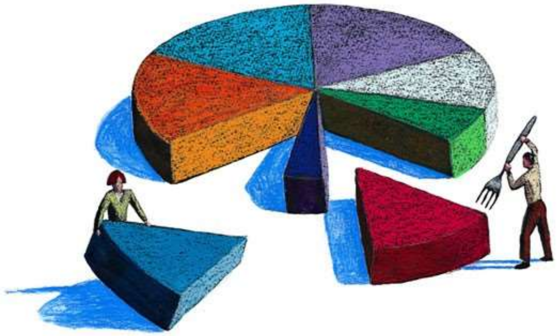
The latest development of tax in Hong Kong (January 2022)



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01

Quick overview of BEPS 2.0

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Overview of Pillar One and Pillar Two

The OECD/G20 Inclusive Framework on BEPS (IF) consists of 141 member jurisdictions. 137 of 141 members (including the HKSAR and Mainland China) have agreed to the IF Statement issued on 8 October 2021.

01

Pillar One - Reallocating profits and taxing rights to market jurisdictions

- New nexus rules not dependent on physical presence
- Sales revenue as allocation key for **Amount A**
- Mechanism for **elimination of double taxation**
- Mandatory and binding **dispute prevention and resolution** mechanism
- **Amount B** – profits for in-country baseline marketing and distribution activities based on simplified ALP

02

Pillar Two – Global minimum tax

- Allow other jurisdictions to "tax back" income not taxed at the **minimum effective tax rate (ETR) of 15%**
- Top-up tax at the parent or/and payer jurisdictions
- Rule status: a common approach (i.e. not mandatory)

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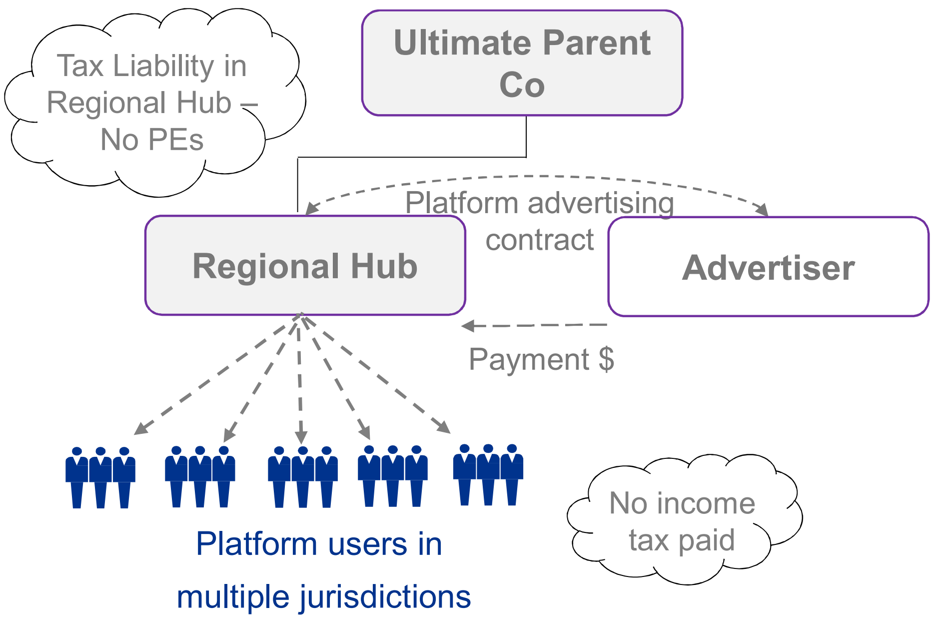
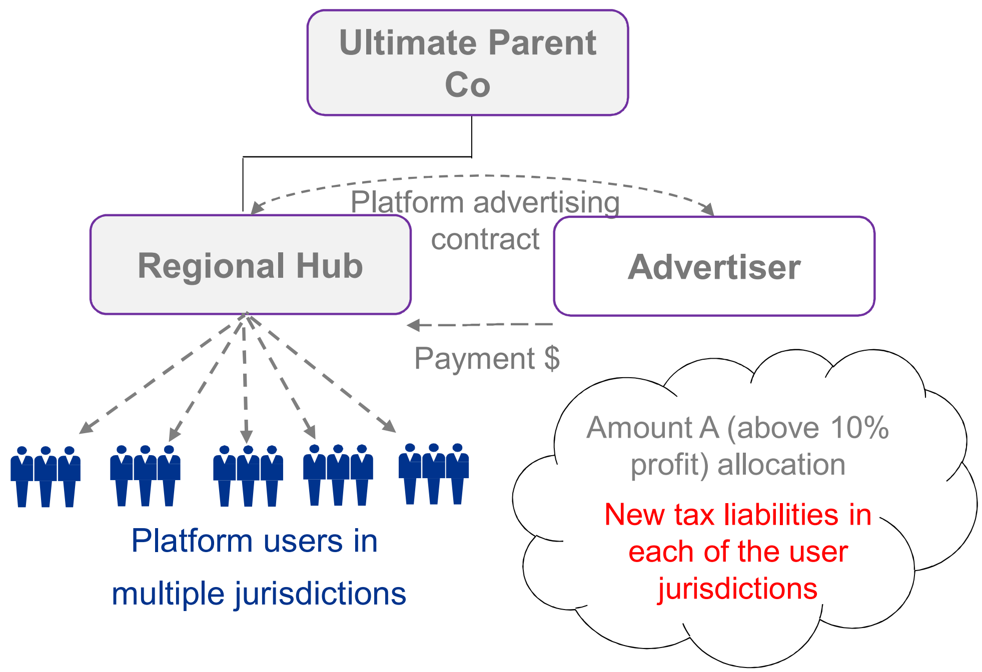
Pillar 1 – High-Level Impact (Market Jurisdictions)

