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# The Dilemma and Solution of the Multilateral Legal Framework of International Taxation

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## Abstract

To avoid double taxation is the basic purpose of the current international tax system. Therefore, an international tax system with bilateral tax treaties as the main form has been formed among states. However, practice has proved that the inherent defects of the international tax system, which is dominated by bilateral tax treaties, have resulted in the problems of tax base erosion and profit transfer. G20 and OECD have led the introduction of *Multilateral Convention on the Implementation of Relevant Measures of Tax Treaties to Prevent Tax Base Erosion and Profit Transfer* (hereinafter referred to as "BEPS Convention"), to which China has also acceded. However, the above BEPS convention is called "Convention". In fact, it is only a modification of some provisions of existing bilateral tax treaties of various countries. In essence, it does not have the function of multilateral tax treaty, but only takes the form of multilateral agreements for the continuation of bilateral tax treaties. The author thinks that in order to solve the problems of tax base erosion and profit transfer, we should change the structure of tax benefit distribution under the traditional benefit principle that "tax on positive income in source areas and tax on negative income in residential areas" and build a new multilateral tax treaty system that "tax on positive income in residential areas and tax on negative income in source areas".

## Keywords

Base Erosion and Profit Transfer, BEPS Convention, Benefit Principle, Tax on Positive Income in Residential Areas, Tax on Negative Income in Source Areas

## 1. Introduction

The cross-border income tax collection rule system starts in 1923 and has been used until now. In the Industrial Age in the 1920s when goods transaction served

as main pattern of trade, the rules aforesaid were still reasonable and alleviated problems of double taxation. However, with prosperous development of digital economy, digital economy makes property recognition and attribution identification of incomes related to digital economy difficult and defines void concept of "permanent establishment". Moreover, the domestic tax rate and conventional tariff of each country are different; it is increasingly possible for multinational enterprise groups to adopt various methods for tax evasion and tax base erosion. In the meantime, due to consistent interests among internal subjects of multinational corporations, each subject has motive to transfer its profits to tax jurisdictions with low tax rate through cost expenditure, expense expenditure and other forms. Developed countries and major international organizations have tried to solve tax base erosion and profit transfer by multilateral treaties and made achievements such as the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* and the *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information* (CRS) which have been recognized and implemented by most states. However, the above multi-literal treaties mainly involve procedures of international tax matters administration and lack regulations on substantial issues. In case of substantial issues, it will be difficult to reach an agreement due to different interest demands, tax systems, and national conditions among involved states. Under such circumstance, increasing substantial issues are solved by unilateral measures by some states, which makes the international society worried about the new round of competition in international taxation. In order to copy with such problems as tax base erosion and profit transfer, OECD led research on issues related to BEPS in 2013 and released 15 action plans in 2015 with *Multilateral Convention on the Implementation of Relevant Measures of Tax Treaties to Prevent Tax Base Erosion and Profit Transfer* (BEPS Convention) introduced. China officially acceded to the Convention in 2017. Nonetheless, in response to relevant problems in international taxation, BEPS Convention only modifies of existing bilateral tax treaties to unify the legal systems of international taxation. In fact, it does not have the function of multilateral tax treaty, but only takes the form of multilateral agreements for the continuation of bilateral tax treaties. In the meantime, BEPS Convention is unable to solve the inherent defects in legal framework of international taxation dominated by bilateral tax treaties.

## 2. Causes and Essence of Double Taxation and Selection of Solution

### 2.1. Fundamentally, Legal Framework of International Taxation Is Established to Resolve the Conflict between Source Area Jurisdiction and Residential Jurisdiction

Power of taxation is based on state sovereignty. Double taxation will not be incurred by tax levied by a state on its natives. Double or even multiple taxations may occur when profits are gained transnationally under jurisdiction of double

or more legal units. Legal practice of international taxation commenced in 1920s was carried out to avoid double taxation from the very beginning (OECD, 2016). Generally speaking, double taxation can be divided into legal double taxation and economic double taxation. Legal double taxation refers to two or more states levying tax of the same nature on a tax payer for the same taxation object during the same period. Economic double taxation refers to over two states levying the same or similar taxes on different tax payers for the same taxation object or tax source during the same period (Higher Education Press, 2016). The two kinds of double taxation are different that the former is aimed at the same tax payer and the latter is aimed at different tax payers. For instance, a state levies not only corporate income tax on companies but also individual income tax on shareholders, which is a typical case of economic double taxation. International taxation mainly solves the legal double taxation.

