

Inclusive Framework BEPS Agreement

The third tranche of Administrative Guidance on
Pillar Two of BEPS 2.0

Policy Perspectives Update – the Hong Kong SAR



The third tranche of Administrative Guidance on Pillar Two of BEPS 2.0

On 18 December 2023, the OECD published the third tranche of [Administrative Guidance](#) on the GloBE Rules of Pillar Two under BEPS 2.0 (the December 2023 AG). The OECD's press release on the release of the December 2023 AG can be accessed via this [link](#).

The December 2023 AG contains the following six sections. Sections 1 and 2 focus on the Transitional CbCR Safe Harbour whereas sections 3 to 6 focus on various other aspects of the GloBE Rules.

<p>1</p>	<p>Purchase price accounting adjustments in Qualified Financial Statements clarifies when purchase pricing accounting adjustments do and do not need to be excluded from an MNE Group's Qualified Country-by-Country (CbC) Report.</p>	<p>2</p>	<p>Further Guidance on the Transitional CbCR Safe Harbour (i) addresses a variety of technical issues, including the definition of Qualified Financial Statements, the Simplified ETR computation and the SBIE amount for the routine profits test and (ii) introduces new rules to counteract concerns about hybrid arbitrage arrangements¹.</p>
<p>3</p>	<p>Administrative Guidance on application of GloBE Rules (i) provides further guidance on the definition of revenue for the purpose of the €750m consolidated revenue threshold and (ii) the treatment of mismatches between the fiscal years of the Ultimate Parent Entity and Constituent Entities (CEs) and between the fiscal and tax years of CEs.</p>	<p>4</p>	<p>Further Administrative Guidance on the allocation of Blended CFC Taxes addresses the application of the temporary CFC tax allocation rules in various scenarios where an MNE Group is not required to compute the jurisdictional ETR under the full GloBE Rules in respect of jurisdictions that are eligible for the Transitional CbCR Safe Harbour under the simplified ETR test.</p>
<p>5</p>	<p>Transitional Filing Deadlines for MNE Groups with Short Reporting Fiscal Years ensure that groups with short fiscal years (i.e. less than 12 months) operating in jurisdictions that adopt the GloBE Rules in 2024 will not be required to file a Global Information Return until 30 June 2026.</p>	<p>6</p>	<p>Simplified Calculation Safe Harbour for Non-Material Constituent Entities (NMCEs) allows the use of simplified calculation methods to compute the revenue, profits and Covered Taxes for NMCEs under the Simplified Calculation Safe Harbour (similar to the Transitional CbCR Safe Harbour).</p>

We set out below the questions and answers on 15 more important issues addressed by the December 2023 AG relating to items 2, 3 and 6 above. For a more detailed discussion of the December 2023 AG that covers all the six items, please refer to our [Global BEPS Publication](#) issued in December 2023.

¹ These include (1) a deduction / non-inclusion arrangement, (2) a duplicate loss arrangement and (3) a duplicate tax recognition arrangement.

15 notable issues addressed in the December 2023 AG

1. Further Guidance on the Transitional CbCR Safe Harbour (CbCR SH)

Q.1 If an MNE group has both CEs and a Joint Venture (JV) / JV Group in the same jurisdiction, is the JV / JV Group being treated as in a separate Tested Jurisdiction than that of the CEs?

Yes, the CbCR SH tests should be applied by treating all the CEs as located in one Tested Jurisdiction and the JV / JV group as located in another separate Tested Jurisdiction.

Q.2 Can an MNE group use different sources of Qualified Financial Statements (QFS) for (i) the same entity / permanent establishment (PE) and (ii) different entities within the same Tested Jurisdiction?

No, the data of an entity or a PE used in the CbCR SH computations must come from the same QFS (i.e. the CE's financial statements used to prepare the ultimate parent entity (UPE)'s consolidated financial statements (CFS) or the separate financial statements of the CE prepared based on acceptable or authorized accounting standards). For example, a group could not use one set of financial statements to determine the Profit/Loss Before Tax (PBT) of a CE and another set of financial statements to determine such CE's Simplified Covered Taxes.

Similarly, a consistent source of data must be used for all entities located in the same Tested Jurisdiction, with exceptions for NMCEs and PEs.

Q.3 Can a CbC Report be considered a Qualified CbC Report if it is based on data from QFS for some but not all Tested Jurisdictions?

