香 港 稅 務 學 會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

CTA
特 許 稅 務 師
Chartered Tax Adviser

International Tax Updates

1. The OECD published the Commentary and Illustrative Examples of the GloBE Rules under Pillar Two of BEPS 2.0

   On 14 March 2022, the OECD/G20 Inclusive Framework on BEPS (IF) published the Commentary on the GloBE Model Rules and Illustrative Examples to provide detailed technical guidance on the interpretation and application of the GloBE Model Rules issued in December 2021.

   Some of the issues addressed / clarified in the Commentary and Illustrative Examples are:

   - Revenue of excluded entities and revenue attributed to minority equity interests have to be included in applying the EUR750 million annual consolidated revenue threshold to the extent such revenue is included in the consolidated financial statements of the group;

   - The 5-year election on unrealised revaluation gains / losses on assets and liabilities remains in force indefinitely until the group actively revokes it;

   - Determination of "short-term portfolio shareholding" for the purposes of excluding dividends and equity gains / losses from the GloBE income will be on a "Last-In-First-Out" basis;

   - Taxes on net income under Pillar One, taxes arising from the Subject to Tax Rule under Pillar Two and taxes paid under the controlled foreign corporation (CFC) rules are regarded as Covered Taxes;

   - An airline with an office in an overseas treaty jurisdiction through which it carries out part of its international aircraft transportation business will not be regarded as having a permanent establishment (PE) in that overseas jurisdiction if the profits attributed to the PE is exempt under the International Shipping and Air Transport Article of the relevant tax treaty instead of being taxed under the Business Profits Article; and

   - The "regulatory regime" requirement under the definition of "investment fund" is intended to encompass different approaches to prudential regulations of investment funds and investment managers (including anti-money laundering and investor protection regulation).

   The IF is in the process of developing the GloBE Implementation Framework to provide further guidance to the tax authorities and MNE groups in respect of the implementation and administration of the GloBE Rules.

For more details and copies of the Commentary and Illustrative Examples, please refer to this link 1 to the OECD's website.

2. The OECD's consultation on the Draft Model Rules for scope of Amount A under Pillar One of BEPS 2.0

On 4 April 2022, the IF released a consultation document for Amount A under Pillar One. The document contains the Draft Model Rules for scope of Amount A (the Scope Rules).

The key points of the Scope Rules are summarised as follows:

- The purpose of the Scope Rules is to determine when a group will be in scope of Amount A using the financial data in the consolidated financial statements of the Ultimate Parent Entity (UPE) as the starting point;

- A group will be in scope of Amount A if **both** (1) the revenue threshold of more than EUR20 billion (which may 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 revenue threshold is met if the Total Revenues (i.e. adjusted revenues reported in the group's consolidated financial statements) of the group for the current accounting period exceed the amount of EUR20 billion **(the global revenue test).**

- The profitability threshold is met if the pre-tax profit margin of the group exceeds 10% **(the profitability test)** in (1) the current accounting period; (2) at least two of the four accounting periods immediately preceding the current accounting period **(the prior period test)** and (3) on average across the current accounting period and the four immediately preceding accounting periods **(the average test)**;

- The global revenue test may also include the rules equivalent to the prior period test and the average test mentioned above. It is still under discussion whether the prior period test and the average test for the profitability threshold would be applied permanently on a rolling basis or only as an "entry test" for a group which has not met the scope thresholds previously; and

- Certain entities (including pension funds, investment funds and real estate investment vehicles as defined that meet the definition of a UPE) are an excluded entity of which the main operative provisions of the Amount A rules do not apply.

Future commentary will be issued by the IF to provide further guidance and clarifications on the Scope Rules.

For more details and a copy of the consultation document, please refer to this link 2 to the OECD's website.

3. The OECD's consultation on Extractives Exclusion under Pillar One of BEPS 2.0

On 14 April 2022, the IF released another consultation document under Pillar One, which is on the Extractives Exclusion under Amount A (Extractives Exclusion). The key points of the Extractives Exclusion are summarised as follows:

- To qualify for the extractives exclusion, a group must (1) derive revenue from sale of the "Extractive Products" as defined (the **product test**) and (2) has carried out the Exploration, Development or Extraction activities (the **activities test**);

- A group that meets the EUR20 billion revenue threshold and 10% profitability threshold before the exclusion will re-determine whether the revenue threshold is met by subtracting third-party revenue derived from Extractive Activities from the group's consolidated revenue to arrive at the figure of the in-scope revenue. If the in-scope (i.e. Non-Extractives Activities) revenue is not above EUR20 billion, the group is not in scope; and

- A group with the in-scope (i.e. Non-Extractives Activities) revenue above EUR20 billion will further re-determine whether the 10% profitability threshold is met by isolating the profits from Extractive Activities and testing the profit margin of the remaining in-scope profits. If this profit margin is below 10%, the group is out of scope.

