Hong Kong Institute of
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香港會計師公會

By email (stephenlo@fstb.gov.hk) and by hand

2 December 2020

Our Ref.: C/TXG, M128169

Financial Services and the Treasury Bureau
24/F West Wing
Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Attention: Mr Stephen Lo

Dear Sir,

HONG KONG'S BEPS 2.0 READINESS

Thank you for inviting the Hong Kong Institute of Certified Public Accountants (the Institute) to take part in the BEPS 2.0 Focus Group meeting held on 9 November 2020. As a follow-up action, the Tax Faculty of the Institute has summarized our views on the possible actions that the Government could take to prepare Hong Kong for BEPS 2.0 for your reference.

1. Background

On 12 October 2020, the Organization for Economic Cooperation and Development (OECD) issued the Pillar 1 and Pillar 2 Blueprints (the Blueprints) for the Base Erosion and Profit Shifting (BEPS) 2.0 project.

The aim of **Pillar 1** is to reach a global agreement on changing the allocation of taxing rights on business profits and as a result, the market jurisdictions would have a fair share of the revenue of the relevant transactions. **Pillar 2** aims to ensure that multinational enterprises would pay a minimum tax on their revenue on their global operations.

The OECD had made it clear that the Blueprints do not reflect agreement by the member jurisdictions of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (Inclusive Framework). However, the Blueprints do provide us with a clear picture on the direction of traffic in the future development of BEPS 2.0. Implementation of the Pillar 1 and Pillar 2 initiatives would mean resetting the international tax order and Hong Kong would not be immune from the shockwave of these changes. It is crystal clear that opting out of the proposals once implemented would not be an option. Therefore, what actions should be taken to make Hong Kong more BEPS 2.0 ready should be a priority of the Hong Kong Government.

It is inevitable that we need to change the tax law of Hong Kong to cater for the

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new international tax order under the BEPS 2.0 rules. In fact, the BEPS 2.0 rules will significantly affect the fundamentals of the Hong Kong tax system. Therefore, changes to the existing Hong Kong tax legislation in relation to the new rules may be significant. While it may be considered simpler to put through piecemeal amendments to the existing Inland Revenue Ordinance (IRO) to cater for the necessary changes, reviewing the tax system on a holistic rather than a piecemeal basis may be far more efficient.

Furthermore, we understand that the Inclusive Framework intends to develop the model tax legislation and guidance to assist countries in implementing both Pillar 1 and Pillar 2. While the existing tax legislation may not be able to cater the Pillar 1 initiatives, the provisions quoted in relation to Pillar 1 are used as illustrations and the possible actions are proposed based on the existing legislation.

The structure of our letter is as follows: the discussion on Pillar 1 introduces each aspect of the proposals and then highlights the relevant possible actions for the Government to consider with reference to the provisions in the existing IRO; while the possible actions on Pillar 2 are proposed after the overall discussion.

We expect that the Government will launch another round of consultation when the OECD releases the model tax legislation. By then, we may make more specific comments. Meanwhile, we urge the Government to take this opportunity to fully review the tax system.

2. ***Pillar 1***[1]

The Pillar 1 architecture consists of three columns and 11 building blocks:

- Column one, Amount A, contains six building blocks
- Column two, Amount B, with two building blocks
- Column three, tax certainty, with two building blocks
- The final building block is implementation and administration

2.1 Amount A – scope

Two types of tests would apply, the activity and threshold tests. The **activity tests** are designed to capture multinational enterprises groups (MNEs) that participate in a sustained and significant manner in the economic life of a market jurisdiction, without necessarily having a commensurate level of taxable presence in that market under existing nexus rules. This covers MNEs that fall in either or both of the following categories: automated digital services (ADS) and consumer-facing businesses (CFB).

[1] Background information of Pillar 1 is mainly extracted from "*An overview of the OECD's Base Erosion and Profit Shifting 2.0 Pillar One blueprint"* by Ernst & Young published in the November 2020 issue of A-Plus, the monthly magazine of the Institute.

ADS are generally defined as services that are both automated (i.e., the provision of the service to a particular user requires minimal human involvement) and digital (i.e., provided over the internet or an electronic network). The Blueprint notes that ADS could be provided remotely and to markets where the MNE has little or no infrastructure to a large number of customers (or users).

The definition of ADS is comprised of positive and negative lists of ADS activities and a general definition. The positive list includes online advertising services, sale or other alienation of user data, online search engines, social media platforms, online intermediation platforms, digital content services, online gaming, standardized online teaching services, and cloud computing services.

If an activity is on the negative ADS list, it is not an ADS activity. The negative list includes customized professional services, customized online teaching services, online sales of goods and services other than ADS, revenue from the sale of a physical goods irrespective of network connectivity, and services providing access to the internet or other electronic networks.

