CHINA'S TAX INCENTIVES UNDER THE GLOBAL MINIMUM TAX: ASSESSMENT AND RESPONSES

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1. INTRODUCTION

In December 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit-Shifting released the Global Anti Base Erosion (GloBE) Model Rules to ensure the 15% global minimum tax agreed under Pillar Two.[1] The GloBE rules will have profound influence on tax policies, especially tax incentives offered by countries. This article explores the interaction of China's various tax incentives and the GloBE rules, especially from the altruistic assumption that underlines Pillar Two,[2] but with a particular focus on the right for economic growth and the right to apply tax policy to balance and correct economic weakness. Based on the potential impact of the international taxation reform, the article categorizes China's tax incentives as low-risk and high-risk. To meet the challenges posed by the global minimum tax rules, China can adopt several responses, including making full use of the 'formula mechanism' (minimum effective tax rate–ETR), changing the high-risk incentives to low-risk ones, and improving tax certainty and the procedural efficiency.

The article is divided into five parts. Part two briefly explains the main features of the GloBE rules and illustrates the inevitable implementation of the new deal. Part three introduces and categorizes China's tax incentives. Part four raises the issue that the new deal oversteps economic growth sovereignty of countries. Part five sets out several possible responses from China.

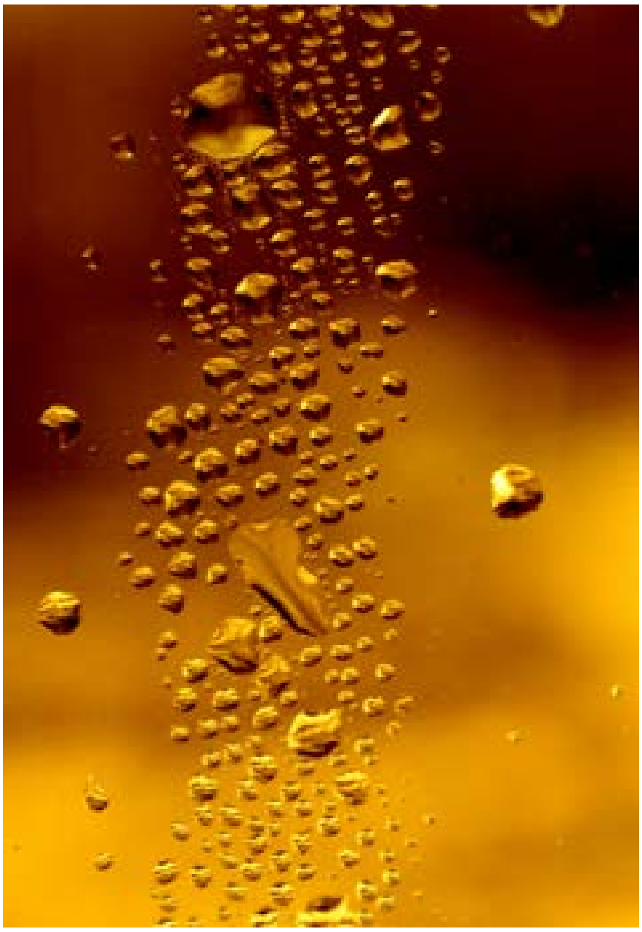
2. PILLAR TWO IN A NUTSHELL

Since 2018, the OECD/G20 Inclusive Framework, which comprises 145 jurisdictions now, has been working on a proposal for an international minimum corporate tax rate. Based on the Policy Note that OECD released in 2019, the GLoBE rules focus on setting a global minimum tax rate to solve the "remaining BEPS issues". Negotiations have culminated into a political agreement by 137 Inclusive Framework members on a common approach to implementing an internationally coordinated effective minimum tax of 15%, as laid down in the joint statement issued in 2021. Consequently, the profits of in-scope multinational enterprises (MNEs) will be taxed at a rate no lower than 15%. The core of the proposal relies on the taxation dependency that will be created between different tax jurisdictions worldwide, making profits taxable somewhere. If one jurisdiction does not exercise its right to tax to the minimum, then the power "slips" to others. This creates an idea of "take it or lose it".