No Profit allocation (no PEs)



Profit reallocation under Pillar One to Market Jurisdictions



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OECD/G20 IF Statement - Pillar One

P1 Key Aspects

MNEs in scope – Turnover EUR20 billion and Profitability above 10%

Exclusions – Extractives and Regulated Financial Services

Market profit allocations – 25% of profit above 10% margin (original proposal 20%-30%)

Market and distribution safe harbour – If residual profit already taxed in market

Jurisdictional taxing rights – €1 million (€250,000 if GDP less than €40 billion)

Sourcing – Where goods/services used/consumed - “reliable method”

Paying entities – Those with residual profits

Tax Certainty – Binding dispute prevention/resolution where “relating” to Amount A

Unilateral Measures – Digital Service Taxes and other relevant measures

Implementation – MLC signing 2022, Amount B on separate track. IF members to use ‘all for effect in 2023

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Pillar One - Key Open Issues

P1 Key Aspects

Scope:

- Deemed MNE group
- Foreign de minimis revenue exclusion
- Definition for ‘Regulated financial services’ and ‘extractives’ exclusions

Features affecting how much tax to be paid and where:

- Design of marketing and distribution safe harbour and double tax relief rules
- Revenue sourcing rules (e.g. intermediate products)

Tax certainty and Dispute Resolution:

- Design of mandatory and binding dispute resolution mechanism
- Scope and status of Amount B rules