If an activity is not on either list, the general definition applies. The general definition is included as a supplement to the two lists to account for the rapidly changing nature of digitalized business models.

CFB are businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers, including those selling indirectly through intermediaries and by way of franchising or licensing. To be considered as a CFB, the MNE should be: (i) the owner of the consumer product/service and holder of the rights to the connected intangible property (including franchisors and licensors); or (ii) the “retailer” or other contractual counterparty of the consumer.

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The following activities are specifically excluded from Amount A: certain natural resources; certain financial services; construction, sale and leasing of residential property; and international airline and shipping businesses. For activities that may be both ADS and CFB, the ADS definition applies. The threshold tests for Amount A are divided into (i) a global revenue test, and (ii) a de minimis foreign in-scope revenue test.

The €750 million threshold that is used for Country-by-Country reporting (CbCR) purposes would be used under the global revenue test. Under the de minimis foreign in-scope revenue test, revenue from the in-scope activities (i.e., from ADS or CFB) should be determined first. Then, one should check if this revenue is related to “foreign” activities. The Blueprint uses a threshold of €250 million in an example illustrating this test.

<u>Issues and possible actions</u>

- Since the CbCR threshold will also be used, the Government may use the

CbCR data to check how many MNEs that have operations will be affected (i.e., impact assessment). Together with the self-declared principal activities included in the profits tax returns, it may be possible to further narrow down if the MNEs which exceed the CbCR threshold and have business operations in Hong Kong are doing ADS and/or CFB business.

- Under Section 14 of the IRO, a profits tax liability arises when a person is carrying on a business in Hong Kong and has Hong Kong sourced profit. However, as mentioned above, ADS could be provided remotely and to markets where the MNE has little or no infrastructure to a large number of customers (or users), we may not be able to apply Section 14 of the IRO to tax the Amount A that got reallocated to Hong Kong if the MNEs engaged in ADS do not have business presence or operations in Hong Kong. Therefore, if we will take the piecemeal approach, the Government should consider the introduction of a deeming provision in Section 15 to tax Amount A.

2.2 Scope - Nexus

The Blueprint sets different nexus rules for ADS and CFB. For ADS, nexus would be established by exceeding a market revenue threshold, which has not yet been agreed. As MNEs are able, through the provision of ADS, to actively participate in the economic life of market jurisdictions without a physical presence, a revenue threshold is the only test to establish nexus.

For CFB, the nexus standard requires a significant and sustained engagement in the market jurisdiction beyond mere sales. The "plus factor" is a subsidiary or permanent establishment (PE) that carries out activities in the market jurisdiction that are connected to in-scope sales. This plus factor would entail a physical presence test with relevant sales-related activities. If any entity in the group meets this test, this plus factor requirement would be met for the entire group and would create a "group-PE" for the purposes of Amount A.

Issues and possible actions

- It is worth noting that the revenue threshold for ADS may be lower than the €750 million threshold mentioned in Section 2.1 above. The lower the threshold, the higher chance that MNEs which engaged in ADS would be regarded as having nexus in the user jurisdictions, and hence, more jurisdictions would enjoy shares of Amount A. The Government should closely monitor the discussions around this threshold as it will affect Hong Kong's entitlements to Amount A, obligations of Hong Kong entities that provide in-scope service to allocate out the residual profit, and tax policy formulation.

- Even though a "group-PE" is required for MNEs with CFB business to be considered as having nexus in the market jurisdiction, it does not necessarily

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mean that Amount A allocated to the "group-PE" would be regarded as having a Hong Kong source by reference to the decisions of the relevant Hong Kong tax cases. Therefore, the deeming provision mentioned in Section 2.1 above should also bring Amount A in relation to CFB in the scope to ensure that Hong Kong can tax the Amount A allocated to Hong Kong.

2.3 Amount A - Revenue sourcing

The sourcing rule is used to determine the revenue that would be treated as deriving from a particular market jurisdiction. The rule would be relevant in applying the scope rules, the nexus rules and the Amount A formula.

The sourcing principles differ between ADS and CFB – and these broad categories are further subdivided based on business model. Each type of activity has its own set of sourcing rules, supported by a range of specific indicators. The indicators are organized in a defined hierarchy. MNEs should generally use the indicator that is first in the hierarchy. If that indicator is unavailable or unreliable, they may use the next indicator under the hierarchy.

Issues and possible actions

- The revenue sourcing rules are not the same as the long-established source rules in Hong Kong. Based on the existing tax legislation, it is less a problem if a deeming provision will be introduced to tax Amount A. If not, we will need to map the revenue sourcing rule with Hong Kong's source rules. We can then amend Hong Kong's source rules to ensure that there is no tax leakage on the Amount A allocated to Hong Kong.

