Inclusive Framework BEPS Agreement

Initial response level agreement on Pillar 1 and Pillar 2

Policy Perspectives update – Hong Kong

KPMG Global Release: OECD/G20 Inclusive Framework (IF) Agreement on BEPS 2.0

On 1 July 2021, in an historic agreement, 130 countries approved a statement providing a framework for reform of the international tax rules. The statement sets forth the key terms for an agreement of a two-pillar approach to reforms and calls for a comprehensive agreement by the October 2021 G20 Finance Ministers and Central Bank Governors meeting, with changes coming into effect in 2023.

Pillar One of the agreement is a significant departure from the standard international tax rules of the last 100 years, which largely require a physical presence in a country before that country has a right to tax.

Pillar Two secures an unprecedented agreement on a global minimum level of taxation which has the effect of stipulating a floor for tax competition amongst jurisdictions.

The statement diverges in important respects from the Pillar One and Pillar Two Blueprints, released by the IF in October 2020. However, in a number of respects the statement builds on the Blueprints and resolves some of the key open items from the Blueprints. For prior coverage of the Blueprints, refer to our reports for Pillar One and Pillar Two.

Contents

Pillar 1:

Reallocation of profits for large companies to market countries

Pillar One's Amount A would provide a new taxing right to market jurisdictions, allocating a portion of residual profit based on a formulary approach.

Scope

Pillar One will apply to multinational groups that have more than EUR 20 billion of global turnover and profitability above 10 percent (measured as profits before tax divided by revenue on a book basis). This threshold would be reduced to EUR 10 billion 7 years after Pillar One enters into force contingent on successful implementation.

> **KPMG Observation:** The agreed scope is a dramatic departure from the Pillar One Blueprint, which had focused on businesses engaged in "automated digital services" and "consumer facing businesses." Based on the defined scope, it appears that Amount A is likely to initially apply to approximately 100 companies.

Extractive industry and regulated financial services will be excluded from Amount A.

> **KPMG Observation:** It is unclear whether the scope of the exclusions for extractives and regulated financial services will be the same as that described in the Pillar One Blueprint.

Calculation of New Taxing Right

The statement provides that for in-scope MNEs, between 20 and 30 percent of residual profit (defined as profit in excess of 10 percent of revenue) will be allocated to market jurisdictions with nexus using a revenue-based allocation key. For most jurisdictions, nexus will only exist if the in-scope MNE derives at least EUR 1 million in revenue from the jurisdiction.

Tax Certainty

The statement commits to making mandatory binding dispute prevention and resolution mechanisms available for in-scope MNEs. These mechanisms would cover all issues related to Amount A, including transfer pricing and business profits (e.g., permanent establishment) disputes. While the dispute prevention and resolution mechanisms would generally be mandatory, the statement notes that consideration will be given to making them elective for certain developing countries (i.e., those that have few or no mutual agreement procedure cases and are eligible for deferral of their BEPS Action 14 peer reviews).

Implementation and Unilateral Measures

The statement provides that Amount A will be implemented through a multilateral instrument, which will be opened for signature in 2022. Amount A is anticipated to take effect beginning in 2023. The final agreement on Amount A will provide for the removal of all digital service taxes and "other relevant similar measures" for "all companies."

> **KPMG Observation:** The language of the statement suggests that digital service taxes and other unilateral measures will be eliminated for all companies, not just for MNEs within the scope of Amount A. The statement does not provide detail on how relevant measures will be identified, or on the timing for their removal.

Pillar 2:

Global Minimum Tax

Overall design

Pillar Two consists of two parts:

- Global anti-Base Erosion (GloBE) Rules imposing top-up tax on a parent entity where the ETR in jurisdictions where their subsidiaries operate is less than 15% (the Income Inclusion Rule (IIR)). A supporting Undertaxed Payment Rule (UTPR) can apply where undertaxed income is not subject to tax under an IIR; and

- a treaty-based Subject to Tax Rule (STTR), which allows limited source taxation at a rate of 7.5% to 9% on interest, royalties, and certain other related party payments that are subject to tax below a minimum rate. Any tax paid under the STTR is creditable under the GloBE Rules.