The aforementioned legal double taxation is mainly caused by two reasons, namely, the conflict of tax jurisdiction among states and different definitions of the states on "resident", the connection point of personal jurisdiction, and "source area", the connection point of territorial jurisdiction. Tax jurisdiction refers to the power of taxation exercised by a state government based on state sovereignty, i.e., generally speaking, a state owns personal jurisdiction and territorial taxation jurisdiction on taxation objects (Liu, 2013). From its own interests, a state can adopt the way of personal jurisdiction, the way of territorial jurisdiction, or the way combining personal jurisdiction and territorial jurisdiction respectively. As a result, international double taxation occurs in the following forms: the conflict between residential jurisdiction of a state and source area jurisdiction of the other state, the conflict between different residential taxation jurisdictions defined by two states, and the conflict between different income tax source area jurisdictions defined by two states (Dagen, 2000). The above conclusion is made by logical deduction based on different jurisdictions, which, however, is inconsistent with practice of international taxation and cannot help to explain and understand the essence of conflict in jurisdiction of international taxation. Upon years of legal practice of international taxation, the international tax laws have formed coherent and consistent framework of international taxation, and the framework has been promoted to customary international law up to a point (Avi-Yonah, 2008). Levying income tax from their territory is the basis of states exercising taxation jurisdiction, which is covered by customary international law practiced for many years. From the point of view of source area country, to solve the taxation jurisdiction in international tax laws is to judge whether a residential state has the right to levy tax on its residents for their income gained from other source areas. In this context, if the residential state does not claim personal jurisdiction, there will be no conflict in taxation jurisdiction. Therefore, international tax laws only need to resolve the conflict between source area jurisdiction and residential jurisdiction so as to solve jurisdiction conflict. The above mentioned conflict in personal jurisdiction among states or conflict in territorial Jurisdiction among states does not exist in fact. Only in

case of dispute over definition of resident and source area will conflict occur, which, however, is not the conflict between taxation jurisdictions.

### 2.2. Main Methods for Solving Conflict of Taxation Jurisdiction

**1) Unilateral Measures**

With development of integrational trends of global economy and regional economy, conflicts of taxation jurisdiction among states are usually resolved by signing bilateral treaties so as to free global trade and investment. As mentioned above, according to practices and from different interests of states, the *Model Convention with Respect to Taxes on Income and on Capital of Organization for Economic Co-operation and Development* (OECD) and the *Model Convention with Respect to Taxes on Income and on Capital of the United Nations* (UN) are formulated. For a long time, most scholars have held that taxation treaty is the method to eliminate double taxation. However, unilateral measures, namely the method adopted by a state under its domestic laws, can also eliminate double taxation, and unilateral measures are even earlier than taxation treaties. For instance, before establishment of legal framework of international taxation, tax credit and exemption methods had been adopted by some states to solve double taxation, which is just the unilateral measure.

Nonetheless, bilateral measure is not a perfect solution. As the global economy develops, due to different taxation systems, new issues are produced continuously without consensus reached by states yet, but such issues are also solved by unilateral measures. For instance, though global economy is being dominated by digital economy, there is no unified solution to unique issues in digital economy and taxation such as liquidity, dependence on data, network effect, extension of multi-level business model, tendency of monopoly or oligopoly, and polygonality, for states are still discussing and studying taxation and coordination of such issues (State Taxation Administration of the People's Republic of China, 2020). In this context, some states adopt unilateral measures; for example, the Commission of European Union drafted resolution of enacting law on digital service taxation in 2018, and France passed the law on digital service taxation in 2019 (Zhang, 2020a). But the above unilateral measures cannot be recognized by most states and may lead to new round of taxation competition or resistance by other unilateral measures, which may hamper development of global trade and development.

