BEPS 2.0 implementation in Hong Kong (SAR): FAQ on Substance Based Income Exclusion

A few questions your group probably has...

Substance Based Income Exclusion (SBIE)

What is it?

The SBIE is an **allowance** under the Pillar Two Global Minimum Tax rules. It enables taxpayers to **reduce the amount of top-up tax** they have to pay in a jurisdiction **based on the amount of substance** they have there.

Why does it matter?

Hong Kong's headline tax rate is relatively low – at 16.5% it is only just above the 15% minimum effective tax rate (ETR) under Pillar Two. In addition, many items are exempted from tax in Hong Kong or are subject to preferential rates. For example, offshore income and capital gains are often not taxed, and special regimes apply to various activities such as research and development, corporate treasury centres and ship and aircraft leasing. As a result many groups will have an ETR below 15% in Hong Kong. Many of these groups also have a significant presence in Hong Kong. By using the SBIE, these groups can **retain some of the benefit of their lower tax rates**.

How much could I save?

Two types of substance can be used to reduce the top up tax liability: payroll costs and tangible fixed assets. These are discussed in more detail below. In the long term, **5% of payroll costs** and **5% of the carrying value of fixed assets** can be reduced from the group's net income (the denominator) in calculating the ETR. However, until 2032 more generous allowances are available, reducing every year. **Between 2023 and 2028** the allowances will reduce from **10% to 9%** for payroll costs and **8% to 7%** for tangible fixed asset carrying values.

The total savings will depend on how large local employment cost and tangible fixed asset carrying values are compared to the taxable profit. Groups with high employment costs, or significant tangible assets may be able to eliminate top up tax entirely, even with very low ETRs.

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How is payroll cost measured?

Payroll costs include compensation expenses such as salaries and other expenses providing a direct and separate personal benefit to employees, such as health insurance or pension contributions. In theory, it also covers payroll taxes, although this is unlikely to be relevant in Hong Kong. Payments to full- and part-time employees are eligible, as are payments to independent contractors provided that they participate in the ordinary activities of the group and are under its direction and control. To prevent double counting, payroll costs that are capitalized as part of fixed assets are not eligible, and payroll costs related to excluded shipping income are also ignored.

An important outcome of this calculation is that there is an important difference between doing activities in-house, which creates substance, and outsourcing to a third-party provider, which may not. SBIE coverage may also become one of the factors to be considered when deciding which jurisdiction to locate particular functions in.

How are fixed asset carrying values measured?

Fixed assets are valued at historic, depreciated cost for SBIE purposes, meaning there is no uplift for revaluations. Where assets have been held for many years the depreciated cost may be a long way below the current market value, which would have a significant impact on the SBIE allowance the asset provided. Investment assets and assets held for sale are not eligible for SBIE.

Where leases are recognized on the balance sheet, they also qualify for allowances, but it is worth noting that the value at which a short lease is capitalized is often significantly below the cost of owning an asset, so the decision whether to buy or rent premises can have a big impact on the amount of substance a taxpayer is deemed to have. Either way, the value of the asset is likely to decrease over time, although a rental asset may decrease more quickly.

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How are fixed asset carrying values measured? (cont.)

Consideration may be given to when it is appropriate to capitalize costs into the value of an asset. Capitalized costs are generally eligible for SBIE, and where they are eligible for initial allowance, refurbishment allowance or prescribed fixed assets, tax deductions for the cost may be available much earlier than the value is written down under accounting depreciation rules. Companies may also consider whether it is appropriate in certain circumstances to extend useful asset lives or recognized residual value in their assets.

What happens where staff and assets are only partly based in Hong Kong?

Where staff or assets are partly based in Hong Kong, a full allowance is granted where more than half the time is in Hong Kong, whereas the allowance is pro-rated in cases where less than half is in Hong Kong. Careful management of the amount of time in which mobile employees and asset spend in each location can help to maximize available allowances.

Key takeaways

Given Hong Kong's low rate of tax, the SBIE may play an important role in preventing top up taxes from applying. Accounting policies and commercial decisions on outsourcing or renting can have significant impacts on the value of the SBIE. KPMG can help groups to **review their substance in Hong Kong** to ensure that the **full value of the allowance is available**.

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