Future commentary will be issued by the IF to provide further guidance and clarifications on the Extractives Exclusion.

For more details and a copy of the consultation document, please refer to this link 3 to the OECD's website.

4. The OECD's consultation on Regulated Financial Services Exclusion under Pillar One of BEPS 2.0

On 6 May 2022, the IF released another consultation document under Pillar One, which is on the Regulated Financial Services Exclusion under Amount A (RFS Exclusion). The key points of the RFS Exclusion are summarised as follows:

- "Regulated Financial Services" (RFS) is defined as services carried out by a "Regulated Financial Institution";

- A "Regulated Financial Institution" (RFI) means: a Depositary Institution, a Mortgage Institution, an Investment Institution, an Insurance Institution, an Asset Manager, a Mixed Financial Institution and an RFI Service Entity. Whether reinsurance and asset management should be excluded from the scope of Amount A is still under discussion.

- The definition for each type of RFI generally contains three elements: (1) a licensing requirement, (2) a regulatory capital requirement and (3) an activities requirement. The revenue and profit of an entity are wholly excluded from Amount A if **all** of the three requirements are met;

- An entity with a "substantial portion" of its business (i.e. total gross income attributable to the intra-group business not less than 50% of the entity's total gross income in an accounting period) is conducted with the other group entities that are not RFIs would not qualify as an RFI;

- An entity that meets the RFI definition is wholly excluded from Amount A whereas an entity that does not meet that definition is wholly included in Amount A;

- A group that meets the EUR20 billion revenue threshold and 10% profitability threshold before the exclusion will re-determine whether the revenue threshold is met by (1) subtracting the total third party revenue of the largest RFIs within the group to the extent that the remaining revenue is below EUR 20 billion or (2) adding the total revenue of all non-RFI entities and testing whether such revenue exceeds EUR 20 billion (without subtracting the intra-group revenue). If such revenue from in-scope entities is not above EUR20 billion, the group is not in scope of Amount A.

- A group with revenue from non-RFI entities above EUR20 billion will re-determine whether the 10% profitability threshold is met by excluding the profits from RFS. The group could (1) first excluding the third-party revenue and costs of RFIs from the consolidated group and then adding back the related-party revenue and costs arising from transactions between in-scope entities and the RFIs or (2) recombing the in-scope entities into a consolidated segment to include the revenue and costs arising from third-party transactions of these in-scope entities and intra-group transactions with the RFIs. If the profit margin of the group after these adjustments is not above 10%, the group is out of scope of Amount A.

Future commentary will be issued by the IF to provide further guidance and clarifications on the RFS Exclusion.

For more details and a copy of the consultation document, please refer to this link 4 to the OECD's website.

5. The OECD's consultation on a new tax transparency framework for crypto-assets and proposed amendments to the Common Reporting Standard (CRS)

On 22 March 2022, the OECD released a public consultation document on the implementation of Crypto-Asset Reporting Framework (CARF) and proposed amendments to the CRS.

The objective of this document is to (i) set out a framework for the reporting and automatic exchange of information in respect of crypto-assets and (ii) further improve the operation of the CRS and expand the scope of the CRS to have a wider coverage to fit the current development in digital assets.

The CARF set out (1) the definition of crypto-assets, (2) the service providers that would be regarded as reporting intermediaries under the CARF and (3) the due diligence procedures and reporting that need to be carried out by the reporting intermediaries.

The reporting scope under the amended CRS framework would be expanded to include a wide range of digital financial products

The reporting requirements under the CRS will also be expanded to cover (i) the role of the controlling person in relation to the entity account holder, (ii) whether the account is a pre-existing or new account and whether a valid self-certification has been obtained, (iii) whether the account is a joint account and the number of joint holders and (iv) the type of financial account.

After the finalization of the CARF and the amended CRS framework, the OECD will continue to develop the exchange instruments and technical solutions to facilitate the implementation of the CARF and the amended CRS by local jurisdictions.

For more details and a copy of the consultation document, please refer to this link 5 to the OECD's website.

6. Potential deferral of Pillar Two implementation in the European Union

Further to the issuance of the EU Minimum Tax Directive in December last year, the European Union (EU) came up with a revised proposal on the Directive (Revised Proposal) on 12 March 2022. However, the EU did not reach a unanimous agreement on the Revised Proposal in the March 15 meeting due to reservations made by four Member States (i.e. Estonia, Malta, Poland and Sweden).

Subsequently, the EU released a revised compromise text on the EU Minimum Tax Directive (Revised Compromise Text) on 28 March 2022, which proposes the following deferral in the implementation timeline of Pillar Two within the EU:

- the Income Inclusion Rule (IIR) to apply for fiscal years beginning on or after **31 December 2023**; and

- an option for EU Member States to defer the application of the IIR and the Undertaxed Payment Rule (UTPR) up to **31 December 2029** if **no more than 12** UPE of in-scope MNE groups are located in those EU Member States.