To implement this idea, Pillar Two embeds a "top-up tax" approach that operates through two domestic rules: the income inclusion rule (IIR) and the undertaxed profits rule (UTPR). The IIR is triggered with priority in the country where the ultimate parent entity (UPE) of a MNE is located when income of the subsidiaries of an in-scope MNE group were not subject to a 15% ETR. Accordingly, the UTPR is triggered when the IIR fails to apply, allowing the country of other subsidiaries of the MNE group (taxing above 15%) either to deny a deduction or take the 'equivalent adjustment'. As a result of the application of these rules, countries that offer low tax rates will no longer be able to maintain their low tax competitiveness while forgoing fiscal revenue as well. In 2022, the OECD Model rules contemplated an alternative approach for those low tax countries, to neutralize unreasonable advantages granted to capital-exporting countries, especially due to the priority of the IIR. The low-tax countries are provided "another chance" to tax, which is through the so-called 'qualified domestic minimum top-up tax' (QDMTT). The QDMTT grants low-tax jurisdictions a primary right to collect their own domestic under-taxed subsidiaries' top-up tax. In other words, counties where low tax entities locate may jump the queue to collect taxes primarily through the QDMTT. However, this primary right has two caveats. First, the domestic top-up tax should be recognized as "qualified", which means meeting the standard set by the OECD Model Rules. Second, the "top-up" revenue collected by QDMTT cannot be used to refund or grant any "collateral benefits" to taxpayers.

3.CHINA'S TAX INCENTIVES UNDER PILLAR TWO

According to the Pillar Two rules, it is important to recognize that the minimum tax rule will not affect all tax incentives equally. The calculation of the ETR is based on a formula, and whether there will be and how much of the top-up tax depend on the ETR. Consequently, on one side, some tax incentives would reduce the ETR and trigger the top-up tax by either reducing the numerator or increasing the denominator, or both, when calculating the ETR. However, some tax incentives will be unaffected either because they will not be considered for the purpose of calculating the GloBE tax base, or simply because they will not reduce the ETR at all.



Currently, China has implemented a variety of corporate income tax incentives for promoting technological innovations, protecting environment and promoting regional development. This article categorizes China's tax incentives into high-risk and low-risk incentives, based on the possibility that the tax incentive incurs the top-up tax.

Low-risk incentives include immediate expensing and accelerated depreciation for investment in tangible assets, which have been widely adopted in China. For example, according to one Announcement issued by the Minister of Finance and the State Taxation Administration in China, the instruments or equipment newly purchased by an enterprise in any industry after 1 January 2019 and exclusively utilized in research and development may, if the unit value is not more than 1 million yuan, be included in the current costs and expenses at one time and deducted in the calculation of taxable income, instead of being depreciated annually. In addition, for the fixed assets newly purchased by an enterprise, they may be depreciated by shortening the depreciation period or by using the accelerated depreciation method. Where an enterprise uses the accelerated depreciation method, it may use the double-declining balance method or the sum-of-the-years-digits method. These two immediate expensing and accelerated depreciation incentives shall apply to all manufacturing industries.[3]

According to the OECD Model Rules (Article 4.4 "Mechanism to address temporary differences"), the "recapture exception accrual" includes cost recovery allowance, research and development expenses. As a result, China's accelerated depreciation incentives will not reduce the numerator of the ETR, allowing companies to benefit from this incentive. For dividends deriving from the oversea subsidiaries, China has adopted a worldwide taxation system, providing also for a foreign tax credit to eliminate double taxation.[4] From 2020, China also offers a participation exemption legislative pilot in Hainan Free Trade Port and Zhuhai Hengqin district to specific industries. As one official notice promulgated stated: "[t]he income obtained by enterprises in tourism, modern service industry, and high-tech industries established in Hainan Free Trade Port from their new overseas direct investments shall be exempt from enterprise income tax."[5] According to Article 3.2 of the OECD Model Rule, the dividends would be excluded for determining the GloBE income or loss. That is, Pillar Two requires countries neither to adopt worldwide taxation nor to treat the exemption of the overseas dividends as a tax incentive. Under this scenario, China's exemption of dividends from specific foreign investment would not be affected.

