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What Does China Want From International Tax Reform?

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What Does China Want From International Tax Reform?

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In this article, the author examines China's possible response to recent global efforts to reach consensus on international tax reform — particularly, a minimum corporate tax rate.

The G-7 countries' June 5 accord to implement a global minimum corporate tax rate promises to set off frenzied negotiations among nations regarding coordinated international tax reform. Finance ministers from the G-20 countries met in Venice on July 9-10, after this magazine went to press. Whether members of the G-7 club can persuade the larger group to endorse their minimum tax proposal will determine what mandate the OECD receives to continue the (re-)negotiations under pillars 1 and 2 of its program of work to develop a consensus solution. How will China respond to the G-7 proposal at the G-20 meeting? That question is especially intriguing, given the growing political antagonisms between China and some G-7 countries.[1]

This article offers some broad reflections on how well aligned China's recent international tax policy choices are with the G-7's minimum tax proposal. The reflections are based on analyses of Chinese tax law and policy, and not on recent pronouncements by Chinese political leaders, diplomats, or commentators. The aim is not to predict the positions the Chinese government will take at the meeting or during further OECD negotiations; instead, it is to identify several tax policy priorities that emerged in recent years for the Chinese government that may be affected by the G-7's global minimum tax proposal. In particular, it argues that in several striking ways, China can be seen as facing policy choices similar to many the United States has confronted.

Recent speculations about China's international tax policy have been made more often in connection with the OECD's pillar 1 proposals, such as whether China may desire to protect its technological titans from digital services taxes or welcome greater profit allocation to market jurisdictions. As pillar 2 ideas drive proposed international negotiations and the scope of pillar 1 shrinks, the questions facing China (and many other countries) are different. Arguably, the global minimum tax proposal is more important for China than even the OECD's earlier pillar 1 blueprint, let alone any "pillar 1 light" that may emerge in the coming months.[2]

The shifting emphasis of political discussions from pillar 1 to pillar 2 calls for one additional preliminary remark. It should be obvious that the position China (or any country, for that matter) takes toward OECD negotiations will depend on what the negotiations are about, including whether they have any substance. The G-7's recent announcement, reflecting the new U.S. policy agenda under the Biden administration, is touted

[1] James T. Areddy, "The G-7's Global Tax Deal Faces a China Test," *The Wall Street Journal*, June 9, 2021; and Karla Adam et al., "G-7 Takes Stronger Stand Against China, at U.S. Urging," *The Washington Post*, June 13, 2021.

[2] For a provocative proposal to give pillar 1 more substance, see Mitchell Kane and Adam Kern, "Progressive Formulary Apportionment: The Case for 'Amount D,'" *Tax Notes Int'l*, June 14, 2021, p. 1483.

first and foremost as about strengthening the corporate income tax throughout the world and ending the "race to the bottom" of tax competition. Yet just less than half a year ago, the OECD stated that the main purpose of international tax cooperation was to end the undesirable proliferation of unilateral taxes — a race to the top in which small, open economies hasten to impose taxes on foreign multinationals.[3] That gives the impression that countries favor coordination on international tax matters to such an extent that any kind of race, either up or down, is too disorderly.[4]

Of course, the apparent versatility of international cooperation has also led many to suggest that other than complexity, very little will change. But if very little of substance changes, it is also humdrum to predict what China (or any other country) will do in a sheer game of diplomacy (and bargaining for bargaining's sake). Therefore, this article considers how China might respond to more substantive versions of global minimum tax proposals, whether or not those versions will eventually be agreed to or are even under serious discussion.

China and the United States are remarkably similar in their aversion to using consumption and personal income tax (PIT) instruments to raise revenue and their preference for the corporate income tax (CIT). Both also drifted away from a paradigm of taxing the foreign income of multinationals that the United States first adopted in the 1960s. While the United States did so over the course of four decades, China did so in just one. The extent to which each is willing or able to halt that drift is what is at stake in the current global minimum tax debate. Taking another page from a book familiar to U.S. policymakers, China offers many incentives to engage in rate-reducing tax competition to attract foreign investment and promote (quasi-)domestic financial centers, including Hong Kong. The meaning of multilateralism in international tax cooperation, however, differs for the two countries.

