

Hong Kong Observations on BEPS 2.0 Developments

July 2021

Executive Summary

On 9-10 July 2021, the G20¹ Finance Ministers and Central Bank Governors met in Venice. At the conclusion of the meeting, a joint communiqué (the communiqué) on key topics discussed at the meeting was issued. With respect to the ongoing G20/OECD² project on addressing the tax challenges arising from the digitalization of the economy (the BEPS 2.0 project), the Finance Ministers endorsed the key components of the two pillars on reallocation of profits and a global minimum tax as set out in the Statement released by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) on 1 July 2021. They also called on the Inclusive Framework to swiftly address the remaining issues, finalize the design elements within the agreed framework and provide an implementation plan for the two pillars by the October G20 Finance Ministers meeting. In addition, they invited the Inclusive Framework member jurisdictions that have not yet joined the agreement to do so.

Detailed Discussion

Background

- ▶ On 12 October 2020, the OECD released a series of major documents in connection with the BEPS 2.0 project. These documents included Blueprints on Pillar One (on new nexus and profit allocation rules) and Pillar Two (on new minimum tax rules), on which stakeholder comments were requested through a public consultation. At the same time, the OECD also released a lengthy Economic Impact Assessment that was prepared by the OECD Secretariat.
- ▶ The cover statement by the Inclusive Framework that accompanied the Blueprints indicated that while the Inclusive Framework had not reached a consensus agreement in 2020, which had been the target, they agreed to keep working to swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021.
- ▶ On 1 July 2021, the Inclusive Framework issued the "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy" which reflected the agreement of 130³ of the 139 member jurisdictions on key components of the two pillars of the BEPS 2.0 project. This followed earlier expressions of strong support for the work on the BEPS 2.0 project that were issued at the conclusion of the G7⁴ Finance Ministers and Central Bank Governors meeting in London on 4-5 June 2021 and at the conclusion of the G7 Leaders' summit in Cornwall on 11-13 June 2021.

Statement

- ▶ The 1 July 2021 Statement provides a description of agreed key components of each Pillar.

Pillar One

- ▶ The scope of the Pillar One rules is to be multinational entities (MNEs) with global turnover above €20 billion and profitability (i.e., profit before tax/revenue) above 10%. Exclusions are provided for the extractive and regulated financial services industries. The Statement notes that the turnover threshold may be reduced to €10 billion, contingent on successful implementation of the new rules including tax certainty. For this purpose, a review process would begin seven years after the agreement comes into force and would be completed in not more than a year.
- ▶ The Statement further indicates that segmentation would be applied in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment of an MNE would meet the scope rules.
- ▶ For in-scope MNEs, between 20-30% of residual profit, which is defined as profit in excess of 10% of revenue, would be allocated to market jurisdictions where there is nexus. For purposes of this allocation, profit or loss would be determined by reference to financial accounting income (with a small number of adjustments), and losses would be carried forward.

- ▶ Under a special purpose nexus rule that will apply for these purposes, the new rules for allocation to a market jurisdiction would be applicable if the in-scope MNE derives at least €1 million in revenue from that jurisdiction. A lower threshold of €250,000 would apply in the case of smaller jurisdictions that have a gross domestic product lower than €40 billion. For this purpose, revenue would be sourced to the end market jurisdiction where goods or services are used or consumed, with detailed sourcing rules to be specified.
- ▶ Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing-and-distribution-profits safe harbor would apply to cap the residual profits that are allocated to the market jurisdiction under the new rules.
- ▶ Double tax relief is to be provided under the exemption or credit method for profit allocated to market jurisdictions under the new rules.
- ▶ The Statement indicates that mandatory and binding dispute prevention and resolution mechanisms are to be provided for issues related to the new allocations to market jurisdictions. However, it further notes that consideration will be given to use of an elective binding dispute resolution mechanism for certain developing countries.
- ▶ MNEs would be allowed to manage the tax compliance process with respect to the new rules through a single entity.
- ▶ The Statement indicates that work on Amount B, relating to a simplified approach for the application of the arm's-length principle to in-country baseline marketing and distribution activities, is to be completed by the end of 2022 and will focus in particular on the needs of low-capacity countries.
- ▶ With respect to unilateral measures, the Statement references appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes (and other relevant similar measures) on all companies.
- ▶ Finally, the Statement indicates that the multilateral instrument through which the new rules for allocations to market jurisdictions are to be implemented will be developed and opened for signature in 2022, with the new rules coming into effect in 2023.

