Latest developments on BEPS 2.0
– What do they mean for Hong Kong businesses?

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01

Quick overview of BEPS 2.0

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Overview of Pillar One and Pillar Two

The OECD/G20 Inclusive Framework on BEPS (IF) consists of 141 member jurisdictions. 137 of 141 members (including the HKSAR and Mainland China) have agreed to the IF Statement issued on 8 October 2021.

01

Pillar One - Reallocating profits and taxing rights to market jurisdictions

- New nexus rules not dependent on physical presence
- Sales revenue as allocation key for **Amount A**
- Mechanism for **elimination of double taxation**
- Mandatory and binding **dispute prevention and resolution** mechanism
- **Amount B** – profits for in-country baseline marketing and distribution activities based on simplified ALP

02

Pillar Two – Global minimum tax

- Allow other jurisdictions to "tax back" income not taxed at the **minimum effective tax rate (ETR) of 15%**
- Top-up tax at the parent or/and payer jurisdictions
- Rule status: a common approach (i.e. not mandatory)

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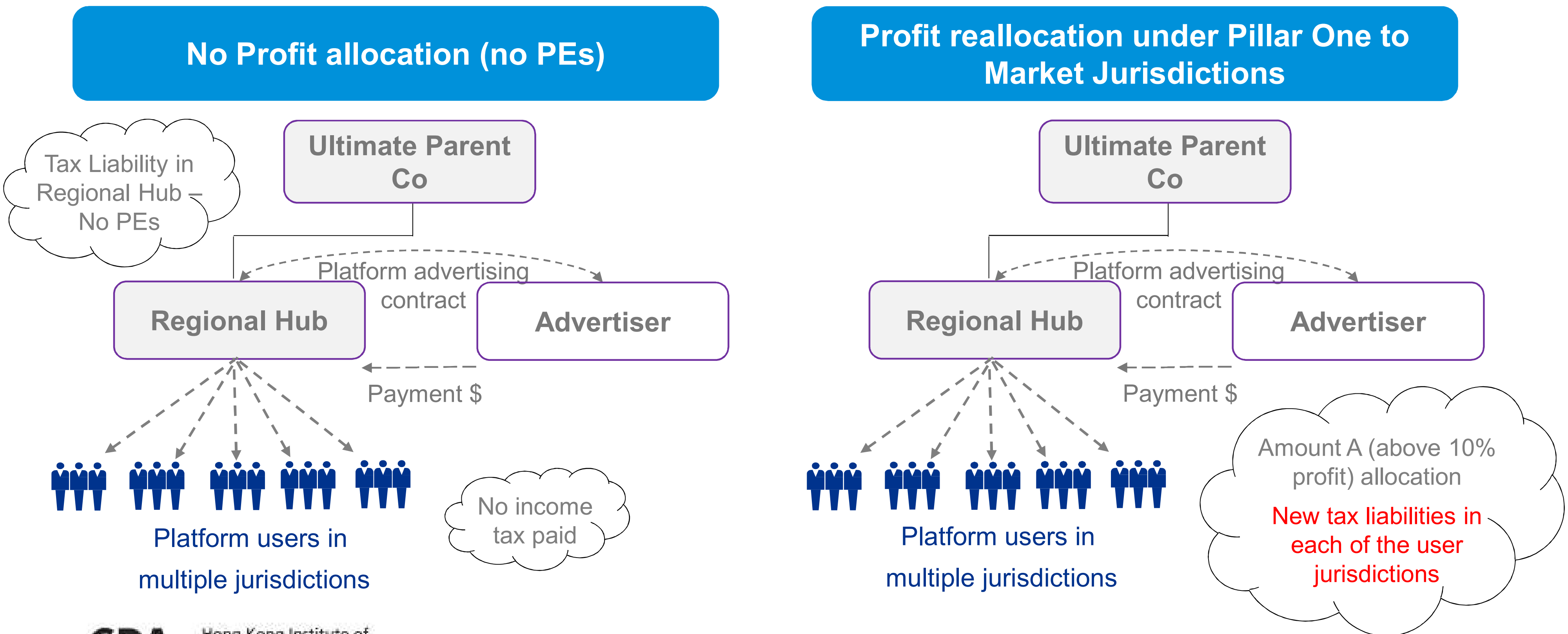
Pillar 1 - High-Level Impact (Market Jurisdictions)



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OECD/G20 IF Statement - Pillar One