Yes, as Qualified CbC Report determination is made on a Tested Jurisdiction-by-Tested Jurisdiction basis. A CbC Report can be considered a Qualified CbC Report for those Tested Jurisdictions of which the data in the report are drawn from QFS and not a Qualified CbC Report for those Tested Jurisdictions of which the data in the report are not drawn from QFS (e.g. internal management accounts).

Q.4 Can a CbC Report be considered a Qualified CbC Report if it is based on data from the UPE's CFS for some jurisdictions and data from local GAAP accounts for other jurisdictions?

Yes, an MNE Group may use different QFS as the source of data for different Tested Jurisdictions in a Qualified CbC Report.

Q.5 What constitutes a QFS for a PE?

The PE's own QFS (if available) or the separate financial statements prepared by the Main Entity for the PE for regulatory / tax reporting or internal management control purposes can be used to determine the amounts used in the CbCR SH tests. If a loss arising from a PE is allocated to the PE, a corresponding adjustment must be made to the PBT of the Main Entity to prevent double counting of the loss.

Q.6 Under what circumstance should dividends be included in the Revenue and PBT of the recipient entity for the CbCR SH purpose?

Although the guidance on CbC Reporting states that an intra-group payment that is treated as dividend for tax purpose in the payer's jurisdiction should be excluded from the Revenue and PBT of the recipient, such dividend should be included in the Revenue and PBT of the recipient for the purpose of the CbCR SH tests **if it is treated as income in the QFS of the recipient and expense in the QFS of the payer**, irrespective of the tax treatment of the amount in the recipient's or payer's jurisdiction and the treatment of the amount in the CbC Report.

An example is where certain preferred shares are treated as debt and the payments arising from them are treated as interest income/expenses for accounting purpose but the preference shares are treated as equity for tax purpose.

Q.7 Can an MNE Group that is within the scope of the GloBE Rules but is not required to prepare and file CbC Report qualify for the CbCR SH?

Yes, an MNE Group that is not required to file a CbC Report (e.g. because it does not meet the EUR 750 million revenue threshold in the immediately preceding fiscal year) can still apply the CbCR SH if it completes the relevant section of the GloBE Information Return using data from QFSs.

Q.8 Is the tax paid in the PE jurisdiction on the PE's income included in the Covered Taxes of the PE or the Main Entity in the Simplified ETR test?

Income tax expense in the PE jurisdiction on the PE's income must be allocated exclusively to the PE's jurisdiction and can only be included in the Simplified ETR computation for the PE's jurisdiction.

Q.9 Should 5% or the transitional rates in Article 9.2 of the GloBE Rules be used for computing the Substance-based Income Exclusion (SBIE) amount for a Tested Jurisdiction for the routine profits test under the CbCR SH?

The SBIE amount shall be computed using the transitional rates for 2024, 2025 and 2026 for the payroll and tangible asset carve-outs that are specified in Article 9.2 of the GloBE Rules.

Q.10 How may the new anti-avoidance rules on hybrid arbitrage arrangements affect an MNE group's eligibility to the CbCR SH?

In determining whether a Tested Jurisdiction qualifies for the CbCR SH, the following adjustments to the PBT or income tax expense must be made in the CbCR SH calculations of a Tested Jurisdiction with respect to any hybrid arbitrage arrangements¹ entered into after 15 December 2022 (i.e. the publication date of the [OECD guidance on safe harbours and penalty relief](#))²:

- excluding any expense or loss arising from a deduction / non-inclusion arrangement or duplicate loss arrangement from the Tested Jurisdiction's PBT; and
- excluding any income tax expense arising from a duplicate tax recognition arrangement from the Tested Jurisdiction's income tax expense.

2. Clarifications on the application of the GloBE Rules

Q.11 What items of income are included in revenue for the purpose of applying the EUR 750 million consolidated revenue threshold?

The December 2023 AG sets out the following principles for determining the consolidated revenue amount:

- Revenue includes the inflow of economic benefits arising from delivering or producing goods, rendering services, or other activities that constitute the MNE Group's **ordinary activities**. An example is included to illustrate that **ancillary** interest income generated by a manufacturing company **outside its ordinary activities** and recorded as interest income **below Costs of Good Sold and Selling, General and Administrative Expenses** shall not be included as revenue.
- Revenue amounts shall be determined in line with the relevant accounting standard, which may allow netting for discounts, returns and allowances, but in any event before cost of sales and operating expenses.
- Revenue shall include (i) net gains from investments (whether realised or unrealised) reflected in the profit and loss statement of the CFSs and (ii) income or gains separately presented as extraordinary or non-recurring items.
- If an MNE Group's consolidated profit and loss statement presents gross gains and gross losses from investments separately, the revenue amount shall be reduced by the amount of such gross losses.
- For financial entities, the income or gains from certain financial transactions (e.g. interest rate swap) may be reported on a net basis under the UPE's financial accounting standards. In such cases, the revenue amount for the purpose of the GloBE Rules would be the net amount from the transaction.