**2) Bilateral Tax Treaties**

As trades and investment among states are increasingly frequent, double taxation cannot be solved by the above literal measures only but also with bilateral and multilateral measures among states. Bilateral and multilateral measures mean bilateral and multilateral tax treaties. Bilateral tax treaties refer to international legal agreement reached by two states to solve double taxation arising from cross border, which the main method commonly taken by states to treat conflicts of taxation jurisdiction. Bilateral tax treaties have the following characteristics. First, from the aspect of subject, the subject is two states. A state needs

to reach bilateral treaties with different states; for instance, China has entered into bilateral tax treaties for avoiding double taxation with 107 states as well as Hong Kong, Macao, and Taiwan (State Taxation Administration of the People's Republic of China, 2020). Second, from the perspective of content, legal framework for bilateral treaties of states has been basically fixed. Developed countries prefer the *Model Convention with Respect to Taxes on Income and on Capital of OECD* and developing countries prefer the *Model Convention with Respect to Taxes on Income and on Capital* of UN. Though bilateral tax treaties are adopted by states as the main method for mediating conflicts of taxation jurisdiction, the method has the following drawbacks: a) Generally, bilateral tax treaties can only restrain contracting parties, but the conditions of states on the same issue are different, which can easily lead to institutional arbitrage; b) In line with the basic principle of "tax on positive income in source areas and tax on negative income in residential areas" commonly accepted, misuse of preference in treaties is found frequently; c) Bilateral treaties cannot solve issues involving multiple parties, which seriously breach the tax neutrality principle.

**3) Multilateral Tax Treaties**

Multilateral tax treaties refer to multilateral treaties signed by more than two states on regulating issues of international taxation. At present, main multilateral tax treaties include the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* and the *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information* (CRS Convention). The issues of double taxation are mainly treated by bilateral tax treaties between states. However, such bilateral tax treaties are not enough to solve the double taxation and even incur such illegal behaviors as tax base erosion and profit transfer. In response to the problems, G20 and OECD have led research on issues related to BEPS as from 2013 and released 15 action plans in 2015 with the *Multilateral Convention on the Implementation of Relevant Measures of Tax Treaties to Prevent Tax Base Erosion and Profit Transfer* (BEPS Convention) introduced. China officially acceded to the Convention in 2017. BEPS Convention applies the way of modifying "covered treaties" to cope with relevant problems of international taxation and unify international tax laws on anti-tax avoidance. In spite of a number of multilateral treaties tried by some states to solve conflict of taxation jurisdiction before, such as Andean Treaty and Nordic Treaty (Doyle, 2018), none of them has received attention as much as that of BEPS Convention from so many states. The fact that BEPS Convention can be introduced and extensively recognized by states should be attributed to the following factors. a) A large number of bilateral tax treaties have been concluded by states based on the above two models of bilateral tax treaties. b) A unified legal framework is formed through years of practice of international taxation. c) Under the existing legal framework, problems of tax base erosion and interest transfer are highlighted and most states are eager for solving the problems. BEPS Convention is also formulated based on baseline of existing legal framework of international taxation, i.e., the basic principle of "tax on positive income in source areas and tax

on negative income in residential areas"; however, practice of the principle has proved that problems related to BEPS have been incurred thereby, and BEPS Convention is just a "patchy modification" of relevant problems, which cannot root out such problems. Hence, it is necessary to reflect on the principle of tax benefit again based on actual situation of global economy and apply the principle of "tax on positive income mainly in residential areas and tax on negative income mainly in source areas" (Xu, 2019).

## 3. Necessity of Multilateral Tax Treaties and Limitation of BEPS Convention Application

### 3.1. Necessity of Adopting Multilateral Tax Treaties to Solve International Taxation Problems

As described above, unilateral measures, bilateral tax treaties, and multilateral tax treaties are the main ways of resolving conflicts of taxation jurisdiction among states. Bilateral tax treaties are applied the most frequently among the three ways. However, upon a hundred years of practice, such problems as tax base erosion and profit transfer incurred by legal framework of international taxation dominated by bilateral tax treaties have challenged the existing legal framework of international taxation. In order to cope with the problems related to BEPS, OECD/G20 have begun to establish the inclusive legal framework as from 2013, proposed 15 actions plans, and introduced BEPS Convention, which manifest the importance of adopting multilateral tax treaties to reflect and improve the existing legal framework of international taxation. Multilateral tax treaties are necessary to remold legal framework of international taxation in that:

1) It has been proved by practice that the existing international taxation system dominated by bilateral tax treaties has failed to realize avoiding double taxation and tax evasion as required by legal framework of international taxation.

