taxnotes® international

Volume 106, Number 5 ■ May 2, 2022

The Impact of Pillar 2 on Hong Kong's Real Estate Sector

by Patrick Yip and Doris Chik

Reprinted from *Tax Notes International*, May 2, 2022, p. 641

tax notes international®

The Impact of Pillar 2 on Hong Kong's Real Estate Sector

by Patrick Yip and Doris Chik

Patrick Yip

Doris Chik

Patrick Yip is an international tax partner and vice chair and Doris Chik is a tax director with Deloitte China.

In this article, Yip and Chik examine the potential effect of the global anti-base-erosion rules on Hong Kong's real estate sector.

In 2020 the real estate sector (including development and investments) represented about 20 percent of Hong Kong's GDP and provided about 470,000 jobs.[1] As a mainstay of Hong Kong's economy, it is important that the sector continue to provide attractive returns on investments for its investors that would in turn benefit society at large in terms of quality housing and employment opportunities.

Return on investment is often measured on an after-tax basis. Historically, Hong Kong-based property companies have been able to leverage Hong Kong's simple and low-tax regime to enhance investors' returns. However, OECD pillar 2 — that is, the global anti-base-erosion (GLOBE) regime — would likely throw a monkey wrench in the works that may take away some of Hong Kong's structural tax edge. This article examines how the regime might affect Hong Kong's real estate industry.

Background

In October 2021 Hong Kong and 136 members of the OECD inclusive framework on base erosion and profit shifting agreed on a two-pillar solution to address tax challenges arising from the digitalization of the economy. Pillar 2 is designed to ensure large multinational enterprises that meet threshold requirements[2] pay a minimum level of tax on the income arising in each jurisdiction where they operate.

Under the income inclusion rule of the GLOBE regime, whenever the effective (not headline) tax rate is below the minimum rate of 15 percent (assessed jurisdiction by jurisdiction), a top-up tax of the difference between 15 percent and the effective rate will be imposed on the profits arising in that jurisdiction.[3] The top-up tax is usually paid to the tax authorities of the headquarters jurisdiction where the MNE parent resides.

If the IIR does not apply to the parent's headquarters jurisdiction (given that it applies primarily to income generated outside the jurisdiction where the parent is located) and the parent and its members are subject to an effective tax rate below the minimum tax rate in the

[1] Hong Kong Census and Statistics Department, "Gross Domestic Product (GDP) by Major Economic Activity" (Feb. 23, 2022); and "Employed Persons by Detailed Industry of Main Employment" (Mar. 17, 2022).

[2] A multinational group that has annual revenue of at least €750 million in its consolidated financial statements is within the scope of the GLOBE regime.

[3] Unless the de minimis exclusion applies, under which, if there is a relatively small amount of revenue and income in a jurisdiction, the top-up tax for that jurisdiction is deemed to be nil (if so elected).

headquarters jurisdiction, the UTPR[4] will apply as a backstop. Under the UTPR, the top-up tax will be paid to the tax authorities of the jurisdictions where the multinational group has operations (including the headquarters location) by reference to the extent of the presence of the group's employees and tangible assets there.

Apparently, it would be to the advantage of the MNE parent's jurisdiction that the UTPR top-up tax otherwise payable to the other jurisdictions be paid to its coffers instead. To achieve that, the parent's jurisdiction would need to ensure that it takes a first bite at the top-up tax, which is typically done through a domestic minimum top-up tax (DMTT).

In his 2022-2023 budget speech, Hong Kong Special Administrative Region Financial Secretary Paul Chan, mentioned that Hong Kong will consider introducing a DMTT to preserve Hong Kong's taxing rights on undertaxed income under the GLOBE rules. If enacted, the DMTT regime is expected to be effective for the year of assessment beginning on or after April 1, 2024.[5] On that basis, a Hong Kong-based MNE would generally have to pay a top-up tax to Hong Kong on undertaxed income generated (1) outside Hong Kong under the IIR and (2) in Hong Kong under the DMTT (when enacted). Accordingly, if a multinational group headquartered in Hong Kong (together with its Hong Kong-based members) is subject to an effective tax rate of less than 15 percent in Hong Kong, a first-bite top-up tax in the form of DMTT would be paid to Hong Kong instead of the other jurisdictions under the UTPR.

Application to Real Estate

When applied to the real estate sector, the GLOBE rules could create unexpected tax issues and burdens for the sector because the income base on which the minimum tax is calculated is generally the company's accounting profits. This section discusses examples of investment property and owner-occupied property for illustration purposes.