² Applicable to arrangements entered into after 18 December 2023 if the new rules in the December 2023 AG cannot be applied retrospectively due to a constitutional constraint.

Q.12 When the UPE and a CE have different fiscal periods, what financial data should be used for the GloBE computation of the CE?

An MNE group should apply the same approach used by it in the CFS to address this discrepancy for the purpose of the GloBE computation of the CE. This means the financial data could be the unadjusted data for the CE's fiscal year or the adjusted data of the CE based on the UPE's fiscal year, depending on the approach adopted in preparing the CFS.

Q.13 How should an MNE Group determine the Adjusted Covered Taxes for a Fiscal Year for a CE if the CE's fiscal year is different from its tax year?

The MNE Group should apply the same method used by it in the CFS (or other financial statements used to determine the Financial Accounting Net Income or Loss of the CE) to determine the CE's Adjusted Covered Taxes for the Fiscal Year. A similar approach should also be adopted for a JV or JV Group that has a tax year different from its fiscal year.

3. Simplified Calculations Safe Harbour for NMCEs

Q.14 What is the definition of NMCE?

- An NMCE is defined as an entity (including a PE) that is not consolidated in the UPE's CFS (solely on size or materiality grounds) but that meets the definition of a CE for the purposes of the GloBE Rules.
- The NMCE definition will only be met if the MNE Group's CFS are prepared in accordance with an Acceptable or Authorised Financial Accounting Standard, and are subject to an external audit.
- For an entity with revenue in excess of EUR 50 million, it will only be an NMCE if its financial accounts are prepared in accordance with an Acceptable or Authorised Financial Accounting Standard.
- A PE will only be considered as an NMCE if its Main Entity is itself an NMCE.

Q.15 What are the key features of the Simplified Calculations Safe Harbour for NMCEs?

- This safe harbour forms part of the permanent Simplified Calculation Safe Harbour (Simplified Calculation SH). It allows an MNE Group to use simplified calculation methods (instead of the detailed calculations under the GloBE Rules) to determine the GloBE Revenue, GloBE Income/Loss and Adjusted Covered Taxes of an NMCE for the purpose of determining whether any of the three tests³ under the Simplified Calculation SH is met for a Tested Jurisdiction.
- The Simplified Calculations for NMCEs is an annual election that is made for each NMCE individually.
- Simplified GloBE Revenue of an NMCE = Total Revenue of such entity per CbC Report
Simplified GloBE Income/Loss of an NMCE = Total Revenue of such entity per CbC Report
Simplified Adjusted Covered Taxes of an NMCE = Current Year's Accrued Income Tax per CbC Report (i.e., excluding any deferred tax expenses, adjustments for non-current items and provisions for uncertain tax liabilities).
- The MNE Group aggregates the above simplified amounts determined for the NMCEs with the amounts computed for other CEs (if any) in the Tested Jurisdiction and determines whether any of the three tests under the Simplified Calculation SH is met.
- The Top-up tax of a Tested Jurisdiction that meets one of the three tests under the Simplified Calculation SH would be deemed to be zero.

³ The three tests are: the de minimis test, the simplified ETR test and the routine profits test.

Hong Kong business considerations

Below are some of our observations on the December 2023 AG from the Hong Kong business perspective:

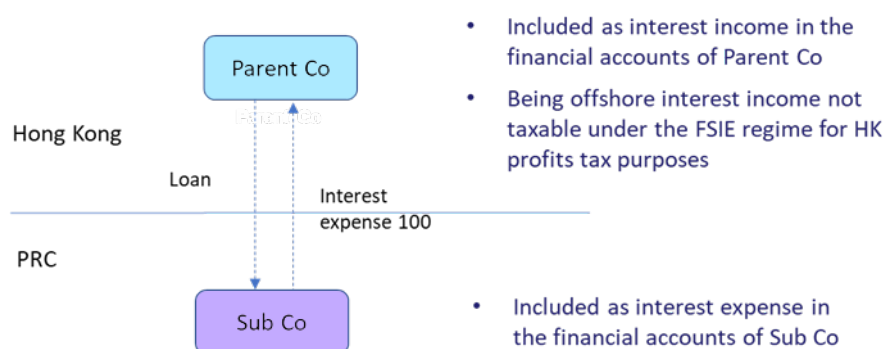
1. Application of the CbCR SH

QFS for a PE – Based on the December 2023 AG, the certified management accounts of a Hong Kong branch used for Hong Kong profits tax filing purpose could be regarded as QFS for the Hong Kong branch.