- The Government should review if it is appropriate to maintain the source rules in the tax system in the long run, given international developments.

2.4 Amount A - Tax base determinations

MNEs are permitted to rely on the Generally Accepted Accounting Principles (GAAP) used by the Ultimate Parent Entity (UPE) in preparing consolidated financial accounts, provided these standards produce equivalent or comparable outcomes to International Financial Reporting Standards (IFRS). Profit before tax (PBT) from the consolidated "profit or loss" statement (P&L) prepared under IFRS should in general be used as the starting point for the calculation.

To account for losses, the Amount A tax base rules will apply consistently at the level of the group or segment irrespective of whether the outcome is a profit or loss. Any losses arising from a taxable period will be preserved and can be carried forward to subsequent years through an "earn-out" mechanism. Losses from one segment will not be available to offset losses in another.

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Issues and possible actions

Companies incorporated in Hong Kong in general prepare their financial statements based on Hong Kong Financial Reporting Standards (HKFRS). HKFRS is considered as an equivalent to IFRS and therefore the IFRS requirement would not cause any problems to those Hong Kong outbound MNEs with in-scope services.

Using the PBT from the consolidated P&L of the UPE as the starting point for calculation of Amount A appears to be logical. Reallocation of Amount A should not have any impact to the PBT figure on the consolidated P&L. However, the reallocation of profit would likely have impact to the entity level, i.e., the need to reallocate in and out.

The reallocation amount, Amount A, Amount B and tax certainty amount could be complicated and takes time to complete. While we are not sure how the tax accounting would be done in relation to these reallocated profit (i.e., whether it will only be reflected as tax adjustments in tax filing of the jurisdictions where reallocation is involved or it will also be reflected in the financial statements of the respective entity in the following year) we trust that the tax consequence of the reallocation of profit should be reflected in the relevant year of assessment.

In the circumstances that the reallocated amounts will likely be only available after the tax returns are filed and the relevant notices of assessment become final and conclusive under Section 70 of the IRO, can the existing tax legislation cater for such reallocation? If the Hong Kong entity receives Amount A reallocation, the Inland Revenue Department (IRD) can raise additional assessment under Section 60 of the IRO. However, if the Hong Kong entity is required to allocate out residual profit, would the IRD accept that as an error or omission in the original tax return filed and allow the taxpayer to re-open the assessment under Section 70A of the IRO? If the entity that needs to allocate out profit is unable to get tax refund, double taxation may arise. Please refer to Section 2.6 for further discussion on this point.

In view of the above, appropriate amendments to the existing tax legislation may be required to simplify the tax administration procedures.

2.5 Amount A - Profit allocation

The Amount A formula is comprised of three distinct components rather than based on the arm's length principle (ALP):

Step 1: A "profitability threshold" to isolate residual profits potentially subject to reallocation

Step 2: A "reallocation percentage" that defines the share of residual profits (actual profits minus the profitability threshold), or allocable tax base, that is

allocated to market jurisdictions
Step 3: Use of an allocation key to allocate the allocable tax base among the eligible market jurisdictions

The allocation key (step 3) defines the mechanism for allocating the Amount A profit to eligible market jurisdictions (that is, jurisdictions with Amount A nexus). The allocation is based on in-scope revenues and could be implemented through either a profit-based or profit margin approach.

Issues and possible actions

- Amount A is not calculated based on the ALP. Whereas, Transfer Pricing Rule 1 (TP Rule 1) in the IRO is based on ALP. Consideration should be given if amendment to the existing TP Rule 1 or introduction of a deeming provision as suggested in Sections 2.1 & 2.2 above is required.

- The profitability threshold would be used to isolate the residual profits. Entities within the MNE group would still be subject to normal transfer pricing function, asset and risk assessment in the profit allocation. As indicated in paragraph 509 of the Pillar 1 Blueprint, the higher the profitability threshold, the lesser number of MNEs and the smaller the estimated global residual profit will be within the scope of Pillar 1. If the profitability threshold is set at 25%, it is estimated that only 150 MNEs and US$100 billion will be within the scope of Pillar 1.

  The profitability threshold would affect the impact assessment mentioned in Section 2.1 above. Yet, since the profitability threshold had not yet been agreed, we can take a wait and see approach on this.

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2.6 Amount A - The issue of double counting

Amount A is an overlay to the existing income tax system, and interaction with that system could lead to duplicative taxation. Specifically, if the existing system already allocates residual profits to market jurisdictions, such profits may be taxed twice through regular transfer pricing rules and again through Amount A.

