Hong Kong Policy Series

Discussing the potential future impact of the OECD's BEPS 2.0 initiatives on Fiscal Policy in Hong Kong

Dating back to 2012, the OECD Base Erosion and Profit Shifting ("BEPS") programme has set out to counteract the perceived inefficiencies in the traditional system of international taxation, particularly when applied to multinational corporations (MNCs) operating within the digital economy. The first iteration of BEPS (now referred to as "BEPS 1.0") produced 15 Action Points that were released during 2015 and have since been implemented to varying degrees by jurisdictions across the globe.

> *"The OECD's measures designed to address global tax inefficiencies with respect to the digitalized economy are likely to have far reaching implications for many global businesses, including for many operating in Hong Kong. Understanding the potential impact that these global changes could have on Hong Kong will need to be carefully considered by industry and government authorities alike. I am honored to be appointed to the Government's Advisory Panel on BEPS 2.0."*
>
> **Ayesha Lau**
> Managing Partner, Hong Kong,
> KPMG China

These BEPS 1.0 Action Points focused on increasing transparency within the system of international taxation and updating the approach to transfer pricing, principally through recognition of the importance of economic substance and the appropriate reward of activities that lead to value creation. In Hong Kong these principles, in particular a formal transfer pricing policy, have been implemented in 2018 through new legislation locally referred to as the "BEPS Bill".

In the meantime, the international tax landscape has continued to evolve. In May 2019, the OECD/G20 Inclusive Framework on BEPS agreed a Programme of Work for Addressing the Tax Challenges of the Digitalization of the Economy. This Programme of Work set the agenda for the next wave of global proposals, referred to as BEPS 2.0, to tackle perceived gaps in the original BEPS Action Plan. BEPS 2.0 comprises two pillars:

Pillar One seeks to update the traditional allocation of taxing rights between jurisdictions and includes considerations of a new taxing right, particularly focusing on attributing additional value to the location where the services or goods are being consumed (which is seen as crucially important for digital services, e.g. search engines and social media platforms), and

Pillar Two (also referred to as Global Anti-Base Erosion "GloBE") seeks to implement a global system of minimum taxation that would provide jurisdictions with the right to tax income that is subject to low or no taxation in the jurisdiction with the primary taxing right.

Whilst BEPS 2.0 is focused on the Digitalization of the Economy, this does not mean that it is limited to digitalized business and both Pillar One and Pillar Two are expected to have implications for businesses across a broad spectrum of industries.

Given the nature of Hong Kong's current tax regime, Pillar Two, in particular, is likely to have a significant impact on future tax policy decisions.

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Pillar One - revised profit allocation and nexus

The main aim of the approach set out in Pillar One is to re-allocate the profits generated by MNCs from the jurisdictions where value is created to the jurisdictions where the goods or services are being consumed (i.e. the "market jurisdiction"). This new approach seeks to redefine some of the original principles that were set out in BEPS 1.0. The principles set out in Pillar One have been the focus of a number of European countries in recent years and have started to be implemented through unilateral domestic taxes, such as the United Kingdom's Digital Services Tax.

The proposals seek to cover digital business but also a broad array of consumer-facing business, though carve-outs are expected for financial services. It is also thought that financial thresholds (possibility in line with the existing EUR 750m revenue threshold for Country-by-Country Reporting) could be introduced to reduce the compliance burden for smaller international businesses.

Nexus

One of the perceived flaws with the current international system of taxation is that jurisdictions, in which a business has a limited or no physical presence, have limited or no taxing rights. The proposals envisage a change to the concept of nexus, which grants taxing rights even in the absence of a physical presence. Under the proposal, the taxing right could instead be linked to the quantity of sales made in the market jurisdiction or potentially the number of users based in the market jurisdiction.

Profit Allocation

In connection with the changes to taxing rights, the Pillar One proposals also set out an adaptation of the traditional arm's length principle that is currently used to allocate a group's profits between different entities and jurisdictions. This new profit allocation would be based on a three-tier approach:

Amount A (the new taxing right): is a portion of the MNCs residual profit that would be allocated to the market jurisdiction. The MNCs residual profit would, rather confusingly, be calculated by deducting Amount B and C from the group's consolidated profit.