The original intention of legal framework of international taxation was to avoid double taxation; however, according to the practice effect, though the double taxation has been avoided by the existing legal framework of international taxation, the framework has gone to the extreme, i.e., double non-taxation, which gives rise to tax erosion. There are many specific reasons that cause tax erosion, including vicious tax planning of multi-national firms (MNFs), interaction of different domestic laws and regulations on taxation, lack of transparency and cooperation among tax authorities of states, limited domestic administration resources, harmful taxation practice, etc. These reasons all result from the legal framework of international taxation dominated and characterized by bilateral tax treaties. Only by multilateralism can we solve the problems and recover people's confidence in international taxation system.

2) Bilateral tax treaties are not unified and the different of agreed conditions among states can lead to institutional arbitrage.

Bilateral tax treaties are signed by and between contracting states as an arrangement for mechanism coordination based on their domestic tax laws. As

conditions of bilateral tax treaties are determined between the contracting states, there is different among bilateral tax treaties. Due to the existence of non-natural person tax paying entity and especially against the trade and investment background highlighting most favored nation treatment and national treatment, it is possible to establish tax paying entities anywhere in the world, and bilateral tax treaties enable institutional arbitrage, which is also one of the primary causes of vicious tax planning of MNFs.

3) Misuse of preference in bilateral tax treaties repeats frequently.

Based on different economic background, culture, history, and other factors, a state may offer preferential policies to the other state in the process of formulating the bilateral tax treaties. After combination of the preferential policies with different local tax systems of favored state and different tax systems of a third state, the preference in tax treaties may be misused. For instance, overseas investment or round-tripping capital of Chinese enterprises is usually completed through Hong Kong with the tax preferences between Chinese Mainland and Hong Kong utilized to certain extent. The above mentioned misuse of preference in tax treaties arise from existence of bilateral tax treaties, because bilateral tax treaties are mainly used to restrain contracting states and have little restraint on the involved third states.

4) Due to different degree of economic development of states, bilateral tax treaties are mainly determined by major economy power.

As a coordination mechanism for resolving conflicts in taxation jurisdiction of states, bilateral tax treaties should have been formulated based free will of contracting states; however, due to different economic power among states, the will of bigger economic power always dominates the formulation of bilateral tax treaties during negotiation, and the benefits of the other party cannot be protected well. Besides, as developing countries lack talents in international taxation, their will and proposition can be hardly realized in theoretical research, taxation practice, design of system for dispute resolving, and other aspects. It is crucial to establish a multilateral taxation framework based on coherent and consistent international taxation practice so as to balance benefits demands of states with different development degree.

### 3.2. Limitation of BEPS Convention Application

As described above, in response to limitation of the legal framework of international taxation dominated by bilateral tax treaties, it is necessary to adopt multilateral tax treaties. OECD/G20 have begun to establish the inclusive legal framework as from 2013 to solve the problems related to BEPS, proposed 15 actions plans, and introduced BEPS Convention. But BEPS Convention itself has limitation and cannot eliminate such problems as tax base erosion and profit transfer. Specifically:

1) BEPS Convention cannot be deemed as multilateral tax treaty but the continuation of bilateral tax treaty covered by multilateral form.

Article II of the BEPS Convention defines "covered tax treaties" as satisfactory treaties for avoiding double taxation. That is to say, BEPS Convention is mainly applied by modifying existing bilateral tax treaties so as to cope with such problems as tax base erosion and profit transfer. Function of the Convention is to modify tax treaties concluded between two more among more contracting parties. Unlike protocol modified by single existing treaty which directly modifies the text of covered tax treaties, the Convention co-exists and is applicable with existing tax treaties and modifies applicability of the existing tax treaties to implement BEPS measures. Therefore, contracting parties to the Convention, for internal purpose, may prepare the integrated edition of covered tax treaties modified by the Convention, which, however, is not the premise of applying the Convention. As to be mentioned below, after the covered tax treaties are modified by the Convention, contracting jurisdictions can still make different modifications to their covered tax treaties (Xu, 2019).

