

Digital tax update

Towards a global solution

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- ◆ Over 130 economies have reached a preliminary deal on taxing large global companies...
- ◆ ...and agreed to suspend digital services taxes...
- ◆ ...paving the way for a permanent global solution to be reached this year and reducing the threat of US retaliatory tariffs

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A preliminary deal

G20 Finance Ministers on 9-10 July 2021 endorsed an initial deal reached by over 130 economies that aims to ensure large companies, including tech multinationals such as Google and Facebook, are paying their "fair share" of tax globally. Although the global initiative was initially focused on digital multinationals, the scope has been expanded to include all sectors except mining, oil and gas and regulated financial services.

Under the two-pillar framework, economies have agreed to:

1. Reallocate taxing rights of the largest global companies based on where they generate profit rather than where they are located, and
2. Establish a 15% minimum corporate tax for companies with annual revenue above EUR750m

The first pillar will apply to multinationals with global turnover above EUR20bn initially and at least a 10% profit margin. Companies will have to allocate between 20% and 30% of profit above the 10% margin for taxation to markets where they operate, based on sales rather than physical presence. However, the deal could materially reduce tax revenues for some low-tax jurisdictions, including Ireland and Hungary, which are opposed to it.

Digital services taxes

In addition, the 132 economies have agreed to remove country-specific digital services taxes (DSTs), targeted at taxing the revenues of large tech companies, which should help to reduce the threat of US retaliatory tariffs for now. The US has already suspended 25% tariffs on around USD3.4bn worth of imports from economies that were considering or had implemented DSTs, such as France and the UK, pending the conclusion of a global tax deal. However, there is a risk that trade tensions could resurface if it takes time for the global tax accord to be finalised, and governments press ahead with unilateral DSTs.

Next steps

Economies are aiming to finalise the global tax deal by October 2021 and have it take effect in 2023. However, the timeframe for conclusion seems ambitious at this stage. The precise details of the deal still need to be agreed and eight economies, including three EU members (Ireland, Estonia and Hungary), are yet to sign up to the agreement. There could also be challenges around ratifying aspects of the deal, particularly in the US.

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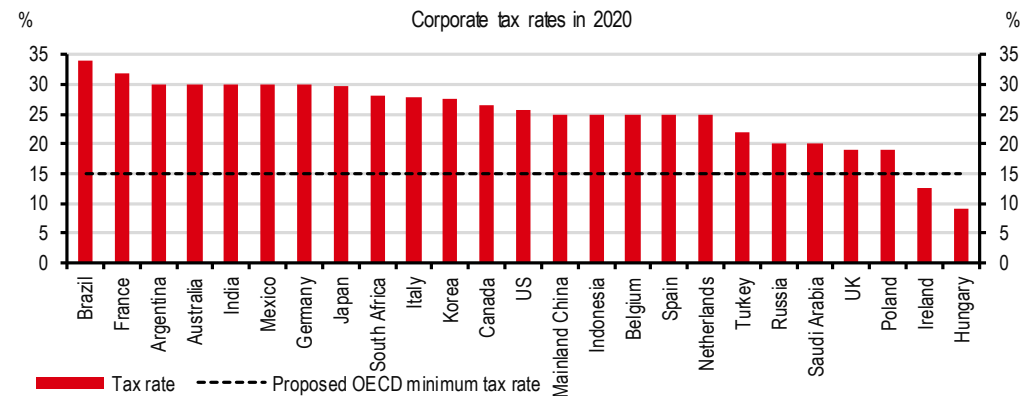
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Taxing times

Scope of the deal

The rise of the digital economy poses challenges for taxation. Under current international tax rules, which date back to the early 20th century, taxing rights are largely based on where companies are located. However, digitisation has made it possible for companies to conduct business in a market without having a physical presence there, enabling large global businesses to take advantage of low corporate taxes abroad (Chart 1).

1. Corporate tax rates vary by market



Source: Tax Foundation

But this means that taxes paid in one jurisdiction (i.e. where the company is physically located) may not necessarily reflect the value and profits created there – raising questions around how much tax should digital multinationals pay? And where should such companies be taxed?

In order to tackle these issues, around 140 economies have been involved in tax negotiations at the OECD. Most recently, 132 of these jurisdictions – comprising more than 90% of global GDP and including the US and mainland China – reached an agreement to address the tax challenges arising from digitisation of the economy. This agreement was endorsed by G20 Finance Ministers over 9-10 July 2021.