Pillar Two

- ▶ The Statement describes Pillar Two as having two elements. The Global Anti-Base Erosion (GloBE) rules are a set of interlocking rules: an Income Inclusion Rule (IIR) that allows parent entities to impose a top-up tax on low taxed income of a constituent entity, and the Undertaxed Payments Rule (UTPR) that denies deductions or requires an equivalent adjustment for low-tax income that has not been subject to tax under an IIR. The Subject to Tax Rule (STTR) allows jurisdictions to impose a withholding tax on certain related-party payments that are taxed at a low adjusted nominal rate. Although the STTR is described second, it would apply before the GloBE rules and thus take priority over those rules.

- ▶ The Statement describes the GloBE rules as having the status of a common approach, specifying that Inclusive Framework jurisdictions would not be required to adopt these rules, but, if they choose to do so, they are to implement and administer the rules in a way that is consistent with the agreed design and accept the application of such rules by other Inclusive Framework members.
- ▶ The GloBE rules would apply to MNEs with total consolidated group revenue of at least €750 million in the immediately preceding fiscal year. However, the Statement notes that countries would be free to apply the IIR to MNEs that are tax resident within their jurisdiction even if this threshold is not met.
- ▶ An exclusion from the GloBE rules would be provided for investment funds, pension funds, governmental entities, non-profit organizations, and international organizations that are at the top of an MNE group. The Statement also indicates that further consideration will be given to a possible exclusion for MNEs that are in the initial phase of their international activity.
- ▶ The Statement indicates that the rights to impose a top-up tax would be allocated to jurisdictions under a top-down approach under the IIR (with special rules for split ownership situations) and under a methodology to be agreed under the UTPR.
- ▶ The GloBE top-up tax would be determined using an effective tax rate (ETR) test calculated at the jurisdictional level, with a common definition of covered taxes and a tax base measured by reference to financial accounting income (with adjustments to be agreed and mechanisms to address timing differences). The Statement notes that in the case of existing distribution tax systems, no top-up tax would apply if earnings are distributed within three to four years and taxed at or above the minimum level.
- ▶ According to the Statement, the minimum tax rate for purposes of the IIR and the UTPR would be at least 15%.
- ▶ The GloBE rules would provide for a formulaic substance carve-out that would exclude income in the amount of at least 5% of the carrying value of tangible assets and payroll. The Statement notes that for a transition period of five years, this amount would be increased to 7.5%. In addition, a de minimis exclusion is to be provided. Furthermore, international shipping income would be excluded.
- ▶ The Statement also notes that mechanisms are to be incorporated in the GloBE rules to avoid compliance and administrative costs that are disproportionate to the policy objectives of Pillar Two.
- ▶ According to the Statement, because the Pillar Two rules are to apply on a jurisdictional basis, consideration will be given to the conditions under which the US Global Intangible Low-Taxed Income (GILTI) regime will co-exist with the GloBE rules, in order to ensure a level playing field.
- ▶ With respect to the STTR, the minimum rate would be from 7.5% to 9% and the taxing right allocated to the source country under the STTR would be limited to the difference between the minimum rate and the tax rate on the received payment. The Statement indicates that the Inclusive Framework members recognize that the STTR is an integral part of achieving a consensus on Pillar Two for developing countries. In this regard, it further states that Inclusive Framework members with nominal corporate income tax rates below the STTR minimum rate for interest, royalties and certain other payments are to agree to implement the STTR into their bilateral treaties with developing members when they are requested to do so.
- ▶ According to the Statement, Inclusive Framework members are to agree and release an implementation plan, that will include model GloBE rules together with the possible development of a multilateral instrument for coordination of such rules, an STTR model provision together with a multilateral instrument to facilitate adoption, and transitional rules including the possibility of deferred implementation of the UTPR. The Statement notes that Pillar Two should be brought into law in 2022, to be effective in 2023.

OECD Secretary-General report

- ▶ On 5 July 2021, the OECD Secretary-General delivered a tax report to the G20 Finance Ministers and Central Bank Governors providing an international tax update. The report included an update on the 1 July Statement and indicated that since its release, Peru had joined the agreement. The report describes the agreement as a historic success that draws on the work done under G20 leadership to ensure more transparency and fairness in the international tax system through the tax transparency efforts and the original BEPS project. According to the report, however, the current international tax system is no longer fit for the increasing challenges of globalization and digitalization, and these challenges can only be effectively addressed through a multilateral solution.
- ▶ The report also briefly covers tax policy and climate change, stating that the OECD stands ready to facilitate international dialogue and cooperation and to build bridges between countries and regions adopting different policy approaches on the path to net zero emissions. In this regard, the report notes that Finance Ministers have a key role to play, in particular with respect to the use of pricing or equivalent measures as a component of mitigation policy packages.
- ▶ The report concludes with an update on tax and development matters, indicating that for the October 2021 G20 Finance Ministers meeting, the OECD will present a requested report on progress made by developing countries participating in the Inclusive Framework and possible areas where domestic resource mobilization efforts could be further supported.
- ▶ Following release of the report, the OECD announced that Saint Vincent and the Grenadines also had joined the agreement, bringing the total number of supporting jurisdictions to 132.