of ‘other relevant similar measures’ for rollback alongside DSTs

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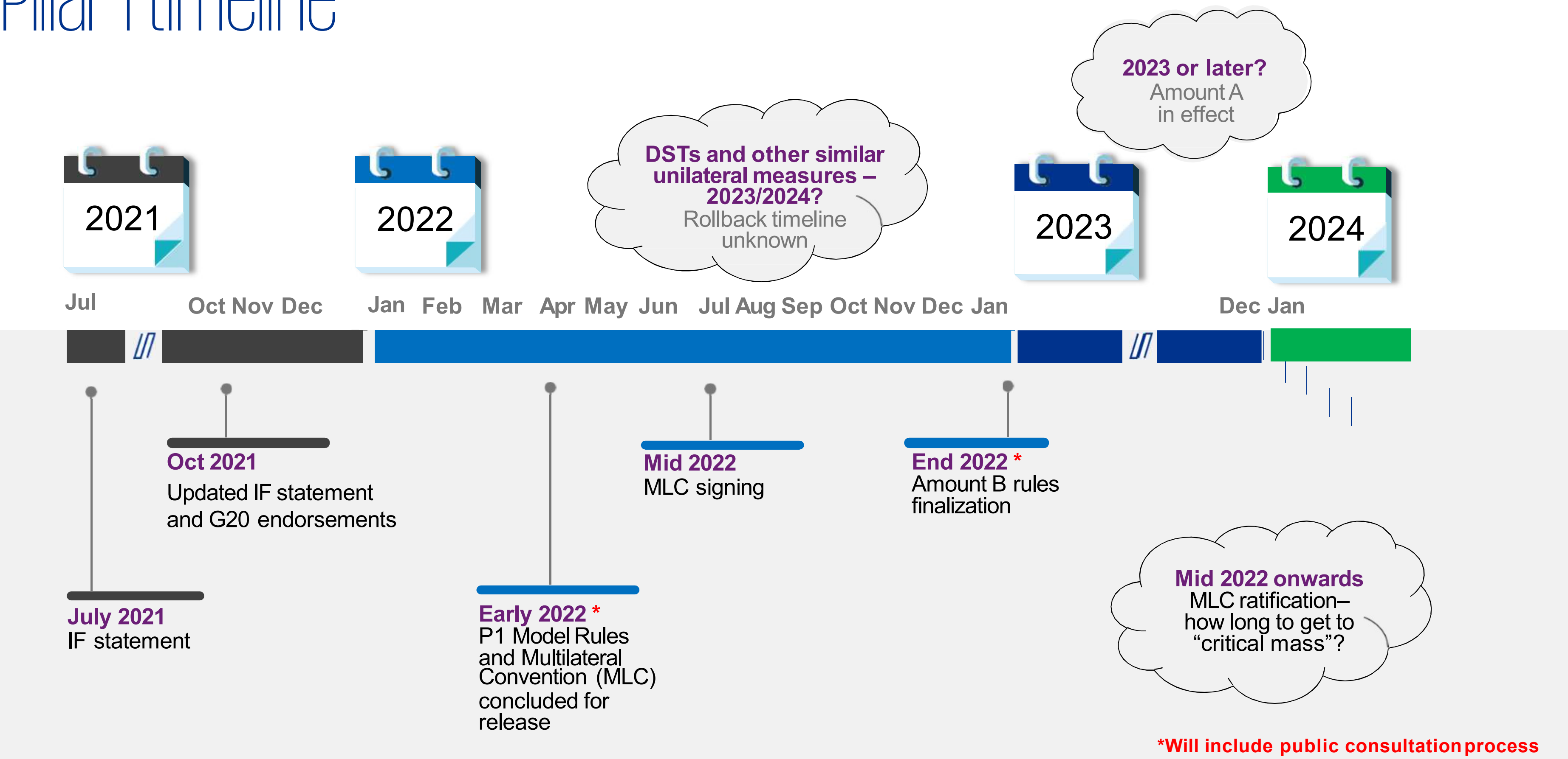
Pillar 1 timeline



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Pillar 2 timeline

2021

2022

2022 onwards
GloBE domestic legislation and STTR MLI related processes

2023

2024

For Dec-year ended MNE groups
First Information Return to be filed by June 2025

Jul Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Dec Jan

July 2021
IF statement

Oct 2021
Updated IF statement and G20 endorsements

Dec 2021
GloBE Model Rules finalization

Jan/Feb 2022 *
GloBE Commentary finalization

Consultation on GloBE Implementation Framework

Mar 2022*
STTR provisions and Commentary concluded for release

Mid 2022
STTR MLI finalization

End 2022
GloBE Implementation Framework finalization

Jan 2023
IIR and STTR targeted to be in effect (excl UTPR)

Jan 2024
UTPR targeted to be in effect (with a 5-year exclusion period for MNE groups in the initial phase of internationalisation)