Although OECD negotiations were initially focused on taxes paid by digital tech companies only (e.g. Facebook, Google), the scope of the deal has been broadened to include all sectors except extractive industries and regulated financial services. These sectors have been excluded as mining and financial services companies already have their operations where they earn income. The expansion was pushed for by the US, which claimed that tech-only taxes would disproportionately target American companies.

Details of the deal

The recent deal comprises two pillars:

- ◆ **Pillar One:** covers the reallocation of taxing rights and aims to ensure a fairer distribution of profits among jurisdictions. Economies will be able to reallocate some taxing rights of companies from their home country to markets where they generate sales, regardless of whether they have a physical presence there. This will apply to large multinationals with global turnover above EUR20bn (reducing to EUR10bn over time) and profitability over 10%. Companies will pay tax on 20% to 30% of the profits made, beyond their 10% profit margin, based on where sales are made.
- ◆ **Pillar Two:** aims to establish a minimum corporate tax rate to put a floor on tax competition. Economies have currently agreed to apply a minimum corporate tax rate of at least 15% to companies with annual revenue of EUR750m or more, although jurisdictions can choose to apply this rate to companies of all sizes. However, the Biden administration is in favour of setting a higher minimum corporate tax rate (i.e. above 15%) so the precise minimum threshold could yet change.

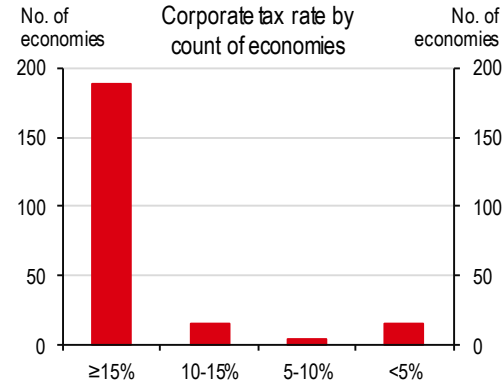
To note, under the prospective deal, a company's profitable business units would be captured by the new regime even if the company as a whole does not meet the 10% profit margin threshold. This means, for example, that Amazon's highly profitable cloud business – Amazon Web Services – would be subject to the new rules even if the company's overall profit margin is low (Politico, 1 July 2021).

Impact of the deal

According to the OECD, taxing rights on more than USD100bn of profit could be reallocated to markets each year under Pillar One, while a 15% minimum corporate tax rate could generate around USD150bn in additional global tax revenue. However, the redistribution of the corporation tax take to sales markets is likely to reduce receipts for low-tax countries (with small domestic markets) where multinationals are headquartered.

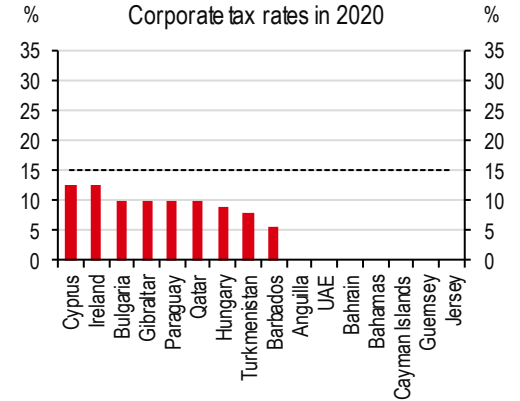
Regarding Pillar Two, it is worth noting that most countries' corporation tax rates are currently above 15%, although some low-tax jurisdictions such as the Cayman Islands and Bermuda have agreed to the OECD plan (Chart 2). But again, there is a potential impact on low-tax jurisdictions such as Ireland and Barbados – which are yet to sign up to the OECD agreement (Chart 3). Indeed, the Irish Department of Finance has estimated that, even if there is no capital flight on the part of multinationals from Ireland, the mechanical impact of the agreement would reduce corporation tax revenue by EUR2bn by 2024. Other economies holding out on the global deal are: Estonia, Hungary, St. Vincent and the Grenadines, Kenya, Nigeria and Sri Lanka.

2. Most economies apply high corporate tax rates...



Source: Tax Foundation, HSBC. Note: Data for 2020.

3. ...suggesting the new rules will impact a small number of low-tax markets



Source: Tax Foundation

Although the scope of the deal has been expanded beyond tech multinationals, the European Network for Economic and Fiscal Policy Research estimates that companies headquartered in the US are still expected to account for the bulk (64%) of Pillar One tax (EconPol Europe, 5 July 2021). Their analysis also found that Pillar One would impact just 78 of the 500 largest companies in the world (excluding companies in the financial and extractive industries) – although up to 100 companies may be subject to the new rules in reality.

