

Reconstruction of International Tax Rules to Meet the Challenges of Digital Economy

Wei Xu

Law School of University of International Business and Economics, Beijing, China

Email: xuwei373@hotmail.com

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Abstract

The current cross-border income tax collection rules of “positive income is levied in the source country and passive income is levied in the resident country” seriously violate the benefit principle in practice. The corporate income tax system is the institutional root of the failure of the above rules. The digital economy with data as the key production factor, invisibility and liquidity, relying on user participation and natural monopoly intensifies the negative impact of the corporate income tax system on the current rules. Starting from the principle of benefit and combined with the theory of value creation, this paper advocates the reconstruction of the cross-border income tax collection rule system, which takes the whole multinational enterprise group as the tax subject, takes the formula distribution as the method, takes the progressive tax rate as the improvement direction, and adopts “positive income is levied in the resident country and passive income is levied in the source country”.

Keywords

Digital Economy, Corporate Income Tax System, Principle of Benefit, Positive Income Is Levied in the Resident Country, Passive Income Is Levied in the Source Country

1. Problem Statement

The cross-border income tax collection rule system of “positive income is levied in the source country and passive income is levied in the resident country” under the guidance of traditional benefit principle starts from the *Double Taxation Report* written by four economists under the entrustment of the League of Nations in 1923 (hereinafter referred to as “1923 Report”) and has been used until now. The rules aforesaid, based on the corporate income tax system which takes

single corporate as the independent tax subject, supplemented by the arm's-length principle, have led the development of cross-border income tax collection rules in last one hundred years. 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 concept of "permanent establishment" vague (Xu, 2021). 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. Accordingly, as a result of invisibility, liquidity and other features of digital economy, the rule of "transfer pricing" demonstrated by the arm's-length principle which impedes these acts aforesaid intends but fails to solve these problems.

In order to solve these problems aforesaid, countries and main international organizations have adopted various solutions. For instance, India, French, the United Kingdom and other countries levy the "digital service tax" on incomes from digital economy. The UN Committee of Experts on Tax adds Clause 12B to the model of Tax Treaty of the United Nations, which includes the computer software income into the category of royalty fee. OECD modifies the clause about "permanent establishment" of the model of OECD Tax Treaty and increases the identification range of permanent establishment to reduce the influence from digital economy on the "permanent establishment". G20 has entrusted Organization for Economic Co-operation and Development (OECD) to implement a package of plans to prevent tax base erosion and profit shift (hereinafter referred to as "BEPS Plan") in 2013 and has issued the latest achievement in front of digital economy—"Double Pillar Plan" in Oct. 2021. However, the plans aforesaid, in adherence to the basic rule system of "positive income is levied in the source country and passive income is levied in the resident country", not only fail to prevent tax base of each country from erosion effectively but also make existing rules more complicated. Intending to start from the features of digital economy and its influence on existing rule system, this article points out that the combination of features of digital economy and corporate income tax system is the institutional root of the failure of existing rule system, and at the same time conducts deep reflection on the benefit principle in accordance with the theory of payment ability and advocates the reconstruction of the cross-border income tax collection rule system, which takes the whole multinational enterprise group as the tax subject, takes the formula distribution as the method, takes the progressive tax rate as the improvement direction, and adopts "positive income is levied in the resident country and passive income is levied in the source country" (Avi-Yonah & Xu, 2017) in combination of the theory of

value creation.

2. Influence from Digital Economy on Existing Rule System and Analysis of Reasons

Under mutual penetration and combination of information and communications technology (hereinafter referred to as “ICT”) with traditional economy, digital economy is developing into an actual economy and fails to be separated from other economic forms. Therefore, in respect of challenges from digital economy on cross-border tax, it can be started from main commercial application scenes of multinational enterprises groups which are closely related to digital economy and analyze negative influence from digital economy on existing cross-border income tax collection rule system.