Amount B: represents the baseline return for routine services (e.g. marketing and distribution services) carried out in the market jurisdiction.

Amount C: represents an arms' length return for other activities carried out in the market jurisdiction in addition to the routine services that are rewarded under Amount B.

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Although the consultation process so far has been conceptual in nature and there remains a wealth of detail to be discussed and agreed upon, there is clearly broad concern that the new concept of nexus and the introduction of Amount A could lead to an overlap of taxing rights and ultimately double taxation.

Further, it appears that the key stumbling block for progress towards implementing Pillar One is the United States' recent claims that it should be implemented on a safe-harbor basis only. Although this proposal has not been fully explained or explored at this stage, it is thought to mean that Amount A would only be relevant for entities in a market jurisdiction that did not fall within a 'safe-harbor' rate of return.

Pillar Two - global anti-base erosion

The principal aim of Pillar Two is to mitigate instances of MNCs generating profits in jurisdictions where they are subject to low or no taxation, through ensuring that these profits can ultimately be taxed in another jurisdiction where they are otherwise subject to tax at an effective tax rate below a minimum rate.

Minimum tax rate

The paper released by the OECD does not specify what the minimum tax rate will be and that it is subject to ongoing work and consultation; however, it seems likely that the minimum rate will fall somewhere in the range of 10 – 15 percent.

Forms of taxation

The OECD proposal sets out four mechanisms through which profits subject to low or no tax would be subject to tax under Pillar Two.

Income inclusion rule: permits the home jurisdiction of a parent company to tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate.

Undertaxed payments rule: operates by way of a denial of a deduction or imposition of source-based taxation (e.g. withholding tax) for a payment made to a related party if that payment would be subject to tax at an effective rate that is below a minimum rate.

Switch-over rule: permits a jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (not otherwise part of a PE) are subject to tax at an effective rate below a minimum rate.

Subject-to-tax rule: subjects a payment to withholding tax or other taxes at source and adjusts the eligibility to claim treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

Although the proposal is currently silent on the priority in which these four additional taxing mechanisms would operate, it is thought that the default mechanism would be the income inclusion rule which could be supplemented, if necessary, by the other three mechanisms.

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Uncertainties within the proposals

There remains much discussion and work to be carried out to determine the tax base that would be subject to these provisions, notably how this tax base could be consistent across jurisdictions to ensure a level playing field, while also minimizing the additional compliance burden that this may trigger. The OECD's proposal currently refers to the use of consolidated financial statements to determine the tax base of subsidiaries, but still the question remains whether differences between global accounting standards could impact consistency.

Clearly, from a Hong Kong perspective, attention should be given to how the calculation of the effective tax rate will be carried out and the potential impact that a Hong Kong business' offshore-sourced income, exempt investment income or broader timing differences may have for this calculation.

Carve-outs

The paper also considers possible options for carve-outs from the rules. These potential carve-outs include:

- A carve out for tax incentive or preferential regimes that have been peer-reviewed and considered not to be harmful tax practices under BEPS Action 5;
- Financial thresholds based on, for example, turnover;
- De minimus thresholders to exclude certain transactions or entities; and
- A carve out for specific sectors or industries.

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> *"The Hong Kong territorial tax system has underpinned its success as an international financial center and trading hub for decades. If Hong Kong needs to make any changes to its tax framework to ensure that any global measures are adequately addressed in the territory, such changes need to be carefully considered to ensure Hong Kong retains its status as an attractive and globally competitive financial center."*
>
> **Darren Bowdern**
> Head of Alternative Investments, Hong Kong
> KPMG China

Impact for Hong Kong

While there remains much work to be undertaken to further develop the proposals and to reach decisions on matters of detail within the proposals under BEPS 2.0, the planned changes (particularly those set out under Pillar Two) could have significant implications for Hong Kong's tax regime. We summarize below our views on the potential impact of Pillar Two for Hong Kong and actions available to Hong Kong.