2) Not only did the BEPS Convention fail to resolve the inherent defects of framework of bilateral tax treaties, but also its remedy for measures have complicated the existing legal framework of international taxation.

It has been said that the actual function of the BEPS Convention is to modify "covered tax treaties" (i.e., bilateral tax treaties). In addition to "minimum standard" that must be observed, states may propose to reserve other terms. Besides, regardless of formulation of the BEPS Convention, bilateral tax treaties are still valid between the contracting states for handling matters not covered by the BEPS Convention; the bilateral treaties can still be modified upon proposal of contracting states. Hence, though BEPS Convention adopts the form of multilateral tax treaties, it is just continuation of bilateral tax treaties in essence. Comparing bilateral tax treaties to contract concluded by and between contracting states for taxation jurisdiction, BEPS is only a supplementary agreement of the states to the above contract. Perhaps, this is concession made by G20 and OECD to reach agreement on BEPS issues. G20 and OECD have offered some plans, especially the 15th action plan, *Preparing Multilateral Agreements for Modifying Bilateral Tax Treaties*, which specifies that multilateral agreement is the way of coping with BEPS problems with its Appendix A, *Reference Toolbox for Multilateral Agreements to Be Quickly Implemented in Response to Tax Base Erosion and Profit Transfer*, providing tools applicable to multilateral agreements. Nonetheless, the BEPS Convention finally fails to form an independent framework of multilateral treaties and is only a remedy for the existing bilateral treaties, which cannot eliminate the inherent defects of bilateral tax treaties but complicate the applicability of the existing framework of bilateral treaties.

3) The basic rule of international taxation of "tax on positive income in source areas and tax on negative income in residential areas" connives tax base erosion and profit transfer.

Leaving aside the question whether the above rule can realize the vision of "levying tax on profits in economic activity area and value creation area" based

on benefit principle, at least two problems cannot be solved by implementation of the rule:

Firstly, the rule of "tax on positive income in source areas" incurs erosion to tax base of the positive income. Tax base of income is corresponding to profit. Broadly speaking, tax base can be eroded by the three methods below. The first is to sell products to associated overseas tax paying entity at low prices so as to decrease tax base and transfer profit to the overseas tax paying entity which is usually established in "tax heaven"; the second is to purchase raw materials from associated overseas tax paying entity at high prices so as to increase costs and transfer profits to the overseas tax paying entity indirectly; the third is to transfer profits by paying disclosure fees, interests, and other fees. According to the basic rule of "tax on positive income in source areas", tax paying entity gaining positive income has the motive to decrease tax base by the above ways so as to pay less tax, and the existence of non-natural person tax paying entity enables such free riding. Though package plans of BEPS manage to prevent the above profit transfer by further determining fair trade standard, purpose test, and other modes, it should be conceded that the existing legal framework of international taxation has enabled speculator to exploit the loophole and transfer profits, and the fair trade standard, purpose test, and the like cannot avoid being intervened by human subjective factors during application in practice of cross-border taxation, which increases management costs of states. The author suggests reversing the rule, namely, instead of taxing on positive income in source state, gathering profits at non-natural person tax paying entities lower than the final natural person tax payer and requiring the non-natural person tax paying entity to distribute profits according to contribution of source area, residential area, and even the area where the conduit corporate is located. In this context, overall tax base will be distributed in different states without erosion.