The G20 communique

- ▶ The communique issued on 10 July 2021 at the close of the G20 Finance Ministers and Central Bank Governors meeting includes the following paragraph on the BEPS 2.0 project:

After many years of discussions and building on the progress made last year, we have achieved a historic agreement on a more stable and fairer international tax architecture. We endorse the key components of the two pillars on the reallocation of profits of multinational enterprises and an effective global minimum tax as set out in the "Statement on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy" released by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) on July 1. We call on the OECD/G20 Inclusive Framework on BEPS to swiftly address the remaining issues and finalise the design elements within the agreed framework together with a detailed plan for the implementation of the two pillars by our next meeting in October. We invite all members of the OECD/G20 Inclusive Framework on BEPS that have not yet joined the international agreement to do so. We welcome the consultation process with developing countries on assessing progress made through their participation at the OECD/G20 Inclusive framework on BEPS and look forward to the Organisation for Economic Co-operation and Development (OECD) report in October.

- ▶ In the communique, the Finance Ministers also welcomed the constructive discussions at the G20 High-Level Tax Symposium on Tax Policy and Climate Change, which took place on 9 July 2021 and which explored how tax, in conjunction with regulatory policies, can contribute to reaching environmental objectives. The Symposium provided an opportunity for a reflection upon how G20 Finance Ministers can incorporate this area of economic policy into their work in the future. The communique noted the Venice International Conference on Climate on 11 July and its focus on the role of global policies and private sector finance in addressing climate change.

Implications and Hong Kong observations

- ▶ The proposals being developed in the BEPS 2.0 project contemplate significant changes in the overall international tax architecture under which multinational businesses operate. The endorsement by the G20 Finance Ministers of the key components of the two pillars of the project that have been agreed by 132 Inclusive Framework member jurisdictions is an important step in advancing the work on these proposals. Moreover, the G20 Finance Ministers are calling for finalization of the agreement and a detailed implementation plan by October 2021.

- ▶ However, there is significant work to be done in the Inclusive Framework to flesh out the technical details and address the remaining open issues. There also will be further discussions with the seven Inclusive Framework jurisdictions that have not supported the agreement reflected in the July Statement. In addition, the European Commission plans to publish its proposal for a European Union (EU) Digital Levy on 20 July 2021, which will have implications for the continuing transatlantic negotiations related to taxation of the digital economy. Looking beyond the October 2021 target for final agreement, the implementation process for each of the pillars will need to play out in countries around the world creating further complexity.
- ▶ 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 proposed international tax changes on their businesses. In addition, looking ahead, companies will need to monitor activity in relevant countries related to the implementation of agreed rules through changes in domestic tax law and bilateral or multilateral agreements.
- ▶ Companies also should follow global developments with respect to tax policy and climate change, including activity in the G20, OECD and EU.
- ▶ Hong Kong has repeatedly expressed its commitment to the BEPS initiative and has taken numerous steps in the past few years to fulfil its requirements as part of the BEPS Inclusive Framework. In so doing, it has continually expressed a focus on maintaining competitiveness and reducing the burden on affected companies. It is anticipated that Hong Kong will implement the BEPS 2.0 plan based on international consensus, and the Hong Kong SAR Government has openly expressed guiding principles along the lines of maintaining competitiveness and minimizing taxpayer's compliance burden. With the global minimum tax rate targeted at 15%, Hong Kong's existing corporate tax rate of 16.5% will be relatively competitive from an international perspective. However, those in-scope companies in Hong Kong with ETR below 15%, including those that may be eligible for certain preferential tax regimes or offshore claims may be impacted. Given that other major economies including Singapore will also likely implement the global minimum tax under Pillar Two of BEPS 2.0, it will be interesting to see how Hong Kong and other such economies may in response change their corporate tax system.

1. 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 (UK) and the United States (US).
2. Organisation for Economic Co-operation and Development.
3. The nine members of the Inclusive Framework that had not joined the Statement as of 1 July were Barbados, Estonia, Hungary, Ireland, Kenya, Nigeria, Peru, Saint Vincent and the Grenadines, and Sri Lanka.
4. The G7 countries are Canada, France, Germany, Italy, Japan, the UK and the US.

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