Investment Property

For accounting purposes, property that is held for capital appreciation or rental purposes is generally considered investment property. According to Hong Kong Accounting Standards (HKAS) 40[6] and International Accounting Standards (IAS) 40,[7] an entity owning investment property can choose to adopt either the cost model or the fair value model to account for the carrying value of the property. Under the cost model, there would not be any revaluation gain or loss because the carrying value of the property is always the historical cost. The fair value model, on the other hand, requires an annual revaluation of the value of the property at the end of the fiscal year, thus generating an unrealized gain or loss that would become a corresponding adjustment to the carrying value of the property.

Holding Period

For Hong Kong profits tax purposes, a revaluation gain under the fair value model is nontaxable and a revaluation loss is nondeductible as long as the investment property is capital[8] in nature — for example, held for long-term investment purposes. Under the GLOBE regime, that accounting treatment would generally have several consequences for a company:

- its accounting profits would have included revaluation gains and losses that are not considered for Hong Kong tax purposes (if the company is a Hong Kong entity) or local

[4]The OECD originally used the acronym for the term "undertaxed payments rule" but has decided to let countries decide whether the "P" should stand for payments or profits; thus, it has taken to using just the acronym without an official definition.

[5]Refers to the year of assessment 2024-2025, which will cover January 1, 2024, to December 31, 2024, for most companies.

[6]Under HKAS 40, investment property would generally be measured initially at cost (plus transaction costs). After the initial recognition, the entity owning investment property would choose either the cost model or fair value model to measure all of its investment property. If the cost model is used, no revaluation is required, and depreciation on the property is allowed. If the fair value model is adopted, a gain or loss arising from a change in the fair value of the investment property would be recognized as a profit or loss for the period in which it arises. No depreciation is allowed under the fair value model.

[7]It is generally recognized that there are no material differences between IAS 40 and HKAS 40.

[8]Gain on disposal of a capital asset is not subject to Hong Kong profits tax. To determine whether a transaction is of a capital or trading nature, the "six badges of trade" test is generally applied. The factors considered are the subject matter, length of ownership, frequency of similar transactions, supplementary work performed, circumstances for realization, and motive.

tax purposes (if the company is a non-Hong Kong entity);
- the amount of tax paid would be based on an amount of income less than the amount of its accounting profits if there is a net revaluation gain, or more than the amount of its accounting profits if there is a net revaluation loss — that is, the tax paid would have been computed based on only taxable (deductible) items of income (losses), which would not have included the revaluation gains or losses; and
- in a net revaluation gain scenario, depending on its magnitude, the gain could make the effective tax rate of the jurisdiction drop below the minimum tax rate (so a top-up tax would be due), or for a net revaluation loss scenario, depending on its magnitude, the loss could push the effective rate above the minimum rate.

Given ever-increasing property prices, it would appear in many situations that the net revaluation gain scenario would be more common than the net revaluation loss scenario. (In fact, that is also why most companies would generally prefer to adopt the fair value model over the cost model because it could provide an upside in the form of enhanced asset values on their balance sheets.) Therefore, the possibility of having to pay a top-up tax on income that would not be realized until the disposition of the property would be more likely.

Before the release of the GLOBE model rules in December 2021, there was not a specific exclusion of revaluation gains and losses from the accounting income base on which the minimum tax would be calculated. The potential implications of that caused widespread concern among the major stakeholders in Hong Kong's real estate sector; fortunately, the GLOBE model rules alleviated that concern.

The model rules allow an entity to make a five-year election for a realization basis such that revaluation gains or losses would be disregarded when calculating the multinational group's effective tax rate and top-up tax for the jurisdiction where the entity is located. Once made, the election applies to all group entities in the same jurisdiction and to all their assets and liabilities and cannot be revoked within five years of the election year.[9]

The election can generally help the MNE avoid having to make an immediate cash top-up tax payment if the revaluation gain had been included in the GLOBE income base that would have pushed the effective tax rate below 15 percent.

The election remains in force indefinitely until the multinational group revokes it. If revoked, a new election cannot be made within five years of the revocation year. Also, the GLOBE income of the revocation year is adjusted to recapture the accumulated revaluation gains or losses since the election. And, depending on the magnitude of the accumulated revaluation gains or losses, the adjustment could make the MNE's effective tax rate drop below 15 percent (in the case of a significant amount of net revaluation gain) for that year such that a top-up tax would become payable.