P1 Key Aspects

MNEs in scope – Turnover EUR20 billion and Profitability above 10%

Exclusions – Extractives and Regulated Financial Services

Market profit allocations – 25% of profit above 10% margin (original proposal 20%-30%)

Market and distribution safe harbour – If residual profit already taxed in market

Jurisdictional taxing rights – €1 million (€250,000 if GDP less than €40 billion)

Sourcing – Where goods/services used/consumed - “reliable method”

Paying entities – Those with residual profits

Tax Certainty – Binding dispute prevention/resolution where “relating” to Amount A

Unilateral Measures – Digital Service Taxes and other relevant measures

Implementation – MLC signing 2022, Amount B on separate track. IF members to use ‘all for effect in 2023

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Pillar One – Key Open Issues

P1 Key Aspects

Scope:

- Deemed MNE group
- Foreign de minimis revenue exclusion
- Definition for 'Regulated financial services' and 'extractives' exclusions

Features affecting how much tax to be paid and where:

- Design of marketing and distribution safe harbour and double tax relief rules
- Revenue sourcing rules (e.g. intermediate products)

Tax certainty and Dispute Resolution:

- Design of mandatory and binding dispute resolution mechanism
- Scope and status of Amount B rules

of 'other relevant similar measures' for rollback alongside DSTs

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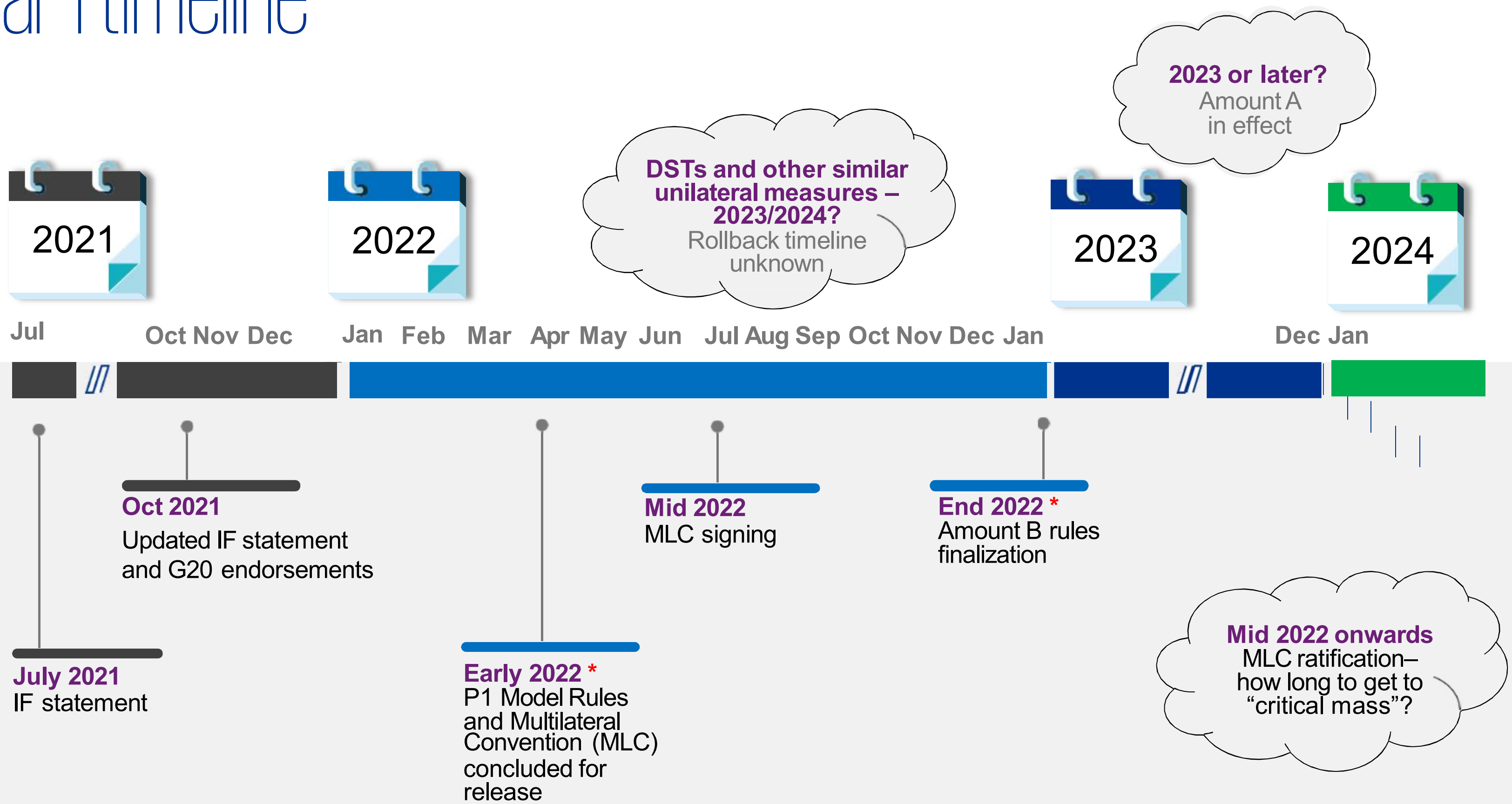
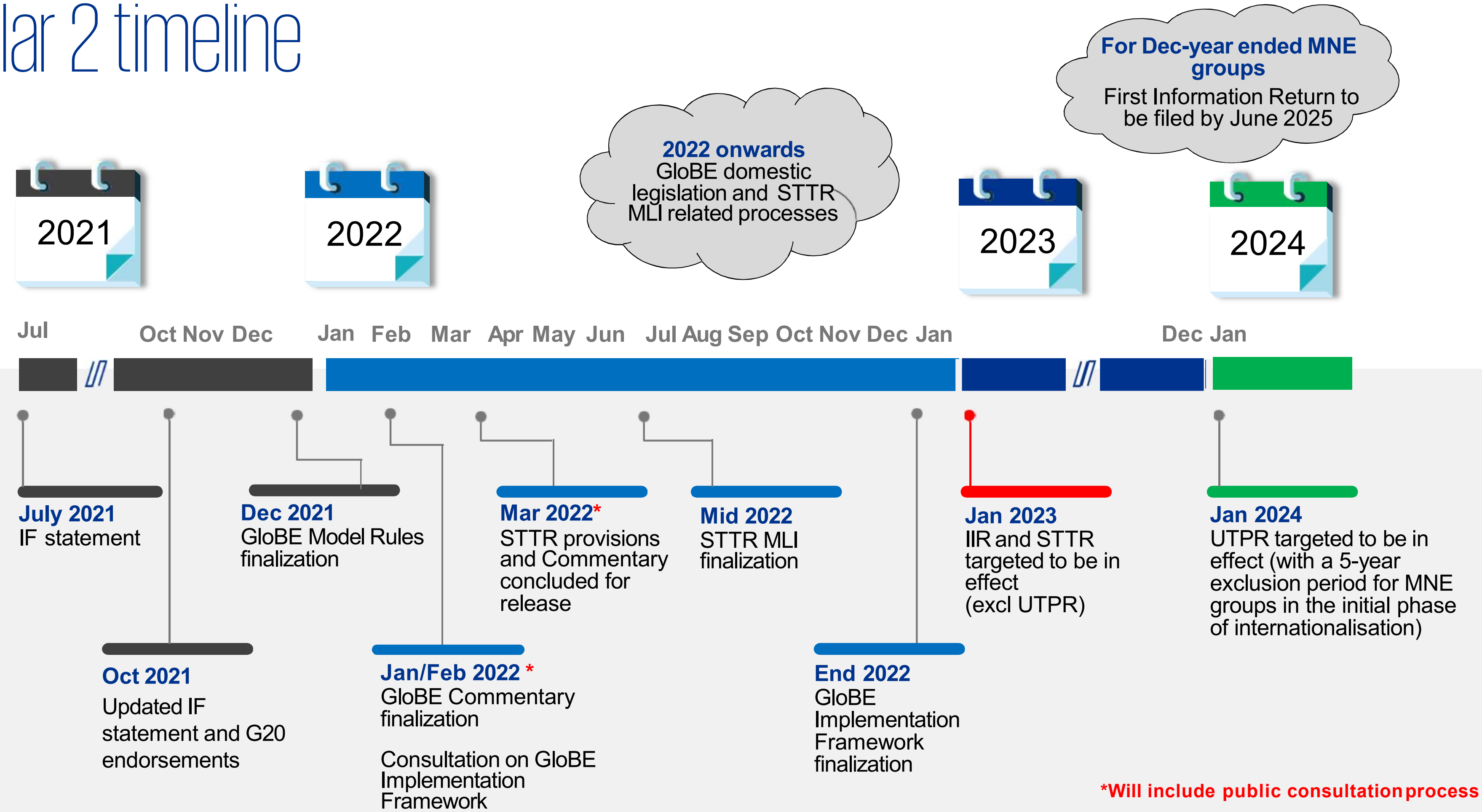
Pillar 1 timeline