Nevertheless, China has announced a variety of tax incentives that directly reduce tax liabilities, such as tax rate reduction, tax exemptions, and tax holidays. For instance, Article 28 of the Enterprise Income Tax Law provides for a preferential tax rate of 15% for high technology enterprises. In an Announcement issued by Minister of Finance, the State Taxation Administration, the National Development and Reform Commission and the Minister of Ecology and Environment, it provided "[t]he enterprise income tax on eligible third-party enterprises engaging in pollution prevention and control shall be taxed at the reduced rate of 15%."[6] Besides, very generous tax exemptions have been granted to certain industries. For example, Article 87 of the Regulation on the Implementation of the EIT law provided, "[t]he income obtained by an enterprise from investing in or operating any of the public infrastructure projects under the support of the state shall be exempted from the EIT for the first three years as of the tax year when the first revenue arising from production or operation it is attributable to, and shall be taxed at the reduced half rate for the fourth to the sixth years." Similarly, an Announcement regarding the promotion of the development of the integrated circuit industry and the software industry stated: "[k]ey integrated circuit design enterprises and software enterprises encouraged by the state shall, from the first profit-making year, be exempt from enterprise income tax from the first to the fifth year, and be subject to enterprise income tax at the reduced rate of 10% in subsequent years."[7] These incentives are highly risk ones, as there is a strong possibility that when applied in combination, they could bring the ETR below 15%, resulting in a top-up tax somewhere else.

Another approach to grant tax benefits is allowing credits to offset final tax liabilities, that is, the so-called "Qualified Refundable Tax Credits (QRTC)". According to the QRTC shall be treated as income rather than the reduction of taxes in calculating GloBE Income or Loss. However, China rarely uses this type of incentives since the country does not recognize a "negative corporate tax". Indeed, the Chinese legislation contemplates several tax credits in the Corporate Income Tax. However, all of them are not refundable to enterprises. For example, in the Regulation of Implementation of the EIT law, Article 100 provided the tax credits as: "where an enterprise purchases and uses any of the special equipment dedicated to environmental protection, conservation of energy and water, safety of work, 10% of the investment in the special equipment may be credited to the enterprise's amount of taxes of the current year. If the amount of taxes is not sufficient for credit, the margin may be carried forward for credit in the following 5 tax years." As the regulation states, if taxes are less than credits, the remaining amounts would be carried forward to the next 5 years. Accordingly, if the credits are not used in the next 5 years, there will be no refund. At first sight, therefore, tax credits in China's tax incentive do not satisfy the QRTC definition. Therefore, they will only reduce the amount of "covered taxes" when applying and trigger the low ETR risk.

4. THE OVERSTEPPING OF SOVEREIGNTY OF PILLAR TWO

When the global minimum tax proposal was first revealed, it appeared as quite appealing. In fact, the global minimum tax grants rather than limits jurisdictions on those under-taxed profits for related countries, and it probably will finally solve the harmful tax competition problem, which has haunted countries for decades, saving them from the "race-to-the-bottom" dilemma.[8] However, despite the ostensible attractive results, there are concerns about the nation's sovereignty of economic development, especially for developing countries.

The IIR and UTPR rules attempt to curb harmful tax competition and aggressive tax planning. However, they overstep economic growth and country's sovereignty to choose the pattern that achieves economic growth, moving from one extreme to the other. The "leveling-the -playing-field" promise is at the price of nullifying certain domestic laws, especially tax incentives. Yet, based on tax sovereignty,[9] all nations have complete authority to determine taxable income, taxpayers, tax rates, tax incentives, etc. Countries may reduce taxes on specific income or even choose not to tax at all. This does not mean that the country has given up jurisdiction at all.

The above is indirectly recognized in the G20 New Delhi Leaders' Declaration, which states: "[w]e reaffirm that achieving strong, sustainable, balanced and inclusive growth (SSBIG) will require policymakers to stay agile and flexible in their policy response, as evidenced during the recent banking turbulence in a few advanced economies where expeditious action by relevant authorities helped to maintain financial stability and manage spillovers".[10] However, the current ambitious global minimum taxation rules have ignored the fact that countries should have full sovereignty to determine their tax policies, which is commensurate with the stable and sustainable development of their economy. For some developing countries, especially those with poor political stability, insufficient skilled labor, and limited natural resources, there is few choices to be competitive for international mobile capital other than making their income tax system more attractive. For other developing countries with better infrastructure, the use tax incentives as economic regulations to promote development of specific areas and weak industries is also needed. It is precisely because of the actual inequalities in economic conditions that many countries provide tax incentives. In this regard, one would expect that emerging international tax rules should allow developing countries to provide appropriate balances and corrections of the potential risks and costs faced by investors due to those less developed economic realities. Nevertheless, the global minimum tax does precisely the opposite: severely limiting the possibilities for countries to choose how to attract investment. This has been —rightfully, perhaps— labeled by some commentators as 'paternalistic behavior' towards developing countries.[11]