Issues and possible actions

- As consolidated P&L will be the starting point for calculation of Amount A, the aggregated amount of turnover at entity level would likely be higher than the consolidated turnover as the intercompany transactions would have been eliminated during the consolidation process. The profitability level of individual entity would unlikely be the same across the group companies. It is worth noting that some entities would need to allocate out and some market jurisdictions would allocate in Amount A. It is possible that the entities that are required to allocate out had been subject to tax in their jurisdictions on the

relevant amount. And the jurisdictions that got Amount A allocated in would impose tax again on the relevant amount. Double counting of taxable profit and double taxation may result.

- As mentioned in paragraph 570 of the Blueprint, elimination of double taxation could be done by the exemption method or the credit method. To apply the exemption method, the timing of Amount A recognition could be an issue. As mentioned in Section 2.4, appropriate amendments to Section 70A of the IRO may be required to cater for the exemption if Amount A would only be allocated out after the year of assessment.

- If the credit method were to be adopted, the introduction of unilateral tax credit set off in the tax legislation is unavoidable as tax credit set off is only allowable for income tax paid in jurisdictions where Hong Kong has comprehensive double taxation agreements with them under the existing IRO.

2.7 Amount B

Amount B is intended to standardize the remuneration of related party distributors that perform “baseline marketing and distribution activities” in a manner that is aligned with the ALP. These rules are intended to simplify the administration of transfer pricing rules and reduce compliance costs, while also enhancing tax certainty and reducing controversy. Amount B will apply to entities or PEs with an existing nexus, and as such is not related to the new nexus rules of Amount A. Importantly, the scope limitations of Amount A relating to the activity tests and threshold tests are not applicable to Amount B.

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The controlled transactions in scope of Amount B could consist of (i) the purchase of products from related parties for resale to unrelated customers predominantly, and the associate performance of baseline distribution activities; and (ii) the performance of baseline marketing and distribution activities in the state of residence, transacting or dealing with a foreign associated enterprise.

Amount B would apply to distribution activities that according to the accurate delineation of the transaction would be characterized as a routine distributor. Marketing and distribution activities as in- or out-of-scope activities will be identified by reference to defined “positive lists” and “negative lists” of qualitative factors. These lists include examples of functions, assets and risks that would be (positive list) and would not be (negative list) expected of a distribution entity with baseline activities. Certain quantitative factors would also be used to further support the identification of in-scope activities. The current intention is for Amount B to apply to a relatively narrow scope of entities that would generally be characterized as a routine distributor in relation to a controlled transaction, excluding commissionaires and sales agents. However, some Inclusive Framework members want to explore the feasibility of broadening the scope.

The quantum of Amount B and thereby the remuneration for the baseline marketing and distribution activities will be determined using the transactional net margin method. A rebuttable presumption may be introduced for cases where evidence is provided that another transfer pricing method is the most appropriate method to use.

Amount B would be implemented through domestic law or regulations. The Blueprint indicates that existing treaties can resolve disputes over Amount B. Where there is no treaty in place, a new treaty-based dispute resolution mechanism may be required.

Issues and possible actions

- While Pillar 1 will be less impactful to smaller MNEs with in-scope activities, the turnover threshold of €750 million for Amount A does not apply to Amount B. Therefore, MNEs that have cross-border in-scope activities would theoretically be subject to the Amount B profit reallocation. We mentioned in Section 2.1 above that the Government can use CbCR information to do an impact analysis, and analysis on Amount B should not be overlooked.

- As Amount B is also calculated based on the residual profit, the double counting issue mentioned in Section 2.6 above may also occur. Method for eliminating double taxation for Amount B should also be introduced in the tax system.

- Under the current proposal, the scope of Amount B is relatively small. It is not clear how Amount B will interact with the current Section 15F of the IRO, the normal profit and TP Rule 1. The Government should make it clear in the tax legislation or at least provide clear guidance to taxpayers on this.

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2.8 Tax certainty and dispute resolution

Regarding Amount A, a mandatory binding dispute prevention process that aims to address in advance potential issues regarding Amount A was proposed – such as the correct delineation of business lines and calculation of its profits, the existence of nexus, or the identification of paying entities. The process would be based on an MNE's self-assessment that would be reviewed by a representative review panel in first instance and, if no agreement can be reached at that stage, by a determination panel in second instance. The agreement reached in this process would be binding on all relevant tax administrations and on the MNE.

The tax certainty approach beyond Amount A includes a number of steps, including dispute prevention, use of the existing mutual agreement procedure (MAP), as well as a new mandatory binding dispute resolution mechanism. For developing countries, elective binding dispute resolution is contemplated.