The EU Member States again failed to reach a unanimous agreement on the Revised Compromise Text in the April 5 and meeting due to reservations from Poland and the Revised Compromise Text was not discussed in the May 24 meeting as originally scheduled.
The EU now aims to reach an agreement on the EU Minimum Tax Directive in the next meeting scheduled on 17 June 2022.

For more details and copies of the Revised Proposal and the Revised Compromise Text, please refer to these link 6 and link 7 to the EU's website.

7. The Cayman Islands issued Enforcement Guidelines on Economics Substance (ES) and CRS

On 31 March 2022, the Tax Information Authority (TIA) of the Cayman Islands issued the ES Enforcement Guidelines and the CRS Enforcement Guidelines. The Guidelines set out the TIA's principles and processes for taking enforcement action under the ES Act and CRS Regulation.

The documents set out (1) the scope of application of the Guidelines; (2) the investigatory functions and enforcement principles of the TIA; (3) the baseline/indicative administrative penalty amounts for different types of non-compliance under the ES Act and the CRS Regulation; (4) sample penalty notices; (5) the appeal process and (6) the instructions for payment of penalty and interest (if any), etc.

For more details and copies of the ES Enforcement Guidelines and the CRS Enforcement Guidelines, please refer to these link 8 and link 9 to the TIA's website.

8. The United Nations (UN) updated the UN Model Double Taxation Convention

The UN published the updated 2021 version of the UN Model Double Taxation Convention (the 2021 Convention) in April 2022. Various changes are made to the Articles and the Commentary of the Convention as compared to the 2017 version. In particular,

- a new article, Article 12B on Income from Automated Digital Services, has been added together with its Commentary;

- a new clause on taxation of offshore indirect transfer has been added to Article 13 on Capital Gains; and

- the Commentary on Article 12 – Royalties has been updated.

Article 12B – Income from automated digital services

Article 12B grants a taxing right to the source state (apart from the taxing right of the residence state) on the income derived from automated digital services (ADS). ADS is defined as services provided on the internet or other electronic network requiring minimal human involvement. The definition of ADS specifically includes (i) online advertising services, (ii) supply of user data, (iii) online search engines, (iv) online intermediation platform services, (v) social media platforms, (vi) digital content services, (vii) online gaming, (viii) cloud computing services, and (ix) standardised online teaching services. On the other hand, the definition specially excludes (i) customised professional services, (ii) customised online teaching services, (iii) services providing access to the Internet or to another electronic network, (iv) online sale of goods and services other than ADS, and (v) revenue from the sale of a physical good, irrespective of network connectivity.

According to the new article, income from ADS arising in a source state may also be taxed in that state on (i) a gross basis or (ii) a net basis upon requested by the beneficial owner of the income.

Under the gross basis, the tax amount in the source state shall not exceed a certain percentage (to be bilaterally agreed between the contracting parties) of the gross amount of the income.

If the beneficial owner of the income elect for the income to be taxed on a net basis instead, the tax in the source state will be arrived at by applying the usual corporate income tax rate in the source state to the amount of "qualified profits". The qualified profits is defined as 30% of the amount resulting from applying the profitability ratio of the beneficial owner's ADS business segment to the gross annual revenue from ADS derived by it from the source state. If segmental accounts are not maintained such that the ADS profitability ratio is not known, the overall profitability ratio of the beneficial owner will be applied to determine the qualified profits. However, where the beneficial owner belongs to a multinational enterprise group, the profitability ratio of the ADS business segment of the group or the profitability ratio of the group as a whole (if segmental accounts are not maintained) will be used to determine the qualified profits instead.

New clause in Article 13 – Taxation of offshore indirect transfer

Paragraph 7 has been added to Article 13 on Capital Gains, which grants a taxing right to the source state on gains derived by a non-resident from disposal of shares or comparable interests in a local or offshore company or entity if, at any time during the 365 days preceding such disposal:

- the alienator, held directly or indirectly at least certain percent (to be agreed through bilateral negotiations) of the capital of that company or entity; and

- these shares or comparable interests derived at least 50% of their value from property with respect to which that source state would, under the other provisions of Article 13, have had the right to tax the gain from a direct alienation.

Commentary of Article 12 – Royalties

In addition to the above changes to the articles, the Commentary of Article 12 on Royalties has also been updated to reflect the alternative minority view that the scope of "royalties" for the purpose of the Royalties article should be widened to include certain software payments. Some jurisdictions take the view that software payments should also be treated as royalties for tax treaty purposes regardless of whether there is commercial exploitation of a copyright by the software user.

However, existing treaties will not be affected by the above updates unless they are renegotiated and amended by the contracting parties.

For more details and a copy of the 2021 Convention, please refer to this link 10 to the UN's website.