2.1. Theoretical Foundation of Existing Rules and Brief Analysis of Rule System

Determining the degree of imposition of cross-border income tax and the way to distribute cross-border income tax collection between the source country and resident country is the primary problem to be solved. As for degree of imposition of such tax, the key is to solve the problem of double taxation, which means income tax is levied once for each income, instead of duplicated taxation, simultaneously, income tax shall be paid for each income at least once, in the source country or resident country (no double taxation) (Zhang, 2020). The distribution of tax base between source country and resident country is guided by the benefit principle. The basic meaning of benefit principle is that the amount of tax payment shall be directly proportional to earnings from social public products. In practice, residents from the resident country mainly establish subsidiaries or branches in the source country to make investment. In case of subsidiaries, as subsidiaries are residents of the source country, the source country is entitled to levy their positive incomes (business profits); in case of branches, the source country is entitled to levy positive incomes of branches constituting permanent establishment based on the fact that whether branches constitute permanent establishment (PE) with physical existence because the source country provides branches with interests, such as improved legal system, good market environment and stable financial market. This is “positive income is levied in the source country”. In the meantime, in terms of passive incomes from equity investment, debt investment, concession license, etc. on subsidiaries and permanent establishment by residents in the resident country (investment income, income from major immovable property, dividend, interest, royalty fee, property income, etc.), such incomes are formed based on assets and other factors provided by the resident country. Therefore, besides that the source country could collect lower withhold income tax on such passive incomes according to the tax treaty, the resident country could levy such passive incomes and eliminate double taxation through method of tax credit, foreign tax exemption, etc. This is “passive income is levied

in the resident country”. The basic rule of “positive income is levied in the source country and passive income is levied in the resident country” forms main features that single corporate serves as an independent tax subject and income source is classified and distributed, emphasizes the legal formalism that single corporate (permanent establishment) serves as tax subject, introduces the transfer pricing rule for positive incomes transferring profits through cost, expenditure and other methods, emphasizes the arm’s-length principle, and intends to adjust the pricing mechanism of related transactions through determination of comparable transaction to prevent profit transfer. As for passive incomes, anti-avoidance rules such as beneficial ownership, controlled foreign corporation (CFC) and earnings-stripping are determined to prevent taxpayer from evading and avoiding tax payment through tax deferral, establishment of conduit corporate and abuse of tax favored benefits.

2.2. Definition, Main Application Scenes and Features of Digital Economy

In 2021, National Bureau of Statistics released the *Statistical Classification of Digital Economy and Its Core Industries (2021)*, in which China official authority provided official definition of digital economy. Digital economy refers to a series of economic activities which take data resources as a key production factor, modern information network as an important medium and effective use of information communication technology as a significant driving force for efficiency improvement and economic structure optimization. It is divided into 5 categories, including digital product manufacture industry, digital product service industry, digital technology application industry, digital factor driven industry and digital efficiency improvement industry. From the perspective of content, the former three categories are mainly related to the physical medium on which the digital economy is based as well as relevant bottom technical means, such as physical equipment manufacture, digital service (such as wholesale, release, retail, etc. of digital products) and digital technology (such as software development, signal tradition, Internet service, information technology service, etc.) that digital economy is involved in. The 5th category “digital efficiency improvement industry”, which is produced by empowerment of traditional industry with application of digital service and digital technology, divides digital economy into smart agriculture, intelligent manufacture, smart logistics, digital government, digital society, etc. from the perspective of industry, is mainly applied to statistic caliber and provides no detailed description of specific application scenes of digital economy. The 4th category “digital factor driven industry” is regarded as the actual application scene of digital economy combined with people’s daily life, mainly including Internet platform, Internet wholesale and retail, Internet finance, digital content and media, information infrastructure construction, data resources, property transaction, etc., which brings huge difficulties to the use of existing cross-border income tax collection rules. In the 2015

BEPS Plan Interim Report, OECD takes digital economy as the primary issue for research with such features as liquidity, dependence on data, network effect, tendency of expansion, monopoly or oligopoly of multilayer business mode and variability and considers that its main business mode includes e-commerce, app store, network advertisement, cloud computing, participating network platform, high-frequency trading and online payment service (OECD, 2015).

The author believes that, although Chinese official summarization on specific application scenes of digital economy has certain difference with OECD research in the form of expression, application scenes with impacts on cross-border income tax collection rules mainly include following three categories in terms of the business mode nature of main application scenes of digital economy. The first is e-commerce, which means physical goods or offline services are sold on the Internet platform upon combination ICT and traditional goods trade, including two modes, specifically Internet platform serves as infomediary to arrange transactions between the buyer and seller and the seller builds the Internet platform for commodity and service sales; the second is users' direct payment of consideration for remote rendering of digital products and digital services for users with the ICT, such as computer software, digital product, cloud computing, app store, high-frequency trading and online payment; the third is activity paid by the third party, such as online advertisement, participating network platform, and digital media, under which the payer is not the user of services and relevant products. Although OECD has summarized several features of digital economy, its main features related to cross-border income tax collection reflected by the three application scenes aforesaid are stated as follows:

Firstly, data has become an essential production factor of the digital economy. Although there is still controversy about the authentic right of data in the academic circle, digital economy could actually analyze massive data provided by various market subjects and use it as the basis for goods and services improvement; at the same time, digital economy could also analyze users' trading habits through these data to greatly facilitate the conclusion of transactions. This has described that data is becoming an independent production factor to create value for economic development. For instance, e-commerce platforms provide suggestions for product design and manufacturing through data collection and analysis and push them to accurate users, which significantly reduce the transaction costs.