I. The CIT as a Stalwart Revenue Source

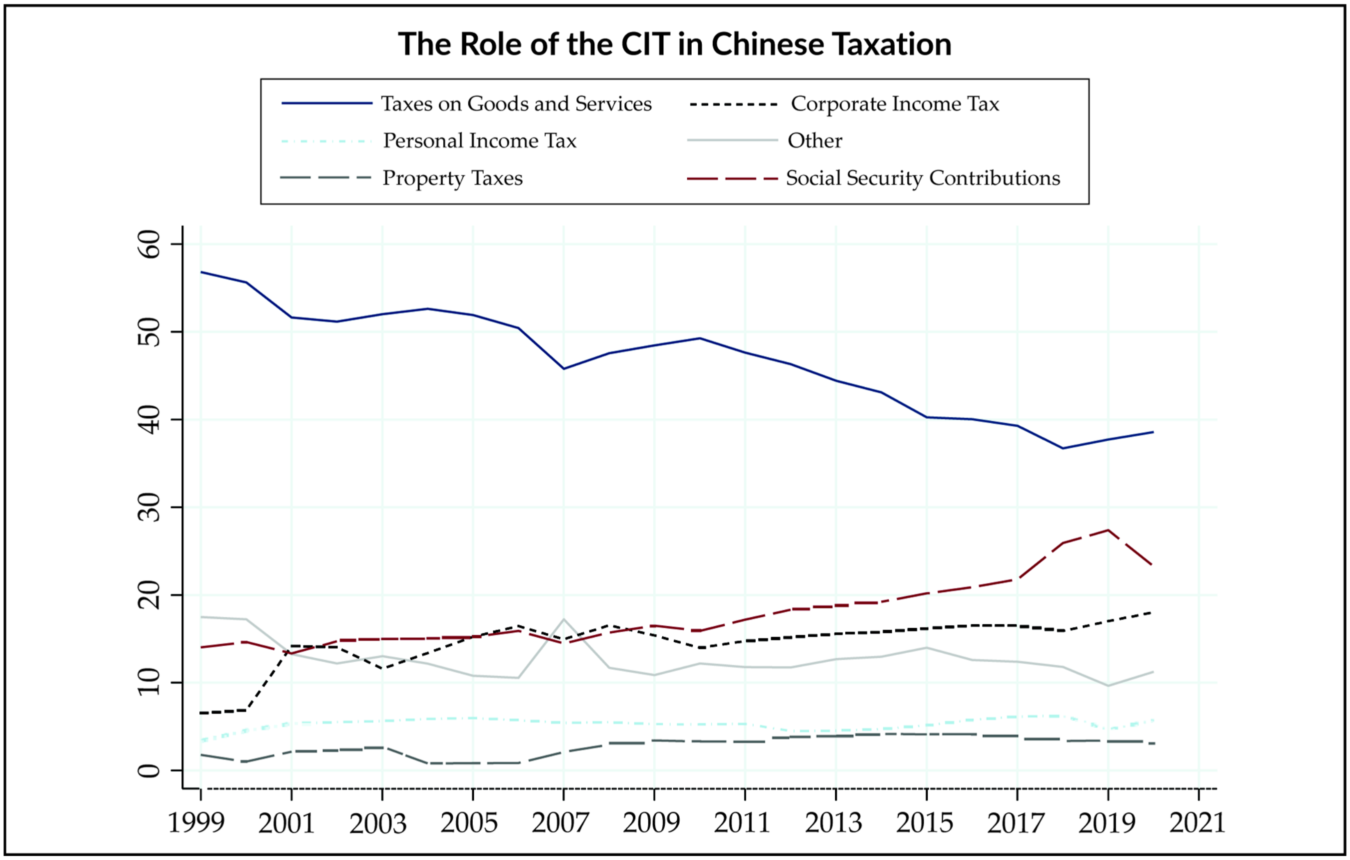
The figure offers an overview of the evolution of China's tax structure since the late 1990s. The CIT's share of total tax revenue (inclusive of social insurance contributions) generally rose after 1999 and remained steady after 2008, when the Enterprise Income Tax Law (EITL) unified previously separate CIT regimes for domestic- and foreign-owned companies. The CIT's share of total revenue has held up despite substantial rate cuts during the past decade, the largest of which were delivered through nominally temporary, but repeatedly renewed, extra-statutory expansions of a preferential regime for small- and micro-profit enterprises (SMPEs).[5] Although the EITL prescribed a 20 percent rate for SMPEs, beginning in 2009 the Ministry of Finance and State Administration of Taxation (SAT) introduced a series of policies to reduce the rate to 10 percent for companies under specific asset, employee, and taxable income thresholds. By 2019 all companies with less than CNY 50 million (approximately $7.7 million) in assets, fewer than 300 employees, and taxable income of less than CNY 1 million enjoyed a 5 percent CIT rate, while those that made between CNY 1 million and CNY 3 million in taxable income had a 10 percent rate.

Because, as in other countries, a large portion of Chinese corporations are loss making in the first place, the Chinese government announced in 2019 that the SMPE tax preference extended to over 95 percent of all Chinese businesses, making it an "inclusive" tax cut. For CIT liabilities to be reduced for such a large population of companies and for CIT revenue to increase at the same time, some Chinese companies must have become very profitable.

[3] OECD, "Tax Challenges Arising From Digitalisation — Economic Impact Assessment," at 11 (Nov. 2020) ("The absence of a consensus-based solution would likely lead to a proliferation of uncoordinated and unilateral tax measures (for example, digital services taxes) and an increase in damaging tax and trade disputes. . . . In the 'worst-case' scenario, these disputes could reduce global GDP by more than 1 percent.").

[4] That is among several unusual features of the recent discourse on international tax coordination discussed in a working paper. *See* Wei Cui, "New Puzzles in International Tax Coordination," SSRN Working Paper (2021).

[5] That expansion of the SMPE regime is documented in Cui, *The Administrative Foundations of the Chinese Fiscal State*, at ch. 7 (forthcoming 2021).



The figure also shows that in contrast to the CIT, the share of taxes on goods and services in China has declined substantially over the last 20 years. The share of the PIT has also remained stagnant, at only around one-third of the CIT's share.

There are many reasons to expect those trends to continue. For taxes on goods and services, the main reason has to do with a reform China implemented between 2012 and 2016 to combine VAT and a turnover tax on services called the business tax. The botched reform retained or introduced many turnover tax features under China's VAT; its resulting inefficiencies (not its impact on consumer prices) generated strong political pressure to reduce VAT rates. Thus, unexpectedly for reform that was supposed to enhance the efficiency of the indirect tax system, the highest VAT rate was cut from 17 percent in 2016 to 13 percent in 2019.

