Major Overhaul of the International Taxation Rules and Implications for Hong Kong

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Introduction

The Organization for Economic Co-operation and Development (OECD) initiated a Base Erosion and Profit Shifting (BEPS) project in 2013 and issued a set of Action 1-15 Reports in 2015. The BEPS Action 1-15 Reports, which could now be known as BEPS 1.0, mainly focused on aligning taxation with economic substance and avoiding non-taxation of income due to the inconsistencies between international tax systems. Since the BEPS 1.0 measures have only been implemented in various jurisdictions recently, their impacts are yet remained to be determined. However, the OECD makes further steps in 2019 by publishing another set of proposed measures to ensure cross-border businesses are paying their fair share of taxes across all the jurisdictions they operate. The proposed measures, which are commonly known as BEPS 2.0[1], are not limited to digitalization of economy but are applicable to all businesses with cross-border activities. The proposed measures are divided into two pillars. Pillar One looks at the implications of the digitalization of the economy and the possible changes on international tax systems. It allocates the taxing rights for cross-border activities based on a set of revised nexus and profit allocation rules. Pillar Two looks at broad proposals to effectively introduce a global minimum tax. It gives the residence and source jurisdictions a right to tax untaxed/undertaxed income where the income is taxed an effective rate below a certain minimum rate.

The BEPS 2.0 proposed measures will change the global tax landscape significantly by changing how profits are allocated between jurisdictions and introducing a new global minimum tax. At the timing of writing, the OECD has released a package of documents in January 2020 that provides the work progress and lays out a revised programme of work. This study firstly outlines the background of the BEPS 2.0 proposed measures. It then identifies the key elements of the proposed measures and examines the impact assessment. This study finally explores the challenges that the BEPS 2.0 proposed measures may bring to the Hong Kong tax regime and multinational enterprises (MNEs).

Background

The OECD began its work to address the tax challenges of digitalization in 2013 under Action 1 of the Action Plan on BEPS. In the 2015 final report of BEPS Action 1 on “Addressing the tax challenges of the digital economy”[2], the Inclusive Framework on BEPS identified nexus, data and characterization 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 final report of BEPS Action 1. Instead, the Inclusive Framework on BEPS agreed that continuous monitoring and further work in this area are required. Subsequently, the Inclusive Framework on BEPS released a Policy Note in January 2019[3], a first public consultation document (namely, Addressing the Tax Challenges of Digitalization of the

Economy") in February 2019[4], a Programme of Work in May 2019[5], a second public consultation document (namely, "Secretariat Proposal for a 'Unified Approach' under Pillar One") in October 2019[6], and a third public consultation document (namely, "Global Anti-Base Erosion Proposal ('GloBE') - Pillar Two") in November 2019[7]. In January 2020, a package of documents was released by the Inclusive Framework on BEPS which outlines the architecture of a consensus-based solution[8]. On the horizon is the Inclusive Framework on BEPS meeting in July 2020 (at which it is intended to reach agreement on the key features of a consensus-based solution which would form the basis for a political agreement) and the G20 Leaders' meeting in November 2020 (at which the G20 will endorse a report prepared by the OECD). The end of 2020 is the target date to reach an agreement on a consensus-based solution. Beyond 2020 is the implementation stage for the new international taxation rules. Table 1 shows the development of BEPS work on digitalization.

Insert Table 1 about here

Proposed Measures

The BEPS 2.0 proposed measures are grouped under two pillars. Pillar One consists of a set of revised nexus and profit allocation rules. Pillar Two provides jurisdictions with a right to tax back where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Pillar One

Pillar One designs a revised set of nexus and profit allocation rules to reflect the transformation of the economy. The Unified Approach[9] under Pillar One, which is endorsed by the Inclusive Framework on BEPS in January 2020, has several key elements:

- Scope. It focuses on two types of businesses: automated digital services (which may include online advertising and searches, cloud computing, social media and intermediation platforms, streaming services), and consumer-facing businesses (where revenues are generated from the ultimate sale of goods and services to individual consumers). The definition of consumer-facing will apply to franchise rights and third-party resellers but will exclude the provision of intermediate products and components that are incorporated into a finished product sold to customers. Consumer-facing businesses are expected to include personal computing products, clothes, branded food, automobiles, and franchise licensing arrangements (such as hotels and restaurants). Possible carve-outs remain under consideration, including for most extractive industries and commodities, financial service activities that are not retail in nature, and airlines/shipping activities.

