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Tax
Issue H99/2020 – 19 October 2020

Hong Kong Tax Analysis

BEPS Pillar Two – Impact on Hong Kong

On 12 October 2020, the G20/OECD inclusive framework on BEPS ("inclusive framework") released two detailed "blueprints" in relation to its ongoing work to address the tax challenges arising from the digitalization of the economy. The Pillar Two blueprint proposes a set of interlocking international tax rules designed to ensure that large multinational businesses pay a minimum level of tax on all profits in all jurisdictions. Comments on the blueprints are invited by 14 December 2020 and a virtual public consultation meeting will be held in January 2021. The OECD's aim is to bring the process to a conclusion by mid-2021.

The Pillar Two blueprint sets out proposals that do not yet have the political agreement of the inclusive framework countries, including the following key elements:

- **The income inclusion rule and the undertaxed payments rule (GloBE)**: Connected rules that are intended to ensure large multinational groups pay tax at a minimum level in each jurisdiction in which they operate. These share common rules for scope, and for calculating effective tax rates and top-up amounts.
    - The principal rule is the income inclusion rule (IIR), which will trigger additional "top-up tax" payable in a group's parent company jurisdiction where the profits of group companies in any one jurisdiction are taxed at an effective tax rate (ETR) below a minimum tax rate. A switch-over rule will apply similarly to exempt branches.
    - An undertaxed payments rule (UTPR) acts as a backstop for low-taxed group companies not controlled by a parent company subject to the income inclusion rule.
- **The subject to tax rule (STTR)**: A separate rule that applies in priority to the income inclusion and undertaxed payments rule. Paying (source) jurisdictions will be able to charge a top-up tax in respect of specific types of intra-group payments made to other group companies, where the recipient jurisdiction has a nominal tax rate less than a minimum tax rate. The rule is applied on a payment-by-payment basis, but may be calculated and administered by way of an annual return.

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A summary of the Pillar Two blueprint was published by Deloitte on 12 October and can be found here. The remainder of this article assumes a base level of knowledge regarding the Pillar Two blueprint and focusses on highlighting the elements that are most relevant to groups operating in Hong Kong and Hong Kong's possible policy response.

Implications of the GloBE for Hong Kong

When considering the implications of the GloBE to Hong Kong taxpayers, it is useful to categorize taxpayers into the following groups.

Country-by-Country reporting groups

The GloBE should only apply to multi-national groups that satisfy the OECD's country-by-country reporting filing rules i.e. those that have consolidated revenue in excess of EUR750m. Therefore, relatively small groups or purely domestic groups should not be impacted.

Groups with jurisdictional ETRs above and below the minimum

The GloBE only applies where jurisdictional ETR falls below a certain minimum ETR at which point the IIR, or UTPR will apply. If the ETR exceeds the minimum, the GloBE will not apply. Consensus has not been reached on the final minimum ETR. However, examples in the Pillar Two blueprint use various tax rates between the range of 10% and 12.5%. While these rates are lower than Hong Kong's headline tax rate of 16.5%, when computing ETR under GloBE we anticipate that many Hong Kong taxpayers will have an ETR below this range. This is due to a combination of factors including, the territorial nature of Hong Kong's tax system, the non-taxation of capital gains and various exemptions and incentives offered in respect of particular classes of income and activities.

Taxpayers below the minimum ETR may not be able to benefit from certain favorable aspects of Hong Kong's tax system. However, taxpayers that have an ETR above the minimum may still wish to benefit from these favorable aspects and may still be attracted by the ability to make offshore claims, tax free capital disposals and benefit from various exemptions and incentives.

Fiscal policy will continue to be an important tool for Hong Kong to attract investment. However, in addition to retaining and improving the existing regime and incentives it may be necessary to adopt a more nuanced approach to tax policy, recognizing the importance of a group's position under Pillar Two and in particular its marginal tax rate when making investment or rationalization decisions.

Inbound as compared to Hong Kong headquartered groups

There will be a difference between groups that are inbound into Hong Kong and those that are headquartered in Hong Kong. As a general matter, where a group is headquartered outside of Hong Kong, assuming that the jurisdiction of the headquarters, or one beneath it in the ownership chain has implemented an IIR, the Hong Kong based operation will be subject to an IIR, such that top-up tax may be collected in respect of Hong Kong entities.