Increases in VAT rates seem unlikely in the near future. Likewise, the Chinese government has chosen to pander to the urban affluent class by repeatedly cutting the PIT. Public opinion is easily mobilized against PIT increases, and given the tax's low revenue share, it is also unlikely that the government will raise it to generate revenue in the next few years.[6]

The only major source of tax revenue that has shown substantial gain in revenue share is social insurance contributions. However, those contributions (by both employers and employees) significantly increase labor costs, especially for micro, small, and midsize firms. Pressures to reduce companies' social insurance contributions are therefore also intense — and, unlike the VAT and PIT, perhaps justifiably so. It is notable, therefore, that China's largest fiscal policy response to COVID-19 in 2020 consisted of temporary suspensions of major social insurance contributions for the vast majority of companies.[7]

[6] For more on the government's decision to shrink the PIT base in China and the botched VAT reform, see *id*. at ch. 6.

[7] *See* Cui, Jeff Hicks, and Max Norton, "How Well-Targeted Are Payroll Tax Cuts as a Response to COVID-19: Evidence From China," SSRN Working Paper (2020).

Overall, it seems reasonable to project that Chinese policymakers are more likely to cut VAT and social insurance rates in the coming years than they are to raise them. And with CIT revenue staying healthy despite recent tax cuts, the government can be predicted to continue to rely on the CIT.

There is a surprising affinity between China's current tax structure and recent U.S. tax policy choices. In contrast to the United States and other developed countries, China raises relatively little revenue from the PIT. The CIT thus serves as an important substitute for taxing capital income earned by individuals — that is, shareholders.

However, increasingly, China's reliance on that substitute cannot be explained by the lack of government capacity to collect the PIT (a factor commonly used to explain low PIT revenue in developing countries). In the early 2000s, China's PIT revenue saw rapid growth as a result of rising incomes. For the CIT to retain its dominance in Chinese income taxation, the Chinese government had to take a series of political decisions to keep PIT revenue from rising. In particular, it kept the individual taxation of capital income low and reduced the PIT liabilities of all but the top 10 percent of urban wage earners.

The general rationale behind those decisions seems to be that strongly progressive tax schedules should be applied only to the very top (for example, 1 percent) of the income distribution. That echoes the Biden administration's policy not to increase taxes on Americans with annual income of less than $400,000.

Similarly, China has the capacity to raise more revenue through the VAT but, especially in the last five years, has increasingly turned away from the VAT as a revenue source. Although that is mainly because of business criticisms of a poorly designed system, it is still notable because a well-designed VAT is regarded as a more efficient tax than the traditional CIT.

The United States has also spurned a VAT, even as Democrats aim to substantially and permanently increase public spending. The decision to embrace the CIT instead of more efficient taxation of personal consumption and shareholder-level taxation thus marks a point of commonality among the world's two largest economies.

II. Retreating From Worldwide Taxation

A simple, if perhaps naïve, view of the gist of the G-7's global minimum tax proposals is that capital exporting countries would strengthen residence-country corporate taxation of the foreign income of their "own" multinationals. Instead of acquiescing to the use of tax havens to achieve either deferral or permanent exemption from residence-country taxation, foreign income earned in or shifted to low-tax jurisdictions would be subject to a residence-country minimum tax on a current basis.[8]

The first thing to note about that policy objective is that China is one of the few leading economies that still operate (nominally) a U.S.-style worldwide tax system in corporate taxation. In fact, China embraced that kind of system just as other major economies began to abandon it. The EITL (adopted in March 2007) introduced a slew of new rules to strengthen residence-based taxation, including rules on controlled foreign corporations and a management and control criterion for corporate residence (in addition to the place of incorporation criterion).[9] Those rules were not adopted based on existing Chinese practice or revenue needs, but simply borrowed from what had appeared to be a normative paradigm of international taxation.[10] Yet in 2009, when the United Kingdom and Japan switched to the exemption treatment of foreign business income, Beijing immediately felt doubt: Had China borrowed the wrong model?

The legislative timing of the EITL was ironic in another way. In 2006, when the law was drafted, China's capital control regime still required all Chinese companies to repatriate foreign earnings immediately. The rapid buildup of China's foreign currency reserve after the country's accession to the WTO had still been so recent that its impact on China's commercial and capital control policies

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[8]In the OECD's pillar 2 blueprint, that objective is reflected in the priority of the income inclusion rule over the undertaxed payment rule.

[9]For an early overview of the EITL, see Fuli Cao, *Corporate Income Tax Law and Practice in the People's Republic of China* (2011). A more recent overview can be found in Jinyan Li, *International Taxation in China: A Contextualized Analysis* (2016).

[10]Two pre-2007 practices — per-country limitations on foreign tax credits and the denial of deductions of foreign losses against domestic income — were continued by the EITL. *See* Cui, "Designing Foreign Tax Credit Rules in China: The Case of Foreign Loss Limitations," 38(5) *Tax Mgmt. Int'l J.* 277 (2009).

could not be fully anticipated. Tax specialists even wondered which companies could have illegally kept income overseas so that the CFC rules would have applied. But just as the EITL was enacted, China's trade and capital control regimes underwent major transformations. Outflows of capital were substantially liberalized — and, in fact, became necessary — because China continued to run large trade surpluses.