  The applicable threshold for in-scope businesses will consider the group gross revenue threshold (which may be the same threshold of EUR750 million as for the Country-by-Country reporting), with carve-out for situations where the total aggregated in-scope revenue is less than a specified threshold, and where the total profit to be allocated is less than a minimum amount.
- New nexus rule. The new nexus rule is not dependent on the physical presence requirement but is largely based on significant and sustained engagement in a market jurisdiction (i.e., the jurisdictions where a business' consumers and users reside). For automated digital services, the revenue threshold nexus will be the only test required to create nexus. For consumer-facing businesses, the nexus test will be

based on indicators of a significant and sustained engagement with market jurisdictions.

- New profits allocation rule. Once it is determined that a jurisdiction has the right to tax profits of a non-resident enterprise under the new nexus rule approach, the next issue is to determine how much profit should be allocated to that jurisdiction. The new profit allocation rule largely retains the current transfer pricing rules based on arm's length principle but complements them with formula based solutions. Three types of taxable returns will be allocated to market jurisdictions and these are described as Amounts A, B and C. A market jurisdiction would then be entitled to tax the sum of these taxable returns[10].
- Three-tier mechanism. A three-tier mechanism for profit allocation will be used to increase certainty for taxpayers and tax administrations:
    - Amount A. It is the centerpiece of the Unified Approach. Amount A is a new profit allocation rule which goes beyond the arm's length principle. It is a new formulaic allocation of a portion of global residual profit among jurisdictions where the customers and users are located, regardless of where the business' physical activities are located. Amount A will be based on a measure of profit derived from the consolidated group financial accounts. Profits before tax is the preferred profit measure to compute Amount A[11]. It requires nexus under the new standard that is not dependent on physical presence.
    - Amount B. It is a revised profit allocation rule which is based on the arm's length principle. Amount B is a fixed percentage return that would be allocated to baseline distribution and marketing activities taking place in the market jurisdiction. The fixed percentage return is based on the arm's length principle with adjustments to account for regional, industry and functionality differences. Although the baseline distribution and marketing activities are not yet defined, it will likely include distribution arrangements with no/limited risks, no ownership of intangibles and routine levels of functionality. Amount B requires nexus under existing rules of physical presence and will operate within the existing treaty network[12].
    - Amount C. It is a revised profit allocation rule which is based on the arm's length principle. Amount C provides an additional return where in-country functions exceed the baseline distribution and marketing activities compensated by Amount B. Amount C requires nexus under existing rules of physical presence and will operate within the existing treaty network.

Amount A will create new taxing rights and reflect the profits associated with active and sustainable participation in the economy of a market jurisdiction. However, Amounts B and C will not create new taxing rights but reflect an improvement in the application of the arm's length principle. The Inclusive Framework on BEPS in January 2020 makes it clear that the transfer pricing rules based on the arm's length principle (including Amounts B and C) will apply first, and that Amount A would be allocated as a partial override to those results. It is expected that there is no significant interaction between Amounts A and B. However there may be instances of double counting where both Amounts A and C are allocated to a market jurisdiction[13]. To eliminate double taxation, legally binding and effective dispute prevention and resolution mechanisms will be in place[14]. Figures 1 and 2 show the key elements and the profit allocation rule of the Unified Approach under Pillar One respectively.

