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RSM Tax Advisory (Hong Kong) Limited
羅 申 美 稅 務 諮 詢 有 限 公 司

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THE DEVELOPMENT OF OECD'S GLOBAL MINIMUM TAX

Following the G7 Finance Ministers issuing a communiqué on 5 June 2021 announcing their agreement in principle on the Organization for Economic Co-operation and Development (OECD)'s two-pillar proposal, the OECD/G20 Inclusive Framework (IF) met on 30 June 2021 and announced the next day a statement stating the majority of their members have agreed on the two-pillar solution to address the challenges arising from the digitalisation of the economy. The statement set forth the key components of each pillar, including the commitment to a global minimum tax of at least 15%. A detailed implementation plan is expected to be finalised by October 2021 for the G20 summit in Rome.

BACKGROUND

The OECD G20 Base Erosion and Profit Shifting (BEPS) project report was first delivered in 2015, setting up an international framework to combat tax avoidance by multinational enterprises (MNEs) using base erosion and profit shifting strategies. Among the 15 Action Plans, the Action 1 "Tax Challenge Arising from Digitalisation" report determined that it would not be feasible to ring-fence the digital economy for tax purposes. In the Interim Report issued in March 2018, OECD returned to whether further measures to address the taxation of digital services were needed. This was then followed by a Policy Note delivered in January 2019, where 139 IF members agreed to examine proposals grouped under two pillars which could serve as a basis for a future solution to address tax issues arising from the challenges of the digitalising economy.

Nevertheless, as the progress of addressing the concerns by OECD was not satisfactory, many countries grew impatient. They introduced or planned to introduce their own Digital Services Tax (DST) domestically to deal with the issues. DST is imposed on large businesses based on their revenue (not profits) from certain digital services provided to domestic users or consumers. Among the G7, France, Italy and U.K. have DSTs implemented during 2019 to 2020. Japan imposed consumption tax on digital services on foreign companies as early as 2015, while Canada proposed DST in its 2021 Budget and intended to apply beginning 2022.

U.S. is concerned that many DSTs are (i) designed to target U.S. digital companies unfairly; (ii) inconsistent with the principles of international taxation; and (iii) restrict U.S. commerce. On 2 June 2020, the Office of the United States Trade Representative (USTR) launched investigations under Section 301 of the Trade Act of 1974 (S301) into the implemented or proposed DSTs of the E.U. and nine countries. S301 grants the USTR a range of responsibilities and authorities to impose trade sanctions on foreign countries that violate U.S. trade agreements or engage in unjustifiable, unreasonable, or discriminatory acts and burden U.S. commerce. The investigations are still ongoing and are pending on whether an agreement can be reached at the OECD in the near term on global tax reform.

On 12 October 2020, the OECD released the Blueprints for the two-pillar proposal which the G20 endorsed in December 2020. Pillar One focused on taxing rights and profit allocation, which would allow market or destination countries to impose tax on MNEs selling goods or providing services within their borders. Whereas Pillar Two focused on addressing remaining BEPS issues by ensuring that the profits of MNEs are subject to a global minimum corporate income tax.

Seeing the need to align the global tax reform with the proposed U.S. domestic tax reform, the Biden administration renewed the U.S. engagement in OECD's tax reform project. It actively led the discussions since the beginning of the second quarter of 2021.

The G7 Finance Ministers' Agreement

After the meeting in London, the G7 Finance Ministers issued a communiqué on 5 June 2021. Paragraph 16 of the communiqué says:

"*We strongly support the efforts underway through the G20/OECD Inclusive Framework to address the tax challenges arising from globalisation and the digitalisation of the economy and to adopt a global minimum tax. We commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises. We will provide for 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. We also commit to a global minimum tax of at least 15% on a country by country basis. We agree on the importance of progressing agreement in parallel on both Pillars and look forward to reaching an agreement at the July meeting of G20 Finance Ministers and Central Bank Governors.*"

The OECD/G20 Inclusive Framework Agreement to the Two-Pillar Approach

The statement issued on 1 July 2021 by OECD/G20 IF on BEPS announced that 130 (including China) out of the 139 IF members have agreed on a two-pillar solution to address the challenges arising from the digitalisation of the economy. The statement set forth key components of each Pillar. In respect of the global minimum tax under Pillar Two, the agreed key design elements are:

Overall Design

Pillar Two consists of:

- Two interlocking domestic rules (the Global anti-Base Erosion Rules (GloBE rules)):

  a) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity currently in respect of income of a foreign controlled entity that is taxed below the minimum rate;

  b) an Undertaxed Payment Rule (UTPR), which denies deductions for an intra-group payment or requires an equivalent adjustment to be made to the extent which will result in the payment to be taxed at or above a specified minimum rate in the recipient's country; and

- A treaty-based rule, Subject To Tax Rule (STTR), to allow the payer jurisdiction to impose a withholding tax on related party payments on interest, royalties and a defined set of payments, at a rate which will be limited to the difference between the minimum rate (from 7.5% to 9%) and the tax rate on the payment at the payee country, if such payments are subject to tax below a minimum rate at the payee country.