Secondly, digital economy is invisible and liquid. At first, the underlying logic of digital economy lies in the application of ICT, as well as great dependence on data and intangible assets such as intellectual property, non-patent technology and business secrets. Liquidity is the basic attribute of data and intangible assets. Usually, the right of data and intangible assets could be easily distributed and transferred among relevant enterprises, and their ownership could be separated from development activities of such assets. Next, business functions related to digital economy could significantly reduce the cost of organization and coordi-

nation of long-distance complicated activities and multinational enterprise groups become increasingly capable to manage their global business in a centralized administration mode, breaking the limitation that actual operation location and suppliers or customers must stay in the same region. At last, from the perspective of users, with continuous development and integration of the global economy, users have more opportunities to cross the country border and users could use and enjoy digital products or services provided based on data and intangible assets in different tax jurisdictions (OECD, 2015).

Thirdly, digital economy is greatly dependent on user participation. As mentioned above, data as a production factor is one of main features of digital economy, and user is one of main sources of data on which digital economy is dependent, accordingly multinational companies could improve efficiency in decision-making, management and production, and obtain user groups accurately through analysis of such data. This tendency greatly improves the ability of multinational companies to transfer the use of user information into commercial profits, which means users have actual participation in the process of value creation of multinational companies. The most significant example is online advertisement. Multinational companies deliver advertisements to users while providing services for users with the ICT and advertisers pay advertising fees to multinational companies accordingly. Obviously, advertisers making payment to multinational companies are driven by the potential influence of users.

Fourthly, digital economy has natural characteristic, monopoly. In the digital economy, digital platform stays in the bilateral market and connects users at both ends. Due to the existence of cross network effect, the more users connected to one end, the more attractive the platform is to users at the other end; the more users connected to both ends, the more adhesive the platform is to the users. In the meantime, as digital economy is greatly dependent on data, the control over user data by multinational companies may form certain data barriers to prevent their potential competitors and accelerate the form of their monopoly position. In addition, the development of digital economy also depends on algorithms. Multinational companies could achieve algorithm collusion and form such advantage in cross-market competitive to help them realize monopoly (Lei & Wu, 2021).

2.3. Influence from Digital Economy on Existing Cross-Border Income Tax Collection Rules

The main applicable logic of existing rules follows three routes. Firstly, it is supposed to recognize the category of relevant incomes, positive income or passive income. Secondly, as for positive incomes, it is required to judge the positive income comes from subsidiaries or branches. In case of subsidiaries, the source country is naturally entitled to levy positive incomes. In case of branches, it is required to judge whether permanent establishment is constituted in the source country. If permanent establishment is constituted, the source country is entitled

to levy positive incomes; if permanent establishment fails to be constituted, the resident country shall levy positive incomes. Thirdly, as for passive incomes, after the source country collects lower withhold income tax according to the tax treaty, the resident country could levy such passive incomes and eliminate double taxation. Upon analysis of theoretical foundation and applicable logics of existing rules and in combination of above features of digital economy, the author considers that the use of existing rules has following problems under the background of digital economy:

2.3.1. It Is Difficult to Recognize the Property of Incomes and Identify the Attribute of Incomes

As mentioned above, the first step to use existing rules is to recognize the category of relevant incomes, positive income or passive income, and then use different rules. As for positive incomes, in case of subsidiaries, the source country shall exercise the right of taxation for positive incomes attributed to subsidiaries because subsidiaries are residents of the source country; in case of branches, judgement on the constitution of permanent establishment is required and the source country is entitled to levy positive incomes attributed to branches. As digital economy is mainly dependent on intangible assets such as intellectual property, non-patent technology and business secrets, such intangibility makes it difficult to recognize the attribute of incomes. For instance, it is controversial to classify incomes from cloud computing into business profit or royalty fee. At present, there is no specific definition of the property of incomes from cloud computing service in most countries, and only the United States classifies cloud computing service into the incomes or rendering of services from property lease (similar to business profits in China) in the items of income tax (Chen, Ding, & Lv, 2022). In the meantime, as the ownership of intangible assets could be separated from development activities, it is difficult to identify the attribute of positive incomes aforesaid, which further influences the distribution of the right of taxation.