Insert Figure 1 about here

Insert Figure 2 about here

Pillar Two

The GloBE under Pillar Two challenges income which is not subject to tax at a minimum rate. It works similar to a Controlled Foreign Company (CFC) rule which brings into tax for a parent company a proportionate share of income in a foreign subsidiary that is not subject to tax at a certain minimum rate. The GloBE under Pillar Two comprises of the following elements.

- Income inclusion rule. The rule applies to foreign subsidiaries and foreign branches and operates as a top-up to a minimum rate. It attributes a corporation's undertaxed income to its shareholders for taxation. The rule provides for a right for the parent jurisdiction to tax back.
- Switch-over rule. The rule complements the income inclusion rule and applies to foreign subsidiaries and foreign branches or income from foreign immovable property. It turns off the benefit of an exemption for income of a foreign branch or for income derived from foreign immovable property, and replaces it with the credit method where that income was subject to a low effective tax rate in the foreign jurisdiction. The rule allows the state of residence to apply the credit method instead of the exemption method. It provides for a right for the residence jurisdiction to tax back.
- Undertaxed payments rule. The rule applies to related-party payments only. It denies a deduction or imposes source-based taxation (including withholding tax) for payments made to related parties if the payments were not subject to tax at a minimum rate. The rule provides for a right for the payer or source jurisdiction to tax back.
- Subject to tax rule. The rule complements the undertaxed payment rule and applies to both related and unrelated party transactions. It denies treaty benefits or improves withholding tax for payments that are not subject to a minimum tax rate. The rule provides for a right for the payer or source jurisdiction to tax back.

These rules would be implemented through changes to domestic law and/or tax treaties. Also, there would be rules to provide for co-ordination between elements of the GloBE, between Pillars One and Two and between the GloBE and other international tax rules (e.g. the existing CFC rules)[15]. The Inclusive Framework on BEPS's package of documents in January 2020 indicates that the technical work on the GloBE under Pillar Two in underway but it only provides few details. Figure 3 shows the essential elements of the GloBE under Pillar Two.

Insert Figure 3 about here

Economic Analysis and Impact Assessment

In February 2020, the OECD released the following initial estimates based on its economic analysis and impact assessment of the BEPS 2.0 proposed measures[16]:

- Revenue gain. The combined revenue gain of Pillars One and Two will be around 4% of the existing corporate income tax (CIT) revenue on a global basis, or approximately US$100 billion annually across all jurisdictions. In general, Pillar Two revenue effects will be larger than Pillar One revenue effects. Also, low- and middle-income jurisdictions will gain relatively more revenue from Pillar One and high-income jurisdictions will gain relatively more revenue from Pillar Two[17].

- Effect of Pillar One. In general, all countries will gain from Pillar One. The range of effects for Amount A are generally greatest as a percentage of CIT in low-income jurisdictions (1-1.9%), then in middle-income jurisdictions (0.3%-1.2%) and finally in high-income jurisdictions (-0.1-1.1%)[18]. However, investment hubs[19] could lose as much as 5% of CIT receipts.
- Effect of Pillar Two. The Pillar Two CIT revenue gain will be more than 4 times larger than that of Pillar One[20].
- Effective tax rates (ETRs). Pillars One and Two together will increase the ETRs by about 0.5%. The increase is almost entirely due to the effects of Pillar Two. Also, the increase in ETRs for investment hubs is nearly 4 times higher.
- Investment and growth. There will be little effects on investment costs. The proposed measures will lead to reallocation of investment to jurisdictions where productivity is higher and will enhance global growth.

The above initial estimates were largely consistent with the OECD report to the G20 Finance Ministers and Central Bank Governors in October 2019 outlining the preliminary findings on the economic and tax revenue implications of the BEPS 2.0 proposed measures[21]. The report showed that the combined effect of Pillars One and Two would lead to an increase in global tax revenues. It also indicated that low- and middle-income economies tend to gain relatively more revenues than high-income economies from Pillar One. Investment hubs would experience losses in tax base. In addition, the report estimated that the BEPS 2.0 proposed measures would not adversely affect investment environment but would instead provide greater tax certainty[22].