Secondly, the specific execution of "tax negative income in residential areas" is that the source area state levies withholding income tax first at low tax rate and the residential area state levies income tax. The part that has been paid in withholding income tax will offset the corresponding part of income tax, or the paying entity will be exempted from the part of income tax. This basic rule has two major problems. The first is the existence of non-natural person taxing entity, which enables tax paying entities to be established in states with low tax rate and results in that negative income is taxed in states with low or even zero tax rate; the second is the existence of non-natural person tax paying entity, which enables tax deferral. For example, if an intermediate non-natural tax paying entity does not share out dividend or bonus deliberately, this part may be taxed in delay. In response the above two problems, logically, the best solution is to withhold full amount of negative income tax in source areas so as to prevent tax base erosion or misuse of taxation system of other states caused by deferral or establishment of tax paying entity in states with low or zero tax rate. As for contribution of residential state to negative income, the profits may be distributed

according to actual situation.

4) BEPS Convention mainly protects benefits of developed countries and adheres to the principle of "tax negative income in residential states", so BEPS Convention cannot eliminate BEPS problems fundamentally.

BEPS package plans directed by G20/OECD are based on the *Model Convention with Respect to Taxes on Income and on Capital of Organization for Economic Co-operation and Development* (OECD), which speaks for benefits of developed counties. Development countries always play the role of capital exporting country, thus adhering to the principle of "tax negative income in residential states". However, developing countries are also considerable in today's world pattern. As taxation concerns state sovereignty, developing counties attach more importance to the basic principle of "tax positive income in source states". Since it is hard to coordinate benefits of the two groups, BEPS Convention adopts the ostensible multilateral mode to modify the existing bilateral tax treaties to solve BEPS problems, which, in fact, places multilateralism-oriented advancement of international taxation framework at a deadlock.

## 4. Feasibility of Rebuilding Multilateral Legal Framework of International Taxation

### 4.1. There Is Coherent and Consistent Customary Law System in International Taxation Laws

Upon years of practice, a coherent and consistent international taxation system has been formed, which is found in taxation convention network and inland laws and is an important part of international laws (including conventions and customary laws). Its practical significance lies in that states cannot apply international taxation rules but operate within the scope (Avi-Yonah, 2008). As there is no legislative institution higher than state sovereignty in international law community, effect of bilateral tax treaties is from the agreement on compulsive requirement of obeying the customary law, and bilateral tax treaty itself is actually a confirmation of habit of parties to solve taxation jurisdiction and distribute benefits. However, as mentioned above, due to limitation of bilateral tax treaties, multilateral tax treaty is the only solution. The current customary law determined by existing bilateral tax treaties has laid foundation for building the system of multilateral tax treaties, and treaties are always modification of customary laws (Zhu & Li, 2008), which are applicable to both bilateral treaties and multilateral treaties.

### 4.2. A legal Framework System Has Been Fixed in Bilateral Tax Treaties between States

Through nearly a hundred years of international taxation practice, bilateral tax treaties have become a main legal method for resolving jurisdiction conflicts and preventing double taxation and tax avoidance. Based on this, the *Model Convention with Respect to Taxes on Income and on Capital of UN* representing benefits of developing countries and the *Model Convention with Respect to*

*Taxes on Income and on Capital of OECD* representing benefits of developed countries have been established, which share similar basic legal framework. Take the bilateral tax treaties between China and Singapore as example. The legal framework mainly contains scope of person, scope of tax categories, general definition, resident, standing body, income from immovable property, operation profits, sea transportation and air transportation, affiliated business, dividend, interest, disclosure fee, assets income, independent personal services, dependent personal services, director's fees, artist and athlete, pension, governmental services, students and trainees, other income, elimination of double taxation, non-discriminatory treatment, mutual agreement procedure, information exchange, other rules, diplomatic representative and consular officer, effect and termination, etc. (China Taxation Publishing House, 2012).

### 4.3. China Facing the Profound Changes Unseen in a Century Will Play a Positive Role in Leading Establishment of Regional Multilateral Taxation System

With implementation of the "Belt and Road" Initiative, China is being transformed from a capital importing country to a capital exporting country and has become the second largest economy in the world. But judging from the economic status, China is still a developing country and is well aware of demands of developing countries and third world countries in distribution of international taxation benefits. Abiding by the basic principle of openness and inclusiveness as well as mutual benefits advocated by "Belt and Road", China is qualified to lead the establishment of regional multilateral taxation system with "Belt and Road".