2.3.2. Permanent Establishment Becomes Vague

After the income is recognized as positive income, recognition of “permanent establishment” is the key to determine whether the source country could exercise the right of taxation. When a non-resident enterprise has connection point of physical property in the source country and associates with the source country based on “economic allegiance”, the source country is entitled to levy positive incomes attributed to such connection point (permanent establishment). The rule of traditional permanent establishment, formulated in the Industrial Age which focuses on goods trade, emphasizes that permanent establishment with physical attribute is mainly divided into “place” permanent establishment and “agent” permanent establishment. The invisibility and liquidity of digital economy enables the concept of the permanent establishment void and non-resident enterprises are less dependent on institutions and places of physical property.

With the application of ICT, non-resident enterprises could obtain incomes without the help of overseas subsidiaries, branches and other mediums to avoid tax collection by the source country. At the same time, analysis of data collected from users through algorithms could create values because digital economy is dependent on users but void permanent establishment further reduces the possibility of the source country to enjoy the right of taxation.

2.3.3. Profit Shift Is Intensified

As mentioned above, the invisibility and liquidity of digital economy enables the ownership of intangible assets to be separated from development activities, while the tax resident identity of single corporate is usually identified according to the place of registration, which brings multinational enterprise groups more opportunities to shift profits through establishment of related parties in the tax haven. For example, profits are shifted to related tax non-residents established abroad, in the tax haven under most circumstances, by means of royalty fees, interest, etc. The monopoly characteristic of digital economy accelerates consistent interests among internal subjects of the multinational enterprise group and further increases its opportunity in profit shift. Although different countries have basically formulated the rule of transfer pricing, intending to find comparable transaction to determine a fair transaction price among related parties to prevent tax base erosion, a fundamental problem occurs no matter for the comparable uncontrolled price method, resold price method, cost-plus method, or the profit split method, transactional net margin method. To be specific, tax authorities are unable to find a fair comparable price under all circumstances. Taxpayers are usually difficult to undertake the responsibility to lodge a proof; as for tax authorities, different rule of tax law and different law enforcement in different countries not only increases their costs of tax collection and administration but also easily produces unfair results (Arnold, 2020).

2.4. Combination of Digital Economy and Corporate Income Tax System Is Main Reason of the Problems Aforesaid

The logic of existing rule system starts from distinguishing positive income and passive income and then using different rules, which is mainly caused by the corporate income tax system. The business income of single corporate (including permanent establishment) is positive income and connected with the source country based on the principle of “economic allegiance”, which works as the basis that the source country exercises the right of taxation. In the Industrial Age when goods transaction served as main pattern of trade, the rules aforesaid was able to solve problems of cross-border income tax collection and alleviated duplicated taxation to certain extent. However, upon one-hundred years of practice, the corporate income tax system which takes single corporate as the tax subject, considers net profits as the tax base and formalizes recognition of the tax resident identity (using the place of corporate registration as the standards to judge

tax residents) provides multinational enterprise groups with convenience to evade and avoid taxation and is the institutional root of the failure of existing rule system (Xu & Xu, 2022).

The development of digital economy further expands negative impacts of the corporate income tax system on existing cross-border income tax collection rules. Digital economy, which takes data and other intangible assets as production factors, is invisible and liquid, and multinational enterprise groups, under the corporate income tax system, are easier to shift profits among related subjects through cost, expenditure and other methods. Accordingly, these features make it more possible for multinational enterprise groups to avoid the “permanent establishment” system for profit shift and erosion of the tax base. In the meantime, multinational enterprise groups could delay profits distribution to defer tax and select treaties to avoid tax through conduit companies due to formalization on the identity of tax residents and differences in treaties for some passive incomes in each country (region), while digital economy further expands negative influence from the corporate income tax system on existing rules. In addition, high dependence of digital economy on users should usually endow the source country with greater right of taxation. However, with development of the digital economy and combination of the corporate income tax system, the tax base of the source country suffers erosion more frequently. The natural monopoly of digital economy makes multinational enterprise groups related to digital economy more possible to form a monopoly position and further improves the interest correlation among their internal subjects. Accordingly, multinational enterprise groups are more motivated and capable to evade and avoid tax payment as mentioned above for the sake of economic interests. All these actions aforesaid have seriously eroded the tax base of the source country and simultaneously increased the possibility for the overall tax base of multinational enterprise groups to be eroded. To sum up, the combination of digital economy and corporate income tax system is the main reason for the failure of existing cross-border income tax rules.

3. Reflection on the Theory of Cross-Border Income Tax Collection Rules under the Background of Digital Economy

Existing rule system is based on the benefit principle and the combination of digital economy and corporate income tax system is the main institutional root of the failure of the above rule system. To solve problems aforesaid, it is required to demonstrate and prove the legitimacy of the right of taxation of the source country under the background of digital economy, conduct deep reflection on the alienation of the benefit principle under the combination of digital economy and corporate income tax system, and further propose reasonable transfer from “economic allegiance” to “theory of value creation” and lay a theoretical foundation for reconstruction of the rule system.

