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Tax Avoidance on Intangible Assets by Multinational Corporations in the Context of the Two-Pillar Solution and China's Response Proposal

Chenlin Li[1,a,*]

[1]*Faculty of Law, Macao University of Science and Technology, Avenida Wai Lung, Taipa, Macao, China*
a. 1210002091@student.must.edu.mo
**corresponding author*

Abstract: International trade has entered the digital economy era due to the sector's rapid development. In order to avoid paying taxes on a global scale, multinational corporations use loopholes in conventional international tax laws. This severely damages the tax bases of many nations, results in significant financial losses, and undermines the fairness of international taxation. Various reform initiatives have developed to address the tax difficulties posed by economic digitalization. The OECD has introduced two significant solutions based on the BEPS action plan, collectively referred to as the "Two-Pillar" solution, to address the issues of tax base erosion caused by the transfer of profits of multinational enterprises and the inability of source countries to tax the profits of certain multinational enterprises in the context of the digital economy. Pillar One breaks through the entity presence rule emphasized in the existing international tax system and redistributes the profits and taxing rights of eligible large multinational enterprises to the market countries to ensure that eligible large multinational enterprises can undertake fairer global tax obligations in the context of economic digitalization. Pillar Two starts from the effective corporate income tax rate and introduces a global minimum tax system to combat the behaviors of multinational enterprises aimed at avoiding tax obligations. China is in favor of promoting the "Two-Pillar" approach as a participant in the OECD "Two-Pillar" declaration, a member of the G20, and the BEPS Inclusive Framework. Facing the new international tax rule system that is about to be implemented, China should be well-prepared in different aspects.

Keywords: Intangible asset, Tax avoidance, Two-Pillar solution.

1. Introduction

In recent years, multinational corporations have begun to frequently utilize intangible asset transfer pricing for tax avoidance, and the United Nations estimates that the global loss of tax revenue due to tax avoidance caused by multinational corporations' profit shifting methods is as high as $500-600 billion per year. Taking the European Union as an example, multinational enterprises using offshore places or tax havens to avoid taxes can carry out international tax avoidance every year to generate nearly 25 million euros of tax avoidance, accounting for 2%-2.5% of the Europe's GDP [1]. In the context of the digital economy, the phenomena of tax base erosion and profit diversion caused by

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intangible asset transfer pricing urgently calls for the implementation of a robust anti-avoidance policy. Therefore, the issue of intangible asset transfer pricing tax avoidance has become the focus of international organizations and countries around the world, and the BEPS action plan launched by OECD regards intangible asset transfer pricing as an international tax issue that needs to be focused on in the era of digital economy. The "two-pillar" solution is the latest research result of OECD, which also marks that the BEPS action plan has entered into the 2.0 era. The "two-pillar" solution provides a new solution for intangible asset transfer pricing anti-avoidance, which is the long-awaited transfer pricing anti-avoidance solution for intangible assets. It is a milestone achievement of the anti-avoidance tax on transfer pricing of intangible assets that countries are eagerly waiting for. As a large digital economy country, the scale of digital economy in China has reached 5.4 trillion U.S. dollars, second only to the U.S. as the world's second largest country [2]. The government must respond to the uncertainty created by the digital economy era by developing appropriate coping mechanisms and finding more efficient ways to address the tax issues raised by the transfer pricing behavior of intangible assets.

2. Tax Avoidance by Multinational Enterprises

2.1. Some Tax Avoidance Methods

2.1.1. Transfer Pricing

Transfer pricing, reduced to its essence, is a means of allocating costs between units of a large organization or multinational company for goods or services supplied [3]. Among the many achievements of the BEPS action plan, transfer pricing documentation and country-specific reporting are two of the minimum standards, which shows that the use of transfer pricing to avoid tax has attracted international attention. Generally speaking, businesses in high-tax countries sell products, services, and intangible assets to their affiliates in low-tax countries at a discount, and businesses in low-tax countries sell the same products, services, and intangible assets to their parent companies in high-tax countries at a premium. To reduce their tax obligations, profits are thus transferred from nations with higher tax loads to nations with lower tax burdens. By using transfer pricing in commodities transactions, multinational firms escape tax in the most significant way. In general commodity transactions, the main manifestation of transfer pricing international tax avoidance is the transfer of profits through the "high in, low out" method.