However, absent a change of domestic law, the Hong Kong operations of a Hong Kong headquartered group would not be subject to the IIR of any jurisdiction. The part of the group that operates outside of Hong Kong may be subject to top-up tax from another jurisdiction's IIR. However, the Hong Kong based component would not be. In this instance, UTPR may be applied elsewhere in the group in respect of certain intra-group payments and deductions may be denied in those jurisdictions that have an ETR above the GloBE minimum, in order to effectively collect top-up tax that cannot be collected by way of IIR.

US headquartered groups

While consensus has not been reached on treating US Global Intangible Low-Taxed Income (GILTI) as a valid IIR for the purposes of the GloBE. The Pillar Two 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 which have 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 the policy responses of jurisdictions to GloBE.

Funds

The Pillar Two blueprint specifically excludes investment funds on broad policy grounds. The exclusion applies where the ultimate parent entity of a group that would be subject to GloBE qualifies as an investment fund. Currently, investment funds that are 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 to cover these scenarios. There is significant overlap between the investment funds exclusion under the Pillar Two blueprint and the unified fund exemption under Hong Kong tax law. While each fund and its subsidiary entities will 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, and do not qualify under the unified funds exemption, may not fall within the Pillar Two blueprint exemption based on the current definition of 'investment fund'.

Hong Kong may wish to consider how its fund exemptions could be more closely aligned with the Pillar Two blueprint definition of investment funds in order to maximize the population of funds that may benefit both from an exemption from Hong Kong tax and GloBE.

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 across years. It may also be difficult for insurance companies to model the potential impact of these changes given the ongoing work being conducted to transition accounting standards for insurance contracts from IFRS 4 to IFRS 17.

The Pillar Two blueprint does provide an exclusion for investment returns of life insurance policyholders in circumstances 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 such time as it is paid to a policyholder. Accordingly, this exclusion would need to be materially broadened in order to be useful.

Banks, broker dealers and other share traders

Dividends received and share trading gains and losses in respect of portfolio shareholdings will be included in the GloBE tax base of the recipient, whereas amounts in respect of non-portfolio shareholdings will be excluded from the GloBE tax base. The treatment of covered taxes will 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 are typically 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 of 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 impacted by GloBE.

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

Implications of the STTR for Hong Kong

The STTR will operate differently to the GloBE rules and will reference a nominal minimum tax rate instead of a minimum ETR. The focus of the STTR therefore is not on considering the jurisdictional ETR of the recipient, but on whether an individual payment will 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, treaty benefits may be denied in order to increase the applicable tax rate up to the minimum. The minimum nominal tax rate is yet to be determined, although the Pillar Two blueprint suggests that it should be below the minimum ETR used for the purposes of GloBE in order to reduce instances of over-taxation. As the STTR focusses on individual payments instead of the ETR of entities in a jurisdiction as a whole, no consideration is given to the deductibility, or non-deductibility of expenses. This could lead to situations where tax charged on income under the STTR is in excess of the economic profit earned, for example, where significant expenses are incurred to generate the income.

The STTR will apply before the GloBE rules, such that any additional WHT suffered as a result of the denial of treaty benefits should be factored into the minimum ETR calculation for GloBE purposes. The STTR is limited in its application to payments between related parties and in terms of the nature of payment will focus on interest, royalties and a defined set of other payments[1].

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. The following areas may be impacted:

- Offshore claims – Any offshore claim in respect of income covered by the STTR is likely to result in the denial of treaty benefits given no tax is charged on this income. In particular, the receipt of offshore royalties that currently benefit from the application of a treaty are likely to be impacted.

- Incentives – Income earned that is subject to a reduced rate of tax under one of Hong Kong's incentives is also likely to be affected. The Corporate Treasury Centre incentive, which is an incentive focussing on related party payments that may be passive in nature (e.g. intra-group interest) is likely to be impacted. The Corporate Treasury Centre regime has not been widely taken up since its introduction a number of years ago and the STTR and GloBE may represent opportunities for the Government to revisit its operation and usefulness.

As the STTR applies to payments based on a nominal minimum tax rate it will need to be considered even where the jurisdictional ETR exceeds the GloBE minimum. This may cause groups to change their intra-group passive income flows to ensure the application of treaties will not be impacted by the STTR. However, we anticipate such changes would be made on a case-by-case basis following a comprehensive review of tax and non-tax factors.

[1] For example franchise fees, insurance or reinsurance premiums, guarantee, brokerage or financing fees, rent for moveable property, payments for the supply of marketing, procurement, agency or other intermediary services etc.