For many international tax advisers, that promised a golden age of serving Chinese clients "going out" by helping them navigate the EITL antiabuse rules. The Chinese government upped the ante in the advertising race among tax advisers by coining the phrase "One Belt, One Road" in 2013. However, for the last 10 years, advisers have struggled to articulate what outbound tax rules their clients should really care about. The problem is that like tax advisers elsewhere in the world, those in China erroneously assumed that international tax policy and trade policies are independent from each other.

In reality, of course, those policies are not independent. The United States' much-admired subpart F rules, for example, were enacted while the country struggled to address a balance of payment crisis and explored all measures to bring capital back. Although curbing the use of tax havens may sound like the right thing to do in any circumstance, President Kennedy acknowledged that the real policy motive was that the United States could "no longer afford existing tax treatment of foreign income . . . if we are to emphasize investment in this country in order to stimulate our economy and our plant modernization, as well as ease our balance of payments deficit."[11] As the crisis worsened, the United States temporarily adopted capital control and an embargo on net direct investment outflows to continental Europe.[12]

If the U.S. introduction of subpart F rules can be seen as a precursor to more stringent capital control policies before the Bretton Woods system collapsed, China's 2007 introduction of anti-deferral rules and other measures for strengthened residence-country taxation can be viewed, conversely, as vulnerable from the start to China's becoming a major capital exporter and the consequent reversals of Chinese capital control and commercial policies. Essentially, many of the EITL's provisions applicable to Chinese companies' foreign activities immediately went into a mode of indefinite nonenforcement.

That is most obvious in the application of the management and control criterion of corporate residence. Most of the Chinese companies listed on the U.S. and Hong Kong stock exchanges — ranging from Alibaba and Tencent today to tech favorites of the past such as Sina, Sohu, Baidu, NetEase, and Ctrip — are incorporated overseas but managed and controlled in China. Indeed, even the companies' shareholder meetings are generally convened in China. Yet few, if any, have been deemed by Chinese tax authorities to have Chinese tax residence.[13] Although those "roundtripping" corporate structures — with layers of holding companies inserted between operating companies in China and Chinese shareholders — historically served to exploit regulatory loopholes and tax preferences offered to foreign investors, nowadays they also offer a generally available and widely used form of de facto corporate inversion that reduces residence-based taxation of foreign income.

The uses of that tax structure have also been unimpeded by Chinese CFC rules (which would be applicable to domestic shareholders). There have been few reports of the enforcement of CFC

[11] President John F. Kennedy's Special Message to the Congress on Taxation (Apr. 20, 1961). The same policy objective of discouraging capital exports led to the adoption of the interest equalization tax to make it less profitable for U.S. investors to purchase foreign securities; *see* the Interest Equalization Tax Act of 1963 (H.R. 8000).

[12] Atish R. Ghosh and Mahvash S. Qureshi, "What's in a Name? That Which We Call Capital Controls," IMF Working Paper WP/16/25, at 18-19 (2016).

[13] In 2009 the SAT adopted a rule that in effect permitted corporate taxpayers to elect Chinese tax resident status. SAT, "Notice Regarding the Treatment of Chinese-Controlled, Foreign-Registered Enterprises as Resident Enterprises Under the 'Body of Substantive Management' Test," *Guoshuifa* [2009] 82 (Apr. 22, 2009). Some taxpayers that repatriate dividends to China have made that election to take advantage of the intercorporate dividend exemption, but there is no incentive to make it if deferral is the objective. For discussion of that rule as a measure to facilitate state-owned companies' tax planning, see Cui, "Taxation of State-Owned Enterprises: A Review of Empirical Evidence From China," in *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* 122-124 (2015).

rules in China,[14] even though the continued use of offshore structures by listed companies and the extent of foreign earnings are regularly disclosed in their financial statements. Meanwhile, there is empirical evidence of rapidly growing uses of tax haven subsidiaries by companies headquartered in China, public or private.[15]

Further signs of the Chinese government's intent to lower taxation of the foreign income of Chinese companies emerged in the application of foreign tax credit rules. In 2011 the MOF and SAT granted permission to China's state-owned petroleum companies to elect out of the per-country FTC limitation. The only condition on that election is that taxpayers must adhere to it for five years. The agencies also relaxed indirect FTC rules so that foreign taxes paid by subsidiaries indirectly owned by Chinese taxpayers through up to five tiers of indirect shareholding can give rise to FTCs when dividends are repatriated. Under prior policies, indirect FTCs would not be available for earnings below the third-tier subsidiary.[16] In 2017 the MOF and SAT released rules that gave all taxpayers access to similar FTC benefits.[17]

If that trickle of increasingly favorable treatment of outbound investment seems too obscure and to offer only indirect evidence of the Chinese government's gradual abandonment of worldwide taxation, developments in 2020 help to dispel doubt. On June 1 none other than the Central Committee of the Chinese Communist Party itself released — jointly with the State Council — a 15-year grand plan for establishing a Hainan free trade port. The plan envisions that the province of Hainan will become a trade, investment, and finance hub comparable to Singapore, Hong Kong, and Dubai — but much larger. Not surprisingly, the Hainan port would be supported by a plethora of tax preferences. The Central Committee and State Council announced that the corporate tax rate for companies established in the Hainan free trade port and in favored industries would be reduced to 15 percent.[18]

