HONG KONG TAX ALERT

May 2021 | Issue 5

The OECD's ongoing work on the BEPS 2.0 Pillars is gathering momentum. Is now the time for Hong Kong companies to get "Pillar Two ready"?

Summary

Significant recent announcements by the European Commission and the United States predicted to put pressure on Hong Kong to implement BEPS 2.0 and amend domestic tax breaks and incentives that lower its effective corporate tax rate below the level expected to be agreed by the OECD shortly.

Significant Global Developments

- In recent weeks, there have been major developments in the field of new international tax standards, both from an European Union (the **EU**) and United States (the **US**) perspective, developments which are likely to have a knock-on effect for international business centers, including Hong Kong.
- On 18 May 2021, the European Commission (the **EC**) unveiled its Communication on Business Taxation for the 21st Century (the **EC Communication**), which contains ambitious short- and long-term tax policy announcements. Notably, the EC Communication highlights their intention to include Pillar Two of the ongoing Base Erosion and Profit Shifting 2.0 project (**BEPS 2.0**) (discussed further below) as a criterion for its notorious list of non-cooperative jurisdictions.
- Just two days later, on 20 May 2021, the US Treasury Department announced its new position to accept businesses paying a global minimum corporate tax rate of at least 15% on their overseas profits during an Organisation for Economic Co-operation and Development (the **OECD**) tax steering group meeting.
- The G7's Finance Ministers may indicate their agreement with the proposals as early as 4 June 2021.

Background

- As discussed in previous KPMG newsletters, in October 2020, the OECD/G20 Inclusive Framework (**IF**) on BEPS approved two updated documents (the **Blueprints**), which set out highly detailed proposals for the two BEPS 2.0 "Pillars".
- Pillar One focuses on where tax is paid. It aims to achieve a reallocation of taxing rights between countries, which entails the design of a new nexus rule beyond the permanent establishment threshold.

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- Pillar Two concerns the total level of tax and aims to ensure that all large internationally operating businesses pay at least a minimum level of tax. A complex set of interlinking rules should ensure that a multinational enterprise (**MNE**) cannot achieve an effective tax rate below a certain level (yet to be fixed but likely between 12 and 15%) in any jurisdiction in which it operates.
- Although the IF countries have not yet reached agreement on either of the Pillars, the EC Communication and the acceptance by the US of a minimum corporate tax rate as high as 15%, are possibly smoothing the way to a global agreement as soon as July that could transform how international businesses are taxed.

The EC Communication

- The timing of the EC Communication is interesting in that it was published during a period of intense negotiation on the global corporate minimum tax rate and the scope of Pillar One. It may effectively put pressure on the OECD to reach an agreement on the global minimum tax rate, a strategy that appears to have paid off to an extent, considering the announcement by the US Treasury shortly after its publication.
- The EC Communication addresses several complex topics including the EC's plan to establish a single corporate tax rulebook for the EU and targeted initiatives in the area of corporate taxation. For a summary of the EC Communication read our recent Euro Tax Flash here.
- For this alert we are primarily concerned with the EC's proposal to introduce Pillar Two as a criterion used to assess third (non-EU) countries for the EU list of non-cooperative jurisdictions and the potential implications for Hong Kong.
- This will sound alarm bells for many in Hong Kong who will recall that Hong Kong was placed on the EU's list of non-cooperative jurisdictions in December 2017 - understandable given inclusion on the list can have a real impact beyond mere stigma. For example, certain EU funding cannot be channeled through entities in a listed country, there are stricter reporting requirements for MNEs with activities in these jurisdictions, etc.
- In response, Hong Kong swiftly took action to counter harmful tax practices, prevent treaty abuse, introduce country-by-country reporting and improve cross-border dispute resolution mechanisms. In March 2019, Hong Kong was removed from the non-cooperative list, as a result of its successful delivery of these reforms.

The US Treasury's Announcement

- The US Treasury Department has just proposed an effective corporate tax rate of 15%. From their perspective, the global minimum tax rate is helpful in minimising the impact of the higher US tax rate on the competitiveness of American companies, which will hopefully deter them from shifting operations or profits to lower-tax jurisdictions.
- The new US proposal of 15% has been welcomed by other G7 members, including Japan, Italy, France and Germany, who have predicted that "a revolution in international corporate taxation" will be agreed within weeks. At the time of writing, the UK has yet to offer public support for the proposal but has commended US commitment to reaching a solution.
- Jurisdictions such as Hong Kong have used lower tax rates to attract corporate business. Whilst the 15% rate proposed by the US is less than Hong Kong's headline rate of corporate tax, i.e. 16.5%, it is still a cause for concern. In reality, the effective tax rate is significantly lower than 15%, due to the availability of various tax breaks and incentives, including the source rule (only Hong Kong sourced income is subject to profits tax) and the concessionary rate of 8.25% for corporate treasury centres, to name a few.

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KPMG Observations

- Hong Kong is committed to meeting international tax standards, which it considers essential to preserve its competitiveness as an international business center. This commitment should put Hong Kong under pressure to accelerate its implementation of Pillar Two considering recent developments, mainly to avoid being placed on the EU's list of non-cooperative jurisdictions again, which would undermine its recent efforts in the international tax standards sphere.

- The EU Communication and the US announcement cumulatively highlight the global impetus to turn Pillar One and Pillar Two from a blueprint into a reality. The G7 is piecing together an agreement that will have a strong influence over multilateral decisions. By the time the G20 leaders meet in July, there should be a sense of unity around a global minimum tax structure, with a final agreement expected later this year.

- These developments will have a marked impact on international markets, including Hong Kong, which has a headline corporate tax rate of 16.5% but an effective tax rate significantly below 15%. Hong Kong will likely have to react by adopting BEPS 2.0 and amending its domestic tax positions (i.e. tax breaks and incentives) that lower its corporate tax rate below the 15% level.

- No public commitments have been made by the Hong Kong Government and specific response measures are not expected until after the OECD has finalised the proposals. However, international tax cooperation was addressed in the 2021-2022 Budget, with the Hong Kong Government emphasising its commitment to maintaining simplicity, certainty, fairness and minimising the compliance burden of its tax regime, but at the same time, confirming it will actively implement the BEPS 2.0 proposals "according to international consensus".

- Now is the time for Hong Kong taxpayers to consider the potential impact these global developments will have on business and seek advice on how to become "BEPS 2.0 ready" sooner rather than later.

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