2.1.2. Tax Havens

For the income of domestic individuals or enterprises, China levies income tax on the income of domestic individuals or enterprises in both domestic and foreign countries in accordance with the principle of resident jurisdiction, but for the income of foreign-funded enterprises, China follows the principle of territorial jurisdiction in levying enterprise income tax on their gains in China. Global firms frequently establish shell businesses in nations or areas that provide reduced tax rates or even exemptions from paying taxes; these include primarily the Virgin Islands and the Cayman Islands, among other places. Multinational corporations conduct formal operations in shell companies and put most of their profits in tax havens.

2.1.3. Thin Capitalization

"Thin capitalization" is the process by which a company reduces its share of equity capital by expanding its borrowings in order to increase the amount of pre-tax deductions and, ultimately, to reduce the company's tax burden. Some companies aim to increase pre-tax cost deductions and reduce

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taxable corporate income by deliberately using borrowing or loans rather than raising shares in the financing process, thereby avoiding tax obligations.

2.1.4. Abuse of International Tax Agreements

International tax treaty abuse refers to the use of tax-specific arrangements with the will of the agreement by individuals or enterprises outside the agreement country, trying to conform their tax procedures to its relevant agreement treaty, from which they can obtain as many tax benefits as possible, obtaining tax benefits that do not belong to them, and finally realizing a specific plan to avoid paying taxes.

2.2. Tax Avoidance Motivations of Multinational Enterprises

In the early days, the transaction objects of multinational enterprises were mainly tangible goods and services, and the transactions mainly took place in the real market, coupled with the relatively simple organizational structure of enterprises, the transfer pricing arrangements of multinational enterprises were also relatively simple. With the rapid development of the global economy, although the essential logic of multinational enterprises using transfer pricing to avoid tax has not changed, but the transfer pricing involved in the object of the transaction, the form of a huge change [4].

With the development of knowledge economy and digital economy, intangible assets have become the favorite in transfer pricing arrangement. In the knowledge-based economy, the main driver of company value has shifted from tangible assets to intangible assets. Transfer pricing, in which the enterprise group sets the sales price and shifts the tax burden from a high-tax jurisdiction to a low-tax jurisdiction in order to avoid taxes, is the most straightforward and efficient technique for multinational enterprise groups to decrease their tax burden. And due to global digitization, the pricing of intangible assets has become more hidden and difficult to measure. Clearly, a major motivation for transfer pricing by multinational enterprises is the existence of tax havens, which often have lower local tax rates to attract foreign investment because of smaller domestic markets. For example, Apple's “two-tier Irish” tax shelter has enabled Apple to avoid tens of billions of dollars in taxes during the period in which it has used the shelter, maximizing the company's operating profits. Over the ten-year period from 2004 to 2014, Apple International Sales Ireland generated sales profits of €110.8 billion, which, assuming an Irish income tax rate of 12.5%, would have resulted in a €14 billion, or 12.6%, reduction in tax payments on sales profits. Meanwhile, Apple International Operations Ireland, one of Apple's “subsidiaries” that avoids tax, received nearly $30 billion in dividends from its subsidiaries between 2009 and 2012, and most surprisingly, these dividends were never taxed. Most surprisingly, these dividends were never taxed. Overall, Apple's “two-tier Irish” model of tax avoidance reduces the company's tax costs by a significant amount in order to maximize economic benefits.

3. Measure Made by the OECD(Two-Pillar Solution)

OECD is a leading international organization in tax avoidance. In response to the impact of the digital economy on international tax rules, the OECD has proposed the Two-Pillar solution, which has more than 130 countries participating in it. Overall, there are two pillars, One way to update outdated international tax laws for the twenty-first century is to give market jurisdictions additional authority to tax multinational enterprises (MNEs), regardless of their physical location. The other is setting a floor on tax competition by imposing a minimum 15% tax on corporate profit [5].

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3.1. Pillar One: Profit Redistribution Rules

Pillar One comprises three main components: a fixed return for specific baseline marketing and distribution activities that are physically conducted in a market jurisdiction, in accordance with the ALP (Amount B); a new taxing right for market jurisdictions over a share of residual profit calculated at an MNE group (or segment) level (Amount A); and procedures to enhance tax certainty through efficient dispute prevention and resolution mechanisms.

The Amount A rule applies the new profit-sharing methodology to in-scope multinational enterprise groups, specifically, multinational enterprises with global annual sales revenues of more than €20 billion and profit margins of more than 10 percent are required to allocate 25 percent of the portion of their profits in excess of 10 percent to the market country. Amount A covers most industries, but extractive industries and regulated financial institutions are excluded. MNEs that fall under the scope of this agreement will gain access to mandatory and binding dispute prevention and resolution mechanisms that prevent double taxation of Amount A. These mechanisms will cover all matters relating to Amount A, such as disputes over company profits and transfer pricing [6].

