

BEPS 2.0 - Will the overhaul of international tax rules reshape the Hong Kong tax regime?

News Flash
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In brief

As follow-up work on Action 1 of the Base Erosion and Profit Shifting (BEPS) Action Plan on addressing the tax challenges of the digital economy, the Organisation for Economic Co-operation and Development (OECD) has published a number of documents setting out the OECD's approach and proposal to deal with these challenges since the issuance of the final report on BEPS Action 1 in October 2015. The proposal put forward by the OECD involves two pillars, namely Pillar One, which allocates taxing rights for cross-border activities based on revised nexus and profit allocation rules and Pillar Two, which gives the parent and source jurisdictions a right to tax untaxed/undertaxed income where the income is taxed at an effective rate below a minimum rate (i.e. the global anti-base erosion (GloBE) proposal). While the proposed rules under Pillar One will mainly affect highly digitalised and consumer-facing businesses, the proposed rules under Pillar Two will affect all businesses with cross-border activities in general. This News Flash focuses on the proposed rules under Pillar Two and the key implications of these new rules to the Hong Kong tax regime and businesses in Hong Kong.

The implementation of the rules under the GloBE proposal may significantly undermine the attractiveness of the capital gain exemption, offshore regime and other concessionary tax regimes in Hong Kong. Although the rules have not been finalised and many details about the operation of the rules have yet to be worked out at this stage, it is imperative for the HKSAR Government to act now and consider how Hong Kong should respond to these changes. In particular, consideration should be given to what can be done to maintain (or even enhance) the competitiveness of the tax system or business environment in Hong Kong in light of these new international tax rules.

On the other hand, multinational groups with Hong Kong entities involving in cross-border transactions should take note of these imminent changes in international tax rules, assess the potential impacts of the proposed rules on their overall global tax liabilities and consider whether any changes to their existing business models are required. They may also want to get their voices heard through the public consultation process on Pillar Two to be launched by the OECD from November to December this year.

In detail

Overview of the BEPS 2.0 rules

In the 2015 final report of BEPS Action 1 on Addressing the tax challenges of the digital economy¹, the Inclusive Framework (IF) on BEPS identified nexus, data and characterisation as the key broader challenges for direct tax raised by the digital economy and discussed a number of potential options to address these challenges. However, none of the potential options was recommended in the report. Instead, the IF agreed that continuous monitoring and further work in this area are required.

Against this backdrop, the IF on BEPS released a policy note in January 2019², a public consultation document in February 2019³, the Programme of Work in May 2019⁴ and the second public consultation document on 9 October 2019⁵, with an aim to deliver a final report providing a consensus-based long-term solution by the end of 2020. For more details of the latest consultation document issued in October 2019, please refer to our *PwC Tax Policy Alert, 9 October 2019*⁶.

In brief, the proposal put forward by the OECD involves two pillars, namely Pillar One on allocating taxing rights for cross-border activities based on revised nexus and profit allocation rules and Pillar Two on giving the parent and source jurisdictions a right to tax untaxed/undertaxed income where the income is taxed at an effective rate below a minimum rate to be specified (i.e. the GloBE proposal). Please refer to the Appendix for an overview of the two pillars mentioned above.

The GloBE proposal under Pillar Two

Pillar Two effectively introduces a global minimum tax through two sets of inter-related rules: (1) the “income inclusion rule” and “switch-over rule” and (2) the “undertaxed payments rule” and “subject to tax rule”. It is worthwhile to note that unlike the proposed rules under Pillar One, the rules under the GloBE proposal apply to all businesses with cross-border activities in general and not just highly digitalised and consumer-facing businesses.

- **Income inclusion rule:** the rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income is not subject to an effective tax rate above a minimum rate.
- **Switch-over rule:** the rule complements the income inclusion rule and extends the coverage to profits attributed to a foreign branch that are tax-exempt in the branch jurisdiction and tax-exempt income derived from foreign immovable property. A switch-over rule proposed to be introduced in tax treaties would allow the state of residence to apply the credit method instead of the exemption method where the profit attributable to the permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to tax at an effective rate below the minimum rate.
- **Undertaxed payments rule:** the rule would deny a deduction or impose source-based taxation (including withholding tax (WHT)) for a payment to a **related party** if that payment is not subject to tax at a minimum rate.
- **Subject to tax rule:** the rule complements the undertaxed payment rule by subjecting a payment to WHT at source and denying treaty benefits on certain items of income (with priority to interest and royalties) where the payment is not subject to tax at a minimum rate. The subject to tax rule can apply to **unrelated party** as well as **related party** transactions.