Challenges to Hong Kong Tax Regime

The BEPS 2.0 proposed measures are somehow eroding the right of different jurisdictions to determine their taxation frameworks, including their tax rates, which are based on their own particular economic and fiscal circumstances[23]. The Financial Secretary in February 2020 indicates that Hong Kong, as an international financial and business center, will inevitably be affected by the BEPS 2.0 proposed measures. In particular the imposition of a global minimum tax rate could undermine the attractiveness of Hong Kong's low tax policy to MNEs[24]. It is not sure whether the corporate profits tax rate of 16.5%[25] could meet the global minimum tax requirement. If the effective tax rate in Hong Kong is below the global minimum tax rate, it may trigger an income inclusion rule in the parent jurisdiction to tax the profits of Hong Kong subsidiaries or anti-base erosion measures which limit deductions for cross border payments.

Also, the BEPS 2.0 proposed measures could impose challenge to the offshore regime in Hong Kong. For example, the current approach to tax interest could come under increasing pressure. Hong Kong subsidiaries which lends overseas could earn tax-exempt interest income if the credit is provided to the overseas parent companies outside Hong Kong. Under the BEPS 2.0 proposed measures, particularly the GloBE, the overseas parent companies could have a right to tax the interest income since the income is exempt from tax in Hong Kong. Alternatively, there could be a denial of foreign interest deduction by the overseas parent companies or a denial of the tax treaty reduction or elimination in regard to interest withholding tax[26]. As such, the BEPS 2.0 proposed measures could bring additional tax burden and compliance costs to MNEs which could affect their incentives for investing and operating in Hong Kong. Hong Kong Government should consider how to respond to the BEPS 2.0 proposed measures and take appropriate actions to maintain (or even enhance) the competitiveness of Hong Kong's tax regime.[27]

Implications for MNEs

Generally, the BEPS 2.0 proposed measures could change the effective tax rate and the amount of cash taxes paid by MNEs. Also, these measures could affect a MNE's choice of capital structure, location of intangible property and related research and development activities and even business model. Furthermore, the proposed measures could cause certain tax planning strategies and advance pricing agreements to become less effective[28].

Specifically, the implications of the BEPS 2.0 proposed measures could be far reaching. First, foreign-capital MNEs with online selling platforms (including goods and services) may be affected. Second, marketing intangibles may not only affect the digital economy industry, but also the traditional industries (e.g., consumer goods retail industry). Therefore, MNE may need to adjust the transfer pricing policy since the profit levels of those industry players could be affected. Third, MNEs may need to predict the tax cost burden in the jurisdictions of its major markets and adjust their market development strategies. Fourth, MNEs may need to fully understand these measures and adjust internal tax process management to make the tax compliance in different jurisdictions. Fifth, if unilateral measures in other jurisdictions result in double taxation, MNEs may need to consider whether the double taxation problem could be resolved through mutual agreement procedure. Last but not the least, MNEs may need to understand the views of different tax authorities and conduct specific analyses of the group's value chain and value drivers to maintain flexibility in strategic adjustment.[29]

Conclusions

The BEPS project aims to ensure cross-border businesses are paying their fair share of taxes across all the jurisdictions they operate. The BEPS 1.0 measures are relatively easy to be implemented by various jurisdictions because all the tax authorities have the same interest and documentation. However, the implementation of the BEPS 2.0 proposed measures may be difficult because these measures create a shift from the existing arm's length principle of allocating profits and taxing value where it is created towards allocating additional profits to market jurisdictions where value is exploited[30]. For instance, the developed economy (like the US) could argue that companies make profits in the jurisdictions where the companies' assets are owned/developed but the developing economy (like China and India) could argue that companies make profits in the markets where consumers and users are based[31].