Finally, the Inclusive Framework is exploring a mandatory binding dispute resolution for MAP cases that remain unresolved after an agreed period. The Inclusive Framework would agree on the defined period after which the dispute resolution mechanism would be triggered and the mutual agreement would be submitted to a panel of experts (a determination panel) who would reach a decision.

Issues and possible actions

- The Blueprint contains a detailed draft outline of the early certainty approach including various elements and stages. In fact, an MNE could make a request to the lead tax administration for certainty on whether it is in the scope of Amount A and whether the determination and allocation of Amount A is correct after filing the self-assessment return. The lead tax administration may establish a review panel with ideally six to eight tax administrations, depending on the MNE's footprint with an aim to reach an agreement on Amount A.

- If an objection is received by the review panel and could not be resolved, the case would be passed to the determination panel. The decision of the determination panel will be binding to all Inclusive Framework members.

- It appears that there will be increased level of international liaison, discussions or even debates on Amount A going forward. It seems that Hong Kong does not have enough sufficiently experienced tax specialists within the IRD to take part in these international discussions. The current recruitment mechanism, which only allows the hiring of entry level staff, makes it impossible for the IRD to hire external experienced tax professionals. To this end, the Government should review the IRD's staffing requirements and explore the possibility to hire more experienced staff members from the market directly.

2.9 Implementation and administration

The Blueprint indicates that the implementation framework for Pillar 1 is yet to be developed. This will require action across three different aspects: domestic law, public international law and guidance to supplement these two elements.

On the key question of removal of unilateral measures, it is expected that any consensus agreement will require a commitment for such removal. However, no implementation guidance on this has been developed yet.

Issues and possible actions

- Many jurisdictions have a digital services tax (DST) in place. It is expected that these unilateral measures will be removed upon implementation of the

Pillar 1 initiatives. In the meantime, the Government should monitor and assess the impact of DST on Hong Kong based MNEs and keep them informed on the latest developments of BEPS 2.0.

- The Government should actively participate in the discussion on the Pillar 1 administration so that it can better prepared for the necessary changes to the tax system and the implementation of the Pillar 1 initiatives.

3. Pillar 2

3.1 Overall design considerations[2]

Pillar 2 is designed to ensure that MNEs having cross-border activities pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in. It does so via a number of interlocking rules that seek to:

(i) Ensure minimum taxation while avoiding double taxation or taxation where there is no economic profit;
(ii) Cope with different tax system designs by jurisdictions as well as different operating models by businesses;
(iii) Ensure transparency and a level playing field; and
(iv) Minimize administrative and compliance costs.

3.2 The interlocking rules

There are four rules under Pillar 2, namely:

(i) Subject to tax rule (STTR);
(ii) Income inclusion rule (IIR);
(iii) Undertaxed payments rule (UTPR); and
(iv) Switch-over rule (SOR).

The **IIR** and the **UTPR** are collectively known as the "**GloBE rules**". They use the same rules to determine scope and the level of effective taxation.

The operation of the **IIR** is, in some respects, based on the traditional controlled foreign company rule principles and triggers an inclusion at the level of the shareholder where the income of a controlled foreign entity is taxed at below the effective minimum tax rate. It is complemented by a **SOR** that removes treaty obstacles from its application to certain branch structures and applies where an income tax treaty otherwise obligates a contracting state to use the exemption method.

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[2] Paragraphs 8-11 of the Pillar 2 Blueprint

STTR complements these rules. It acknowledges that denying treaty benefits for certain deductible intra-group payments made to jurisdictions where those payments are subject to no or low rates of nominal taxation may help source countries to protect their tax base, notably for countries with lower administrative capacities.

3.3 The GloBE rules

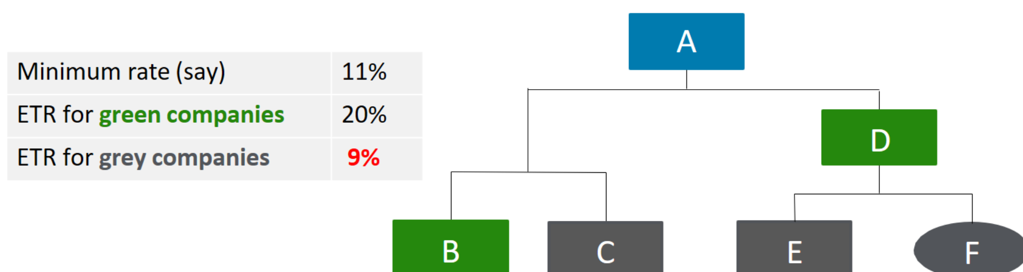
MNEs with consolidated group revenue of at least €750 million (or equivalent) in the immediately preceding fiscal year are in scope of the GloBE rules.