More importantly, the plan contemplates complete CIT exemption for foreign income earned by Hainan companies in favored industries — namely, tourism, modern services, and high and new technology industries. Although the exemption is supposed to last only until 2025, given the long-term horizon of the Hainan undertaking and the Chinese government's record of repeatedly extending CIT preferences,[19] it would be surprising if the exemption was not renewed. According to MOF and SAT guidance, for the exemption to apply, the minimum statutory — not effective — tax rate of the foreign jurisdiction where the income arises must be 5 percent.[20]

Overall, therefore, China's retreat from the rigorous residence-based taxation initially announced in the EITL has been unidirectional and suggests that China's choice of the worldwide taxation approach in 2007 was inadvertent. If the EITL had been submitted to the legislature for vote a few years later, the drafters may well have chosen to copy the exemption system instead. After all, if there is ever any fear that too much capital would leave China for tax reasons (despite low effective CIT rates), the Chinese government could simply use the levers of capital control to reduce that outflow.

Of course, China's retreat from the worldwide toward the territorial system in corporate taxation represents a convergence with the world's advanced economies. Like many other countries, China may have simply found it irresistible to subsidize the business expansion abroad of national champions. That would also be consistent with evidence that Chinese companies' foreign activities increasingly resemble the activities of companies from advanced economies. A recent study showed that in

[14] The rare reported cases of enforcement present exceptions that prove the rule. *See, e.g.*, Jinji Wei, "Increasing Chinese Tax Risk for CFCs' Undistributed Profits," *Tax Notes Int'l*, Aug. 21, 2017, p. 754.

[15] Katarzyna Bilicka, Yaxuan Qi, and Jing Xing, "Geographical Diversification of Tax Havens: How Did the Use of Tax Haven Subsidiaries Change in Recent Years?" Working Paper (2020).

[16] *See* Cui, *supra* note 13, at 124.

[17] MOF and SAT, "Notice Regarding Improving Tax Credit Policies for Enterprise Foreign Income," *Caishui* [2017] 84 (Dec. 28, 2017).

[18] One may expect that to be only the headline rate, given that, as discussed in Section I, *supra*, lower CIT rates of 5 percent and 10 percent have been applied to China's most profitable SMPEs.

[19] For example, the SMPE temporary tax reduction had been extended for over a decade.

[20] MOF and SAT, "Notice Regarding Preference Enterprise Income Tax Policies for the Hainan FTP," *Caishui* [2020] 31 (June 23, 2020).

mergers and acquisitions, Chinese companies behave similarly to non-Chinese companies in many respects.[21] An IMF study suggests that other than having a greater propensity to lend to emerging markets and developing economies, Chinese financial institutions engaged in outbound lending behave similarly to financial institutions from advanced economies.[22] Both studies offer evidence that the impact of the Belt and Road Initiative is limited, implying that standard market considerations often drive outbound investments.

There are even plenty of parallels between China's outbound tax policies and past U.S. policy choices. After abandoning the Bretton Woods system, the United States took important steps to enhance the competitiveness of U.S. businesses abroad. Although the attempt to emulate the European exemption system through a series of income tax regimes favoring exports was unsuccessful and found to be inconsistent with WTO rules,[23] other measures, such as the cost-sharing and check-the-box regulations, delivered similar benefits. In fact, because much multinational activity today involves trade in services — for example, pharmaceutical inventions and digital services — countries have relatively free rein to subsidize service exports, given the limited coverage of the General Agreement on Trade in Services.

The first critical question, therefore, is whether the G-7's call for strengthened residence-based taxation is a call to end the long-running competition (especially among advanced economies) of export subsidies through the income tax system. That is clearly different from the way both G-7 lawmakers and the press have characterized the global race to the bottom — which is as one among countries trying to attract capital inflows (either as destinations or as conduits of capital flows). Another important question is whether any consensus includes commitments to adopt minimum tax rules or merely a commitment not to object to other countries' adoption of those rules.

III. Making Doing Business in China Compelling

During the first few years after the EITL took effect in 2008, China's SAT issued several informal policy directives to crack down on tax avoidance by foreign companies. One policy announced in 2009[24] introduced criteria for beneficial ownership (required for claiming treaty benefits) that were much stronger than the watered-down beneficial ownership notion then expounded by the OECD model convention commentaries. Another policy introduced that year applied the EITL general antiavoidance rule to disregard offshore entities and tax capital gains realized on indirect sales or transfers of the shares of Chinese companies.[25] The SAT also made a statement of policy through the U.N. Practical Manual on Transfer Pricing for Developing Countries, claiming that considerations of "location saving advantages" required the allocation of more multinational profits to China as a producer jurisdiction.[26]

All those policies were declared well before the OECD launched its base erosion and profit-shifting project. Although China is not an OECD member, the SAT's antiabuse policies made China a perhaps welcome observer to the work of the OECD Committee on Fiscal Affairs during the project. But China's input into whatever negotiations went on in the original BEPS project was likely limited. It may be hard to remember, but because the OECD's inclusive framework was not formed until 2016 — a fact routinely written out of narratives about international tax cooperation — the adoption of unilateral policy

[21] Clemens Fuest et al., "What Drives Chinese Overseas M&A Investment? Evidence From Micro Data," 3 EconPol Working Paper 33/2019 (Nov. 2019).