On Sale

For financial accounting purposes, when an entity disposes of an investment property, the resulting gain or loss, which is generally the difference between the sales proceeds and the carrying value — that is, the fair value as accounted for under the fair value model — will be recognized in the financial statements. The gain or loss would likely not be significant, given that the carrying value would have periodically been adjusted to fair value. For Hong Kong profits tax purposes, the disposal gain would generally not be subject to profits tax if the investment property is treated as a capital asset. Consequently, the financial accounting treatment and the tax treatment would generally create a permanent book-tax difference, which, as mentioned above, might not be significant.

However, the gain calculated as the difference between the sales proceeds and the carrying value (as determined for GLOBE purposes under the fair value realization basis model) is what matters. The carrying value could be much lower than that reflected in the financial statements because the

[9] The election generally applies to all assets (tangible and intangible) and liabilities of each entity in the jurisdiction unless the election is limited to covering only tangible assets.

value in the statements would have been enhanced with the unrealized gains over the holding period.

For GLOBE purposes, there would have been no basis enhancement resulting from the realization basis election, which lets the entity exclude unrealized gains from the GLOBE income base. The disposal gain calculated based on the GLOBE carrying value could generally not be carved out under the GLOBE regime — that is, it may have to be included in the GLOBE income base in the year of disposal, which would affect the effective tax rate and top-up tax calculation.

Fortunately, not all is lost. Under the model rules, in determining the gain or loss for GLOBE purposes, if the realization basis is elected, the cost base of an already owned investment property is the asset's accounting carrying value — that is, fair value — as of the first day of the election year. In other words, all of the accumulated revaluation gains or losses up to the first day of the election year would have been crystallized in the cost base, thus avoiding inclusion as part of the GLOBE income base. If an investment property is acquired after the first day of the election year, its cost base would simply be its historical accounting cost base.

Consider an example. An entity has owned an investment property for 30 years and adopted the fair value model under HKAS/IAS 40. The entity's multinational group falls under the GLOBE rules and elects to determine gains and losses on the realization basis in 2023.[10] The entity sells the investment property in 2028 at a gain. Despite the amount of gain recognized in the financial statements, the gain to be included in the GLOBE income base will be the difference between the sales proceeds in 2028 and the fair value in 2023. Effectively, the cost base of the investment property would have stepped up automatically to the fair value as of the first day of the election year. That would mean that the accumulated appreciation in the value of the property over the 30 years before 2023 would not be taken into account for GLOBE purposes. Obviously, as long as the entity does not sell the property, there would not be any top-up tax exposure under GLOBE.

To summarize, if an MNE elects the realization basis to determine gains and losses, there would generally be several GLOBE implications in the year of disposal. First, because no Hong Kong tax (or local tax in a non-Hong-Kong jurisdiction, if applicable) is payable on the capital gain from the disposal of the investment property, the numerator — that is, covered tax — of the fraction of the effective tax rate calculation would not include any tax paid or payable on that gain.

Second, the disposal gain as reflected in the entity's financial statements will be subtracted from its accounting profits and replaced with an amount determined under the realization basis as described above. Therefore, the denominator of the fraction of the effective tax rate calculation would include a gain to which no tax relates. Depending on the magnitude of that calculated GLOBE disposal gain, the effective rate for the year of disposal could be below the minimum tax rate. That could give rise to a top-up tax.

MNEs may justifiably be concerned that they would need to pay a large amount of top-up tax in the year in which a large disposal gain occurs, even if the effective tax rates in the prior years were well above the global minimum rate of 15 percent. To alleviate that concern, the model rules provide an additional election under which an entity can spread the disposal gain over the election year (generally the year of the disposal) and the prior four fiscal years and recalculate the effective tax rates and any top-up taxes for each previous fiscal year. As an ordering rule, the gain will first be carried back to set off any net loss on immovable property in that jurisdiction in the previous four years; the remainder will then be allocated evenly to each fiscal year of the five-year period.

That election would likely help smooth out the effect of the disposal gain over the five-year period that may reduce or eliminate the top-up tax burden. However, to discourage aggressive tax engineering, the election will not apply to property sales between group entities.

[10] Pillar 2 and the IIR will be effective in 2023, with the UTPR coming into effect in 2024. *See* OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

Owner-Occupied Property

Property held for use in the production or supply of goods or services or for administrative purposes (for example, an office for self-use) is generally regarded as owner-occupied for accounting purposes. According to HKAS 16[11] and IAS 16,[12] an entity holding owner-occupied property may choose the cost model or the revaluation model to account for the property, but revaluation can be adopted only when the fair value of the property can be reliably measured.