The Amount B rule is a simplified application of the traditional stand-alone transaction principle and is a simplified transfer pricing methodology for distributors designed to provide a standardized return on benchmark marketing and distribution activities undertaken in a jurisdiction.

3.2. Pillar Two: Global Minimum Tax Rules

The Global Minimum Tax Rule, which is the cornerstone of Pillar Two, is intended to guarantee that the global minimum tax cannot be lower than the effective effective tax rate (ETR) of major multinational firms in any jurisdiction in the world.The Subject to Tax Rule (STTR) and the Global Anti-Base Erosion Rules (GloBE) make up the second pillar.

There are two basic regulations that make up the GLoBE rules. The Undertaxed Payment Rule (UTPR) and the Income Inclusion Rule (IIR) are the two. The terms "IIR" and "UTPR" relate to the imposition of a top-up tax on a parent entity in relation to a constituent entity's low-taxed income and, respectively, the denial of deductions or the requirement for an equal adjustment to the extent that a constituent entity's low-tax revenue is not subject to tax under an IIR.These GLoBE regulations are specifically designed for MNEs that satisfy the BEPS Action 13 level of 750 million euros. nations can freely apply IIR to MNEs headquartered in their nations, even if this threshold is not met [7]. By setting the minimum tax rate used for purposes of the IIR and UTPR to 15%, it can effectively prevent tax avoidance in their own countries by setting up subsidiaries in other low-tax jurisdictions.

In addition to completing those regulations, the STTR modifies the underlying methods and principles for use in treaty settings. When specific categories of intra-group covered income have domestic taxing rights over that revenue relinquished by treaty and are subject to nominal corporate income tax rates below the STTR minimum rate, source jurisdictions are permitted to "tax back" under the STTR. The STTR is intended to assist developing Inclusive Framework members in safeguarding their tax bases, and it supersedes the GloBE Rules (STTR tax is creditable under those regulations) [8].

4. Effects and Advices

4.1. The Significance of the OECD "Two-Pillar" Solution

First, it promotes deeper shared governance in the area of international taxation. The "two-pillar" approach is a multilateral approach that pursues in-depth co-governance among tax jurisdictions in the area of international taxation. On the one hand, there may be a gradual convergence in the identification of global tax bases and the determination of tax rates. The "two-pillar" approach is not

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limited to a single entity, but takes the consolidated statements of multinational enterprise groups as the logical starting point, and is based on the multilateral governance of all stakeholders under the same system of rules, which is likely to advance international taxation towards the convergence of tax bases. The Global Minimum Tax (GMT) regulations aim to level the playing field in taxation by minimizing the disparities in business income tax rates across different jurisdictions. On the other hand, the multilateral tax governance system will gradually take shape, especially when the Pillar I program becomes binding through the signing of a multilateral convention in the future, which will tighten the network of multilateral tax governance mechanisms [9].

Second, it updates international tax laws in a methodical manner. The core of international tax law is the division of the right to tax cross-border business profits. However, previous international tax laws focused more on the division of the right to tax cross-border income and neglected to address aspects of the tax base and tax rate that impact tax burdens. Additionally, the division of the right to tax cross-border profits focused primarily on factors related to production and supply, such as personnel and assets, essentially ignoring market factors like marketing performance [10]. The Pillar One is a breakthrough in that it recognizes the profit-creating value of data and allocates taxing rights to a separate market country for a portion of the multinational enterprise's residual profits. Pillar Two takes a closer look at the interaction between domestic tax law and international tax treaties, and takes an unprecedented approach to curbing base erosion and profit shifting by multinational enterprises, starting with the fundamentals of the tax base and tax rates. The "Two-Pillar" solution is a systematic upgrade compared with the traditional international tax rules and other countermeasures in the past, which is a major step forward in international tax concepts and rules, and lays a solid foundation for the construction of a fairer and more reasonable global tax governance system.

4.2. Proposals for China's Response under the "Two-Pillar" Solution

The OECD's international tax reform program is always being paid attention to and adopted by all countries. In order to effectively respond to the "Two-Pillar" solution and the changes in the international tax landscape under the current international tax reform environment, China should improve its laws and related aspects, so as to be able to respond to the upcoming reform program in a more relaxed manner.