[22] Eugenio Cerutti, Catherine Koch, and Pradhan Swapan-Kumar, "Banking Across Borders: Are Chinese Banks Different?" IMF Working Paper WP/20/249 (2020).

[23] David L. Brumbaugh, "A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy," Congressional Research Service (2004).

[24] SAT, "Notice on the Understanding and Determination of 'Beneficial Owner' in Tax Agreements," *Guoshuihan* [2009] 601 (Nov. 5, 2009). For discussion, see Li, *supra* note 9, at section 5.12.

[25] SAT, "Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds From Equity Transfers by Non-Resident Enterprises," *Guoshuihan* [2009] 698 (Dec. 10, 2009). *See* Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," 33 *Va. Tax Rev.* 653 (2014).

[26] *See* Sébastien Gonnet, "Location Specific Advantages — China," 10/11 *Transfer Pricing Int'l J.* 261 (Oct. 2011); Richard T. Ainsworth and Andrew Shact, "Transfer Pricing: UN Practical Manual — China," Boston Univ. School of Law Public Law Research Paper No. 14-1 (2014); and Kane, "Location Savings and Segmented Factor Input Markets: In Search of a Tax Treaty Solution," 41 *Brook. J. Int'l L.* (2016).

The extent to which Chinese tax authorities actually implemented the SAT's conceptual declaration is less clear.

initiatives by various countries was regarded as a faux pas at best, and certainly not worthy of trade wars or arduous efforts at international consensus.

When China hosted the G-20 meeting in Hangzhou in September 2016, the SAT's antiabuse credentials in international taxation provided China's political leaders with ready talking points. But in reality, after 2013, the SAT's antiabuse initiatives against nonresidents came to be seen as inconsistent with larger policy initiatives — much as the EITL antiabuse measures for taxing residents' foreign income succumbed to the reversal of China's capital control policy. First and foremost, Premier Li Keqiang launched a forceful campaign to improve China's business environment that resulted in the country's spectacular rise in the World Bank's "Doing Business" rankings from 91st place in 2013 to 31st place in 2020. Most of the measures under that campaign involved reducing red tape and eliminating government approval requirements.

That has had a notable impact on the way Chinese tax authorities handle foreign investors. For example, the SAT announced new procedures for claiming treaty benefits in 2015, according to which supporting documents had to be filed only with the payer or withholding agent — not local tax authorities — for approval.[27] In 2019 the enforcement of beneficial ownership rules was further relaxed when the SAT ushered in a remarkable, pre-FATCA U.S.-style regime for claiming treaty benefits: Eligibility became completely self-assessed, without a requirement to submit supporting documents — even with the withholding agent.[28]

Aggressive enforcement against foreign investors may also have come to be viewed as politically incorrect. The SAT proposed strengthened antiabuse measures on cross-border transactions in September 2015,[29] only to drop them after encountering broad objections in public comments. That happened just as the OECD was beginning to market its finalized BEPS actions, but that auspicious timing was apparently not enough for the SAT to go against the new, pro-foreign-investor policy direction chosen by China's political leaders. As readers of *Tax Notes International* may have realized, China has recently been the source of far fewer reports of, for example, guerilla warfare launched by Chinese local tax authorities against foreign indirect transfers, government transfer pricing victories, and treaty benefit denials. Instead, tax cuts have become perhaps the most important theme in tax news from China.

Some tax practitioners suggest that China's recent turnaround in its approach to taxing nonresidents is attributable to tax competition and reflects a strong reaction to U.S. enactment of the Tax Cuts and Jobs Act in 2017.[30] The narrative that China is engaged in tax competition with the United States certainly has some currency in Chinese business (and even policy) circles, but it seems unlikely to stand up to scrutiny. For one, even after the enactment of the TCJA, China's headline corporate tax rate of 25 percent is still lower than the combined federal and state corporate tax rates in most U.S. states. And Chinese local governments engage in plenty of domestic tax competition to drive down effective corporate tax rates even further.[31] Moreover, even though the TCJA lowered U.S. corporate rates, the base erosion and antiabuse tax increased the tax burden on foreign investors. That should have eased — not increased — competitive pressure to attract foreign investment.

In any case, both the size of China's economy and its still-operative capital control system make it unlikely that the country would compete for capital through tax policy. Instead, tax policy is better seen as being merely complementary to a government's general policy regarding further attracting foreign direct investment. In the past decade, China has displayed greater willingness to grant market access to foreign investors. That is motivated in part by the desire to ease trade

[27] SAT, "Notice on Managing Non-Resident Claims Treaty Benefits," Bulletin [2015] 60 (Aug. 27, 2015). *See* Wei, "China Updates Policy on Treaty Benefits for Nonresidents," *Tax Notes Today Int'l*, Sept. 21, 2015.

[28] SAT, "Notice on Managing Non-Resident Claims Treaty Benefits," Bulletin [2019] 35 (Oct. 14, 2019).

[29] Yansheng Zhu, "Do China's Revisions to Circular 2 Localize BEPS Actions?" *Tax Notes Int'l*, Nov. 9, 2015, p. 519.

[30] *See*, *e.g.*, Abe Zhao, "China's New Beneficial Ownership Rules Create Tax Saving Opportunities," *Tax Notes Int'l*, Apr. 9, 2018, p. 327.