3.1. Legitimacy of the Right of Taxation of the Source Country

The right of taxation is a necessary national sovereignty. The new round of international tax reform since 2013, on one hand, devotes to improving the coordination and transparency and containing the problem of tax evasion and avoidance in the world; on the other hand, proposes innovative solutions to disputes on uncertain division of the right of taxation caused by digital economy and its business mode. In order to achieve the purpose aforesaid, the international society has reached a consensus that profits shall be levied at the place of economic activity occurrence and value creation (Zhang & Li, 2021), which means the right of taxation shall match the place of economic activity occurrence and value creation. In the Industrial Age in the 1920s when goods transaction served as basic pattern of trade, based on the traditional supply-based approach, enterprise profits are created after such two factors as assets or labor are included in enterprises operation and the contribution of market demands to enterprise profits is denied. The resident country is naturally entitled to collect tax because enterprise profits come from the resident country; the “permanent establishment” qualification is established due to the existence of corporate income tax system, with which the source country could exercise the limited right of taxation. Since the end of the 20th century, the supply-based approach is unable to adapt to current economic development situation, establishment of physical existence, including business institutions, places or agents, in the sales market is not necessary anymore, and rapid development of digital economic reinforces such trend. And as developing countries, as market demand countries, develop constantly, they have interest demands on tax base sharing. The supply-based approach is gradually replaced by the supply-demand based approach based on production and sales, which describes that supply and demands act together to create profits (Liao, 2021). The value of commodity is reflected by its price and the price is determined by both supply and demands. There are lots of market factors that affect demand changes, such as income level and consuming capacity of consumers, price of relevant alternatives, consumer preferences and the number of consumers, which all exert impacts on the price of commodity and contribute to the value of commodity (Mankiw, 2010). In summary, the value of commodity is influenced by the source country (market demand country) even under the traditional economic mode. The source country makes more significant contributions to the creation of commodity value under the background of digital economy. Digital economy is mainly characterized with data, an inseparable production factor, and its dependence on user participation. One of functions of data application is to collect tremendous data from users of the source country, provide suggestions for improvement on the quality of commodities and services through algorithm analysis, and simultaneously push them to accurate users in accordance with user habits, and further make contributions to value creation. Therefore, in accordance with the fundamental theory that “profits shall be levied at the place of economic activity occurrence and value creation”, the source country with the right of taxation is legitimate.

3.2. Alienation of the Benefit Principle under Existing Rules

3.2.1. The Benefit Principle Has Double Meaning

Tax theory, starting from the “Exchange Theory” of the Social Contract Theory, states that taxes paid by taxpayers should be the cost consideration of public products provided by the government; the benefit principle is gradually accepted because public products provided by the government cannot be measured exactly, which means taxes are the consideration of incomes from the government. This is the preliminary concept of the benefit principle. As the society pays attention to fair taxes, the “Exchange Theory” is replaced by the “Theory of Payment Ability” step by step (League of Nations, 1923). One of key factors to measure the design quality of tax systems is to judge whether such tax system is fair with the Theory of Payment Ability as an important standard (Mankiw, 2010). The Theory of Payment Ability means that taxpayers with stronger payment ability shall pay more taxes and taxpayers with similar payment ability shall pay equivalent taxes. Therefore, the benefit principle shall be interpreted under the Theory of Payment Ability to understand its whole meaning, specifically, the payment ability of a person could be measured according to his/her degree of benefit and the degree of benefit could be measured according to his/her incomes. It is shown from the contents aforesaid that the benefit principle shall have double meaning. Firstly, taxes paid by taxpayers are the consideration of public products provided by the government; secondly, the amount of taxes paid should be directly proportional to the degree of benefit, that is, incomes.

3.2.2. Alienation of the Benefit Principle—The Payment Ability of Single Corporate Fails to Be Measured Effectively

With occurrence of an organization form – corporate and the corporate income tax system, corporate, as an independent legal entity with juridical personality, is entitled to obtain, own and dispose of the property and seems to accept measurement of its payment ability. However, in fact, the corporate could shift profits through related transactions because the tax base of corporate income tax belongs to net profits of the corporate. Therefore, the degree of incomes of single corporate is insufficient to reflect its actual degree of benefit. For instance, certain single corporate with negative net profits of the multinational enterprise group is not required to pay the corporate income tax but obviously benefits from public products provided by the government. Therefore, the fiction theory of the corporate has decided its failure in tax payment and only the natural person could become the tax subject (Harris, 2010). In respect of the essence of the corporate, there are academic theories, such as corporate contract theory, corporate community theory, corporate team production theory, corporate constitution theory, royalty theory and natural entity theory (Easterbrook, 2016), which are generally divided into three categories, including corporate contract theory, fiction entity theory and natural entity theory. Analyzing the corporate income tax, the author considers that the fiction entity theory and natural entity theory could be classified into one category, collectively referred to as “entity theory”,