*Will include public consultation process

Pillar 2 timeline



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02

Key features of the GloBE rules under Pillar 2

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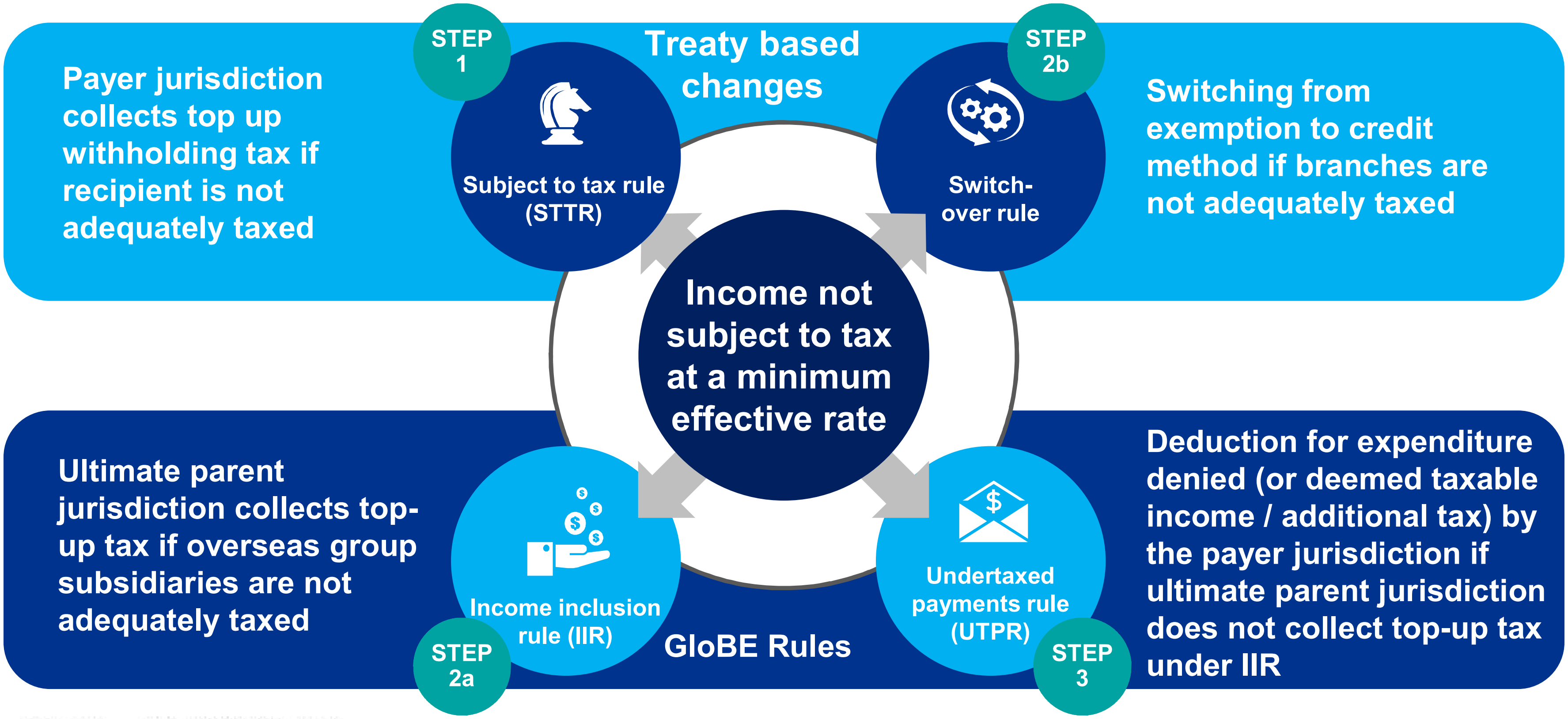
Key elements of Pillar 2



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Scope of the GloBE rules

1.1 What is a "MNE group"?

- A group with at least one entity or permanent establishment (PE) that is not located in the jurisdiction of the ultimate parent entity (UPE)

1.2 Identify MNE groups within scope

- Annual consolidated group revenue of €750m or more in 2 of the 4 prior fiscal years of the UPE
- Special rules for mergers / demergers

1.3 Identify constituent entities (CEs) within the MNE group

- All consolidated / controlled entities + PEs

1.4 Remove excluded entities

- Investment funds and REITs that are the UPE
- Certain SPVs held by excluded entities
- Pension funds, etc.