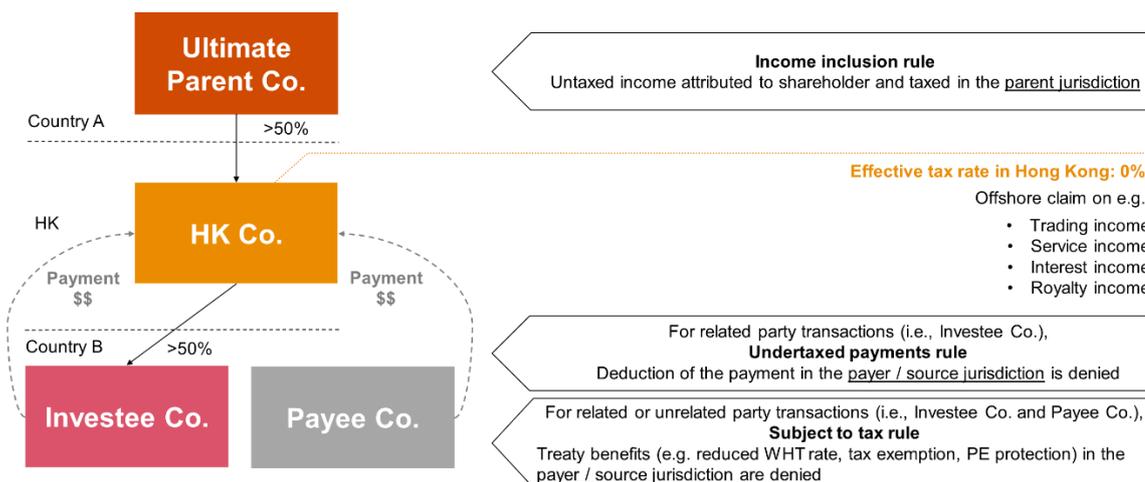
The OECD plans to issue another public consultation document on Pillar Two in November and conduct a public consultation meeting in December this year to seek comments on certain key design issues, including the effective tax rate test, different forms of blending of high taxed and low taxed income derived from different sources, possible carve-outs and the rule order of different rules proposed under Pillar Two.

Impacts of the GloBE proposal on Hong Kong businesses

As the GloBE proposal is targeting at profits that are not subject to tax at a minimum effective tax rate, it would have a significant impact on the offshore regime, various concessionary tax regimes and the capital gains exemption in Hong Kong as the effective tax rates resulting from these regimes/exemption will likely be below the minimum tax rate. Under the GloBE proposal, the taxing right of such income untaxed or undertaxed in Hong Kong will be allocated to other jurisdictions. It has yet to see whether certain carve-outs will be available under the final rules (e.g. carve-outs for preferential tax regimes that are regarded as not harmful under the OECD’s BEPS Action 5 peer review⁷).

The following two simplified examples illustrate the application of the proposed rules under Pillar Two and the potential tax consequences to the businesses in Hong Kong.

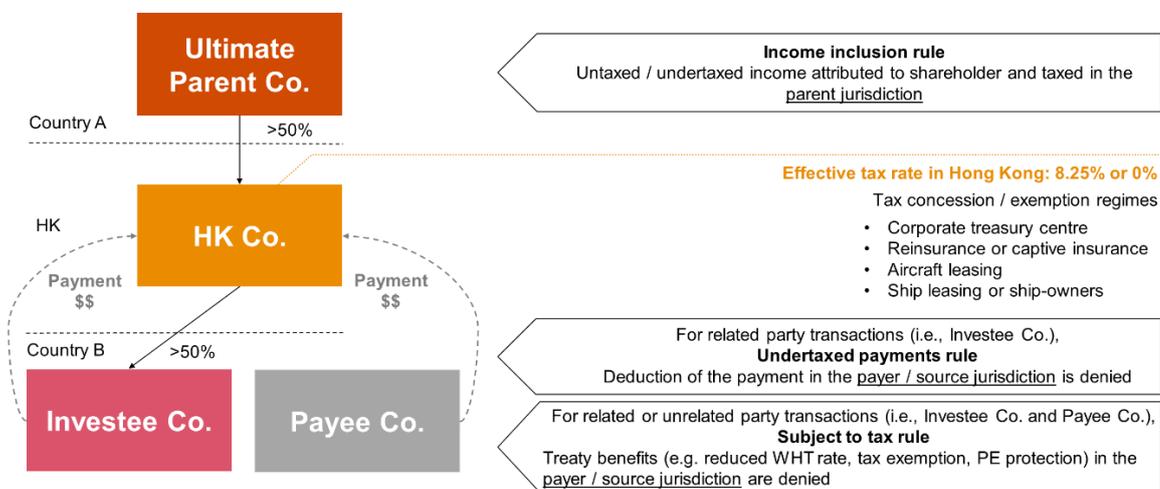
Example One – A multinational group with a Hong Kong entity making an offshore claim on its profits



Assuming (1) the ownership threshold and minimum effective tax rate are set at 50% and 15% respectively, (2) the payment is not subject to any WHT in Country B and (3) the controlled foreign corporation (CFC) rule in Country A does not apply in respect of the Hong Kong company.

