caused by economic digitalization to the international tax system, the organization for economic cooperation and development (OECD) first proposed the "two pillar" scheme design framework in 2019. After tortuous and arduous negotiations among countries, 136 of the 140 members of the g20/ OECD inclusive framework on tax base erosion and profit transfer issued a statement on October 8, 2021, Formal agreement on key parameters in the new international tax rules (the "two pillar" scheme). Among them, "pillar I" mainly solves the re division of tax right, and aims to build a

tax jurisdiction distribution mechanism matching the business model of digital economy by redistributing part of the residual profits of large multinational enterprises. The purpose of "pillar 2" is to systematically and comprehensively solve the problem of tax base erosion by establishing a minimum effective tax rate of 15% of corporate income tax worldwide. According to OECD estimates, "pillar I" will bring about US \$100billion in tax revenue to market countries every year, and "pillar II" will generate about US \$150billion in tax revenue every year.

1.2. Main Contents of the Two Pillar Scheme

1.2.1. Pillar 1: Rules for the Division of Taxation Rights

Pillar 1 consists of amount a, amount B and tax certainty. Amount a is the core content of pillar 1. The new rules require multinational enterprises to distribute part of their profits to the market countries in the form of amount a even if they do not set up any institutions, places or permanent institutions in the market countries. Applicable to multinational enterprises with a global operating income of more than 20billion euros and a profit margin of more than 10%, the relevant threshold is calculated on an average basis, and 25% of the remaining profits higher than 10% of the conventional profit margin are redistributed to market countries with income as the distribution factor. The profit level of 10% is calculated as the ratio of pre tax profit to income. If it goes well in the future, the threshold of operating income will be reduced to 10billion euros.

Amount B is to set a fixed rate of return for the basic marketing and distribution activities engaged in by the Distribution Agency, standardize the relevant remuneration, and simplify the application of the independent transaction principle. At present, the specific scheme of this part is still under study. OECD will carry out further work on amount B, that is to clarify the scope of application, simplify and optimize the pricing principles of related party transactions applicable to "basic marketing and distribution activities". The compensation for affiliated distributors who only carry out basic marketing and distribution activities shall be standardized.

To enhance tax certainty, the mandatory and binding dispute prevention and resolution mechanism will be applicable to all matters related to amount a, including transfer pricing, operating profit and determining whether a dispute belongs to the scope of the amount a dispute resolution mechanism. Some small-scale developing countries with fewer disputes in the mutual consultation process will have the opportunity to choose whether to apply the dispute settlement mechanism. The eligibility of relevant jurisdictions to apply the selective mechanism will be reviewed regularly. Once it is considered as disqualified, it will not be restored in subsequent years.

1.2.2. Pillar 2: Global Minimum Tax Rules

Pillar II mainly includes global anti-tax base erosion (Globe) rules and taxable rules based on bilateral tax treaties. The globe rule consists of interrelated income inclusion rules and low tax payment rules. The income inclusion rule refers to the supplementary tax levied on the low tax income of multinational group members from the parent company to the minimum tax burden level. The low tax payment rules refer to the supplementary tax levied on the low tax income of a member of a multinational group to the minimum tax burden level by refusing to deduct or requiring equivalent adjustment, but are limited to the part where the income is not included in the rules. The minimum tax burden level jointly implemented by the income inclusion rule and the low tax payment rule is the global minimum tax rate. The taxable rules allow the income source jurisdiction to impose a limited tax on certain related payments where the recipient's tax rate is lower than the minimum tax rate of the taxable rules.

1.3. Significance of the Two Pillar Scheme

1.3.1. Prevent Tax Base Erosion

In the traditional tax system, the profits generated by user traffic and volume are not included. It is difficult to calculate the value creation brought by such intangible assets, which brings huge losses to the country where the user data and traffic are located. For many transnational Internet companies, due to the particularity of their business, compared with traditional enterprises, they can earn high profits and bear less taxes, and the cost is correspondingly reduced, which makes it easier for transnational Internet companies to gain an advantageous position in the market competition. The traditional way of tax collection and management needs the existence of real economy or profit entity. On the one hand, under the digital economy model, a large number of digital products and services no longer need to rely on physical objects, that is, they can provide goods or services to consumers without establishing entities in tax jurisdictions. On the other hand, the digital economy makes the source of profits no longer limited to the production mode of "product profit", and a new profit generation mode of "user flow value profit" is emerging, which makes users, as the provider of data, indirectly create profits for enterprises with the help of data and flow, and they do not directly generate profits themselves. Although the user data has generated great value, it is difficult to determine where the user is as the source of profit according to the traditional tax jurisdiction. OECD establishes new tax jurisdiction by revising the new linkage rules to ensure that the tax sources of market countries will not be eroded.