Dividend income and the related Covered Taxes – Intragroup dividends are generally excluded from the PBT reported in a Qualified CbC Report. This gives rise to the question of whether an adjustment is required to exclude the Covered Taxes (e.g. withholding taxes) paid on the excluded dividends from the amount of Simplified Covered Taxes (which is the income tax expense reported in QFS) for the purpose of the Simplified ETR computation under the CbCR SH. The December 2023 AG does not contain any further guidance on this (other than specifying the circumstance where intragroup dividends need to be added back to the Total Revenue and PBT amounts reported in a Qualified CbC Report). As such, there are not any specific provisions requiring such adjustment to the Simplified Covered taxes amount based on the AG issued so far.

Hybrid arbitrage arrangements – The December 2023 AG contains new anti-avoidance rules dealing with hybrid arbitrage arrangements for the CbCR SH purpose that are much broader in scope than the anti-mismatch rule for intragroup financing arrangements in Article 3.2.7 of the GloBE Rules. Please refer to the following example that illustrates the application of the rules to a typical HK-PRC intragroup financing arrangement:

Example:



Note: The intragroup loan arrangement was entered into after 15 December 2022

In the above example, Parent Co in the Hong Kong SAR (Hong Kong) provided an interest-bearing loan to Sub Co in the PRC. The interest is included as income in Parent Co's accounts and expense in Sub Co's accounts. In addition, the interest income is treated as offshore and not taxable for Parent Co under the foreign-sourced income exemption (FSIE) regime as the economic substance requirement under the regime is met.

Under the anti-avoidance rules, the loan arrangement will be regarded as a deduction / non-inclusion arrangement. As a result, the interest expense of \$100 has to be excluded from the PBT of the PRC for the purpose of the CbCR SH computation. It should also be noted that even if the loan arrangement was entered into before 15 December 2022, any amendments to the arrangement (e.g. a change in the repayment schedule of the principal amount which may be business instead of tax driven) or changes in the accounting treatment with respect to the arrangement after 15 December 2022 will also trigger the anti-avoidance rules.

In-scope Hong Kong business groups with similar intra-group financing arrangements will need to assess whether the above anti-avoidance rules will have any impact on their eligibility to the CbCR SH.

Another point to note is the December 2023 AG states that similar rules to deal with comparable hybrid arbitrage arrangements will be introduced into the GloBE Rules for application beyond the CbCR SH.

2. Application of the GloBE Rules

Consolidated revenue threshold for Pillar 2 scoping – Although the December 2023 AG clarifies that **ancillary** income derived by an MNE group **outside its ordinary activities** can be excluded from revenue for the purpose of applying the EUR 750 million consolidated revenue threshold under Pillar 2, considerable uncertainties remain as there is no clear guidance on what constitute “ancillary income” and “ordinary activities” of an MNE group. This issue is particularly relevant to in-scope Hong Kong MNE groups which very often are conglomerates engaging in multiple and diverse businesses.

BESP 2.0 implementation in Hong Kong

Other than the release of the December 2023 AG, another important BEPS 2.0 development for Hong Kong business groups is the issuance of the [consultation paper](#) on the BEPS 2.0 implementation in Hong Kong by the Hong Kong SAR Government on 21 December 2023.

The consultation paper sets out the government’s proposals on implementing the GloBE Rules and a domestic minimum top-up tax in Hong Kong and seeks views on certain aspects of the government’s proposals and other open issues. Please refer to our previous [Hong Kong BEPS Publication](#) for more details.

The public consultation period will end on 20 March 2024. Upon the completion of the consultation, it is expected that the government will develop the Pillar 2 legislative proposal for submission to the Legislative Council in the second half of 2024. Affected business groups in Hong Kong should take the opportunity of the public consultation to provide their views and inputs on the Pillar 2 implementation in Hong Kong to the government.

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