In the above example, the Hong Kong company made an offshore claim on its profits resulting in an effective tax rate of 0% in Hong Kong, which is lower than the minimum tax rate of 15%. This will trigger the income inclusion rule under which the untaxed profits in Hong Kong will be taxed in Country A at 15% in the hands of the ultimate parent company. On the other hand, subject to the proposed mechanism to avoid double taxation, the undertaxed payments rule may also be triggered in Country B under which the tax deduction of the payment made by the investee company to the Hong Kong company will be denied. Accordingly, the overall global tax burden of the group may be increased unless there is an effective mechanism to eliminate this potential double taxation in the final rules.

Example Two – A multinational group enjoying a concessionary tax regime in Hong Kong



Assuming (1) the ownership threshold and minimum effective tax rate are set at 50% and 15% respectively, (2) there is a tax treaty between Hong Kong and Country B and (3) the CFC rule in Country A does not apply in respect of the Hong Kong company.

In the above example, the Hong Kong company’s profits are exempt or taxed at 8.25% under a concessionary tax regime in Hong Kong, resulting in an effective tax rate that is lower than the minimum tax rate of 15%. This will trigger the income inclusion rule under which the untaxed/undertaxed profits in Hong Kong will be taxed at a top-up rate (i.e. 15% minus the effective tax rate in Hong Kong) in Country A in the hands of the ultimate parent company. On the other hand, subject to the proposed mechanism to avoid double taxation, the undertaxed payments rule and/or the subject to tax rule may also be triggered in Country B under which the tax deduction and/or applicable treaty benefits under the HK/Country B tax treaty (e.g. reduced WHT rate, tax exemption or PE protection) will be denied. Accordingly, the overall global tax burden of the group may be increased unless there is an effective mechanism to eliminate this potential double taxation in the final rules.

Another scenario that may trigger the income inclusion rule or undertaxed payments rule/subject to tax rule is where a Hong Kong company is applying the two-tiered profits tax rate in Hong Kong. In this case, the first HK\$2 million assessable profits of the company are taxed at 8.25% whereas the remaining assessable profits are taxed at 16.5%. Depending on the total amount of assessable profits of the company in a given tax year, the effective tax rate of the company in Hong Kong may be lower than the minimum tax rate, thus triggering the GloBE rules.

The takeaway

The implementation of the rules under the GloBE proposal may significantly undermine the attractiveness of the capital gain exemption, offshore regime and other concessionary tax regimes in Hong Kong. Although the rules have not been finalised and many details about the operation of the rules have yet to be worked out at this stage, it is imperative for the HKSAR Government to act now and consider how Hong Kong should respond to these changes. In particular, consideration should be given to what can be done to maintain (or even enhance) the competitiveness of the tax system or business environment in Hong Kong in light of the overhauled international tax rules.