[31] Xing, Cui, and Xi Qu, "Local Tax Incentives and Behavior of Foreign Enterprises: Evidence From a Large Developing Country," Singapore Management University School of Accountancy Research Paper No. 2018-S-71 (Jan. 19, 2018).

tension, in part by the hope to obtain reciprocal market access in foreign markets, and in part simply by the lowered need for protectionist policies.[32] Because China is clearly no longer interested in just remaining the world's factory floor and is on its way to becoming a leading nation in technology, finance, and other tradable services, allowing greater market access to foreigners may be a logical choice. Offering tax incentives — especially regional tax incentives that are already used as a result of purely domestic tax competition — is not a hard decision. After all, like most other large economies, China does not depend on taxing foreigners for revenue.

Two considerations regarding China's preferential regimes for foreigners deserve special comment. They apply both to purely domestic regional preferential regimes (such as the Hainan free trade port and several other free trade zones in China) and, more prominently, to Hong Kong.

First, low-tax jurisdictions like Hong Kong play an important role even just for China's own tax system. Hong Kong allows China to impose a lower tax on mobile capital, and even on some mobile labor, and thereby mitigates the pressure to lower taxes more generally for all labor and capital in the country. When Chinese bankers and fund managers can effectively operate from Hong Kong instead of Shanghai or Beijing, China faces less need to create preferential PIT regimes in the latter cities — and therefore less need to lower tax rates in the country as a whole. Similarly, in liberally allowing holding companies to be set up in Hong Kong and tolerating the Chinese version of corporate inversions, China simultaneously gives its companies access to foreign portfolio capital and segregates the taxation of domestic and international portfolio capital. Thus, even though Hong Kong's tax system and fiscal policies are different from China's, the Chinese government should be thought of as invested in Hong Kong's low-tax system.

There is much evidence consistent with that view. For instance, although China strengthened beneficial ownership rules in 2009, it relaxed the rules in a somewhat secret fashion for Hong Kong in 2013.[33] Treaty shopping is at least a lesser sin, and perhaps even a desired outcome, when the treaty is with Hong Kong.

Second, Hong Kong's status as a leading global financial center is important for China's global economic strategies. Although China may well aspire to host a greater number of global financial hubs — whether in Hainan, Shanghai, or elsewhere — low taxation of financial capital is likely to remain an essential component of policy packages to nurture those hubs. Thus, any global minimum tax proposal that threatens to shut down tax incentives for creating financial hubs should hold China's attention.

Many salient aspects of U.S. tax policy on inbound investment are meant to lure financial capital through low taxes — including, for example, the tax exemptions for foreign deposit interest and portfolio interest, as well as the securities trading safe harbor from net basis taxation of U.S. trade or business.[34] Not only did those policies break then-prevailing international tax principles when enacted,[35] but they also remain some of the most distinct features of the U.S. tax regime for foreign investors.[36] More broadly, it is also relevant that even under the most ambitious international financial agreement that the world has known — the Bretton Woods system for maintaining currency exchange stability — the two major sponsors of the system, the United States and the United Kingdom, refrained from international cooperation to promote their own financial institutions and centers. The Bank of England and the U.S. Treasury tolerated the emergence of a Eurodollar market to keep London as an international financial center, and the United States declined to cooperate in enforcing other countries' outflow restrictions.[37] That suggests that insofar as new international tax agreements may encroach on the

[32] "Foreign Asset Managers Are Eyeing China's Vast Pool of Savings," *The Economist*, June 10, 2021.

[33] Zhao, *supra* note 30, at 328 (discussing *Shui Zong Han* [2013] 165).

[34] David R. Sicular and Emma Q. Sobol, "Selected Current Effectively Connected Income Issues for Investment Funds," 56(4) *Tax L.* 719 (2003).

[35] The securities trading safe harbor from the definition of U.S. trade or business of IRC section 864(b)(2), for example, limits the scope of net basis taxation more than the treaty-based concept of permanent establishment.

[36] For a recent discussion of the United States as a tax haven, see Steven Dean and Attiya Waris, "Ten Truths About Tax Havens: Inclusion and the 'Liberia' Problem," 70(7) *Emory Law J.* (forthcoming 2021).

[37] Ghosh and Qureshi, *supra* note 12.

development of new financial centers, China (and other countries sponsoring those kinds of centers) should be wary.

IV. Multilateralism: Why Not?

Summarizing the discussion so far, the main components of China's tax policy that may have a bearing on the G-7's global minimum tax platform appear to be the following: China relies on the CIT for revenue more than does the United States, and its CIT revenue has been strong despite recent substantial tax cuts for small companies and a proliferation of local preferential regimes. Although the foreign activities and profits of Chinese multinationals have likely risen in absolute terms in the past decade, it is unknown how much the share of foreign profits in the same companies' total profits has risen.

In any case, there is no sign that China, in the absence of new international agreements, wants to tax its multinationals' foreign profits more to raise additional revenue. Instead, it has taken notable measures to reduce that taxation by continuing to tolerate its version of corporate inversions, relaxing FTC rules, unevenly enforcing CFC rules, and experimenting with territorial taxation. It had many examples to follow in policies adopted by advanced economies such as the United States, the United Kingdom, and Japan.

China also presents itself as more open to foreign investment than ever. Without any clear threat of external tax competition, the SAT has toned down the antiabuse policies and pronouncements against nonresident taxpayers it issued just after the EITL's enactment. Preferential income tax measures are now regularly offered in policy packages supporting domestic trade and investment hubs. Hong Kong as a low-tax jurisdiction and global financial center adjacent to mainland China is also playing an ever-more-entrenched role in China's own tax system. Before and unless it is replaced by some purely domestic jurisdiction that serves as a hub of global financial capital, Hong Kong will likely remain vital to China's global economic strategy.