The IIR and the UTPR use a common tax base and a common definition of taxes – "covered tax". Covered tax in general encompasses income taxes (both domestic and foreign) but excludes turnover taxes, digital services taxes and government levies.

If an MNE's jurisdictional effective tax rate (ETR) is below the agreed minimum rate, the MNE will be liable for an incremental amount of tax that is sufficient to bring the total amount of tax on the excess profits up to the minimum rate. The ETR calculation therefore operates both as a trigger for the imposition of the tax liability and as a measure of the amount of top-up tax imposed under the rules.

Jurisdictional ETR is determined by applying the tax base and covered taxes on a jurisdictional basis.

Operation of the IIR is illustrated in the following example:

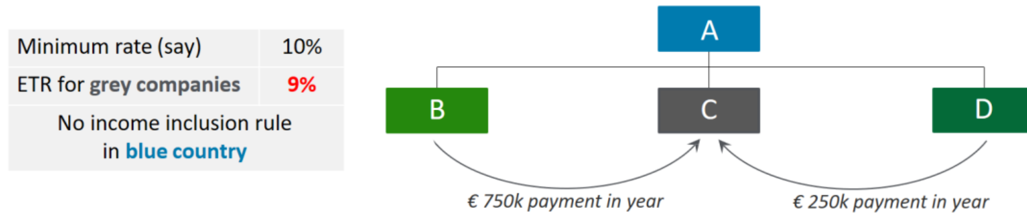


Source: Jonathan Culver, Deloitte China

- The IIR operates on a top-down approach
- If the UPE is in a jurisdiction where the IIR operates, any top-up tax is payable by the UPE to its tax authority. If not, the next intermediate holding companies in the ownership chain should apply the rule instead for their low-taxed subsidiaries
- If A is in a jurisdiction where IIR operates, it will collect the top-up tax from C, E and F and pay the top-up tax to the local tax authority where A is situated

- If A is in a jurisdiction where IIR does not operate, D will collect the top-up tax from E and F and pay the top up tax to the local tax authority where D is situated
- SOR will allow a parent country to "top up" the tax on the income of overseas permanent establishments

Operation of the UTPR is illustrated in the following example:



Source: Jonathan Culver, Deloitte China

- The UTPR is a secondary/backstop rule and it only applies when the IIR has not been applied
- Top-up tax is allocated to other companies in the group based on a formulaic approach
- As A is in a jurisdiction where the IIR does not operate, the UTPR applies and the top-up tax will be collected by B and D and paid to the respective local tax authorities

3.4 STTR

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The STTR applies before the IIR and UTPR. Paying (source) jurisdictions would be able to charge a top-up tax in respect of specific types of intragroup payments made to other group companies, where the recipient jurisdiction has a nominal tax rate less than a minimum tax rate. The rule would be applied on a payment-by-payment basis, but could be calculated and administered by way of an annual return.

3.5 *Implications of the GloBE rules for Hong Kong taxpayers*[3]

<u>Groups with jurisdictional ETRs below the minimum</u>

Consensus has not been reached on the minimum ETR. However, examples in the Blueprint use various tax rates between 10% and 12.5%. While these rates are lower than Hong Kong's headline tax rate of 16.5%, the presence of offshore claims or exempt capital disposals and other adjustments, e.g. reduced tax rates

[3] A substantial part on the Pillar 2 implications to Hong Kong is extracted from *"An overview of the OECD's Base Erosion and Profit Shifting 2.0 Pillar Two blueprint"* by Deloitte China, published in the November 2020 issue of A-Plus, the monthly magazine of the Institute.

applicable to preferential tax regimes, may decrease a group's ETR below the minimum.

Groups below the minimum ETR may be subject to top-up tax and may not be able to benefit from certain favourable aspects of Hong Kong's tax system such as exemptions, reliefs and incentives.

Inbound versus Hong Kong headquartered groups

Under the proposed rules, there would be a difference between groups that are inbound into Hong Kong and those that are headquartered in Hong Kong. Generally, where a group that is headquartered outside Hong Kong has implemented an IIR, the Hong Kong based operation would be subject to the IIR, such that top-up tax may be collected in respect of Hong Kong entities.

However, absent a change in domestic law, the Hong Kong operation of a Hong Kong headquartered group would not be subject to the IIR of any jurisdiction, while the part of the group that operates outside Hong Kong may be subject to top-up tax from another jurisdiction's IIR. In this instance, the UTPR may be applied elsewhere in the group in respect of certain intragroup payments, and top-up tax may be paid in respect of the Hong Kong headquartered operation by those jurisdictions that have an ETR above the GloBE minimum and are therefore eligible to collect top-up tax under the UTPR.