1.5 Exclude international shipping income

- International shipping income + Qualified ancillary international shipping income
- Excluded from GloBE Income/Loss
- Strategic or commercial management of ships is effectively carried on from within the location of the CE

1.6 De minimis exclusion (for jurisdictions)

- Average GloBE Revenue < €10m + Average GloBE Income/Loss < €1m or is a loss in the current and 2 preceding fiscal years of the UPE
- Subject to annual election

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Three shots at achieving global minimum tax rate of 15%

1. Domestic tax in jurisdiction

- ETR of an MNE group in each jurisdiction < 15%?
- Calculate Jurisdictional top-up tax
- Reduce Jurisdictional top-up tax by any domestic top-up tax

2. IIR

- Jurisdictions of parent entities of the MNE group adopt an IIR?
- If yes, determine jurisdictional top-up tax absorbed by the IIR
- If no or unabsorbed amount, determine if the UTPR applies

3. UTPR back stop

- Determine total remaining top-up tax owed by the MNE group
- Allocate total UTPR top-up tax to each jurisdiction that has adopted the UTPR

- 50% x $\frac{No.\,of\ employees\ in\ the\ jurisdicton}{No.\,of\ employees\ in\ all\ UTPR\ Jurisdictions}$ +
- 50% x $\frac{CV\ of\ tangible\ assets\ in\ the\ jurisdiction}{CV\ of\ tangible\ assets\ in\ all\ UTPR\ Jurisdictions}$
- CV = Carrying value

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Computation of Jurisdictional ETR and Top-up Tax

Adjusted Covered Taxes
calculated on a jurisdictional basis

———

Net GloBE Income
calculated on a jurisdictional basis

=

Jurisdictional Effective Tax Rate (ETR)

*** Substance-based income exclusion:**
- Initially: 8% of CV of tangible assets; 10% of eligible payroll costs
- After 10-year transition period: 5% for both

Net GloBE Income - Substance Based Income Exclusion* = **Excess Profit**

×

15% Minimum Rate - Jurisdictional ETR = **Top-up Tax %**

Jurisdictional Top-up Tax = (Excess Profit x Top-up Tax %) – Qualified Domestic Minimum Top-up Tax

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Allocation of Jurisdictional Top-up Tax to a CE

Top-up tax of a CE with GloBE income within a MNE group

$$= \text{Jurisdictional Top-up Tax} \times \frac{\text{GloBE Income of the CE}}{\text{Aggregate GloBE Income of all CEs}}$$

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Computation of GloBE Income / Loss of a CE

Determining GloBE Income / Loss

Financial Accounting Net Income or Loss for the CE	For preparing the consolidated financial statements of the UPE and before any consolidating adjustments
Adjustments	✓ Net tax expenses ✓ excluded dividends ✓ excluded equity gain or loss ✓ policy disallowed expenses ✓ stock-based compensation ✓ exclusion of international shipping income ✓ arm's length adjustments for intragroup transactions ✓ Others
Allocation of GloBE income / loss	✓ To permanent establishments ✓ To owners of flow-through entities
Special cases	✓ Constituent Entities joining and leaving a group ✓ Transfer of assets and liabilities and certain reorganizations ✓ Treatment of flow-through entities, hybrids and joint ventures

Computation of GloBE Income / Loss of a CE

5-Year Election on unrealised gains / losses

May elect to determine gains or losses using the realisation principle for computing GloBE income or loss

Applies to all CEs located in the jurisdiction and to all assets and liabilities of such CEs

Unless choose to limit the election to tangible assets of such CEs or to CEs that are Investment Entities

All unrealised FV gains or losses from revaluation of assets (including immovable property) and liabilities will be excluded from GloBE income or loss

Only deals with the timing difference but not permanent difference from non-taxability of capital gains in HK

Special rules apply in the year of disposal – An Annual Election to carry back the Aggregate Asset Gain in a jurisdiction to 4 prior years to set off against Net Asset Loss (i.e. loss from disposal of local tangible assets) of any CE in that jurisdiction

Adjusted Covered Taxes of a CE

Determining Adjusted Covered Taxes

How about Pillar one tax and STTR tax?