which means the corporate with independent juridical personality could pay taxes independently. However, the “entity theory” is unconvincing due to alienation of the benefit principle caused by the corporate income tax system. In the corporate contract theory, corporate is considered as a “contract bundle” (nexus of contracts) or a group of “implicit” or “specific” contract economic structure, and an assembly of contracts of a series of interested parties such as shareholders, creditors, suppliers and customers. The corporate income tax levied could be treated as withhold income tax collected for individual incomes of natural person shareholders (Green, 1993). In the meantime, the invisibility and liquidity and other features of digital economy equips single corporate subject with more possibilities to shift profits through related transactions, and the ownership of data and intangible assets could be separated from development activities of such assets, which further aggravates the problems aforesaid. Therefore, actual ability of benefit of single corporate cannot be measured effectively when single corporate serves as an independent taxpaying subject. This is the alienation of the benefit principle, which goes against tax fairness.

3.3. Transfer from “Economic Allegiance” to Theory of Value Creation

As mentioned above, existing rule system based on the benefit principle takes the traditional supply-based approach as the theoretical foundation and emphasizes the tax jurisdiction of the resident country. When the non-resident enterprise is qualified for a “permanent establishment” in the source country, the source country enjoys the right of taxation. And the “economic allegiance” serves as main theory that “permanent establishment” is connected to the right of taxation of the source country. A report in 1923 states that it is supposed to use various factors that could increase the ability to obtain wealth and consumption ability as the basis for taxation of taxpayers in related countries with these factors, the theory of “economic allegiance” is developed from the correlation between these factors and tax jurisdictions, the source of wealth, attribution of wealth, enforcement power of wealth as well as residence or domicile consumed, possessed or disposed and other connection factors are summarized upon analysis of the acquisition, possession and dispose of wealth (Lin, 2020), and the average tax base distribution pattern for the resident country and source country is formed. The author considers that with supply-based approach as its theoretical foundation, which emphasizes the contribution of such two factors as assets and labor to value, the “economic allegiance” aforesaid also emphasizes the contribution of such two factors as assets and labor of the source country to value. The source country enjoys the right of taxation when the combination of such two factors as assets and labor is qualified for the “permanent establishment” of physical existence property. This not only demonstrates the economic background of the Industrial Age at that time but also reflects the interests of developed countries as capital-exporting countries. However, as mentioned above, with development of economic globalization and digital economy, the supply-based approach

aforesaid, unable to adapt to current economic development, has been gradually replaced by the supply-demand based approach based on production and sales, which describes that supply and demands act together to create profits. At the same time, with development of digital economy, intangible assets such as data have become an indispensable key production factor. Data itself also contributes to value creation and the dependence of digital economy on users further enables the source country (market demand country) to make more contributions to value. And with development of economic globalization, the world has gradually formed a global cooperation system, the multinational enterprise group is also developing its global supply chain layout, the development of digital economy enables both the production demander and sales demander to be possibly located in several different tax jurisdictions, and the traditional average tax base distribution pattern for the source country and resident country may change accordingly. The theory of value creation that “profits shall be levied at the place of economic activity occurrence and value creation” may be good for understanding and reconstructing the cross-border income tax collection rules. Macroscopically speaking, the benefit degree of taxpayers is related to the wealth obtained and the overall wealth obtained by all taxpayers shall comply with the overall value of the wealth created by the society. Therefore, it is able to solve the basic theoretical problem about tax base division of cross-border income tax collection and beneficial to solving the alienation of the benefit principle aforesaid when the value is distributed among different tax jurisdictions with formulas and methods according to the contribution degree.

To sum up, using the theory of value creation to replace the theory of economic allegiance is more consistent with the development background of economic globalization and digital economy and simultaneously good for demonstrating double meaning of the benefit principle.

4. Basic Position on Reconstruction of Existing Rule System

The combination of the benefit principle and the theory of value creation, which is better to reflect the theory of payment ability which measures whether the tax system is fair, should serve as the theoretical foundation on reconstruction of cross-border income tax collection rules. The corporate income tax system is the main institutional reason for the defects of existing rules and digital economy aggravates the negative impact on existing rules. It is supposed to pay special attention to the coordination of the corporate income tax system with the benefit principle and the theory of value creation under the background of digital economy for reconstruction of the rule system.