As a result of limitations on the tax that can be collected under the UTPR, where intragroup payments are relatively low, groups may pay less tax overall through the application of the UTPR as compared to the IIR.

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US headquartered groups

While consensus has not been reached on treating the United States Global Intangible Low-Taxed Income (GILTI) regime as a valid IIR for the purposes of the GloBE rules, the Blueprint specifically addresses the need to consider this issue further and outlines the rationale for treating GILTI as an IIR. If GILTI were to be treated as an IIR, this would effectively create a new category of taxpayers under GloBE – those with an ultimate, or in certain cases, intermediate, US headquarters. While GILTI has certain similarities to the IIR proposed under GloBE, it also has significant differences, which may complicate jurisdictions' policy responses to GloBE.

Funds

The Pillar 2 Blueprint specifically excludes investment funds on broad policy grounds. The exclusion applies where the UPE of a group that would be subject to GloBE qualifies as an investment fund. Currently, investment funds owned by a group that undertakes a non-investment management business are not covered

by the exclusion, however, the consultation document will explore further whether this is necessary, and how the exclusion could be broadened.

There is significant overlap between the investment funds exclusion under the Blueprint and the unified fund exemption under Hong Kong tax legislation. While each fund and its subsidiary entities would need to be considered on a case-by-case basis, a significant population of funds that are incorporated, established, or administered in or from Hong Kong should be excluded from these rules. Importantly, offshore funds that are exempt under Section 20AC of the IRO, and do not qualify under the unified funds exemption, may not fall within the Pillar 2 Blueprint exemption based on the current definition of “investment fund”.

Banks, broker dealers, and other share traders

Dividends received, and share trading gains and losses in respect of portfolio shareholdings would be included in the GloBE tax base of the recipient, whereas, amounts in respect of non-portfolio shareholdings would not. The treatment of covered taxes would follow the inclusion or exclusion of income in order to provide symmetry. The conditions or thresholds to be met for a shareholding to be considered a portfolio holding are to be determined. However, portfolio shareholdings typically are shareholdings of a relatively low percentage, often less than 10% of the total ordinary shares issued.

Hong Kong does not tax dividends, or share trading gains in respect of transactions executed on an exchange outside Hong Kong. Accordingly, groups engaged in share trading are likely to have relatively low ETRs, particularly where share trading represents one of their main activities and therefore may be significantly affected by GloBE.

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Helpfully, covered taxes would be taken into account, and it appears that taxes in excess of the minimum ETR may be blended with those below the minimum ETR in order to reduce the top-up tax that an entity may be required to pay. Anti-avoidance rules would be introduced to prevent the intentional shifting of withholding tax to a jurisdiction in order to increase its ETR and thus reduce the amount of top-up tax payable. As the focus of these rules is likely to be passive income, commercial trading portfolio aggregation may be acceptable.

Life insurance companies

Several considerations are unique to insurance companies. Firstly, life insurance companies, particularly those taxed under the 5% net premium basis, are taxed in a manner that is entirely disconnected from the accounts. Applying the IIR or UTPR based on a minimum ETR in this instance could effectively change the basis of taxation for these insurance companies, and would likely lead to a significant increase in taxation. This will be further complicated by the implementation of IFRS 17 *Insurance Contracts*.

The Pillar 2 Blueprint provides an exclusion for investment returns of life insurance policyholders where the policyholder is beneficially entitled to the investment return. However, for most investment-linked products written by life insurance companies in Hong Kong, the life insurer remains beneficially entitled to this income until it is paid to a policyholder. Accordingly, this exclusion would need to be broadened significantly in order to be useful.

3.6 Implications of the STTR for Hong Kong

The STTR would operate differently to the GloBE rules and reference a nominal minimum tax rate instead of a minimum ETR. The focus of the STTR is not on considering the jurisdictional ETR of the recipient, but on whether an individual payment would be subject to a minimum rate of tax under the tax law of the relevant jurisdiction.

Where a payment is not subject to a minimum nominal tax rate and a jurisdiction has ceded its taxing rights through a treaty, top-up tax may be applied in order to increase the applicable tax rate up to the minimum. The minimum nominal tax rate is yet to be determined, although it is likely to be below the minimum ETR used for the purposes of GloBE in order to reduce instances of over-taxation.

The STTR would apply before the GloBE rules and would be limited to certain payments between related parties.

The STTR could have significant implications for Hong Kong and due to its application to payments, could apply even where a group has a high jurisdictional ETR for purposes of the GloBE. Offshore claims and the use of incentives applying to related party payments such as the corporate treasury centre may be particularly affected.