Definition of "Covered Taxes"	✓ Taxes on income, profits, profit distributions, retained earnings, withholding taxes ✓ Does NOT include turnover taxes, stamp duty, digital services tax (DST), domestic top-up tax, etc.
Starting point	✓ Current tax expense accrued in financial accounts with respect to Covered Taxes
Adjustments	✓ Additions to Covered Taxes ✓ Reductions to Covered Taxes ✓ Total Deferred Tax Adjustment Amount ✓ Increase / decrease in Covered taxes recorded in equity/OCI on GloBE income subject to tax

Adjusted deferred tax approach to deal with timing differences and losses

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Adjusted Covered Taxes of a CE

Current tax expense accrued in financial accounts with respect to covered taxes

+ **Additions to Covered Taxes** (e.g. WHT paid on passive income booked as an expense, GloBE Loss Deferred Tax Asset[1], covered taxes paid related to an uncertain tax position (UTP)[2]);

- **Reductions to Covered Taxes** (e.g. current tax expense related to excluded income, refund of certain covered taxes, current tax expense accrued related to a UTP[2], current tax expense not expected to be paid within 3 years);

+ **Total Deferred Tax Adjustment Amount** (see next slide); and

+/- **Increase / decrease in Covered taxes recorded in equity or OCI on GloBE income subject to tax**

= Adjusted Covered Taxes of a CE

Notes:

1. *GloBE Loss Deferred Tax Asset:*
    - *In lieu of applying the adjusted deferred tax approach, may make a GloBE Loss Election for a jurisdiction*
    - *A GloBE Loss Deferred Tax Asset is established in each Net GloBE Loss year: Net GloBE Loss for a jurisdiction x 15%*
2. *Accrued current tax expense related to a UTP not counted as a Covered Tax until it is paid*

Adjusted covered taxes of a CE

Total Deferred Tax Adjustment Amount =

Deferred tax expense accrued in financial accounts with respect to Covered Taxes (recast at lower of the domestic CIT rate or 15%[1])

- **-** **Exclusions** (e.g. deferred tax expense related to excluded income, deferred tax expense related to Disallowed Accrual and Unclaimed Accrual, impact of valuation adjustment or accounting recognition adjustment in respect of a DTA);
- **+** **Disallowed Accrual or Unclaimed Accrual paid during the year**;
- **+** **Recaptured Deferred Tax Liability paid during the year[2];** and
- **-** **DTA for a current year tax loss not recognised due to recognition criteria not being met**

Notes:

1. *A deferred tax asset (DTA) attributable to a GloBE loss may be recast at 15% in the year of recognition if it is recognised at a domestic CIT rate of < 15%*
2. *Amount of deferred tax liability (DTL) not paid within the 5 subsequent years must be recaptured unless it is a Recapture Exception Accrual (which includes DTL in relation to cost recovery of tangible assets and FV accounting on unrealised gains, etc.) => Reduction to Covered Taxes starting with the 5th preceding year and recalculation of ETR & top-up tax*

Treatment of pre-regime tax losses / timing differences

- Transitional rules to take into account pre-regime losses and other timing differences
- ETR for a jurisdiction in a Transition Year and each subsequent year **=> take into account all DTA and DTL** as reflected in the financial accounts of all CEs in that jurisdiction for the Transition Year
- DTA / DTL **recast at the lower of the domestic CIT rate or 15%** but a DTA attributable to a GloBE loss may be recast at 15%
- Disregard any valuation adjustment or accounting recognition adjustment with respect to a DTA
- Anti-avoidance rule – DTAs arising from items excluded from computing the GloBE income or loss must be excluded when such DTAs are generated in a transaction that takes place **after 30 November 2021**

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03

Potential changes to the Hong Kong tax system

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The HKSAR Government's response to BEPS 2.0

The HKSAR Government's work

- Participating in the OECD meetings
- Advisory Panel on BEPS 2.0
- Consultation with stakeholders
- A report with recommendations to the Financial Secretary after the rules are finalised by the OECD

The 2021/22 Hong Kong Budget

- Pending finalisation of the OECD's proposals
- Direction of response measures:
  - BEPS implementation based on international consensus
  - Minimise impact on local SMEs while maintaining simplicity, certainty and fairness of HK's tax system
  - Minimise compliance burden while safeguarding taxing rights
  - Improve business environment and enhance HK's competitiveness

A domestic minimum tax (DMT) in Hong Kong?