Hong Kong policy response to Pillar Two

The Hong Kong Government has established a working group to consider its response to Pillar One and Pillar Two, which we understand will primarily focus on determining an appropriate domestic policy response to protect Hong Kong's economy. We have outlined below at a high level why this is necessary and included considerations for such a response.

Hong Kong is a global financial center, but can also be considered a through-bound jurisdiction. Many large multi-national companies have their regional headquarters in Hong Kong and make investments into the broader Asia Pacific region from Hong Kong.

In circumstances where groups have a jurisdictional ETR lower than the minimum, which will often be the case except where controlled foreign company rules effectively top-up the jurisdictional ETR, it is very likely that the group will be subject to top-up tax in respect of its Hong Kong operations, which will represent an overall increase in taxation for the group.

This is problematic for Hong Kong as its attractiveness may be eroded by the additional tax burden on the group. The additional revenue would also not be collected by the Hong Kong Inland Revenue Department, but would be collected and retained by the fiscal authorities of another jurisdiction. This is likely to be the headquarters jurisdiction, assuming that jurisdiction has implemented an IIR. Groups would be subject to this additional tax burden in respect of their Hong Kong operations, which in a sense penalizes them for operating in a low tax jurisdiction. There are those who may question the fairness of such a rule applying to operations in a jurisdiction such as Hong Kong, which is not a tax haven, but is a highly developed and fiscally responsible economy operating a low, yet robust tax regime. The current global pandemic aside, Hong Kong has no need to collect additional tax revenue, but finds itself in an a set of international tax reform that will cause additional tax to be collected in respect of the operations of multi-nationals in Hong Kong.

It may be unnecessary from a fiscal policy perspective for Hong Kong to collect additional tax and may even be contrary to the broader policy concerns of the government. However, given that top-up tax in respect of Hong Kong based operations is likely to be collected by the tax authorities of other jurisdictions, Hong Kong may wish to consider introducing rules that would ensure that any such top-up tax must be paid in Hong Kong. This should allow the jurisdictional ETR of the relevant multi-national group to be raised to the minimum ETR through the payment of tax within Hong Kong, as opposed to in another jurisdiction. This measure is mooted by the Pillar Two blueprint as an option that jurisdictions may wish to consider. While the additional tax burden on groups investing in Hong Kong may be inevitable, introducing this measure would at least allow Hong Kong to benefit from the additional revenue, which could be used to further incentivise investment in Hong Kong.

As mentioned earlier, Hong Kong headquartered groups will be impacted by the GloBE differently to inbound groups. This is because the IIR does not apply within the jurisdiction of the headquarters and there is no relevant ownership above the jurisdiction of the group headquarters that can apply an IIR. While an IIR may not apply in these circumstances, the UTPR could still apply. However, as a result of limitations on the tax that can be collected under the UTPR, in circumstances where intra-group payments are relatively low, groups may pay less tax overall through the application of the UTPR as compared to an IIR. On this basis, Hong Kong headquartered groups may prefer not to pay a minimum tax that is modelled on the GloBE. Consideration should be given to the policy approach to Hong Kong headquartered groups as compared to inbound groups and whether differing rules are possible or desirable in the context of fairness, harmful tax practices, revenue collection and the overall attractiveness of Hong Kong.

Takeaway

The introduction of Pillar One and Pillar Two represent a rewrite of the international tax system. While the introduction of Pillar One and Pillar Two stem from Action 1 of the BEPS project, the changes proposed under Pillar One and Pillar Two are likely to be more widespread and significant than all of the other actions from the BEPS project combined. Pillar Two will be particularly impactful for Hong Kong and other jurisdictions that operate tax systems with relatively low tax rates and where exemptions or incentives are available for certain types of income. While Hong Kong will be impacted, the new rules also represent an opportunity. To the extent groups are required to pay top-up tax in respect of their Hong Kong operations, provided these operations are substantive and should not be exited, groups may choose to invest further in Hong Kong in order to average down the incremental cost of the top-up tax, while limiting investment in traditionally high tax jurisdictions, which often will not have the same level of infrastructure and development as Hong Kong.

While neither Pillar One nor Pillar Two are yet to receive consensus, it is very likely that consensus will be achieved around Pillar Two. Tax practitioners should be flagging these changes and potential impacts to their CFOs and impact assessments should be conducted. The Pillar Two rules are also likely to cause some distortions, or shifts in equilibrium within the marketplace that will give rise to further opportunities for businesses and these should be considered also.

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