***Will include public consultation process**

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02

Key features of the GloBE rules under Pillar 2

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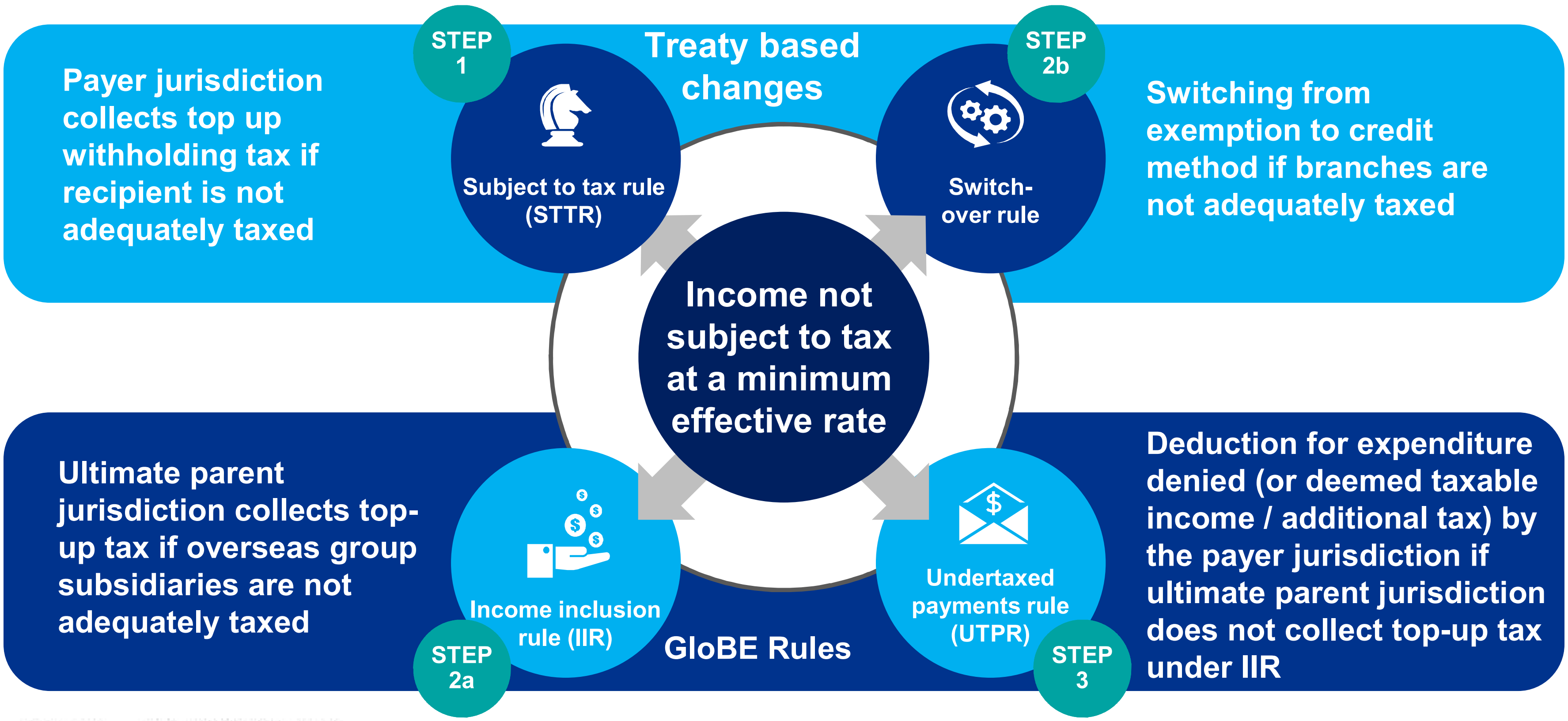
Key elements of Pillar 2



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Scope of the GloBE rules

1.1 What is a "MNE group"?

- A group with at least one entity or permanent establishment (PE) that is not located in the jurisdiction of the ultimate parent entity (UPE)

1.2 Identify MNE groups within scope

- Annual consolidated group revenue of €750m or more in 2 of the 4 prior fiscal years of the UPE
- Special rules for mergers / demergers

1.3 Identify constituent entities (CEs) within the MNE group

- All consolidated / controlled entities + PEs

1.4 Remove excluded entities

- Investment funds and REITs that are the UPE
- Certain SPVs held by excluded entities
- Pension funds, etc.