4.1. Necessity of the Corporate Income Tax System

The alienation of the benefit principle caused by the corporate income tax system originates from the fact that the corporate income tax system takes single corporate as the tax subject, considers net profits as the tax base and formalizes recognition of the tax resident identity, and the invisibility and fluidity of digital

economy aggravates the alienation aforesaid. Therefore, the first problem to be solved is to judge whether the corporate income tax is necessary. The author considers that, corporate should be considered as a “contract bundle” (nexus of contracts) or a group of “implicit” or “specific” contract economic structure, and an assembly of contracts of a series of interested parties such as shareholders, creditors, suppliers and customers. The corporate income tax levied could be treated as withhold income tax collected for individual incomes of natural person shareholders. As corporate has become a main strength of global economic development and such organization form as legal person has formed mature systems in different countries, the reasonability of corporate should be treated correctly. From the perspective of tax collection and administration, the amount of corporate is obviously less than that of individuals and it is easier to reduce management costs through collection of income tax on corporate compared with individuals. On the contrary, if the corporate income tax is withdrawn, corporate, as an entity with independent corporate capacity, may suffer severe tax payment deferral. Therefore, the corporate income tax system is necessary.

4.2. Transfer of Tax Subject from Single Corporate to Multinational Enterprise Group Uses the Formula Distribution Method

4.2.1. Coordinating with the Benefit Principle—Multinational Enterprise Group Serves as the Tax Subject

After acknowledging the corporate income tax system is necessary, it is required to realize coordination between the corporate income tax system and the benefit principle under the background of digital economy. As mentioned above, the corporate income tax levied could be treated as withhold income tax collected for individual incomes of natural person shareholders. The thorough solution to measure the payment ability of a multinational corporate accurately is to abandon the method which takes the single corporate as the tax subject and considers the whole multinational enterprise group as the tax subject, under which the overall tax base of multinational enterprise group will not be eroded and profit shift and tax base erosion caused by the invisibility and liquidity of digital economy will vanish. When the whole multinational enterprise group serves as the tax subject, it is of vital importance to select the place for taxation of such multinational corporate. Such tax jurisdiction, not only responsible for tax collection on the whole multinational enterprise group but also responsible for collection and sharing of relevant tax information of the multinational enterprise group as well as tax base division of other related tax jurisdictions, requires strong capability in tax collection and administration. Theoretically, it seems more reasonable to take the location of the next corporate entity of the actual controller as the place of taxation because it is relatively accurate to measure the payment ability of a natural person. However, in practice, it should take the tax declaration ability of the corporate entity in the place of taxation and the ability of local tax authority in tax collection and administration into full consideration and prevent the pos-

sibility that the actual controller selects the place of taxation manually. And primary office of the headquarters of a multinational corporate, usually located in the tax jurisdiction with developed economic situation and comparatively improved legal environment as well as strong ability in tax collection and administration, is appropriate to serve as the place of taxation. The standards for recognition of the place of primary office of the headquarters of a multinational corporate are determined according to the tax treaty.

4.2.2. Coordinating with the Theory of Value Creation—Using the Formula Distribution Method

In existing rules, the source country exercising the right of taxation depends on the rule of “permanent establishment” which is theoretically based on the “economic allegiance” theory about the contribution of such two factors as assets and labor of the source country to value. However, under the background of economic globalization and digital economy, the value of commodities is contributed by intangible assets including data as well as users, not limited to such two factors as assets and labor. Therefore, the “economic allegiance” theory is unable to adapt to requirements of the development of the digital economy era. The theory of value creation that “profits shall be levied at the place of economic activity occurrence and value creation” may be good for understanding and reconstructing the cross-border income tax collection rules. Under the theory of value creation, the tax jurisdiction in the resident country and source country shall receive equal treatment and tax base is distributed according to different influence of different production factors on the value. The formula distribution method exactly complies with this requirement of the theory of value creation. In the meantime, the whole multinational enterprise group serving as the tax subject in combination of the formula distribution method and division of the tax base according to the contribution of production factors to the value in different tax jurisdictions not only acknowledges the contribution of data and other intangible assets to the value but also solves the problems about profit shift and tax base erosion by multinational corporates through related transactions. Therefore, it is suggested to calculate the overall taxable amount according to the relevant tax information collected by local tax authorities in the place where the primary office of the headquarters of a multinational corporate is located and divide the taxable amount according to distribution factors in different tax jurisdictions. In case of objection on the division of the taxable amount aforesaid, the tax jurisdictions may solve such objection properly by means of the negotiation mechanism or dispute resolution mechanism.