Holding Period

Under the cost model, the carrying value of the property is the cost less any accumulated depreciation and accumulated impairment losses. There will not be any revaluation gain or loss during the holding period, and there should not be much of any discrepancy[13] between book and tax for GLOBE purposes.

If the revaluation model is adopted, similar to the discussion above, an annual revaluation gain or loss would arise that would affect the carrying value of the property. That gain or loss would not affect the entity's accounting profits because it would have been accounted for as other comprehensive income and accumulated in the equity section under the revaluation surplus heading. However, under the model rules, there is a specific adjustment to GLOBE income for "included revaluation method gain or loss," which generally refers to net gain or loss arising from a change in the fair value of a property that is recorded in other comprehensive income but not in the profit or loss.

The unrealized revaluation gain for owner-occupied property accounted for under the revaluation model would be regarded as included revaluation method gain or loss and added to GLOBE income annually. Thus, the effect would be similar to the inclusion of unrealized gains in GLOBE income under the fair value model for investment property. If so, the entity may still make the five-year election for the realization basis and exclude the unrealized revaluation gain from GLOBE income until actual disposal. From that perspective, during the holding period of the owner-occupied property there would not seem to be much difference for GLOBE purposes in electing either the cost or revaluation model.

That said, some tax practitioners believed (until the issuance of the commentary on March 14) that the upward revaluation of property used in the production or supply of goods and services would be beneficial under a particular provision under the GLOBE rules. Because the GLOBE rules are meant to combat abusive tax avoidance schemes involving no- or low-tax jurisdictions where the multinational group has next to no economic substance, jurisdictions where the group has substantial economic substance are generally viewed more favorably because they are where genuine business profits are generated. Under the substance-based income exclusion (SBIE) GLOBE rule, income from a substantive jurisdiction would be given an exclusion or deduction for calculating the global minimum tax income base on which the top-up tax would be computed. Thus, for any given level of tax liability for the jurisdiction, SBIE would help reduce the amount of any top-up tax otherwise payable.

The amount of SBIE is equal to the sum of (i) 5 percent of the carrying value of the MNE's tangible assets in the jurisdiction and (ii) 5 percent of the MNE's payroll costs for employees and independent contractors that perform activities under its direction and control in the jurisdiction.[14]

Tangible assets include property (including land and buildings) in the jurisdiction. Property held for sale, lease, or investment is excluded from SBIE to keep MNEs from acquiring investment property (which is not necessarily

[11] HKAS 16, "Property, Plant and Equipment," prescribes the accounting treatment for property, plant, and equipment (PPE). Owner-occupied property (part of PPE) would generally be measured initially at cost (plus transaction costs). After the initial recognition, an entity owning the property can choose the cost model or the revaluation model to measure the entire class of PPE to which the property belongs. If the cost model is adopted, no revaluation is required. If the revaluation model is adopted, any revaluation gain or loss would be recognized in other comprehensive income and accumulated in equity under the revaluation surplus heading. Depreciation is allowed for the property under either model.

[12] It is generally recognized that there are no major differences between IAS 16 and HKAS 16.

[13] Except for the temporary book-tax difference for depreciation.

[14] There is a 10-year transition period whereby the amount of income excluded will be 8 percent of the carrying value of the tangible assets and 10 percent of the payroll, declining annually by 0.2 percent for the first five years, and by 0.4 percent for tangible assets and 0.8 percent for payroll for the remaining five years.

required for their active trade or business) to boost the value of their tangible assets merely for the purpose of qualifying for the exclusion.

In short, the higher the asset's carrying value, the higher the SBIE and lower the top-up tax. Therefore, adopting the revaluation model could be more beneficial than the cost model if property prices increase over time. However, according to the commentary on the model rules, the revaluation gain may not be treated as part of the asset's carrying value for SBIE purposes. Therefore, it seems there is not much benefit in electing the revaluation model from that perspective.

On Sale

For Hong Kong profits tax purposes, similar to the treatment applicable to investment property, when an MNE disposes of an owner-occupied property, the gain on disposal is not subject to profits tax in Hong Kong because the property would generally be treated as a capital asset. However, for GLOBE purposes, the gain recognized in the financial statements is not carved out from the GLOBE income base. In other words, the gain is included as GLOBE income for calculating the effective tax rate and top-up tax. Thus, depending on the magnitude of the gain, the mathematical likelihood of pushing the effective rate below 15 percent increases.