1.5 Exclude international shipping income

- International shipping income + Qualified ancillary international shipping income
- Excluded from GloBE Income/Loss
- Strategic or commercial management of ships is effectively carried on from within the location of the CE

1.6 De minimis exclusion (for jurisdictions)

- Average GloBE Revenue < €10m + Average GloBE Income/Loss < €1m or is a loss in the current and 2 preceding fiscal years of the UPE
- Subject to annual election

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Three shots at achieving global minimum tax rate of 15%

1. Domestic tax in jurisdiction

- ETR of an MNE group in each jurisdiction < 15%?
- Calculate Jurisdictional top-up tax
- Reduce Jurisdictional top-up tax by any domestic top-up tax

2. IIR

- Jurisdictions of parent entities of the MNE group adopt an IIR?
- If yes, determine jurisdictional top-up tax absorbed by the IIR
- If no or unabsorbed amount, determine if the UTPR applies

3. UTPR back stop

- Determine total remaining top-up tax owed by the MNE group
- Allocate total UTPR top-up tax to each jurisdiction that has adopted the UTPR

- 50% x $\frac{No.\ of\ employees\ in\ the\ jurisdicton}{No.\ of\ employees\ in\ all\ UTPR\ Jurisdictions}$ +
- 50% x $\frac{CV\ of\ tangible\ assets\ in\ the\ jurisdiction}{CV\ of\ tangible\ assets\ in\ all\ UTPR\ Jurisdictions}$
- CV = Carrying value

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03

The EU grey list

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Inclusion of Hong Kong in the EU's grey list

2. Fair Taxation

2.1. *Existence of harmful tax regimes*

The following jurisdictions, which committed to amend or abolish their harmful foreign-source income exemption regimes, were granted until 31 December 2022 to adapt their legislation:

Costa Rica, Hong Kong, Malaysia, Qatar, Uruguay

The Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes (5 October 2021)

Source: https://www.consilium.europa.eu/media/52208/st12519-en21.pdf

Council of the European Union

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What are the EU's concerns?

How about dividends and capital gains?

Offshore regime may lead to double non-taxation via HK shell companies

Focus on passive income (such as interest and royalties)

Exclusion of income without substance / specific conditions

Changes to the tax system by end of 2022 and be effective from 1 Jan 2023

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04

Potential changes to the Hong Kong tax system

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The HKSAR Government's response to BEPS 2.0

The HKSAR Government's work

- Participating in the OECD meetings
- Advisory Panel on BEPS 2.0
- Consultation with stakeholders
- A report with recommendations to the Financial Secretary after the rules are finalised by the OECD

The 2021/22 Hong Kong Budget

- Pending finalisation of the OECD's proposals
- Direction of response measures:
  - BEPS implementation based on international consensus
  - Minimise impact on local SMEs while maintaining simplicity, certainty and fairness of HK's tax system
  - Minimise compliance burden while safeguarding taxing rights
  - Improve business environment and enhance HK's competitiveness

A domestic minimum tax (DMT) in Hong Kong?

IRD

BTPU

FSTB

Government Economists

Financial Secretary's Office

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Potential changes to the Hong Kong tax system

The EU grey list

1. Scope of “passive income” covered by the revised regime?
2. Definition of passive income?
3. Only taxable on remittance basis?
4. Substance requirement vs subject-to-tax condition or both?
5. Dividends and gains from share disposal – participation exemption?
6. Royalties – need to conform with the OECD’s nexus approach?
7. Double tax relief by means of unilateral tax credit?

BEPS 2.0

1. Implement IIR and UTPR?
2. Introduce a DMT in Hong Kong?
3. Design features of the DMT?
4. How to deal with the existing tax incentives?
5. Impact of concessionary tax rate vs government financial subsidies on the ETR?
6. Any group loss relief?