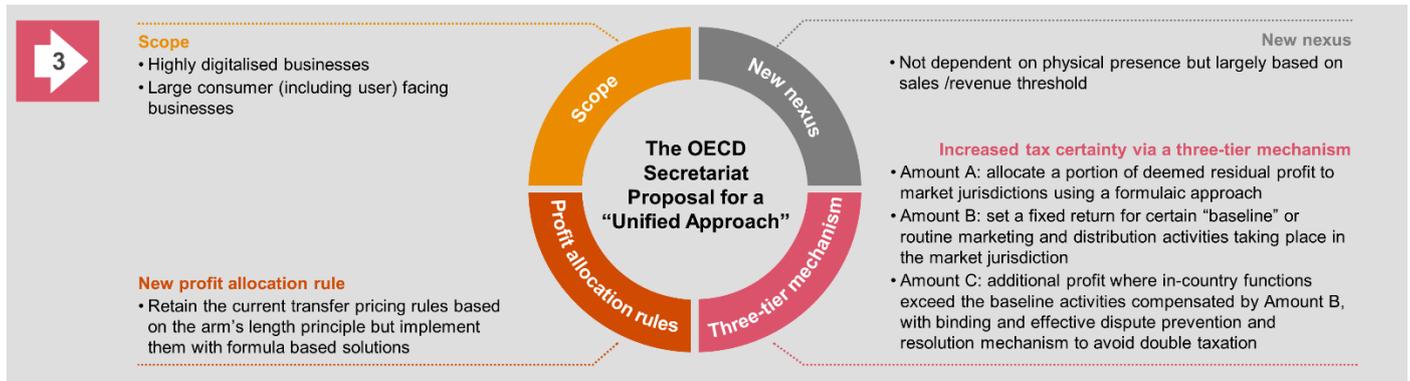
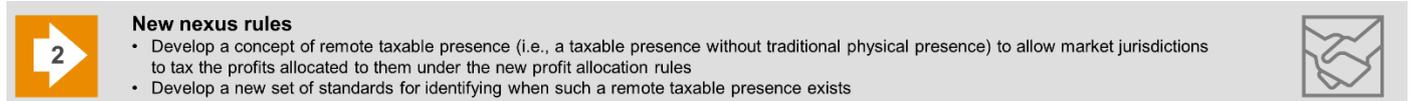
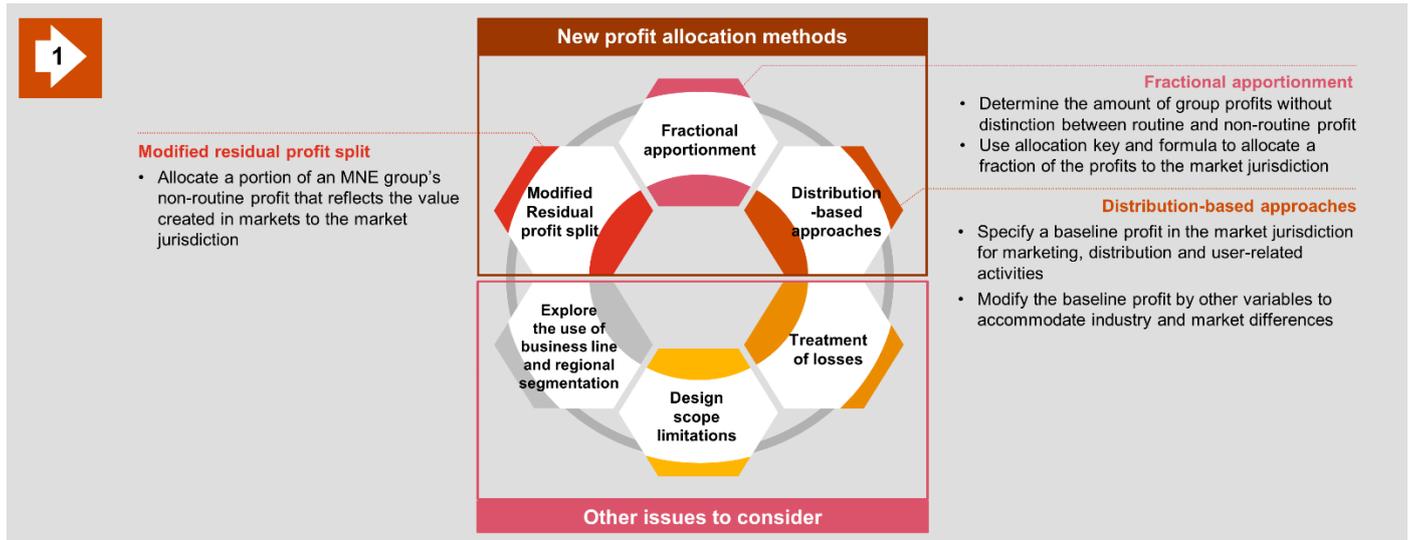
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Endnotes

1. The 2015 final report of BEPS Action 1 on Addressing the tax challenges of the digital economy can be accessed via this link: <http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm>
2. The policy note can be accessed via this link: <https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf>
3. The first OECD public consultation document can be accessed via this link: <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>
4. The OECD Programme of Work can be accessed via this link: <http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm>
5. The second OECD public consultation document can be accessed via this link: <http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf>
6. The PwC Policy Alert, 9 October 2019 can be accessed via this [link](#)
7. The latest BEPS Action 5 peer review results can be accessed via this link: <https://www.oecd.org/tax/beps/harmful-tax-practices-peer-review-results-on-preferential-regimes.pdf>

Appendix

Pillar One – Revised nexus and profit allocation rules



Pillar Two – Global anti-base erosion proposal



Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

PwC's International Tax Advisory Team

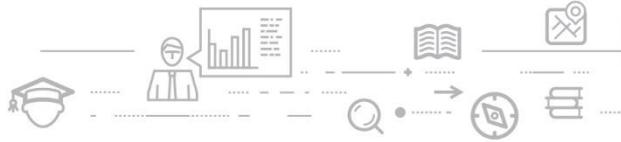
Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

David Smith
+852 2289 5802
david.g.smith@hk.pwc.com



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For more information, please contact:

Matthew Mui
+86 (10) 6533 3028
matthew.mui@cn.pwc.com

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