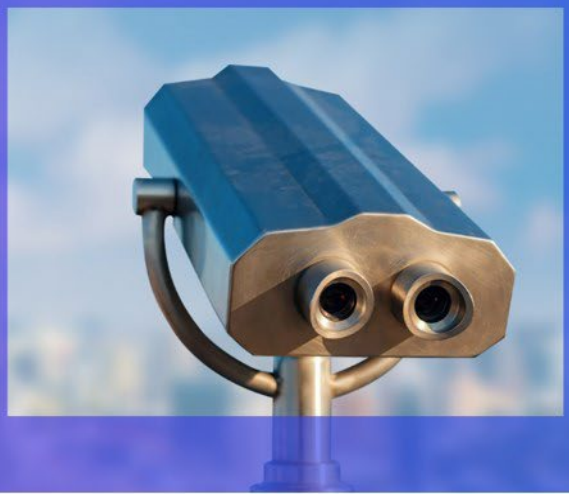
KPMG

BEPS Pillar 2

Side-by-Side Package



Frequently Asked Questions for Hong Kong SAR and the Chinese Mainland

On 5 January 2026 the OECD published the highly anticipated "Side-by-Side Package" document as part of its ongoing work in respect of BEPS Pillar 2. The Side-by-Side Package contains the following measures.

1. A Side-by-Side System (SbSS) which prevents income inclusion rules (IIRs) and undertaxed profit rules (UTPRs) from applying to US-headquartered groups.

2. The replacement of the UTPR Safe Harbour with the Ultimate Parent Entity (UPE) Safe Harbour in order to reduce administration, particularly in jurisdictions that have a corporate alternate minimum tax.

3. A one-year extension to the Country-by-Country Reporting Safe Harbour (CbCR SH).

4. The introduction of a Simplified Effective Tax Rate Safe Harbour (SESH) which will replace the CbCR SH and is intended to simplify compliance procedures.

5. New rules permitting certain substance-based tax incentives through the introduction of a Substance-based Tax Incentive Safe Harbour.

The Side-by-Side Package is considered significant from a Pillar 2 policy perspective, and we have received a substantial number of queries with respect to its scope and application. We have set out a series of frequently asked questions and their answers below.

Side-By-Side System

1. What is the Side-by-Side System?

In simple terms the SbSS prevents an IIR or UTPR from applying to a multinational enterprise (MNE) group that has its UPE in the US.

The SbSS is likely to be of most relevance to US-headquartered groups that have operations in low-tax jurisdictions that have not implemented a Qualified Domestic Minimum Top-up Tax (QDMTT) or domestic minimum top-up tax (DMT). As these jurisdictions would effectively be exposed to top-up tax under an IIR or UTPR without the application of the SbSS.

2. Will the Side-by-Side System apply to groups headquartered in any other jurisdictions?

The SbSS requires several domestic and international tax conditions to be met and whether a jurisdiction qualifies under the SbSS is ultimately subject to the purview of the OECD/G20 Inclusive Framework on BEPS (IF).

It is currently unclear whether any other jurisdictions could benefit from the SbSS and beneficiaries of the SbSS are expected to be limited. Hong Kong SAR (Hong Kong) and Singapore will not benefit from the SbSS. Initially, it would appear that the Chinese Mainland does not meet the required conditions either.

3. Will the Side-by-Side System apply retroactively to 2024 and 2025?

The SbSS is expected to apply in respect of financial years beginning on or after 1 January 2026. This means that the SbSS is fundamentally prospective in nature. In other words, US-headquartered groups would continue to be exposed to applicable IIRs and UTPRs for 2024 and 2025.

4. How will jurisdictions implement the Side-by-Side System?

Jurisdictions may need to update their domestic legislation in order to give effect to the SbSS in order to effectively prevent their IIR and UTPR from applying to US-headquartered groups. The OECD suggests that legislation should be passed that applies on a retroactive basis from 1 January 2026, or, if retroactive legislation cannot be passed, prospective legislation should be passed as soon as practicable.

The SbSS applies in respect of financial years commencing on or after 1 January 2026. Therefore, MNE groups with 31 December year ends should immediately be able to take advantage of the SbSS, while those with 31 March or 30 June year ends will be slightly delayed.

5. What does this mean for provisioning?

Generally, the 2025 tax provision for groups with a 31 December year-end should not need to be adjusted, as the SbSS applies on a prospective basis. Therefore, accounts currently being closed do not need to be adjusted.

We generally expect the Q1 and Q2 2026 provisions to be prepared on the basis that the IIR and UTPR continue to apply to US-headquartered groups, until such time as the relevant jurisdiction substantively enacts legislation to give effect to the SbSS at which point top-up tax accruals in respect of an IIR or UTPR can be unwound for groups with 31 December year ends. Groups with 31 March or 30 June year ends would continue to accrue top-up tax under an IIR or UTPR until their next financial year, assuming SbSS legislation has been substantively enacted at that point.