1.3.2. Promoting Tax Equity

With the in-depth development of the trend of economic globalization, the cost of cross-border transfer of goods, services, capital and labor is getting lower and lower. In order to attract the mobile tax base of neighboring tax jurisdictions, in recent years, various jurisdictions have made efforts to reduce the corporate income tax rate. The average corporate income tax rate of OECD member countries has continued to decline, such as Singapore, Thailand and other Southeast Asian countries also attract investment with low tax rates. Ireland, Bermuda, Cayman Islands, Luxembourg and other well-known tax havens also attract a large number of international capital with zero or low tax rates. Under the traditional international tax rules, many large multinational enterprises set up their headquarters in low tax countries or non tax countries, and adopt a series of transfer pricing methods to transfer the profits obtained by market countries to low tax countries or non tax countries, which has seriously infringed the tax interests of other countries. The "double pillar" new international tax rules can plug the loopholes of the traditional international tax rules and bring much-needed tax revenue under the epidemic. According to OECD estimates, pillar I will bring about US \$100 billion of tax revenue to market countries every year, and pillar II will generate about US \$150 billion of new tax revenue every year. In addition, pillar 1, in terms of tax certainty, proposes to establish a dispute prevention and settlement mechanism to avoid double taxation on amount a in a mandatory and binding manner, which will help to create a more stable international tax environment for the development of multinational enterprises. And promote the fair distribution of tax jurisdiction among countries (regions) and safeguard the tax interests of many developing countries, including China.

1.3.3. Contribute to the Construction of International Tax Governance System

Taxation is an important part of a country's sovereignty. There are great differences in the tax systems and policies of various countries due to the economic, cultural and regional differences of a country, which often leads to contradictions and even conflicts in the field of taxation. In order to solve the various problems caused by the uncoordinated tax systems in various countries, tax coordination has become an important way. Tax competition and tax coordination are a core thread in tax governance. Tax Governance seeks to reach a general

consensus among contracting countries and form a stable regulation with formal binding force, which takes bilateral tax agreements as the main tool. However, as more and more digital service enterprises begin to evade taxes by taking advantage of the imperfection of the international tax system, in order to protect their tax base from erosion, countries have begun to explore the unilateral digital service tax, and France, the United Kingdom and India are the first to carry out the trial. With the introduction of unilateral digital service tax, countries have begun to act independently in the field of international taxation, resulting in tax burden imbalance and even rule loopholes while imposing aggressive taxes on some enterprises or markets, which leads to harmful tax competition and increases the difficulty of coordination and unification of international tax rules. The determination of the two pillar scheme is conducive to in-depth cooperation in the field of international taxation and the establishment of a more complete global bilateral tax governance system.

2. The Challenge of Double Pillar to China's Tax System

2.1. Enterprise Income Tax Law Needs to be Improved

With the rapid development of the digital economy, the traditional tax system is facing great challenges. The emergence of the double pillar scheme breaks through the traditional standard of permanent institutions and the way of profit distribution. It puts forward a new scheme to adapt to the tax system under the digital economy, and puts forward new requirements for China's current tax system. First, pillar 1 proposes to locate the tax object in the automatic digital service industry and consumer-oriented service industry. However, at present, China has no special tax system for digital enterprises, and the definition of the above two enterprises is also lack of clear provisions. Secondly, the innovation of pillar I is that it breaks through the traditional standard of permanent establishment and puts forward a new rule of connection degree. The new connectivity rule recognizes the contribution of value creation. As long as the enterprise has a large-scale income from consumers, that is, the market income exceeds 1million euros and meets the relevant indicators, it can be confirmed that there is a relevant linkage between the consumer market countries and enterprises. However, at present, the recognition of permanent institutions in China is still based on tangible existence, which is incompatible with the new economic model of digital economy and the new connection rules of pillar 1. Finally, pillar 1 uses a formulaic profit distribution rule, which recognizes multinational digital enterprises as independent entities and distributes tax rights to connected market countries according to their overall income and profits. At present, the distribution of profits in China's tax law is still based on various taxable entities, which cannot be well connected with the pillar I profit distribution rule.

2.2. Weakening Effect of Preferential Tax Policies

At present, the nominal income tax rate of enterprise income in China is 25%. However, after tax concessions such as tax rate reduction for high-tech enterprises, exemption or halving for integrated circuit enterprises and software enterprises, and tax rate reduction for encouraged enterprises in the western low region, the actual tax rate of some enterprises may be lower than the nominal tax rate. With the introduction of the global minimum tax rate, the preferential tax policies of some Chinese enterprises may be affected and cannot be well implemented. According to the income inclusion rules in pillar II, if the effective tax rate of some cross-border enterprises is lower than the minimum tax rate of 15% specified in pillar II, their parent companies need to make up the difference in the jurisdiction, which means that China's tax preferential policies cannot really benefit the enterprises enjoying tax preferential policies, but also make China's tax preferential funds flow abroad. In addition, in order to attract foreign enterprises to invest in China, China has given some overseas enterprises more preferential withholding income tax policies than domestic enterprises. However, under the influence of the

taxation rules of pillar 2, the relevant withholding income tax preferential policies have also been affected to a certain extent, which has led to a decline in the attractiveness of China to overseas enterprises, On the other hand, it also makes our tax revenue flow abroad.