## 5. Basic Standpoint of Rebuilding Multilateral Tax Treaties System

### 5.1. Preventing Double Taxation and Tax Avoidance Ought to Be Purpose of Legal Framework of International Taxation

As described above, from the perspective of historical development, legal framework of international taxation is mainly aimed at preventing double taxation, but deficiency of the existing legal framework of international taxation enables tax base erosion and profit transfer (namely, BEPS problems). According to incomplete estimation, the eroded global corporate income tax (CIT) caused by BEPS is USD100 billion to USD240 billion each year, accounting for 4% - 10% of total amount of corporate income tax. Profit margin (relative to assets) declared by affiliated business of multi-national firms in states with low tax rate is almost twice of profit margin of global group of the firm, which manifests that BEPS problems have given rise to economic distortions (State Taxation Administration of the People's Republic of China, 2020). Hence, legal framework of international taxation should not only aim to avoid double taxation but also prevent tax avoidance.

### 5.2. Principle of "Single Taxation"

As a response to the first question above "how to tax on cross-border transaction

income properly", "single taxation" means to tax cross-border transaction income only once (not more than or less than once) (Avi-Yonah, 2008), which agrees with the required purpose of preventing double taxation. It should be noted that the "single taxation" here only refers to single taxation in legal sense. Due to existence of tax paying entity other than natural person (like corporate), such entities are levied not only on corporate income but also on individual income of shareholders, which has been extensive accepted by states tax laws. Economically, natural persons, as the final tax bearer, have to pay both corporate income tax and individual income tax; however, besides natural person, non-natural person tax paying entities are also necessary to the modern cooperate system, and the economic "double taxation" has been received by the public, so it is no need to worry it about. Nonetheless, attention should be paid to that tax paying entities under the modern corporate system may lead to deferral of the final tax borne by natural person, which is also one of major causes of BEPS problems. Another importance of "single taxation" manifested in practice is that states prevent double taxation by the ways of tax credit and tax exemption, which proves legitimacy of "single taxation principle".

### 5.3. Based on Reflection on Traditional Benefit Principle, It Is Suggested to Adopt the Basic Principle of "Tax on Positive Income in Residential Areas and Tax on Negative Income in Source Areas"

**1) Applicability of traditional benefit principle**

A consensual mindset has been formed on taxing on cross-border transaction income, which is to identify type of income first and distribute tax profits to different states according to the type of income. Under the international taxation framework, "source classification and distribution" method is applied to many bilateral tax treaties by adopting different rules of taxation power distribution to different incomes. The preliminary of judging distribution rule is to classify income into one of categories therein according to tax treaties upon conflict occurs. If the income is classified into one of the categories above, the conflict will be resolved by the bilateral tax treaties by sequence rule. After identifying the income according to tax treaties, the taxation power will be distributed in line with the tax treaties. Generally, taxation power is fully owned by a contracting party, or a party is prioritized to exercise the taxation power with residual taxation power reserved by the other party.

In 1920s and 1930s, the basic framework for taxation power distribution between source state and residential state was established by economists mainly based on benefit principle. In the principle, taxation priority is granted to source states on the basis of limiting the taxation power of source states, and the responsibility of eliminating double international taxation is imposed on residential state on the basis of entitling residential state to unlimited taxation (Zhang, 2020b). After the principle was applied to practice, a basic legal framework was established, i.e., "tax on positive income in source states and tax on negative in-

come in residential states". "Positive income" refers to business incomes like business profit; "negative income" refers to investment incomes such as dividend and bonus income, interest income, and disclosure fee income.

**2) Reflection on traditional benefit principle**

The above legal framework is unable to cope with at least the following two problems and has finally hindered realization of the purpose of preventing double taxation and tax avoidance:

a) Principle of "tax on positive income in source states" gives rise to tax base erosion and transfer pricing.