  KPMG Observation: The language included in the statement makes no reference to the specific approach for managing timing difference. While the Pillar Two Blueprint contained a detailed carry-forward approach, the statement seems to leave open the possibility of alternative approaches, such as deferred tax accounting.

The statement describes the GloBE Rules as a "common approach," meaning that IF member jurisdictions are not required to adopt the GloBE rules, but must accept their application by other IF members (including the specified rule order and the application of any agreed safe harbors). IF members that adopt the GloBE rules would agree to implement and administer the rules consistently with the agreement reached on Pillar Two.

> **KPMG Observation:** While the GloBE rules are presented as a common approach, the statement provides that IF members applying nominal rates below the STTR rate to covered payments would agree to incorporate the STTR into their bilateral treaties with developing IF members when requested to do so, indicating that the STTR would be more akin to a minimum standard.

Scope

The statement provides that the GloBE rules will apply to MNEs with revenues exceeding the €750m threshold as determined under BEPS Action 13 (country by country reporting). Countries are, however, noted to be free to apply the IIR to MNEs headquartered in their countries whose revenue fall below this threshold.

Exclusions are provided from the GloBE rules for government entities, international organizations, non-profit organizations, pension funds or investment funds that are ultimate parent entities (UPE) of an MNE group or any holding vehicles used by such entities, organizations or funds.

> **KPMG Observation:** Under this approach, the UTPR would still be limited in application to MNEs above the €750m revenue threshold. While not explicit, it appears that the threshold would still apply to the application of the IIR to MNE subgroups (i.e. where a jurisdiction other than the residence of the UPE applies the IIR).

International shipping income is also excluded from the GloBE rules using the definition of such income under the OECD Model Tax Convention.

In addition, while not directly positioned as an "exclusion", the statement notes that the IF is exploring excluding MNEs in the initial phase of their international activity.

Minimum tax rate

The statement provides for a minimum tax rate of at least 15% for purposes of the GloBE Rules.

> **KPMG Observation:** The failure to indicate a specific rate indicates that further negotiation of the rate will be required.

Carve-out

A formulaic substance carve-out is provided that would exclude an amount of income from the GloBE rules, determined as a mark-up on the carrying value of tangible assets and payroll. The mark-ups would be at least 7.5% for the first 5 years in which the rules are in effect and at least 5% after that.

The IF statement also provides for a de minimis exclusion.

> **KPMG Observation:** The statement explicitly links the discussion of the minimum tax rate to the availability of carveouts. While the statement does not indicate an intent to apply favorable rules with respect to existing tax incentives, the carve outs, the possible exclusion for MNEs starting to expand overseas, and the deferred implementation of the UTPR may combine to preserve the value of some incentives otherwise impacted by Pillar Two.

Implementation

The statement provides that the Pillar Two rules are anticipated to be brought into law in IF member jurisdictions in 2022, and made effective beginning in 2023.

It is noted that IF member jurisdictions will finalize remaining issues and release a detailed implementation plan by October 2021. The implementation plan will include (i) GloBE model rules with proper mechanism to facilitate over time the coordination of the GloBE rules that have been implemented by IF members, including the possible development of a multilateral instrument, (ii) an STTR model provision together with a multilateral instrument to facilitate its adoption, and (iii) transitional rules, including the possibility of a deferred implementation of the UTPR.

> **KPMG Observation:** A 2023 effective date for the Pillar Two rules seems to assume prompt resolution of all remaining open issues, and swift implementation. It seems particularly challenging for the STTR to be effective by 2023 since its widespread adoption would require a multilateral instrument.