Territorial regimes

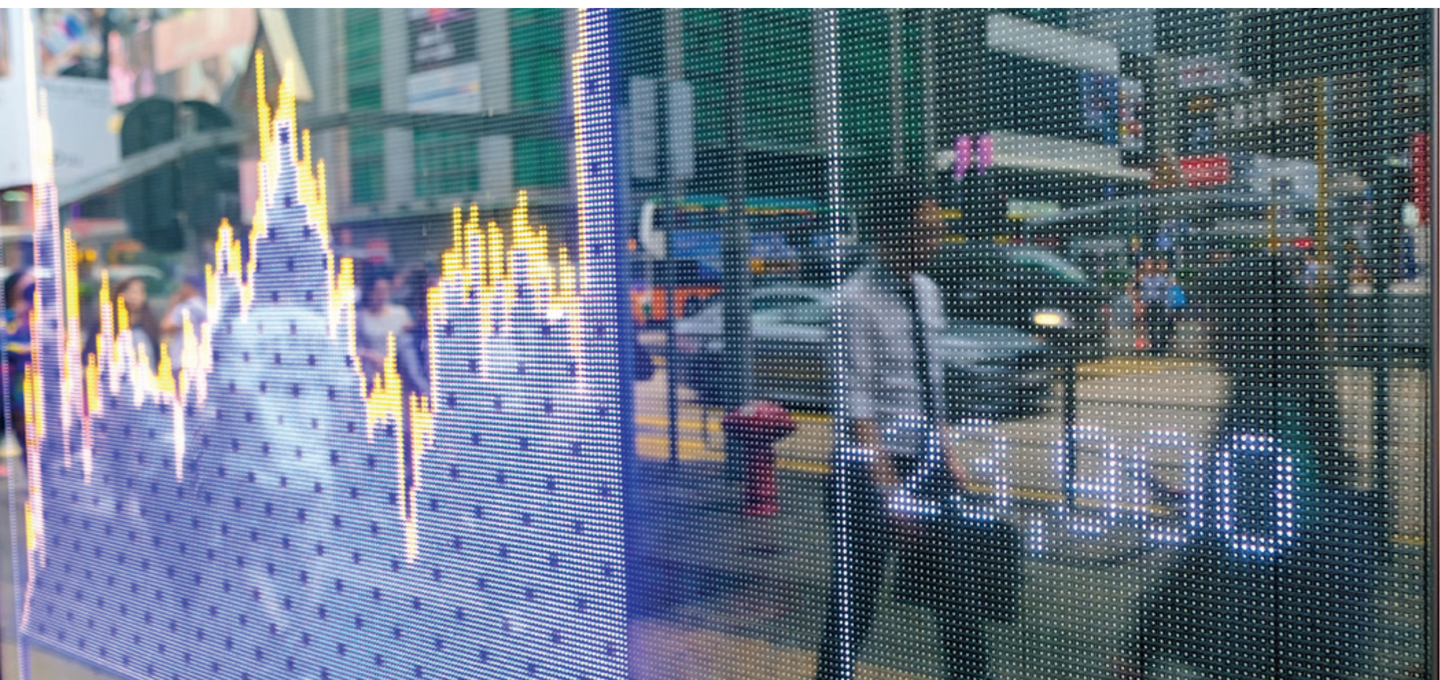
The Pillar Two consultation document does not currently include any guidance on how territorial systems of taxation would be treated under the proposed measures. Unless there is a specific carve-out for territorial systems of taxation, then situations where income is treated as non-Hong Kong sourced income and therefore not subject to tax in Hong Kong may lead to this income being taxed elsewhere under, for example, the income inclusion rule described above.

Consideration will need to be given to maintaining the integrity of Hong Kong's current system of territorial taxation, whilst also mitigating the risk of another country exercising taxing rights over income that would not otherwise currently be taxable in Hong Kong.

Preferential regimes

Hong Kong has a number of preferential regimes that seek to tax specific activity, such as aircraft leasing or reinsurance, at a preferential tax rate – currently 50% of the headline statutory rate of 16.5%. These regimes have been reviewed and approved (following some required changes) as not constituting harmful tax practices under BEPS Action 5.