What does all that imply for China's response to the G-7's global minimum tax proposal? As stated, the answer depends on what is in that proposal — and the proposal's substance will also determine the forms of international cooperation China may be expected to participate in. Consider, for instance, a simplified characterization of the global minimum tax proposal based on the OECD's pillar 2 blueprint: An income inclusion rule (IIR) and an undertaxed payment rule (UTPR) will be used to ensure that multinationals bear a minimum effective tax rate on their profits. Two questions can be raised about how those two rules will work. The first is whether they will be made mandatory in an international consensus — that is, whether they are minimal standards to be adopted by all participants in an international agreement.[38] The second is how strong the rules will be and whether there will be extensive carveouts. Those questions are related because mandatory requirements on a large group of countries will also likely be much weaker in substance.

Suppose the minimum tax proposal does not impose any strict requirement that countries enact the IIR or UPTR. Instead, countries would simply agree that the imposition of those rules is permitted, even if some may otherwise view them as violating "prevailing international tax policy principles."[39] That leaves some countries to form a "coalition of the willing" to impose the rules.[40] And the expectation of some of those countries — at least the United States — is that countries not part of the coalition will be encouraged to adopt the IIR or UTPR because they stand only to gain from adopting, given the adoption by the initial coalition countries.

Should China be expected to join the initial coalition of the willing? It seems the answer should be no. Consider first the IIR: Rigorous worldwide taxation of corporate income (of the kind the United States introduced during the Bretton Woods era) is a well-known approach to international taxation, and its adoption by many countries has long represented a loose coalition of

[38] Mary C. Bennett, "Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2," *Tax Notes Int'l*, June 14, 2021, p. 1453.

[39] That appears to be the standard that the Office of the U.S. Trade Representative uses to justify retaliatory tariffs against DSTs. *See* a release on the office's conclusion of a section 301 investigation into France's DST (Dec. 2, 2019).

[40] Whether and how the members of that small coalition will bind themselves to adopt the minimum tax policies and enforce obligations against one another will be a matter outside the broader (for example, inclusive framework) consensus.

the willing. Early adoptions of that approach were uncoordinated, and there is little evidence that countries like the United Kingdom and Japan began to defect only because they could not bind other countries to adopt (there seems to be no evidence of any attempt to bind others).

China also wrote the principles of worldwide taxation of corporate income into its legislation, but from the start was not prepared to enforce them. That suggests that the benefits of rigorous worldwide corporate taxation for China were unclear, regardless of the strategic decisions of other countries. Because countries that do not join the initial coalition in adopting the IIR have the option of adopting it later — in fact, the United States predicts that other countries will adopt those rules once the UTPR is in place in enough countries — it seems that a better strategy is to wait to decide on adoption. (That argument, of course, applies to most countries, not just China.)

By the same token, China should not want to join the initial coalition to adopt the UTPR either. Any country may adopt the UTPR either to force other countries to adopt the IIR or to simply raise revenue (while leveling the playing field for multinationals). If China is unlikely to join the initial IIR coalition, it seems unlikely that it would be interested in forcing other countries to adopt the rule. Moreover, judging by its policy choices in the last decade, China does not appear to be keenly interested in raising more revenue from foreigners or removing any tax advantage for other countries' multinationals.

In short, if the global minimum tax proposal of the G-20 and inclusive framework does not require most participating countries to adopt the IIR and UTPR, China would probably not be an initial adopter. In the meantime, because China has not purported to be the arbiter of what international tax policy principles are acceptable, it presumably would not have the power to stop adoption by a small group of other countries, either. Thus, whether it is able to support a multilateral agreement would depend mainly on what stake it has in the pillar 1 blueprint.

If, on the other hand, the global minimum tax proposal requires most countries to commit to adopting specific new practices — such that it must be made acceptable to countries such as Ireland and Singapore — then China will presumably work to ensure that the resulting international agreement at least does no more damage to Hong Kong (and other aspiring trade and financial hubs in China) than it does to the likes of Ireland and Singapore. Further, it would make sure that its obligations under any mandatory IIR would be no more burdensome than the obligations on other advanced economies.

Are there decisive considerations for China under pillar 1? The answer again appears to be no. China does not have any DST to withdraw. Nor does it rely on taxation of its multinationals' foreign profits such that whether those profits are allocated to other countries for taxation would make a significant difference. Regarding whether China might gain revenue by virtue of pillar 1 allocation to itself, it seems unlikely that the revenue would really matter to China so much that it would be determinative in the country's position in international negotiations.

In conclusion, it seems the G-7's global minimum tax proposal offers China plenty of opportunities to act as a good multilateralist (President Xi's favorite role).[41] That is because if obligations are created under any new international tax agreement, multilateralism can serve as a way to weaken those obligations so as to minimize harms to China's competitive position as a rising center for global finance.

On the other hand, if few obligations are created under the new international tax agreement, China also has nothing to lose through participating. In those ways, one can even say that China's interests in the upcoming international negotiations are aligned with the OECD's. Whether they are with the United States' is a different question. ■

[41] "Xiplomacy: Xi's Remarks on Upholding Multilateralism," Xinhuanet, May 7, 2021.