An example of the above is the major shift in the OECD's perspective on international tax competition has been taking place under the new regime.[12] Over the past nearly thirty years, a clear distinction was made between harmful tax competition and others forms of competition. According to the previous documents of the OECD,[13] only those lack economic substance and attract mobile capital selectively are labeled as "harmful". Consequently, tax incentives designed to attract substantial investment and generate income cannot easily be shifted should be allowed, even if they will lead to an effective tax rate below 15%. However, all tax incentives leading to rates lower than 15% ETR will be counteracted under the GloBE proposal. Reviewing China's recent reform and market opening, tax incentives have been applied extensively to attract substantive investment, especially in the high-tech industry. Although the CIT liability was reduced, there was little risk of BEPS as the economic activities were performed where profits were generated. Therefore, even though Pillar Two was designed to solve only the "remaining BEPS issues", many tax incentives in China will be affected regardless of whether BEPS is ultimately present.

5.POSSIBLE RESPONSES THAT CHINA CAN TAKE

By the end of 2024, the implementation of Pillar Two has progressed in more than 140 jurisdictions, some countries already taken steps towards legislation with rules coming into effect in 2025.[14] In simple words, despite the potential interference with the economic sovereignty, the global minimum tax proposal likely prevails, forming the worldwide minimum corporate income tax regime. For China, a thorough review of the current incentives is suggested, as well as acting strategically to adjust incentive approaches to maintain the ETR.

Since the top-up tax is calculated according to a formula, it is natural to figure out responses based on that formula. Tax incentives that are applied to enterprises outside the scope of the GloBE can still provide benefits. In addition, the

ETR is calculated on a jurisdictional basis and based upon consolidated financial accounting rules. China is a vast country with a strong industrial system, for keeping tax incentives in certain areas, such as technology and innovation, incentives can be granted to one entity performing specific activities, while other entities in an MNE group are taxed at the normal rate, thereby increasing the average ETR and not triggering the extra tax liability. Consequently, tax incentives that are narrowly targeted are recommended, since they will leave room for blending with others. Moreover, Pillar Two contains a substance-based income exclusion (SBIE) rule, which may limit the impact of the minimum tax on entities with substantial tangible assets and payroll. In essence, SBIE is a carve-out rule, which works under the idea that profits arising from mobile income, especially intangibles, are more easily exploited for tax avoidance, and profits deriving from the “brick-and-mortar” economy should be excluded from the anti-BEPS rules. China can give full play of its substantial economy, matching entities deriving profits from intangibles with tangible assets and labor investment, reducing in this way the amount of ‘excess profits’ (which is on which the jurisdictional top-up tax is applied).

For general tax incentives, China can take the opportunity to re-evaluated them and improve the tax legislative quality. Tax holidays and rate reduction should be recognized as “red flag” incentives and determined whether they should be maintained or eliminated. In addition, expensing-based incentives would be more recommended when compared to income-based incentives. As mentioned previously, a qualified refundable tax credit (QRTC) is a tax incentive that the GloBE rules allow in a great extent. The

legal effect of this incentive is that the QRTC amount not actually borne by the entity is“deemed to have been borne” and is included in the covered tax. Although the net GloBE income increases accordingly, the effective tax rate of the entity will not be significantly reduced as the QRTC amount is still retained in the numerator. In other words, it is more of a financial subsidy than a tax incentive.

As noted already, China does not recognize the idea of a ‘negative corporate income tax’, and none of the credits provided in the current laws and regulations meet the “qualified” requirement provided by the OECD. However, when the existing credits and subsidies are applied together, they are very close to a QTRC. For example, Article 18 of the Notice of the Ministry of Finance, the Ministry of Environmental Protection, and the National Development and Reform Commission on Issuing the Measures for the Collection, Use and Administration of Funds for the Disposal of Discarded Electrical and Electronic Products, provided: “[e]nterprises that have obtained the qualification to process waste electrical and electronic products may apply for a subsidy from the fund for processing waste electrical and electronic products listed in the Catalogue."[15] These enterprises can apply Article 100 of the Regulation of Implementation of the CIT law as well, acquiring 10% of the investment in their equipment which is used for environmental protection purpose (processing waste electronic products). China can adjust the subsidy and credits rules to switch the current tax credits into "qualified" ones, thereby mitigating the adverse effects of the GloBE rules.

