

Hong Kong Tax Alert

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OECD releases statement in October finalizing certain quantitative parameters including the global minimum tax rate be set at 15%, 25% of the residual profits of an in-scope MNEs be allocated to the market jurisdictions and the tax rate for the subject to tax rule be at 9%

On 8 October 2021, at the conclusion of a virtual meeting of the OECD¹/G20² Inclusive Framework on BEPS³ (the Inclusive Framework), the OECD released a statement reflecting the agreement reached by 136 out of the 140 Inclusive Framework members on core design features of the two-pillar solution developed in the BEPS 2.0 project (October Statement)⁴.

The October Statement describes agreed components with respect to both pillars of the project:

- ▶ *Pillar One on revisions to nexus and profit allocation rules*
- ▶ *Pillar Two on new global rules that seek to introduce a minimum tax*

The October Statement builds on the statement released in July 2021, providing further specificity on several key parameters. In particular, the amount of residual profit to be re-allocated to market jurisdictions under Pillar One has now been set at 25% (as compared to 20-30% as provided in July) and the rate for the minimum tax under Pillar Two has now been agreed at 15% (as compared to “at least 15%” as provided in July). In addition, other thresholds, rates and administrative mechanisms are covered in the October Statement.

1. Organisation for Economic Co-operation and Development

2. The G20 includes the European Union and 19 individual countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

3. Base Erosion and Profit Shifting

4. <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

Additional substantive and technical details for key elements of both pillars have not yet been released, including revenue sourcing rules, adjustments for the tax base determination, design of marketing and distribution safe harbor rules, and dispute prevention and resolution rules for Pillar One; as well as rules to address timing differences, simplification mechanisms and transition rules for Pillar Two.

The October Statement includes an annex with further information on plans for implementation, providing generally for entry into effect in 2023, with the exception of the Pillar Two Undertaxed Payment Rule (UTPR) that is to enter into effect in 2024.

The G20 Finance Ministers are scheduled to consider the outcome of the Inclusive Framework meeting at their meeting in Washington on 12-13 October 2021.

Detailed discussion

October Statement

On 8 October 2021, the OECD published a statement⁵ indicating that the Inclusive Framework has agreed on a two-pillar solution to address the tax challenges arising from the digitalization of the economy. 136 out of 140 jurisdictions of the Inclusive Framework have agreed to the October Statement. Estonia, Hungary and Ireland, which did not join the July agreement, have joined the October Statement. Pakistan, which joined the July statement, has not joined the October Statement. Kenya, Nigeria, and Sri Lanka did not join either statement.

The October Statement updates the July Statement regarding the conceptual agreement on fundamental reforms to international tax rules. The July Statement is described in detail in our previous Hong Kong Tax alert⁶. Key updates included in the October Statement are outlined below:

Pillar One

- ▶ The scope of Amount A is restated without change as multinational entities (MNEs) with a global turnover above €20 billion and profitability above 10%. These thresholds will be calculated using an average mechanism (this mechanism has not been described in detail).
- ▶ Amount A will allocate 25% of “residual profits”, which is defined as profit in excess of 10% of revenue, to market jurisdictions with nexus using a revenue-based allocation key (as compared to the 20-30% range provided in the July Statement).
- ▶ A mandatory and binding dispute resolution mechanism will be available for all issues related to Amount A. For certain developing countries, an elective binding dispute resolution mechanism will be available. The eligibility of a jurisdiction for the elective binding dispute resolution mechanism will be regularly reviewed. If a jurisdiction is found to be ineligible, it will remain ineligible in all subsequent years.
- ▶ The removal of all Digital Services Taxes and other relevant similar measures with respect to all companies will be required by the Multilateral Convention (MLC) through which Amount A is to be implemented. No newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the MLC.
- ▶ The October Statement reiterates that the MLC through which Amount A is implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023.



5. Together with the statement, the OECD also released a set of Frequently Asked Questions and a brochure providing additional background and information on this development: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm>

6. https://www.ey.com/en_cn/hong-kong-tax-alerts/hong-kong-observations-on-beps-2-0-developments

Pillar Two

- ▶ It is restated that Inclusive Framework members are not required to adopt the Global Anti-Base Erosion (GloBE) rules but if they choose to do so, they should implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two, including the model rules and guidance agreed to by the Inclusive Framework. It also is restated that Inclusive Framework members accept the application of the GloBE rules applied by other Inclusive Framework members.
- ▶ The October Statement restates that the GloBE rules will apply to MNEs with total consolidated group revenue of at least €750 million as determined under country-by-country reporting.
- ▶ The design of Pillar Two is restated, including the GloBE rules, consisting of the Income Inclusion Rule (IIR) and the UTPR, and the Subject to Tax Rule (STTR). Exclusion from the UTPR will be available for MNEs in the initial phase of their international activity (i.e., MNEs with a maximum of €50 million tangible assets abroad that operate in no more than five other jurisdictions). This exclusion is limited to five years after the MNE comes into the scope of the GloBE rules for the first time.
- ▶ In respect of existing distribution tax systems, there will be no top-up tax liability if earnings are distributed within four years (as compared to the three or four years provided in the July Statement) and taxed at or above the minimum level.
- ▶ The minimum tax rate for purposes of the IIR and UTPR will be 15% (as compared to “at least 15%” provided in the July Statement).
- ▶ The substance-based carve out is modified from the July Statement, with a transition period of 10 years (rather than 7 years) during which the amount excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually for the first five years by 0.2 percentage points, and for the last five years by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll. After the transition period, the amount excluded will be 5% of the carrying value of payroll and tangible assets.
- ▶ A de minimis exclusion is provided for those jurisdictions where the MNE has revenues of less than €10 million and profits of less than €1 million.
- ▶ The nominal tax rate used for the application of the STTR will be 9% (as compared to the 7.5-9% range provided in the July Statement).
- ▶ It is restated that Pillar Two will apply a minimum rate on a jurisdictional basis. It also is restated that in that context, consideration will be given to the conditions under which the United States Global Intangible Low-Taxed Income regime will co-exist with the GloBE rules, to ensure a level playing field.
- ▶ The October Statement reiterates that Pillar Two generally should be brought into law in 2022, to be effective in 2023. However, the entry into effect of the UTPR has been deferred to 2024.