4.2.1. Improvement of the Enterprise Income Tax Law of the People's Republic of China

China, as a member of G20, has agreed to the "two-pillar" program statement issued by OECD. When the "Two-Pillar" solution officially comes into effect in China, China must follow the requirements of the program, but there is a lack of relevant content in the current EIT law. However, the lack of relevant content in the current CIT law makes it difficult for the tax authorities to exercise their taxing power without a legal basis. Therefore, the current corporate income tax law should be improved to provide strong protection for the tax authorities in exercising their taxing power.

First, a new method of accounting for taxable income on a group basis has been introduced. The "two-pillar" program requires that taxable income be calculated on a group basis, whereas in our tax law it is calculated on a legal entity basis. In order to match the new rules, new provisions can be added to the tax law. For example, "Pillar One" involves consolidated financial statements, increasing the adjustment of tax differences, and "Pillar II" involves the calculation of the effective tax rate, increasing the exclusion of income and the calculation of the effective tax amount. Secondly, the scope of permanent establishment is expanded. According to the current tax law, only when a non-resident enterprise establishes a permanent establishment in China can it levy enterprise income tax, and this permanent establishment is defined in the form of "physical existence". However, in Amount A, as long as a certain economic presence is established in the market country, the market country

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has the right to tax. Therefore, it is possible to expand the scope of permanent establishment in the tax law by adding a new provision on virtual subjects, which is mainly based on economic existence. For example, an enterprise that has not set up a physical form of organization or place in China but has online continuous business services in China can also be regarded as constituting a permanent establishment in China. Thirdly, it is to refine the approved collection method. Currently, China's tax law lacks an approved collection method for non-resident enterprises engaged in online business. It is proposed to delineate a clear range of approved levy margins, taking into account the current types of business of digital enterprises and on the basis of analyzing the revenues and profits of a large number of digital enterprises.

4.2.2. Enhancing Digital Tax Administration

In the era of digital economy, all countries are facing great challenges in tax collection and management, with new technologies and concepts emerging, and multinational conglomerates using intangible asset transfer pricing for tax avoidance becoming more and more complicated [11]. Tax authorities should seize the new opportunities of technological development and apply emerging technologies to anti-avoidance work, such as big data and cloud computing. Applying new technologies to the supervision and adjustment of intangible asset transfer pricing can effectively reduce tax-related risks and establish channels for collecting tax-related information. It can also establish a database of intangible asset transfer pricing, strengthen international information and intelligence exchange, and promote the sharing of global tax information under the digital economy.

4.2.3. Preparation of Complex Tax Personnel in International Taxation

In the field of international taxation, the development of digital economy inevitably means that digital enterprises have richer means of tax avoidance, and for the anti-avoidance of tax in the digital economy, intangible assets present characteristics such as high risk and easy to hide the value which bring great challenges to tax collection and management. The complex characteristics and various tax avoidance means have put forward high requirements for the relevant tax personnel, who not only need to have practical experience related to the anti-avoidance work of the international tax system, but also have an understanding of the latest bilateral international tax agreements, multilateral international tax conventions, and some new tax avoidance means, and also must have the knowledge of IT, artificial intelligence, data services, etc., in order to be competent for the anti-avoidance work in the era of the digital economy. In order to be competent in the anti-avoidance work in the era of digital economy. Therefore, in order to improve the relevant intangible asset transfer pricing anti-avoidance system, it is necessary to strengthen the cultivation of complex tax personnel and build the international anti-avoidance personnel system.

5. Conclusion

The transfer pricing of intangible assets has given rise to numerous new forms of tax avoidance by multinational conglomerates in the context of the digital economy. To address these tax challenges, the OECD has introduced a "Two-pillar" approach that aims to create a globally harmonized solution. The "Pillar One" program is designed to match the costs incurred by multinational enterprises in their actual business activities in their market jurisdictions with their value contributions, while "Pillar Two" is designed to prevent MNEs from utilizing transfer pricing for tax avoidance through the introduction of the Global Minimum Tax (GMT). China's current development cannot be separated from the digital economy, and the digital economy is bound to be a key focus of development in the future. As a member of the G20, the BEPS Inclusive Framework, and a participant in the OECD's "Two-Pillar" statement, China is actively promoting the "Two-Pillar" solution. In the face of the new

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system of international tax rules that will soon be implemented, China should prepare for the new system in terms of the corporate income tax law and other aspects. Although there are still uncertainties, no matter how the international tax reform program will eventually evolve, China should find its own balance of interests in the global tax rights and interests.

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