The BEPS 2.0 proposed measures involve two pillars. Pillar One allocates the taxing rights for cross-border activities based on a set of revised nexus and profit allocation rules. Pillar Two gives the residence and source jurisdictions a right to tax untaxed/undertaxed income where the income is taxed below a minimum tax rate. If Pillar One is implemented, then the intra-group prices would be determined based on methods which are beyond the arm's length principle and that the taxing rights would be determined based on methods which are beyond the physical presence principle. Likewise, if Pillar Two is adopted, then profit will be subject to a minimum taxation.

The major overhaul of the international taxation rules would have implications on the Hong Kong tax law and practice. In particular, the GloBE could increase the uncertainty for sustainability of the Hong Kong's low tax policy and offshore tax regime which in turn could reduce the competitiveness of Hong Kong. Hong Kong Inland Revenue Department states on its recently revised notes that the taxing practice will be further updated if new nexus and profit allocation rules are adopted in Hong Kong after completion of work on a consensus-based and long-term solution to the tax challenges of the digitalization of the economy[32]. Clearly Hong Kong is keeping a close watch on the BEPS 2.0 developments and will make assessments and devise corresponding measures.

Furthermore, the BEPS 2.0 proposed measures could lead to the taxation rights in places where MNEs conduct sustained and significant businesses even when the MNEs do not have a physical presence in these places. Accordingly, MNEs should assess the impact of these proposed measures for their business structure and tax profile because the measures could affect MNEs across all industries irrespective of their engaging in the digital economy. Also, MNEs operating in jurisdictions with competitive business and tax environments such as Hong Kong should evaluate the implications of the BEPS 2.0 proposed measures on the operating efficiencies and values. As OECD aims to deliver a long-term consensus-based solution by the end of 2020, MNEs are advised to design contingency plans to respond for any changes which may have short lead time.

Endnote:

[1] Sharon Burke (2019). "BEPS 2.0 – OECD initiative on tax challenges of digitization", KPMG, 29 January, p. 1. Available at: https://home.kpmg/ie/en/home/insights/2019/01/beps-2-oecd-initiative-on-tax-challenges-of-digitalisation.html

[2] The 2015 final report of BEPS Action 1 is available at http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm

[3] The January 2019 policy note is available at: https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

[4] The February 2019 public consultation document is available at: https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf

[5] The May 2019 programme of work is available at: 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.pdf

[6] The October 2019 public consultation document is available at: http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

[7] The November 2019 public consultation document is available at: http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

[8] The January 2020 set of documents is available at: http://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf

[9] The word "unified" reflects that the Unified Approach incorporates elements of all three approaches (namely, a modified residual profit split approach, a fractional apportionment approach, and a distribution-based approach) which were previously laid out in Programme of Work in May 2019.

[10] Brian Jenn (2019), "A primer on the OECD's 'Unified Approach' for taxing digital and non-digital companies", International Tax Journal, 45(6), November – December, pp. 7-10.

[11] PricewaterhouseCoopers (PwC) (2020). "OECD/G20 inclusive framework moves forward on new tax rules", Tax Policy Alert, 4 February, p. 2. Available at: https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecdg20-inclusive-framework-moves-forward-on-new-tax-rules.pdf

[12] See note 11 above for PwC (2020).

[13] KPMG (2020), "OECD's revised Unified Approach to tax challenges of digitalization", Insights, 13 February, p. 6. Available at: https://assets.kpmg/content/dam/kpmg/us/pdf/2020/02/tnf-kpmg-report-oecd-unified-approach-feb13-2020.pdf

[14] PricewaterhouseCoopers (PwC) (2019). "OECD publishes proposal to rewrite international profit allocation rules", Tax Policy Alert, 9 October, p. 2. Available at: https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-publishes-prop-rewrite-intl-profit-allocation-rules.pdf

[15] Brian Chiu (2019). "Recent changes in tax legislation, new departmental practice and proposed tax initiatives", Annual Taxation Update, Hong Kong Institute of Certified Public Accountants, Seminar Notes, 20 July.

