

Inclusive Framework BEPS Agreement

Public Consultation on Pillar One Amount A – April 2022

Policy Perspectives Update – the Hong Kong SAR



Public consultation on the draft model rules for scope of Amount A under Pillar One

On 4 April 2022, the OECD published another public consultation document on Pillar One Amount A. The document contains the **draft model rules for scope of Amount A** and can be accessed via this [link](#). There are two previous consultation documents on Amount A issued by the OECD, one set out the draft model rules on nexus and revenue sourcing and the other on tax base determination. For more details, please refer to our previous Hong Kong BEPS publications in these [link](#) and [link](#).

Similar to the previous consultation documents, this consultation document is structured as a general legislative article that articulates the domestic legislation on scope of Amount A at a high level, with the detailed practical application of certain aspects of the rules to be elaborated in the Commentaries to follow.

Summary of the rules

The draft model rules for scope of Amount A set out the rules for determining when a group will be in scope of Amount A (i.e. having a portion of its residual profits (Amount A) subject to reallocation to market jurisdictions).

The key scoping provisions

- The starting point of determining whether a group is in scope of Amount A will be the revenue and financial accounting profit (or loss) reported in the consolidated financial statements of the Ultimate Parent Entity (UPE), subject to a number of adjustments.
- In general, a group will be in scope of Amount A if **both** (1) the **revenue threshold** of more than EUR20 billion (which will be reduced to EUR10 million, contingent upon successful implementation of Amount A and with the relevant review beginning seven years after Amount A comes into force) **and** (2) the **profitability threshold** of greater than 10% are met.
- The draft model rules further elaborate the details of the above two thresholds:
 - the revenue threshold is met if the “Total Revenues” of the group for an accounting period exceed EUR20 billion (**the global revenue test**). “Total Revenues” means the revenues reported in the group’s consolidated financial statements, subject to the following adjustments: excluding dividend income, certain equity gains or losses and revenue derived from excluded entities, and including eligible restatement adjustments and the group’s share of revenue from joint venture(s); and
 - the profitability threshold is met if the pre-tax profit margin of the group as measured against its Total Revenues exceeds 10% (**the profitability test**) in (1) an accounting period (**the period test**); (2) at least two of the four accounting periods immediately preceding the accounting period (**the prior period test**) and (3) on average across the accounting period and the four immediately preceding accounting periods (**the average test**).

- There are also special rules for applying the prior period test and the average test in the case of a group merger or a group demerger.

Open issues for the global revenue test and the profitability test

The following are the open issues for the global revenue test and the profitability test that are still under discussion:

- Whether the global revenue test should include rules equivalent to the prior period test and the average test mentioned above, which are currently only applicable to the profitability test; and
- Whether the prior period test and average test under the profitability test should be applied as an “entry test” (i.e. only to groups which have not met the scope thresholds previously) or permanently on a rolling basis as set out in the current draft.

Excluded entities

- Certain entities are regarded as an excluded entity and excluded from the main operative provisions of Amount A. These include (1) an investment fund or a real estate investment vehicle that satisfies the specified definition of a UPE and (2) entities that are at least 95% owned by such investment fund or real estate investment vehicle, subject to certain conditions.
- The global revenue test and the profitability test would not take into account the revenues and profits of excluded entities.

Exclusions for extractive activities and regulated financial services

In respect of the exclusions for extractive activities and regulated financial services, the rules do not include detailed provisions on these exclusions but indicate that:

- The revenues and profits derived from extractive activities and regulated financial services will be excluded from the scope of Amount A; and
- The global revenue test and profitability test will be reapplied to a group after such exclusions and if the group does not meet either the revenue threshold or the profitability threshold in such case, the group is not within the scope of Amount A.

On 14 April 2022, the OECD issued the public consultation document on the extractives exclusion under Amount A. The consultation document can be accessed via this [link](#). Based on the document, the definition of Extractive Activities contains two elements i.e. the “product test” and the “activities test”. This means that the exclusion only applies when a group (i) derives revenue from the sale of extractive products **and** (ii) has carried out the relevant exploration, development or extraction. The public consultation document also set out the detailed steps and rules to exclude the profits derived from extractive activities from the scope of Amount A. It also indicates that work is underway to consider simplification of applying the Extractives Exclusion and whether an initial transition period for compliance is required.

The anti-fragmentation rule

- This rule aims to prevent a group from splitting into two or more groups artificially (i.e. Internal Fragmentation) with the principal purposes of circumventing the global revenue test.
- This rule only applies when the UPE of a group is controlled by an excluded entity, an investment fund or a real estate investment vehicle. However, Internal Fragmentation taking place from which date will be within the scope of the anti-fragmentation rule is still under discussion.

What's next

The draft model rules are released for public comments and do not reflect the final views and consensus of the members of the OECD Inclusive Framework on BEPS. Further changes to the model rules may be made.

It is expected that the OECD will issue separate working documents with detailed provisions dealing with the following issues at a later stage:

- The exclusion for regulated financial services; and
- The exceptional scoping provisions governing the application of Amount A to a disclosed business segment reported in a group's consolidated financial statements when the disclosed segment meets the revenue and profitability thresholds on a standalone basis, but the group as a whole does not.

Hong Kong business considerations

Apart from the exclusions for extractive activities and regulated financial services, we consider that the profits generating from real estate (e.g. rents, unrealised revaluation gains/losses and realised disposal gains/losses) should also be excluded from the scope of Amount A given the close connection of these profits with the jurisdictions where the real properties are located. Applying the same policy rationale for excluding extractive activities, which is mainly to exclude (1) profits derived from immovable assets that are closely connected with the jurisdictions in which the assets are located and (2) businesses that are unlikely to give rise to BEPS concerns, we consider that the profits generating from real estate should be out of the scope of Amount A and be taxed in the home/source jurisdiction only. In particular, reallocating unrealised profits from revaluation of investment properties to other market jurisdictions under Amount A will be problematic for real estate businesses in Hong Kong given these profits are not real economic profits and the high value of real estate in Hong Kong.

The new features of the profitability threshold (i.e. the prior period test and the average test) should be helpful to those large groups in Hong Kong with relatively volatile profitability. The two tests together would prevent a group from being brought into the scope of Amount A merely because its profitability exceeds 10% in one or two years. Similar leeway to fall outside the scope of Amount A would be available under the revenue threshold if the two tests are also adopted for applying the revenue threshold. Large business groups in Hong Kong that meet the EUR20 billion revenue threshold should explore whether they can benefit from the two new tests currently applicable to the profitability threshold.

Another issue that would be of interest to the large financial service groups in Hong Kong would be the detailed rules for the exclusion of regulated financial services.

In-scope large groups in Hong Kong should closely monitor the developments in this area in the coming few months and consider taking the opportunity of the OECD's public consultation to voice out their concerns and submit their recommendations.

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