MNE groups will need to identify top-up tax driven by an IIR or UTPR and monitor that jurisdiction's SbSS implementation status in order to ensure the tax provision is appropriate.

6. Will the SbSS override QDMTTs?

No, the operation of QDMTTs will be largely unaffected by the SbSS. This means that US-headquartered groups will continue to be subjected to QDMTTs in the jurisdictions in which they have been implemented.

The SbSS has made clear that, in computing top-up tax under a QDMTT, the QDMTT must not treat CFC taxes or taxes allocated from a head office to a branch as Covered Taxes, or otherwise provide credit for these taxes.

Therefore, where a jurisdiction has implemented a QDMTT, the SbSS is unlikely to significantly impact the overall amount of top-up tax to be collected, except in respect of switch-off rule scenarios.

7. What are switch-off rules and how do they interact with the SbSS?

A jurisdiction can choose to "switch-off" its QDMTT in respect of certain types of entity. Under a switch-off rule the jurisdiction that implements the QDMTT will not collect top-up tax in respect of those entity types. For example, Hong Kong and Singapore do not collect top-up tax in respect of investment entities.

Where a switch-off rule applies to an entity, even though the QDMTT will not apply, it may still be subject to an IIR or UTPR, such that top-up tax is still collected in respect of that entity. However, if the entity is part of a US-headquartered group, the SbSS should apply, such that top-up tax will not be collected under an IIR or UTPR. This could mean that entities that are located in QDMTT jurisdictions that apply switch-off rules are subject to less top-up tax than those that do not apply switch-off rules.

Switch-off rules apply in discreet scenarios, in particular in respect of investment entities and joint ventures. Where a switch-off rule applies in respect of a joint venture, only the top-up tax relating to the US-headquartered group will be protected from IIRs and UTPRs.

Neither Hong Kong nor Singapore use switch-off rules to prevent top-up tax being collected in respect of joint ventures.

8. Can Hong Kong switch off the QDMTT for US-headquartered groups while continuing to apply it for non-US-headquartered groups?

The IF appears to have considered that jurisdictions may adjust their legislation so that US-headquartered groups are not subject to a QDMTT while non-US-headquartered groups continue to be subject to a QDMTT.

If a jurisdiction chooses to adjust its tax law to apply in this manner it will not be considered as qualified for the purposes of the QDMTT definition. It is also possible that the tax charged upon non-US-headquartered groups will not be considered to meet the definition of Covered Taxes, meaning that MNE groups operating in that location could suffer double taxation, firstly through domestically collected taxes and secondly through top-up tax collected under an IIR or UTPR by another jurisdiction.

MNE groups will need to carefully consider their tax positions in such territories, which are more likely to be tax haven jurisdictions.

Undertaxed Profit Rule Safe Harbour

9. What is the Ultimate Parent Entity Safe Harbour?

The UPE SH is similar to the UTPR SH but has more stringent conditions. Under both the UTPR SH and the UPE SH the top-up tax of the UPE jurisdiction is deemed to be zero. While the remainder of the group will continue to be subject to top-up tax in the normal way.

10. What changes have been introduced?

The UTPR SH was initially a temporary measure that expired on 31 December 2025 for MNE groups with calendar year-ends. The OECD has introduced the UPE SH on an indefinite basis which can apply for financial years starting from 1 January 2026. Additional conditions have been introduced which make the UPE SH more difficult to satisfy and may ultimately limit its usefulness as compared to the UTPR SH.

The following conditions must be met for the UPE SH to apply:
1. a headline corporation tax rate of 20%
2. the operation of a QDMTT or corporate alternative minimum tax (CAMT)
3. there being no material risk of the ETR of an MNE group falling below 15% in respect of that jurisdiction

Hong Kong and Singapore would fail these conditions on the basis that their headline corporation tax rate is below 20%. It would also appear that the Chinese Mainland will not meet these conditions on the basis that it has not implemented a QDMTT or corporate alternative minimum tax.

It would appear that a large number of European jurisdictions may benefit from the UPE SH, as these jurisdictions generally have corporate tax rates above 20% (with some exceptions) and have implemented QDMTTs.

However, it is unclear how much benefit the UPE SH will provide, as if jurisdictions will need to be subject to a QDMTT or CAMT, they are likely to have an ETR above 15% in any case. The UTPR SH did not have these conditions and was potentially far more powerful than the UPE SH. The UPE SH is likely to be most beneficial for those jurisdictions that have a CAMT and do not operate a QDMTT as it could alleviate the need to prepare Pillar 2 computations.

CbCR and permanent safe harbour

11. What will happen to the CbCR Safe Harbour and will it be made permanent?

The CbCR Safe Harbour will be extended by one year. For MNE groups with a 31 December year-end the CbCR Safe Harbour was set to expire on 31 December 2026. It will now expire on 31 December 2027. MNE groups with financial year-ends on 31 March or 30 June will have a further 3 and 6 months, with the CbCR Safe Harbour expiring on 31 March 2028 and 30 June 2028 respectively.