Implementation

The October Statement includes an annex with information regarding the implementation plan, including target dates.

According to the plan for Pillar One, Amount A will be implemented through an MLC, regardless of whether a tax treaty currently exists. Where necessary, Amount A will also be implemented by way of correlative changes in domestic law. The Task Force on the Digital Economy will seek to conclude the text of the MLC and its Explanatory Statement by early 2022 so that the MLC is open for signature by mid-2022. Jurisdictions will be expected to ratify the MLC as soon as possible after having signed it, with the aim for it to be in force and with effect from 2023. The Task Force on the Digital Economy will also develop model rules for domestic legislation by early 2022.

Pillar Two model rules and accompanying commentary will be developed by the end of November 2021. A model treaty provision to give effect to the STTR also will be developed by the end of November 2021. An MLI will be developed by the Inclusive Framework by mid-2022 to facilitate the implementation of the STTR in bilateral tax treaties. The model treaty provision will be supplemented by commentary that explains the purpose and the operation of the STTR. A process to assist in implementing the STTR will be agreed. By the end of 2022 at the latest, an implementation framework will be developed to facilitate the implementation of the GloBE rules.

Target deadlines

Pillar One

Early 2022	Text of an MLC and Explanatory Statement to implement Amount A of Pillar One
Early 2022	Model rules for domestic legislation necessary for the implementation of Pillar One
Mid 2022	High-level signing ceremony for the MLC
End 2022	Finalization of work on Amount B for Pillar One

Pillar Two

November 2021	Model rules to define scope and mechanics for the GloBE rules
November 2021	Model treaty provision to give effect to the subject to tax rule
Mid 2022	MLI for implementation of the STTR in relevant bilateral treaties
End 2022	Implementation framework to facilitate coordinated implementation of the GloBE rule

2023	Implementation of the Two-Pillar Solution
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Next steps

It is expected that the G20 Finance Ministers will endorse the outcome of the Inclusive Framework meeting at their meeting in Washington on 12-13 October 2021.

Implications

The October Statement marks an important milestone in the BEPS 2.0 project on fundamental changes to the global tax rules, with all OECD and G20 countries (including the European Union) now supporting the agreement on key parameters. However, more work will be required to reach agreement on some key design elements of the two pillars. In addition, there is significant work to be done to fill in the substantive and technical details in the development of the planned model rules, treaty provisions, and explanatory material. That work will need to be completed quickly in order to meet the timelines reflected in the implementation plan. It should be noted that while the October Statement provides that the work will continue to progress in consultation with stakeholders, the implementation plan provides limited time for policymakers to engage with businesses and other stakeholders. Therefore, companies that wish to provide input into the process should seek to engage now as the Inclusive Framework turns its attention to the next steps following the October Statement.

It is important for companies to follow these developments closely as they unfold in the coming months and to evaluate the potential impact of the global tax changes on their businesses, especially given the very ambitious implementation timeline. In addition, looking ahead, companies will need to monitor activity in relevant jurisdictions related to the implementation of these proposed rules through changes in domestic tax rules and bilateral or multilateral agreements.

Implications for Hong Kong

As an international financial and commercial center, the HKSAR Government reiterated its earlier position that Hong Kong will actively participate in and implement this BEPS 2.0 package based on the BEPS 2.0 model rules to be finalized by the OECD. Stakeholders will also be consulted during the domestic legislative exercise⁷.

The HKSAR Government acknowledged that the proposed changes would reduce the effectiveness for tax jurisdictions to introduce tax exemption or extremely low preferential tax rate as a means to enhance their tax competitiveness in future. However, this would also mean that Hong Kong will be able to reinforce its competitive advantages under a more level playing field in terms of taxation.

While there will be reduced scope of tax competition when BEPS 2.0 initiatives are implemented, the competition for investments will be shifted to other areas such as talent supply, infrastructure etc. As such, it is imperative for the HKSAR Government to further enhance the business environment to maintain the attractiveness of Hong Kong in the post-BEPS era.

Coupled with the proposed amendments to Hong Kong long-established territorial source regime in respect of passive income (e.g., interest, royalties and dividends) in order for Hong Kong to be removed from the EU's "gray list", and not moved to the "black list", the inclusion in the latter could attract sanctions from EU member states⁸, there will be sea changes to the Hong Kong domestic tax law in the next year. Taxpayers should closely monitor these developments and contact their tax advisors to understand how these changes would impact their investments and businesses.



7. <https://www.info.gov.hk/gia/general/202110/09/P2021100900320.htm>

8. For more details, please refer to our Hong Kong Tax alert – 6 October 2021 (2021 Issue No. 7): https://www.ey.com/en_cn/hong-kong-tax-alerts/eu-concluded-that-hong-kong-offshore-income-exemption-regime-as-regards-passive-income-is-harmful

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