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05

Implications to Hong Kong businesses

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Some general issues / observations

01 **Significance of accounting policies and treatments**

- Financial accounts and deferred tax accounting play an important role in determining the GloBE Income/Loss and Adjusted Covered Taxes
- Need more detailed breakdown / analysis of the current tax expense and DTA / DTL movements

02 **Treatment of losses**

- DTA arising from current and prior years losses treated as a Covered Tax but no DTA is recognised for offshore losses and loss with a capital nature

03 **Substance-based carve out for tangible assets**

- Do not include assets that are held for sale, lease or investment
- How to ascertain the locations of movable assets?

04 **Recast of deferred tax for timing differences at 15%**

- This may lead to unexpected results - e.g. lowering the GloBE ETR and giving rise to GloBE top-up tax in a given year

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Some general issues / observations

05

Domestic top-up tax not treated as Covered Tax

- Compliance burden of computing the ETR & jurisdictional top-up tax + filing the GloBE Information Return remains for in-scope MNE groups
- Yet to see whether there is any safe harbor

06

Special rules apply to joint ventures

- ETR and top-up tax calculation as if the JV group a separate MNE group and the JV as the UPE
- JV partner's share of top-up tax under the IIR capped at 50%

07

Issues with minority shareholding, minority-owned sub-groups and minority-owned entities

- Complex rules for applying the GloBE rules to holding structures with minority interests

Some sector-specific issues / observations

Financial services

01 **Investment funds**

- Private equity / venture capital funds - Is the current LPF registration regime in Hong Kong a “regulatory regime”?
- Not required to prepare consolidated financial statements in general under IFRS 10
- The fund and its SPVs may be excluded but the potential Pillar 2 impact on its investee companies need to be assessed

02 **Banking groups**

- Distributions from Additional Tier One Capital treated as an expense in the computation of GloBE income or loss
- No special treatment for Tier Two Capital and profits upon written down of regulatory capital securities?

03 **Insurance businesses**

- Benefits of 5% premiums tax base (for life insurance businesses) and 8.25% tax rate (for other insurance businesses) likely offset by top-up tax

04 **Intra-group financing businesses**

- Special anti-mismatch rules to add back intra-group interest expenses to GloBE income under certain circumstances

Some sector-specific issues / observations

Real estate / investment properties

01 **The 5-year election on unrealised revaluation gains / losses**

- The 5-year election can be rolled over indefinitely?
- Pillar 2 impact on non-taxable capital gains from disposal of properties => need to provide for deferred tax?

02 **Substance-based carve-out for tangible assets**

- Immovable property held for lease or investment not eligible for the tangible asset carve-out

03 **Exclusion of REITs**

- Subject to various conditions e.g. must be the UPE, widely held and a single level of taxation in the hands of either the REIT or its interest holders

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Some sector-specific issues / observations

Aircraft and shipping businesses

01

Airlines

- Why international shipping income is excluded but not international aviation income?
- Profits allocated to a PE not taxable in the PE jurisdiction under a tax treaty => need to pay top-up tax?
- In which jurisdictions the aircrafts are located for the tangible asset carve-out purposes?

02

Shipping groups

- International shipping income includes "income from leasing a ship on a bare boat charter basis, for the use of transportation of passengers or cargos in international traffic, to another CE"
- A group purely engaged in leasing of ships to provide financing (e.g. finance lease) without any ship transportation activities => not qualified for the exclusion?

03

General

- Aircraft / ships held for lease not eligible for the tangible asset carve-out

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Some sector-specific issues / observations

Telecommunication

01 Substance-based carve-out for tangible assets

- In which jurisdictions(s) are the satellites / submarine cables located for the tangible asset carve-out purposes?
- Costs of indefeasible right of use (IRU) of spectrum represent significant business investment but not eligible for any substance-based carve out

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10 recommended actions for tax leaders

Fact finding

Stakeholder management

Budget

Updates

Implementation

+ ....