A potential carve-out for preferential regimes approved under BEPS Action 5 would therefore be welcome; however, we note caution here as the Pillar Two consultation document suggests that a carve-out of this nature would likely undermine the effectiveness of the Pillar Two proposals.



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> *“The impact of a minimum effective tax rate that may be mandated by the OECD could have a significant impact on some of our preferential tax regimes designed to promote Hong Kong as an aircraft leasing, reinsurance and corporate treasury hub. We will need to ensure that these tax regimes that have already been cleared as non-abusive are not impacted by any of the BEPS 2.0 changes, where possible.”*
>
> **John Timpany**
> Head of Tax, Hong Kong
> KPMG China

If a carve-out of this nature is not forthcoming, Hong Kong would need to consider alternative means to incentivize these activities instead of preferential tax rates, for example, using grants to ensure that Hong Kong businesses operating in these areas remain in a similar economic position within the new BEPS Pillar Two environment.

If a carve-out for specific preferential regimes is not considered feasible within the Pillar Two proposals, then an alternative could be to provide carve-outs for specific activities in highly-regulated areas in a ring-fenced manner and with strict regulatory requirements. This carve-out would likely impact activities that are subject to preferential regimes of taxation in Hong Kong, e.g. shipping and insurance.

Similarly, a case should be made for collective investment vehicles to be carved out of the Pillar Two proposals on the basis that they are simply vehicles for the pooling of assets with tax ultimately being borne at the investor level; a position which is already broadly reflected in Hong Kong through the unified fund exemption.

Exempt income

The Hong Kong tax regime also exempts certain forms of income from Hong Kong Profits Tax, most notably capital gains and dividends. As previously stated, the nature of the BEPS Pillar Two proposals means that this type of exempt income in Hong Kong could potentially be taxed elsewhere in the future.

It is worth highlighting, however, that rules allowing for the exemption of dividends and capital gains are a relatively common feature of tax regimes globally, for example the forms of “participation exemption” that are common within European countries. As such, we would expect the OECD to follow suit and carve out capital gains and dividend income from the calculation of effective tax rate.

If this carve-out is not forthcoming then again consideration in Hong Kong will need to be given to preserving Hong Kong’s tax base, while maintaining its attractive tax regime.

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Observations and next steps

It is clear from the consultation papers that there is still significant progress to be made by the OECD Inclusive Framework to meet its revised deadline of November 2020 for delivery of a consensus-based solution to be presented at the G20 Leaders Summit. Achieving consensus on these issues is likely to be a challenging balance of certain jurisdictions seeking to preserve sovereignty over the design of their tax systems to support economic growth and other jurisdictions seeking to prevent the flow of profits and capital to low tax jurisdictions.

The EU Tax Commissioner, Paolo Gentiloni, has also recently confirmed that in the absence of global consensus on BEPS 2.0 by the end of 2020, the European Commission will move ahead with its own version of the provisions, which would include a form of minimum tax and digital services tax, and may similarly impact Hong Kong businesses. The EU's commitment to the BEPS 2.0 proposals reinforces the importance of Hong Kong businesses to engage seriously with these proposals.

Furthermore, the Hong Kong Finance Secretary noted the potential impact that the Pillar Two proposals may have for Hong Kong's taxation regime in his budget speech in February 2020 and recommended that a panel of experts be established to provide advice on Hong Kong's response to these initiatives. In June, this panel has now been convened and Ayesha Lau, Managing Partner, KPMG China in Hong Kong, has been appointed to the Advisory Panel on BEPS 2.0.

Hong Kong businesses should start to assess how these new rules may impact them, particularly the impact of Pillar One on sales hubs or IP holdings structures based in Hong Kong and the potential impact of Pillar Two for businesses with preferential tax rates, material offshore-sourced income claims and significant exempt income. They should also use these considerations to help the Hong Kong Government influence the debate of these proposals over the coming months.

We would welcome the opportunity to discuss how the BEPS 2.0 measures may impact your business.

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