[16] The OECD hosted a live webcast to present the preliminary results on the revenue and investment effects of the BEPS 2.0 proposal measures on 13 February 2020: http://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm. Also, see PricewaterhouseCoopers (PwC) (2020), "OECD findings on the economic analysis of pillar one and two", Tax Policy Alert, 14 February, pp. 1-2. Available at: https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-findings-on-the-economic-analysis-of-pillar-one-and-two.pdf

[17] The OECD presented the results at the level of jurisdictional groups (i.e. low-, middle, and high-income jurisdictions based on World Bank classifications).

[18] The OECD only estimated the effect of Amount A in Pillar One. The effect is modelled by assuming 20% of profits above a threshold of 10% or 20% of pre-tax profits would be reallocated to market jurisdictions.

[19] Investment hubs are identified by the OECD as jurisdictions with foreign direct investment greater than 150% of GDP.

[20] The effect on Pillar Two was estimated based on the assumptions of a minimum tax rate of 12.5% on a per jurisdiction basis and the imposition of the income inclusion rule before the anti-base erosion measures.

[21] The October 2019 report is available at: http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-october-2019.pdf

[22] Wengee Poon and Doris Chik (2019). "Applications of the recently enacted Hong Kong tax legislation", Hong Kong Institute of Certified Public Accountants, Seminar Notes, 27 November. Also, see Ernst & Young (2019), "The OECD takes next step on BEPS 2.0 – proposal for a "unified approach" for additional market country tax", Global Tax Alert, 10 October, p. 5. Available at: https://www.ey.com/en_sg/tax/tax-alerts/the-oecd-takes-next-step-on-beps-2-0-proposal-for-a--unified-app

[23] Barbara Angus and Luis Coronado (2019). "INSIGHT: What does BEPE 2.0 mean for your business?", Daily Tax Report (International), 24 September, p. 6. Available at: https://news.bloombergtax.com/daily-tax-report-international/insight-what-does-beps-2-0-mean-for-your-business

[24] Hong Kong Government (2020). The 2020-21 Budget, paragraph 179-182, 26 February. Available at: https://www.budget.gov.hk/2020/eng/pdf/e_budget_speech_2020-21.pdf

[25] There are two-tier corporate profits tax rates in Hong Kong effective from year of assessment 2018/19. The first HK$2 million assessable profits are taxed at half rate of 8.25% with the remaining assessable profits taxed at rate of 16.5%. In addition, concessionary corporate profits tax rates are available to certain taxpayers.

[26] Gwenda Ho and Peter Brewin (2019), "BEPS 2.0 and the Future of Intra-group financing in Hong Kong," Asia-Pacific Journal of Taxation, 23(2), p. 30.

[27] PricewaterhouseCoopers (PwC) (2019). "BEPS 2.0 – Will the overhaul of international tax rules reshape the Hong Kong tax regime?", News Flash, Hong Kong Tax, October, p. 3. Available at: https://www.pwchk.com/en/hk-tax-news/2019q4/hongkongtax-news-oct2019-8.pdf

[28] KPMG (2019), "BEPS 2.0 Model", September, p. 2. Available at: https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/09/KPMG%20BEPS%202.0%20Model%20slipsheet.pdf

[29] Cecilia Lee and Wengee Poon (2019). "DIPN 59: Transfer pricing between associated persons – Part 1", Hong Kong Institute of Certified Public Accountants, Seminar Notes, 25 September.

[30] See note 23 above for Barbara Angus and Luis Coronado (2019), p. 5.

[31] Hong Kong Institute of Certified Public Accountants (2019). "Is Hong Kong ready for BEPS 2.0?", APLUS, September, p. 27. Available at: http://app1.hkicpa.org.hk/APLUS/2019/09/pdf/24_Accounting.pdf

[32] Hong Kong Inland Revenue Department (2020), "Departmental interpretation and practice notes no. 39 (Revised): profits tax –digital economy, electronic commerce and digital assets", March, paragraphs 3 and 30. Available at: https://www.ird.gov.hk/eng/pdf/dipn39.pdf