Finally, promoting tax certainty could be an interesting incentive. China has not made a clear position regarding the global minimum tax, whether and which tax incentives would be effective is indeed highly uncertain. As one of the world's most attractive destination for FDI, and the world's second-largest capital exporting country,[16] China should consider the long-term development and the two-way capital flow. The IIR, UTPR and/or QDMTT need to be adopted into the Chinese domestic tax law, but they need to be well designed to connect with the existing tax system, including clear details, such as the scope of application, triggering conditions, and the procedural requirements.

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1 See OECD, Tax Challenges Arising from the Digitalisation of the Economy -- Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS (2021) [OECD Model Rules]. See also, OECD, Challenges Arising from the Digitalisation of the Economy: Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two) (2022)

2 As many commentators have already argued, the altruistic assumption of the GloBE is unrealistic. For example, see Leopoldo Parada, 'Global Minimun Taxation: A Strategic Approach for Developing Countries. Columbia Journal of Tax Law' 15(2), 187–211 (2024); Afton Titus, 'Global Minimum Corporate Tax: A Death Knell for African Country Tax Policies?' Intertax 50 5 : 414-423 (2022); Pereira, R. Codorniz Leite, 'Pillar Two and Developing Countries: The Perils of Jurisdictional Blending' World Tax Journal 15 4 : 545-573 (2023).

3 See Announcement of the Ministry of Finance and the State Taxation Administration on Expanding the Scope of Application of the Preferential Policies on the Accelerated Depreciation of Fixed Assets. (2019).

4 See Article 3 and Article 23 of the Enterprise Income Tax Law of PRC.

5 See Notice by the Ministry of Finance and the State Taxation Administration of Preferential Income Tax Policies for Enterprises in Hainan Free Trade Port (2020).

6 See Announcement of the Ministry of Finance, the State Taxation Administration, the National Development and Reform Commission and the Ministry of Ecology and Environment on Issues Concerning Enterprise Income Tax Policies for Third-Party Enterprises Engaging in Pollution Prevention and Control (2023).

7 See Announcement of the Ministry of Finance, the State Taxation Administration, the National Development and Reform Commission and the Ministry of Industry and Information Technology on Enterprise Income Tax Policies for Promoting the High-Quality Development of the Integrated Circuit Industry and the Software Industry (2020).

8 "Race to the bottom" has been widely used to describe the worldwide tax competition could reduce countries fiscal revenue and their general welfare. See Rosanne Altshuler, Harry Grubert, 'The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies' 7 Fla. Tax Rev. 153 (2005).

9 Diane Ring, 'Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation' 9 Fla. Tax Rev. 555 (2009); Brian J. Arnold, 'The Evolution of Controlled Foreign Corporation rules and Beyond' Bulletin For International Taxation, 73(12): 631-648 (2019); Noam Noked, 'Defense of Primary Taxing Rights' 40 Va. Tax Rev. 341 (2021); Aitor Navarro, 'Jurisdiction Not to Tax, Tax Sparing Clauses, and the OECD Minimum Taxation (GloBE) Proposal' Nordic Tax Journal 2021: 6 - 19. (2021).

10 See G20 New Delhi Learders' Declaration,9-10 September 2023, available here: https://www.mea.gov.in/Images/CPV/G20-New-Delhi-Leaders-Declaration.pdf

11 Parada, supra note 2, 187–211.

12 Ibid.

13 See OECD, Harmful Tax Competition: An Emerging Global Issue (1998); and OECD, Base Erosion and Profit Shifting Action 5 Harmful Tax Practices (2013).

14 OECD Pillar Two Country Tracker, available here: https://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html

15 Article 18 of the Notice of the Ministry of Finance, the Ministry of Environmental Protection, and the National Development and Reform Commission on Issuing the Measures for the Collection, Use and Administration of Funds for the Disposal of Discarded Electrical and Electronic Products.

16 See Statistical Bulletin of FDI in China 2024, Department of Foreign Investment Administration of the Ministry of Commerce, available at here: https://wzs.mofcom.gov.cn/cms_files/filemanager/195082220/attach/20249/1534906939894198bbb5b6b86a752466.