

G7 consensus on international tax reforms and considerations for the Asia Pacific region

Issue date: 9 June 2021

Introduction

On 5 June 2021 the Group of Seven (G7) issued a statement which gives significant momentum to the negotiations between the 139 jurisdictions in the Inclusive Framework on BEPS (base erosion and profit shifting), led by the OECD and the Group of Twenty (G20). The G7 includes the United States, Japan, Germany, France, the United Kingdom, 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 100 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 from only covering the top 100 companies to covering more than 2,000 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, 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 percent of the profit of a multinational group above a nominated profit threshold of 10 percent. This could mean, for example, that a multinational with over EUR20 billion of global revenues would allocate 20 percent of its global annual profits (exceeding a 10 percent 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 is a key consideration for many of the 139 Inclusive Framework members.

Pillar Two - 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 percent 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 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 Asia Pacific

Regionally, there will be jurisdictions that stand to gain from these measures and those that are likely to lose revenue.

With a proposed global minimum tax rate of 15 percent, many tax incentive regimes across the Asia Pacific region will be impacted, including tax holidays, exempt income classes, enhanced deductions, as well as certain research and development regimes. Special economic zones set up to offer long-term tax rate reductions below the proposed 15 percent tax rate will be particularly hard hit. It should be noted though that the value of incentives to multinationals operating in large market economies may, in some instances, be protected by a special Pillar Two rule feature. This lets the tax burdens of all local subsidiaries, both high taxed and incentivized, be aggregated when calculating whether the country tax burden is above or below the minimum rate. Multinationals may, in some cases, have more than one entity in the same country with which to perform such aggregation. This is referred to as jurisdictional blending and will require detailed calculations on a case-by-case basis.

Governments will need to determine how to respond to these proposals. Such responses could include a no change policy, particularly where those tax incentives are also enjoyed by a number of taxpayers outside the scope of the Pillar Two rules. Responses could also include a repeal or increase in incentive tax rates to meet the global minimum tax rate or the introduction of local alternative minimum tax. Other responses might include the replacement of tax incentives with cash grants.

It will be important for multinational groups to obtain certainty on existing jurisdiction level tax incentives and any plans to wind back, modify or repeal such incentives to assist with long-term business planning.

Separately for the largest 100 global taxpayers, there will also be a reallocation of profits under Pillar One. While it is not yet clear precisely how these rules will operate, based on the earlier public drafts issued by the OECD, there is an expectation that jurisdictions in the region with large markets, in particular the region's most populous countries, will benefit from a reallocation of profits. By contrast, those jurisdictions hosting a large number of regional hubs, headquarters or intellectual property management companies will likely see a decrease in tax revenue collections. It should be noted though that a lot of detailed factors will impact the final assessment, including whether much of a given multinational's profits are already booked in the markets under existing transfer pricing rules.



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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 5 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 industries, sectors or commercial activities, which remains a point of contention with developing countries.

Readers should monitor these developments closely.



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“Cambodia is still limited in dealing with international tax issues. Transfer Pricing and Double Tax Treaties are comparatively recent matters to be dealt with by the Government. To date BEPS has not been a consideration. The G7 announcement on revision of international tax rules may mean that multinational companies operating in Cambodia may be forced to consider their Cambodian tax circumstances based on their overall global tax position. We await further developments with interest”.

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