



HONG KONG TAX ALERT

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G7 consensus on international tax reforms poses challenges for Hong Kong businesses

Summary



On 5 June 2021 the G7 Finance Ministers issued a statement indicating that they have reached an in-principle agreement on updated international tax rules.

The key aspects of the G7 agreement comprise a global effective tax rate of at least 15 per cent and a new profit allocation mechanism where at least 20 per cent of the profit of a multinational group above a nominated profit threshold of 10 per cent will be allocated to market jurisdictions.

Hong Kong businesses who may be affected by BEPS 2.0 should start considering which parts of their business may be affected and understand the impact for various stakeholders.

Introduction

On 5 June 2021 the G7 issued a statement which gives significant momentum to the negotiations between the 139 jurisdictions in the Inclusive Framework on BEPS, led by the OECD and the G20. The G7 includes the US, Japan, Germany, France, UK, Canada, and Italy and their resolution of several long-standing disagreements removes key obstacles to the ultimate global agreement. The intention is to reach a global agreement on updated international tax rules for release at the G20 Finance Ministers meeting in early July.

If agreement is achieved this would be the culmination of many years of work to seek global compromise and would arguably represent the biggest change to international tax rules in over one hundred years.

Structure of the Proposed Rules

Two core issues are addressed with two sets of rules. The first set, the Pillar One rules, involve the reallocation of taxable profits of the largest multinationals to 'market jurisdictions'. The second set, the Pillar Two rules, seek to set a global minimum effective tax rate for large multinationals operating around the world. The idea is that the location chosen for business activities cannot be used to achieve more desirable (lower) tax outcomes.

It is important to also highlight that the proposed Inclusive Framework Pillar Two rules are different to the existing US global minimum tax rules. Further to recent US tax reform proposals, there is likely to be an alignment of sorts between proposed Inclusive Framework rules (applicable to non-US multinationals) and the US domestic tax rules (applicable to US multinationals).

Pillar One and its Unresolved Issues

The essential trade-off in Pillar One is that market jurisdictions will give up their right to introduce Digital Services Taxes or similar taxes on the so-called digital economy, in exchange for greater taxing rights over the global profits of the largest multinational taxpayers.

There are three key issues still to be negotiated and many smaller technical issues that will have a significant impact on how the rules will be implemented.

The first main Pillar One issue concerns the size of the multinationals that will be impacted. A considerable range has been mooted from the scope only covering the top 100 companies to covering more than two thousand companies. This means that the multinational group revenue threshold could be set as high as EUR20 billion or as low as EUR750 million.

The second main issue, which impacts many developing and resource-rich countries, concerns potential exclusions from the rules. It is likely, but not certain, that there will be a carve-out for natural resources and commodities. Previously, carve-outs for financial institutions, real estate, infrastructure and airlines and shipping have been discussed, but it is not yet clear whether they will be within the scope of final rules.

The third main issue is the level of profit that will be reallocated to market jurisdictions under Pillar One. The G7 release says that it will be at least 20% of the profit of a multinational group above a nominated profit threshold of 10%. This, could mean, for example, that a multinational with over EUR 20 billion of global revenues would allocate 20% of its global annual profits (exceeding a 10% return on sales) to market jurisdictions. The agreed reallocation percentage will have a significant impact on the size of the pie to be reallocated to market jurisdictions and obviously is a key consideration for many of the 139 Inclusive Framework members.

Global Minimum Tax

For Pillar Two, the main issue is the negotiation of the Global Minimum Tax rate amongst the 139 Inclusive Framework members. The G7 statement seeks an effective tax rate of at least 15% and that this rate should be calculated on a country-by-country basis and not on a global or entity basis. This means that multinational operations in each country will be assessed separately to see if the minimum tax rate is met – if not then a 'Top-Up' tax will be applied. This will obviously mean that countries with low corporate tax rates or which offer generous tax incentives will be impacted by this rule.

There are many technical issues on the calculation of the rate, how it is imposed, the size of companies that will be impacted and the interface with other international tax rules.

Consequences for Hong Kong

A minimum global tax rate of 15% would only be 1.5% lower than Hong Kong's headline tax rate of 16.5%, meaning that many businesses in Hong Kong that have offshore profits or are making claims under incentive regimes may find that their effective tax rate is below the global minimum. Hong Kong is likely to adopt the provisions of BEPS 2.0 and may also take steps to update its tax base to ensure that its tax system for multinational enterprises remains fit for purpose in light of the international tax changes.

Multinational groups who may be affected by BEPS 2.0 should start considering which parts of their business may be affected and understand the impact for various stakeholders.

Consequences for large multinational taxpayers

The G7 position is generating substantial interest in how individual multinationals will be affected by the final rules.

For most large multinationals this will not be a simple answer and early preparation will be critical for timely communications to boards and senior management. This will include consideration of accounting and tax systems that need to be put into place to collect information to comply with the rules. Multinationals will need to evaluate whether existing group structures and intra-group transactional arrangements are still appropriate or need to be restructured.

Furthermore, the financial impact of these proposed rules is not easy to calculate for individual multinationals given complex taxpayer facts and circumstances. KPMG has developed a modelling tool to assist with this impact analysis. This tool can also assist with determining how jurisdictional tax footprints will change and thereby help with the identification of likely new tax compliance considerations.

There are still many steps along the path to agreement, but given the political will shown by the G7 in the 5th June 2021 communique, consensus may be reached sooner than one might have envisaged. That said, there are still significant challenges to meeting the demands of other Inclusive Framework members. This includes the G7 statement requiring the roll back of all unilateral tax measures designed to target particular industry, sectors or commercial activities which remains a point of contention with developing countries.

Readers should monitor these developments closely.

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