While the sales consideration is fixed, the cost base — that is, carrying value — plays an important role in determining the magnitude of the gain. The higher the cost base, the lower the gain — thus increasing the effective rate and lowering any top-up tax. As discussed above, the automatic step-up of the cost base to fair value applies only to assets accounted for under the fair value model on election of a realization basis for GLOBE purposes.

Unlike investment property, entities that hold owner-occupied property have historically tended to adopt the cost model over the revaluation model primarily because under the second model, any revaluation gain would go into equity — that is, no benefit to the profit and loss statement — while depreciation expense would be elevated — that is, detrimental to the profit and loss statement — based on an enhanced asset value. Even so, it would require costly and complicated periodic revaluations of the property that can be avoided under the cost model.

However, if in the year of disposal the owner-occupied property would throw off a gain that would cause the multinational group to owe a big top-up tax bill, it may be worthwhile to consider whether the revaluation model should be adopted instead. Similar to the discussion above, there would be an opportunity to crystallize prior unrealized gains in the carrying value of the property as of the first date of the election year. Therefore, for preexisting owner-occupied property, it would be worthwhile to consider whether and to what extent it would be possible and desirable to change the accounting method from the cost model to the revaluation model.

What if an MNE does not want to adopt the revaluation model but wants to reduce the gain on disposal for GLOBE purposes? One could possibly come to the simple (or overly simplified) solution to have the property transferred from one group member to another to have the cost base stepped up internally. On the surface, that would seem to work if there are no consolidated tax return rules that would disregard the intragroup gain step-up, and transaction costs like stamp duty can be avoided (both of which are the case in Hong Kong). So what's the catch?

Under the model rules, if assets are transferred between group entities after November 30, 2021, and before the multinational group falls within the scope of GLOBE — that is, when the GLOBE rules become applicable and the group comes in-scope — the bases in the acquired assets will be determined based on the disposing entity's carrying value of the transferred assets on disposition.[15] In other words, even if the property is sold to a group entity at fair market value, the cost base of the property for calculating its future disposal gain for GLOBE purposes will remain the pre-transfer carrying value — that is, historical cost for owner-occupied property adopting the cost model — regardless of the new carrying value — that is, fair value — reflected in the acquiring entity's accounts. The entire disposal gain, which is the difference between the sales consideration and the cost less accumulated depreciation, will be considered GLOBE income. Thus, that kind of intragroup transfer cannot help

[15] With the associated deferred tax assets and liabilities taken into account.

step up the cost base or help save any top-up tax for GLOBE purposes.

Conclusion

It seems the model rules might have provided the major stakeholders of the real estate industry in Hong Kong (and perhaps in other jurisdictions as well) a collective sigh of relief.

For investment property, it would be possible via a realization basis election to avoid paying a top-up tax on phantom revaluation gains until actual disposal. Unrealized revaluation gains for already-owned investment property before the election year could be exempt for calculating the disposal gain for GLOBE purposes. As icing on the cake, even on actual disposal, it would be possible via another election to spread the gain over several years to minimize the impact of the top-up tax.

For owner-occupied property, the problem of unrealized revaluation gain will be moot if cost model accounting is adopted. Even if the revaluation model is elected, the risk of paying a top-up tax on any unrealized revaluation gain before actual disposal can be eliminated by the realization basis election. SBIE, which takes into account the carrying value of owner-occupied property, can reduce the amount of top-up tax in the jurisdiction where the property is located. Owner-occupied property, for all its worth, would count for SBIE purposes even though the unrealized gain recognized under the revaluation model would not be able to enhance the cost basis for SBIE purposes. On actual disposal of the property, the entity can elect (similar to that for investment property) to spread the gain over several years to minimize the top-up tax in each of those years, when applicable. However, when the cost model is adopted, the amount of disposal gain included in GLOBE income would likely be larger than that under the revaluation model because the cost base would generally be the historical cost (without any benefit of a step-up allowable under the revaluation model).

Multinational groups in the real estate sector must now review how their investment and owner-occupied property portfolios would affect their GLOBE positions. In particular, they should ascertain the viability and desirability of each election for both investment property and owner-occupied property and how they would affect book versus tax income. They should also consider such topics as alternative means to dispose of the property that could sidestep these issues and to what extent intragroup transfers of property would help.

Prompt action may be not only necessary but critical because GLOBE developments are moving fast, and every jurisdiction is hurtling along its legislative path to conform its taxing regime to comport with GLOBE. The old adage "the early bird gets the worm" may be apt for both the taxing jurisdictions and the MNEs that can get their acts together in the first instance in preparing themselves for the most advantageous positions in the uncharted world of GLOBE. ■