Open issues

While the statement represents very significant progress, many key political and technical issues remain open, including:

GloBE rules:

— The precise minimum rate to be applied
— Mechanism for managing timing differences for the ETR calcualtion
— Precise mark-up percentages on the carrying value of tangible assets and payroll
— Design of the “de minimis exclusion” carve-out
— Design of exclusion for MNEs in the “the initial phase of their international activity”
— Design of elements to ensure “limited impact on MNEs carrying out real economic activities with substance”
— Transitional related issues including the treatment of pre-existing losses
— Design of the UTPR generally
— The scope of simplification measures, including “safe harbors and/or other mechanisms”

STTR:

— Precise minimum rate
— Scope of “other payments”
— Rules for determining the tax rate on specific payments

Hong Kong Key Considerations:

Hong Kong operates a simple and low tax system, characterized by a territorial taxation principle under which foreign sourced income of a company is exempt from Hong Kong Profits Tax, non-taxation of capital gains and a relatively low headline rate of corporation tax (i.e. currently 16.5%) which may cause a considerable reduction in a company's ETR. In addition, Hong Kong currently offers some incentives which may also bring down a company's ETR to below 15%.

With a proposed globally minimum tax rate of 15%, it is expected that a significant number of large MNE Groups (i.e. with a total consolidated group revenue above €750 million) with presence in Hong Kong will be adversely affected by Pillar Two proposals.

Hong Kong entities could effectively end up being subject to "top up tax" in the MNE parent entity jurisdiction on its exempt income (e.g. foreign sourced income, capital gains) or income subject to a reduced corporate tax rate where the combined ETR of the entities within Hong Kong is less than the global minimum tax rate of 15%.

The STTR is also expected to impact many Hong Kong entities on their cross-jurisdictional transactions. Where interest, royalties or high-risk services payments received from foreign related parties will often be subject to no or low tax in Hong Kong, the source jurisdiction may apply withholding tax to bring the total up to the STTR minimum rate (proposed to be between 7.5% and 9%). There is no jurisdictional blending for this rule, and it is applied on a transaction basis so it would need to be considered regardless whether the entity has an ETR of 15% or above.

Although no public commitments have been made by the Hong Kong Government, we note that the Hong Kong Government has previously confirmed that it will actively implement the BEPS 2.0 proposals "according to international consensus", whilst emphasizing that it will work to maintain the simplicity, certainty, fairness and minimise the compliance burden of its tax regime. Separately, the European Union has expressed concern about foreign sourced income exclusions. The combined impact of these initiatives may result in significant changes to Hong Kong's tax system, at least for large multinationals.

Hong Kong MNEs or foreign MNEs with Hong Kong subsidiaries should now therefore be undertaking the preparatory work necessary to be ready to comply with these rules in a little over 18 months. The size of the potential impact for a Hong Kong MNE with global operations should not be underestimated, and it is critical that in-scope groups move quickly. Some key activities to start being undertaken by tax leaders in Hong Kong, may be:

(i) Model at high level the impact of BEPS 2.0 proposals on existing use of preferential regimes and offshore profits and capital claims and communicate with the C-Suite and other stakeholders;

(ii) To the extent a consultation process is opened by the Hong Kong Government, engage in such consultation process to keep informed and help to shape the evolution of potential response measures in Hong Kong;

(iii) Begin the process of planning ahead for the necessary changes in legal entity and supply chain structures along with the significant overhaul of systems & processes required in order to be ready to comply from 2023.

Contacts

Global Tax Policy Leadership Group

Grant Wardell-Johnson
Global Tax Policy Leader and Chair
E: gwardelljohn@kpmg.com.au

Manal Corwin
Americas Regional Tax Policy Leader
E: mcorwin@kpmg.com

Vinod Kalloe
EMA Regional Tax Policy Leader
E: kalloe.vinod@kpmg.com

Conrad Turley
Asia Pacific Regional Tax Policy Leader
E: conrad.turley@kpmg.com

Chris Morgan
Responsible Tax Project Leader
E: christopher.morgan@kpmg.co.uk

Regional contacts

John Timpany
Head of Tax, Hong Kong
E: john.timpany@kpmg.com

Ivor Morris
Hong Kong BEPS 2.0 Project Leader
E: ivor.morris@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/cn/socialmedia