2.3. The Traditional Tax Collection and Management Model has been Impacted

Under the traditional tax collection and management mode, the tax base only depends on the difference between income and input cost to determine the profit and thus determine the tax base. This mode ignores the huge value generated by data and flow. On the one hand, transactions in the digital economy are generally provided through digital applications or online digital services on the Internet, and the source of value and the source of profits are generally not in the same place, which brings severe challenges to the tax authorities in determining the tax base. On the other hand, in the digital economy, the way for enterprises to make profits is not limited to the cost of capital investment. Obtaining users' traffic and data can also bring huge profit returns to enterprises. The two pillar scheme attaches importance to the value of data and has also developed a series of tax collection and management processes for digital cross-border enterprises. However, at present, China has not put forward the idea of special taxation for digital enterprises, nor formulated the policy of tax collection and management for digital enterprises, nor upgraded China's current tax collection and management policy, and failed to keep up with the pace of international taxation. After the formal implementation of the two pillar scheme, China's tax collection and management system may not be able to adapt to the international tax collection and management cooperation mechanism, and there may be a large room for upgrading.

3. Countermeasures and Suggestions for the Double Pillar Scheme

3.1. Improve the Enterprise Income Tax Law

The adoption of new connection rules and profit redistribution rules in the amount a of pillar 1 has brought new breakthroughs to the traditional international tax law, and put forward a new direction for the revision of China's enterprise income tax law. China should comply with the trend of digital economy and timely revise China's enterprise income tax law to provide complete legal support for China's tax collection and management. First, it is necessary to supplement the existing standard of permanent establishment and add some new rules and regulations of connection degree. For example, set up some specific quantitative standards to determine whether the city site has connectivity. The specific standards can be set as 150 days for more than 10million active online users within a certain period of time in a country, such as 6 months. Secondly, the articles of the principle of independent transaction are revised. There are certain contradictions and conflicts between China's traditional geographical transaction principle and the formula profit distribution rule in pillar 1. China can consider supplementing this rule. For example, in the "special tax adjustment" clause, a targeted explanation is given for which enterprises fall within the scope of amount a. Finally, the provisions on repeated tax collection should be revised. On the basis of domestic tax direct credit and indirect credit, the distribution of tax right should be simplified, and the residual profits of enterprises included in the new tax right should be exempt from repeated taxation as far as possible.

3.2. Adjust Preferential Tax Policies

At present, although there are some conflicts between China's preferential tax policies and the two-pillar scheme, the current preferential tax policies are designed on the basis of the experience accumulated in the continuous tax practice. Therefore, in order to achieve the coordination and coexistence of the two-pillar scheme and China's preferential tax policies, it is necessary to partially adjust the current preferential tax policies. First, simplify the current complicated preferential policies for enterprise income tax, ensure that the preferential policies

can reflect the tax preferential dividends at the threshold of the minimum tax rate of 15%, and encourage some enterprises that have set up regional tax preferential policies to explore boldly, so as to provide practical and effective solutions for adjusting the preferential tax policies. Second, some enterprise income tax preferences can be shifted to value-added tax preferences. For enterprises within the scope of pillar II taxation, effective value-added tax preferential policies can be formulated, such as the development of digital enterprise value-added tax relief or low tax rate policies to reduce the tax burden of enterprises affected by pillar II schemes. Third, give enterprises the option to waive or choose to apply the enterprise income preferential policies. Enterprises can either choose to waive the applicable tax preferential policies to ensure that the tax paid is above the minimum tax rate specified in pillar II, or choose to make up the difference between the two tax rates to the minimum tax rate. The purpose of this move is to reduce the burden on those enterprises affected by the pillar II scheme, and at the same time, to achieve China's tax goals, to achieve a win-win effect between the state and enterprises.

3.3. Improving China's Tax Collection and Management Program

At present, the framework of the two-pillar scheme has been preliminarily determined, but there are still some details to be improved. China should seize the opportunity to further improve China's tax collection and management model, to better implement the two-pillar scheme in China. First, make preparations before the implementation of the plan. The tax authorities should help relevant enterprises understand the new international tax rules and actively guide them to make preparations, and constantly optimize China's business environment, so as to lay a solid foundation for attracting foreign investment. Second, strengthen the digital upgrading of China's tax collection and management. On the one hand, make full use of the advantages of big data to establish an intelligent tax declaration system and an intelligent tax sharing mechanism for enterprises involved in pillar I. On the other hand, we should fully improve our grasp of tax related information and create an intelligent tax system based on the tax jurisdiction. Third, we should strengthen the construction of China's specialized tax talent team. All regions should formulate policies for the introduction of tax professionals according to their own conditions, and create a high-quality tax talent team with excellent professional knowledge and rich practical experience. Colleges and universities can also offer specialized courses and training to contribute to the talent reserve. Fourth, China should actively participate in international multilateral tax collection and management cooperation, and the two-pillar plan is committed to achieving global multilateral tax cooperation. China should actively explore new cooperation mechanisms under multilateral tax collection and management, and timely promote the deepening of international tax collection and management cooperation among all parties.

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