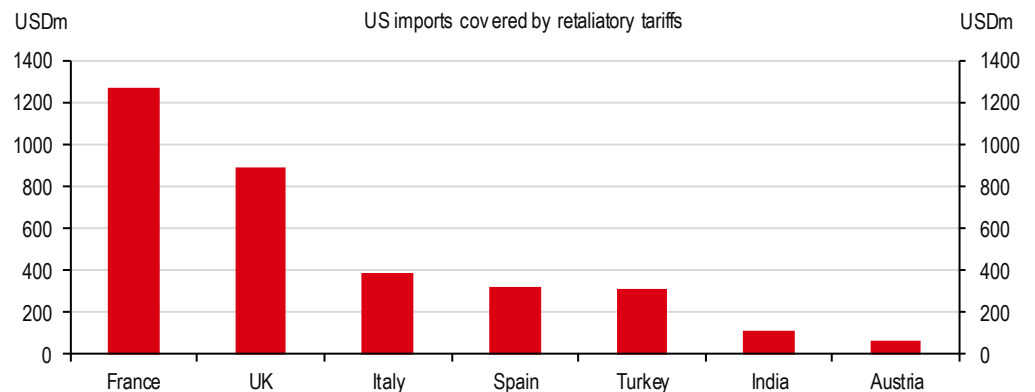
What about digital services taxes?

As part of the deal, economies also agreed to remove all digital services taxes (DSTs), potentially putting a stop to US tariff retaliation. In recent years, and in the absence of a global solution on corporate tax, a number of economies have implemented or have considered implementing DSTs targeted at taxing the revenues of large tech companies. However, the US responded by undertaking a series of trade investigations (under Section 301 of the Trade Act) into foreign DSTs, which found that such taxes in seven economies (France, India, Italy, Turkey, Austria, Spain and the UK) would discriminate against American tech companies.

In response, the US announced additional 25% tariffs on USD3.4bn worth of imports from these markets (Chart 4). Products targeted include cosmetics from France and the UK, Turkish carpets, and basmati rice from India. But the tariffs have not yet taken effect. The US announced earlier this year that it would hold off on imposing additional duties on French imports indefinitely, and suspended tariffs on imports from Austria, India, Italy, Spain, Turkey and the UK until 29 November 2021. It also terminated investigations into digital taxes under consideration by Brazil, the Czech Republic, the EU and Indonesia (USTR, 31 March 2021).¹

¹ Note: The suspension of tariffs on French goods was made under the Trump administration, while the suspension of tariffs on imports from other economies was made under the Biden administration.

4. The US announced but suspended retaliatory tariffs over digital services taxes



Source: USA Trade Online, USTR, HSBC. Note: Data for 2019. Based on tariff lists announced by the USTR.

Although the US has suspended its retaliatory tariffs, there is a risk that tensions could flare up if economies struggle to finalise a global deal on corporate tax and some markets reinstate DSTs in the meantime. It is also not clear what measures economies might take against jurisdictions that do not sign up to the global deal.

For its part, the EU paused its plan to implement a digital levy following pushback from the US and as economies work to finalise the global deal. The EU was reportedly considering a levy of 0.3% on goods and services sold online that would apply to all companies in the EU with annual sales of EUR50m or more (Politico, 12 July 2021). The levy was intended to help the bloc fund its recovery from the pandemic. French Finance Minister Bruno Le Maire also recently noted that he is prepared to commit to removing France's DST once the OECD tax arrangement is implemented (Politico, 6 July 2021).

Next steps

G20 Finance Ministers have called on economies to finalise global negotiations by their next meeting on 15-16 October 2021, with negotiating parties aiming for the deal to take effect in 2023. However, it may take longer than three months to conclude the deal given some economies are yet to sign up to the agreement and the precise details still need to be fleshed out. US Treasury Secretary Janet Yellen recently noted that she hoped US lawmakers would approve a global minimum tax rate this year and consider Pillar One by Spring 2022 (Bloomberg, 12 July 2021).

Any tax deal will need to be ratified by each economy, with commentators already warning that the agreement is likely to face challenges getting approved by US Congress – although it is unclear whether Pillar One will require a two-thirds vote in the Senate (FT, 9 June 2021 and The Department of the Treasury, 11 July 2021). On the plus side, the prospective deal has warded off the threat of unilateral DSTs and US retaliatory tariffs for now.

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