The GloBE rules will have the status of a common approach, meaning that IF members are not required to adopt GloBE rules but are required to accept the application of GloBE rules applied by other IF members, including agreement as to rule order and the application of any agreed safe harbour.

Scope

The GloBE rules apply to MNEs whose global turnover meets the €750 million threshold defined under country-by-country reporting (BEPS Action 13 CbCR). Countries may opt to adopt a lower threshold for MNEs headquartered in their own country.

Government entities, international organisations, non-profit organisations, pension funds or investment funds that are the ultimate parent of the group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules.

Effective Tax Rate Calculation

The IIR and UTPR use a common definition of covered taxes and a tax base determined by reference to financial accounting income, with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences.

Minimum Tax Rate

The minimum tax rate used for the IIR and UTPR will be at least 15% on a country-by-country basis.

Carve-outs and Exclusions

A formulaic substance carve-out is provided that will exclude an amount of income from the GloBE rules that will equal to 7.5% for the first 5 years (transition period) of the carrying value of tangible assets and payroll, with the carve-out rate to reduce to 5% after the first 5 years transition period.

The GloBE rules also provide an exclusion for international shipping income using the definition of such income under the OECD Model Tax Convention.

Implementation

The plan is to have Pillar Two brought into law in 2022 in IF member countries, and the law will be effective in 2023. The implementation will include safe harbours and/or other mechanisms to avoid compliance and administrative costs disproportionate to the policy objectives.

Removal of All DTS and Other Similar Measures on All Companies

Although the statement mentioned that digital services taxes and other unilateral measures would be removed on all companies, not just in scope MNEs, it is silent on the timing for their removal.

Up to Countries to Adopt

OECD is not a legislative body, and it can only make recommendations. If an agreement to the global tax reform is finally reached, it would be up to countries to implement it. However, if enough countries agree to adopt and implement, the other countries will be compelled to follow suit.

Challenges Still Lie Ahead

Despite the fact that G7 has agreed with the principle on the two-pillar approach and the key components of the two pillars have been identified by OECD/G20 IF, there are 9 IF members, which include E.U. members (Estonia, Hungary and Ireland), not consenting to the proposed global minimum rate of at least 15%, expressing the rate is set too high. France, on the other hand, has indicated that it will fight to ensure the rate is as high as possible. There are still many differences to be resolved, compromises to be made, and details to be worked out. The plan to have such a complex law to be drawn up by October 2021 and the law to become effective in 2023 is ambitious.

Knowing that big changes in global tax policy will come very soon, countries and jurisdictions around the globe will be busy this summer thinking of other ways to attract foreign investment in the future, given that low tax will no longer work as the minimum tax that a jurisdiction does not collect, another jurisdiction will do it.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Provide tax expert witness services at Courts
- Act as tax advisor on transfer pricing and tax compliance reviews for IPO applications
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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Mr. Eric Chen T +852 2583 1259 E ericchen@rsmhk.com	Mr. Samuel Chan T +852 2583 1242 E samuelchan@rsmhk.com	Ms. Lilian Poon T +852 2583 1241 E lilianpoon@rsmhk.com	Mr. Patrick Ho T +852 2583 1258 E patrickho@rsmhk.com
Mr. Caesar Wong T +852 2508 2851 E caesarwong@rsmhk.com	Ms. Catherine Tsang T +852 2583 1256 E catherinetsang@rsmhk.com	Ms. Joanna Lee T +852 2583 1317 E joannalee@rsmhk.com	Mr. Alan Chow T +852 2583 1378 E alanchow@rsmhk.com
Ms. Catherine Wong T +852 2583 1396 E catherinewong@rsmhk.com	Ms. Shirley Lo T +852 2583 1211 E shirleylo@rsmhk.com		

RSM Tax Advisory (Hong Kong) Limited

29th Floor, Lee Garden Two
28 Yun Ping Road
Causeway Bay, Hong Kong

T +852 2598 5123
F +852 2598 7230
E tax@rsmhk.com

www.rsmhk.com