"Tax on positive income in source areas" in practice is that positive income of tax paying entity or standing institution of non-resident in residential state shall be taxed by source state. It is "net income" of both the above tax paying entity and standing institution that is taxed; that is to say, it is allowed to take income of the tax paying entity or standing institution with costs and fees deducted under applicable rules as tax base. As mentioned above, it is easy to establish a non-natural person tax paying entity in a third state; thus, the final bearer (natural person) of tax has the motive to establish a non-natural person tax paying entity in areas with low or zero tax rate and transfer relevant profits in the ways such as fees, costs, and even transfer pricing to avoid paying tax. Such conduct can incur losses to tax benefits of the aforesaid residential state (which is source state in comparison of non-residential state). Though G20/OECD have modified rules on transfer pricing and advocate fair trade standard in response to the problem, the rules are limited subjectively or objectively in application and cannot patch the vulnerabilities from the perspective of system itself.

b) Principle of "tax on negative income in residential states" leads to tax deferral, misuse of preference in tax treaties, and other problems.

"Tax on negative income in residential areas" in practice is that residential states tax on negative income, source states levy withholding income tax with lower tax rate, and the final residential states deduct the withholding income tax in the ways of tax credit or tax exemption. The principle has two deficiencies. First, after being taxed with low tax by lower tax rate of withholding income tax, the negative income may be transferred to other states where non-natural person tax paying entity may generate due to different tax systems of other states, which may lead to deferral of negative income. That is to say, if the non-natural person tax paying entity does not share out dividends deliberately, the residential state where the natural person is located cannot tax on the income and the tax will thus be avoided. In this context, though G20/OECD have modified rules on controlled foreign corporate and the like to prevent tax avoidance, the above problem will not be solved in case of too many conduit corporates. At the same time, as source states tax on such income only by withholding income tax, tax base must be eroded after the income enters areas with low or zero tax rates.

**3) Legitimacy of "tax on positive income in residential states and tax on negative income in source states"**

Design of international multilateral taxation system should solve two prob-

lems, namely, tax source division between residential states and source states and tax base erosion of corporate. As proved by practice, all states are concentrated on solving the first problem and have neglected the second one, which leads to frequent profit transfer and tax base erosion. Many multi-national firms take advantage of difference of taxation jurisdiction and design of taxation system (like tax rate) among states to transfer profits. "Positive income" and "negative income" are mainly differentiated by the following definition. Positive income refers to business incomes most of which are gained by non-natural person tax paying entity; negative income refers to investment incomes such as dividend, interest, and disclosure fees. From the perspective of tax base, negative income can be divided into pre-tax nondeductible incomes like dividend and pre-tax deductible incomes such as interest and disclosure fees. As for payers, the negative income means expense which may be used by the payers as the main method for eroding tax base.

Against the background where corporate tax system becomes internationally universal tax system, as for positive income, it is suggested to collect positive income, tax on positive income in the area where actual controller of multi-national firm is located, and distribute tax benefits to involved states by formula apportionment. As for negative income, in order to protect tax base from being eroded as far as possible, it is suggested to withhold full amount of payable tax at source in the process of payment, namely the source of income flowing. Such withholding shall not be defined as withholding income tax, because the general withheld income tax has small amount and is mainly used for tax credit; by contrast, tax withheld in the process of payment is roughly equal to the amount calculated by the minimum income tax rate jointly determined by states involved in multilateral treaties system and income of different industries in recent years. That is to say, income should be first taxed by the source state by general tax rate and then be integrally audited by the state where actual controller of multi-national firm is located; in the meanwhile, tax benefits are distributed to involved states by formula apportionment and finally distributed by the source state taxing the income to states involved in the income according to formula apportionment. In case of dispute, states may seek ways to solve the dispute through negotiation.

## 6. Conclusion

Taxation power is an integral part of state sovereignty, and it has been universally acknowledged that tax benefits are essential to all states. All states have been well aware of the inherent defects of existing legal framework of international taxation in tax base erosion and profit transfer. G20 and OECD have released actions plans to solve the problems with BEPS Convention introduced. However, since G20 and OECD are clubs mainly consisting of developed countries, their reform speaks for residential area taxation jurisdiction of developed countries. Therefore, the BEPS Convention is only concession to reform of ac-

tual legal framework of international taxation. Only by revolutionizing the traditional international taxation system dominated by bilateral tax treaties based on "benefit" principle can problems such as tax base erosion and profit transfer be eliminated and demands of developing countries be better satisfied.

## Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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