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3.7 Possible actions

<u>Introduction of the IIR and domestic minimum tax in the Hong Kong tax legislation</u>

Groups with a Hong Kong jurisdictional ETR lower than the minimum are likely to be subject to top-up tax in respect of their Hong Kong operations, representing an overall increase in taxation for the group.

As illustrated in Section 3.3 above, the UTPR applies or top-up taxes be collected at the intermediate holding company level where an IIR operates if the UPE jurisdiction does not operate an IIR. Hence, it is important for Hong Kong to introduce the IIR in its domestic tax legislation such that MNEs with UPE located in Hong Kong would be able to collect top-up tax of the groups and remit such tax revenue to the IRD.

In addition, the low-tax income of the group entities located in the UPE jurisdiction cannot be subject to any IIR, and only the UTPR can apply in respect of such low-tax income. A domestic minimum tax on income, however, could be introduced in a jurisdiction for in-scope taxpayers. This would aim at ensuring that the MNE's jurisdictional ETR in the ultimate parent and foreign subsidiary jurisdictions are at least equal to the agreed minimum rate and would prevent tax leakage at jurisdictional level due to application of an IIR on UTPR. Therefore, the Government should seriously consider the introduction of domestic minimum tax for those Pillar 2 in-scope taxpayers in the tax legislation.

Review the effectiveness of the preferential tax regimes and tax rules for special industries

A few industries, including investment funds, will be carved out under Pillar 2. However, not all of the preferential tax regimes in Hong Kong are on the carve-out list. A top-up tax applicable to those in-scope entities enjoying the benefits of the preferential tax regimes, may make the regimes ineffective. To this end, the Government should conduct a comprehensive review of the preferential tax regimes and consider removing ineffective ones.

The Government could consider applying the domestic minimum tax in the preferential tax regimes for those in-scope entities. The Government could also consider the introduction of non-tax incentives to attract foreign investments as an alternative to the preferential tax regimes. The additional revenue received from the top-up tax collected could be used to fund the non-tax incentives.

The Government should review the tax rules that apply to special industries, e.g. insurance, and revise such tax rules to avoid tax leakage due to application of the GloBE rules.

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Tax loss in the ETR calculation

In the ETR calculation, any tax loss of an entity will be blended with profit of other entities within the group in the same jurisdiction. As a result of this consolidation, the ETR of a group in a jurisdiction may increase. To this end, the Government may consider introducing group tax loss set off in the domestic tax legislation such that it is in line with the logic of the proposed ETR calculation basis.

Explore the possibilities of introducing re-domiciliation rules in the Companies Ordinance

Many MNEs are reviewing the impact that implementation of BEPS 2.0 may have on their operations. Though many MNEs are taking a wait and see approach and preparing to take actions when the detailed rules of BEPS 2.0 are finalized, many are considering cross-border group restructuring to lower their overall ETRs.

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Hong Kong, being a relatively low tax jurisdiction, is an attractive jurisdiction for MNEs in which to relocate their relatively mobile group activities, and "economic substance". However, at present the Hong Kong Companies Ordinance does not make provision for foreign companies to re-domicile to Hong Kong. While there were discussions on the possible introduction of re-domiciliation rules into the Companies Ordinance in 2019 when certain offshore jurisdictions, e.g. the British Virgin Islands, Cayman Islands and Bermuda, introduced economic substance laws, in response to the OECD's substantial activities requirements, this was not a policy priority of the Government. As BEPS 2.0 will likely have bigger impacts on Hong Kong compared to the economic substance laws, the Government should reconsider the introduction of re-domiciliation rules into the Companies Ordinance as a policy priority.

<u>Fairness</u>

Hong Kong headquartered groups would be affected differently than inbound multinationals. They could be subject to the UTPR, but should not be subject to the IIR of another jurisdiction. Accordingly, they may prefer not to pay a minimum tax in Hong Kong that is modelled on the GloBE and STTR. Consideration should be given to the policy approach towards these groups and whether differing rules are desirable in the context of fairness, harmful tax practices, revenue collection, and the general attractiveness of Hong Kong.

Overall, Hong Kong's ability to pursue certain fiscal policy aims may be curtailed by Pillar 2 and Hong Kong will need to be mindful of the implications of Pillar 2 when making policy decisions. Beyond attempting to retain and improve existing fiscal policy measures, it may be necessary to adopt a more nuanced policy approach in the future, recognizing the importance of a group's position under Pillar 2, and in particular its marginal tax rate, when making investment or rationalization decisions.

If you have any questions on our above comments, please do not hesitate to contact me at 2287 7075 or ericchiang@hkicpa.org.hk.

Yours faithfully,

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