The minimum rate that must be attained under the CbCR Safe Harbour for 2027 will be 17%, which is the same as that used for 2026.

The CbCR Safe Harbour will not be made permanent. Instead, a new permanent safe harbour will be introduced. That permanent safe harbour will not be based on the CbCR.

12. How will the permanent safe harbour work?

The permanent safe harbour will be known as the Simplified ETR Safe Harbour (SESH). Its default application will be for financial years starting 1 January 2027 but can apply for financial years starting 1 January 2026 if conditions are met and the implementing jurisdictions permits it to apply from this date. The SESH is intended to be available indefinitely.

The SESH will apply on a jurisdiction-by-jurisdiction basis to the extent that an MNE group qualifies and elects into the SESH.

The SESH is relatively similar to the full Pillar 2 rules. The key difference between the SESH and the full Pillar 2 rules is that the SESH provides some flexibility for an MNE group to reduce the administrative burden of complying with the full Pillar 2 rules. In short, this is achieved by permitting an MNE group not to make certain adjustments to GloBE Income and Covered Taxes. However, this is generally only in respect of those adjustments which would be beneficial to the MNE group. In other words, if an MNE group clearly has an ETR above 15%, to the point that the MNE group does not need to claim the benefit of certain adjustments, the SESH allows the MNE group not to make those adjustments. Therefore, the data the MNE group must collect and its processes can be reduced.

For MNE groups that operate in low tax jurisdictions or that have already implemented and even automated their compliance processes, the SESH may be of little benefit. However, for groups currently struggling with the additional workload created by Pillar 2, the SESH may provide at least some relief in respect of high tax jurisdictions and should make it easier for MNE groups to comply with the letter of the law.

Substance-based tax incentives

13. What has changed?

There is a recognition in the IF that jurisdictions should be allowed to implement certain substance-based tax incentives without MNE groups being penalised for taking advantage of them. The revised framework allows greater flexibility for jurisdictions to make use of incentives in their tax systems without triggering top-up taxes and introduces a Substance based Tax Incentive Safe Harbour. Arguably, the Safe Harbour is more of an adjustment to Adjusted Covered Taxes, than a true safe harbour and allows the benefit of certain tax incentives to be added back to Adjusted Covered Taxes, within limits. This should have the effect of increasing the ETR of a jurisdiction.

14. Which incentives are affected?

The changes do not apply to all incentives. The revisions only apply to incentives that are based directly on either expenditure or production. In the context of Hong Kong, this is likely to mean that double or triple deductions for research and development expenditure are included, but older, broader exemptions for offshore income or capital gains will not be eligible. The fact that an incentive has a minimum expenditure requirement in order to be eligible is not enough in itself if the incentive is not directly linked to the expenditure incurred. This may mean that, as currently drafted, the reduced rates of tax on corporate treasury centres or leasing arrangements do not qualify. In the Chinese Mainland, it is expected that super-deductions would be eligible,

but concessions focused around special economic zones or non-taxation of government bond income may not be.

In light of these changes, MNE groups should review their incentive claims and confirm whether there is now a benefit in making further claims. MNE groups should also take part in any consultation processes to ensure that incentives continue to function effectively in the context of Pillar 2.

15. Are there any other restrictions?

As might be expected, the OECD is concerned about the potential for tax systems to undermine the core purposes of Pillar 2. In addition to the above requirements, allowances for incentives will be capped according to substance. The test is similar to the Substance Based Income Exclusion test, although the cap is based on 5.5% of payroll costs or eligible depreciation costs (rather than an allowance for both employment costs and tangible fixed assets). An election is available to substitute this test for 1% of tangible fixed asset carrying value.

The adjustment can be made when the expense is accrued or when it is paid. No adjustment is allowed for future expenses (unless accrued under GAAP) or for expenses incurred before the incentive came into effect.

The incentive must be generally available. It cannot be limited to MNE groups within the scope of Pillar 2 or be based on government discretion. The OECD will develop further guidance (which, based on previous experience, may include changes) and continue to monitor and update the rules.

16. What adjustment is allowed?

The adjustment is subject to an election. Where the election is made, an amount equal to the lower of the effect of the tax incentive and the substance cap will be added to Adjusted Covered Taxes, effectively increasing the ETR. The value of the tax incentive cannot exceed the expenditure in respect of which the incentive was granted.

The old rules allowed qualifying refundable tax credits to be treated as an adjustment to financial accounting net income or loss rather than a reduction to tax. In certain cases it may be beneficial to elect for these to be dealt with under the new rules on incentives rather than the old rules (as the adjustment will be to the numerator rather than the denominator). Taxpayers with refundable tax credits should review their position.

17. When do the revised rules take effect?

The Substance-based Tax Incentive Safe Harbour election can be made in respect of financial years commencing on or after 1 January 2026.

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