4.3. Coordinating the Progressive Tax Rate, Proportional Tax Rate and Minimum Tax Rate

It is a convention to use the proportional tax rate applicable to the corporate income tax but starting from the benefit principle, the proportional tax rate is neither able to distinguish the difference in incomes among different corporate

subjects nor able to fully demonstrate the benefit principle. At the same time, in respect of functions of the corporate income tax, it not only serves as withhold income tax collected for individual incomes of shareholders but also restrains the corporate from developing into monopoly. This is shown in the legislative history of collection of corporate income tax in the United States in 1909. At that time, collection of corporate income tax was used to restraint such large-scale companies as Standard Oil and Rockefeller from developing into monopoly. Guided by this function, the progressive tax rate applicable to the corporate income tax is more consistent with such function demands (Avi-Yonah, 2020). In addition, the natural monopoly property of digital economy further facilitates development of multinational enterprise groups towards monopoly. When the multinational enterprise group serves as the tax subject and the formula distribution method is used, the progressive tax rate applicable to the positive incomes of the multinational enterprise group is more consistent with the benefit principle. The formula distribution method and the progressive tax rate can mitigate the impact of natural monopoly of digital economy. However, as it is a convention to use the proportional tax rate, it is allowable to pay corresponding taxes for positive incomes, which is regarded as withhold tax, according to the proportional tax rate in the tax jurisdictions of relevant value creation. After the multinational enterprise group distributes the tax amount supposed to be distributed to different tax jurisdictions, the source country could make settlement with local tax authorities in the place where the primary office of the headquarters of a multinational corporate is located according to the amount distributed and in combination of the withhold tax amount levied. However, profit shift among different jurisdictions and tax evasion and avoidance through differences in collection and administration time in different tax jurisdictions due to different tax rates in different tax jurisdictions of the system design aforesaid still occur. As a result, it is suggested to set the minimum tax rate. The “Pillar II” Plan proposed by OECD determines the global minimum tax rate, i.e., 15% (OECD, 2020), which also serves as the system foundation of the reconstruction plan mentioned herein.

4.4. Positive Income Is Levied in the Resident Country and Passive Income Is Levied in the Source Country

The theory of value creation based on the supply-demand based approach is the theoretical foundation of formula distribution. Under economic globalization and development of digital economy, it is supposed to respect the formed customary international law and fully respect existing tax collection rules with source classification and distribution as the basis, which refers to reasonability of division of positive incomes and passive incomes when existing cross-border income tax collection rule system is reconstructed. Under the background of digital economy, it is unfair for the resident country if positive incomes and passive incomes serve as the unified tax base for distribution according to relevant

factors because the value creation is more dependent on data and other intangible assets and mainly benefits from the resident country. In addition, as mentioned above, the corporate income tax system is particularly necessary and distinguishing positive incomes and passive incomes is one of important features of the corporate income tax system. As a result, it is suggested to distinguish positive incomes and passive incomes.

As for positive incomes, when the corporate income tax system becomes an international general tax system, it is suggested that positive incomes are gathered, the place where the primary office of the headquarters of a multinational corporate is located (resident country) levies positive incomes as per the progressive tax rate and uses the formula distribution method to distribute them to relevant countries according to their value contribution. Under this circumstance, transfer pricing, earnings stripping, capitalization and other systems are still necessary to measure the reasonability of related transactions but subordinate to existing systems. As for passive incomes, in order to prevent loss of tax base of passive incomes, it is suggested that the income tax is levied in the source country instead of by the source country in advance and then the source country divides corresponding tax amount to the resident country according to applicable regulations of the tax treaty because the source country could collect taxes in the payment link immediately.

5. Conclusion

The corporate income tax system is main institutional root of the failure of existing rules, and digital economy aggravates the negative impact of the corporate income tax system on existing rules and makes exiting rules seriously deviated from the benefit principle. No matter the BEPS package of plans led by OECD or unilateral or bilateral measures adopted by the country and main international organizations all fail to fully notice the above reasons for the failure of existing rule systems. Therefore, they are certainly unable to solve problems such as profit shift and tax base erosion thoroughly. The author considers that it is necessary to recognize that corporate income tax is the institutional root, pay full attention to the overlapping influence of digital economy, use the rule system which takes the whole multinational enterprise group as the tax subject, take the formula distribution as the method, take the progressive tax rate as the improvement direction and adopt “positive income is levied in the resident country and passive income is levied in the source country” to solve the problems aforesaid and realize authentic fair taxation.

Conflicts of Interest

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

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