IRD

BTPU

Government Economists

FSTB

Financial Secretary's Office

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Potential changes to the Hong Kong tax system

BEPS 2.0

1. Implement IIR and UTPR?
2. Introduce a DMT in Hong Kong?
3. Design features of the DMT?
4. How to deal with the existing tax incentives?
5. Impact of concessionary tax rate vs government financial subsidies on the ETR?
6. Any group loss relief?

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04

Implications to Hong Kong businesses

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Some general issues / observations

01 Significance of accounting policies and treatments

- Financial accounts and deferred tax accounting play an important role in determining the GloBE Income/Loss and Adjusted Covered Taxes
- Need more detailed breakdown / analysis of the current tax expense and DTA / DTL movements

02 Treatment of losses

- DTA arising from current and prior years losses treated as a Covered Tax but no DTA is recognised for offshore losses and loss with a capital nature

03 Substance-based carve out for tangible assets

- Do not include assets that are held for sale, lease or investment
- How to ascertain the locations of movable assets?

04 Recast of deferred tax for timing differences at 15%

- This may lead to unexpected results - e.g. lowering the GloBE ETR and giving rise to GloBE top-up tax in a given year

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Some general issues / observations

05

Domestic top-up tax not treated as Covered Tax

- Compliance burden of computing the ETR & jurisdictional top-up tax + filing the GloBE Information Return remains for in-scope MNE groups
- Yet to see whether there is any safe harbor

06

Special rules apply to joint ventures

- ETR and top-up tax calculation as if the JV group a separate MNE group and the JV as the UPE
- JV partner's share of top-up tax under the IIR capped at 50%

07

Issues with minority shareholding, minority-owned sub-groups and minority-owned entities

- Complex rules for applying the GloBE rules to holding structures with minority interests

Some sector-specific issues / observations

Financial services

01 **Investment funds**

- Private equity / venture capital funds - Is the current LPF registration regime in Hong Kong a “regulatory regime”?
- Not required to prepare consolidated financial statements in general under IFRS 10
- The fund and its SPVs may be excluded but the potential Pillar 2 impact on its investee companies need to be assessed

02 **Banking groups**

- Distributions from Additional Tier One Capital treated as an expense in the computation of GloBE income or loss
- No special treatment for Tier Two Capital and profits upon written down of regulatory capital securities?

03 **Insurance businesses**

- Benefits of 5% premiums tax base (for life insurance businesses) and 8.25% tax rate (for other insurance businesses) likely offset by top-up tax

04 **Intra-group financing businesses**

- Special anti-mismatch rules to add back intra-group interest expenses to GloBE income under certain circumstances

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Some sector-specific issues / observations

Real estate / investment properties

01 **The 5-year election on unrealised revaluation gains / losses**

- The 5-year election can be rolled over indefinitely?
- Pillar 2 impact on non-taxable capital gains from disposal of properties => need to provide for deferred tax?

02 **Substance-based carve-out for tangible assets**

- Immovable property held for lease or investment not eligible for the tangible asset carve-out

03 **Exclusion of REITs**

- Subject to various conditions e.g. must be the UPE, widely held and a single level of taxation in the hands of either the REIT or its interest holders

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Some sector-specific issues / observations

Aircraft and shipping businesses

01 Airlines

- Why international shipping income is excluded but not international aviation income?
- Profits allocated to a PE not taxable in the PE jurisdiction under a tax treaty => need to pay top-up tax?
- In which jurisdictions the aircrafts are located for the tangible asset carve-out purposes?

02 Shipping groups

- International shipping income includes "income from leasing a ship on a bare boat charter basis, for the use of transportation of passengers or cargos in international traffic, to another CE"
- A group purely engaged in leasing of ships to provide financing (e.g. finance lease) without any ship transportation activities => not qualified for the exclusion?

03 General

- Aircraft / ships held for lease not eligible for the tangible asset carve-out

Some sector-specific issues / observations

Telecommunication

01

Substance-based carve-out for tangible assets

- In which jurisdictions(s) are the satellites / submarine cables located for the tangible asset carve-out purposes?
- Costs of indefeasible right of use (IRU) of spectrum represent significant business investment but not eligible for any substance-based carve out

10 recommended actions for tax leaders

Fact finding

Stakeholder management

Budget

Updates

Implementation

+ ....

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