

Taxation Law Research Programme (TLRP)

Seminar – 30 November 2021

Hong Kong and BEPS 2.0

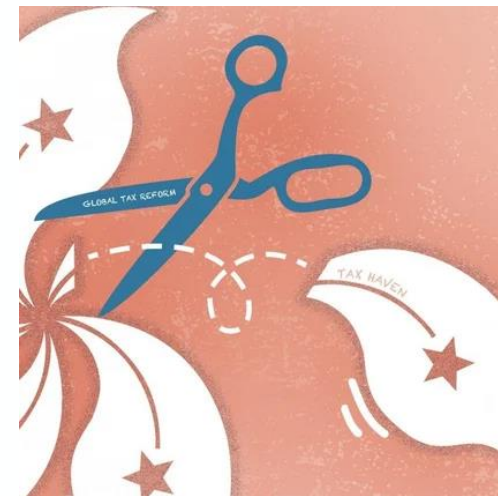
Prof Adrian Sawyer
Department of Accounting & Information Systems
UC Business School
University of Canterbury
Christchurch NZ

Email: adrian.sawyer@canterbury.ac.nz



Overview

1. Introduction and background
2. Base Erosion & Profit Shifting (BEPS) 1.0 and 2.0: An outline
3. Hong Kong's (HKSAR's) approach to BEPS
4. Implications of BEPS 2.0 for HKSAR
5. Questions and comments



Introduction

- The presenter has a longstanding interest in HKSAR's taxation system, including a number of publications and presentations on numerous aspects of taxation over the last 10 years, with the support of the TLRP & AIIFL at HKU:
- *Double tax agreements:*
 - Sawyer, A.J., 'The Hong Kong Special Administrative Region's Emerging Double Tax Agreement Regime: A Case Study of the Hong Kong Special Administrative Region-New Zealand DTA', (2011) 41(3) *Hong Kong Law Journal*, 659-676.
- *Tax policy:*
 - Sawyer, A.J., 'New Zealand's Successful Experience with Introducing GST: Informative Guidance for Hong Kong?', (2013) 43(1) *Hong Kong Law Journal*, 161-187.
 - Sawyer, A.J., 'Establishing a Rigorous Framework for Tax Policy Development: Can New Zealand Offer Instructional Guidance for Hong Kong?', (2013) 43(2) *Hong Kong Law Journal*, 579-609.
 - Sawyer, A.J., 'Comparative Tax Policy Approaches in New Zealand and Australia: Instructional Guidance for Hong Kong?', (2016) 70(9) *Bulletin for International Taxation*, 526-537.

Introduction (2)

- *Exchange of information:*
 - Sawyer, A.J., ‘Charting the Future: How is Hong Kong Responding to International Pressure for Enhanced Transparency, Cooperation and Information Exchange on Taxation Matters?’, (2013) 17(1) *Asia Pacific Journal of Taxation*, 56-66.
 - Sawyer, A.J., ‘Will Hong Kong Succumb to International Pressures on Taxation Matters?’, (2014) 22(2) *Asia Pacific Law Review*, 3-32.
 - Sawyer, A.J., ‘Hong Kong Continues to Enhance its Information Exchange on Taxation Matters – A Stocktake’, (2015) 19(2) *Asia Pacific Journal of Taxation*, 26-36.
- *BEPS 1.0 & BEPS 2.0:*
 - Sawyer, A.J., ‘An Update on Hong Kong’s Exchange of Information Developments and Engaging with BEPS’, (2017) 25(2) *Asia Pacific Law Review*, 170-189.
 - Freedman, J. and Sawyer, A., “BEPS 2.0”, Virtual seminar delivered as part of the Taxation Law Research Programme (TLRP), Asian Institute of International Financial Law, in the Faculty of Law, The University of Hong Kong, 22 November 2019.



Introduction (3)

- This presentation will commence with some background to BEPS, including BEPS 1.0 and 2.0
- It will review how HKSAR is engaging with the work of the G20/OECD with respect to BEPS
- The focus will be on BEPS 2.0: the digital economy
- Note: as BEPS 2.0 is only at the high level agreement phase, observations are at best tentative.

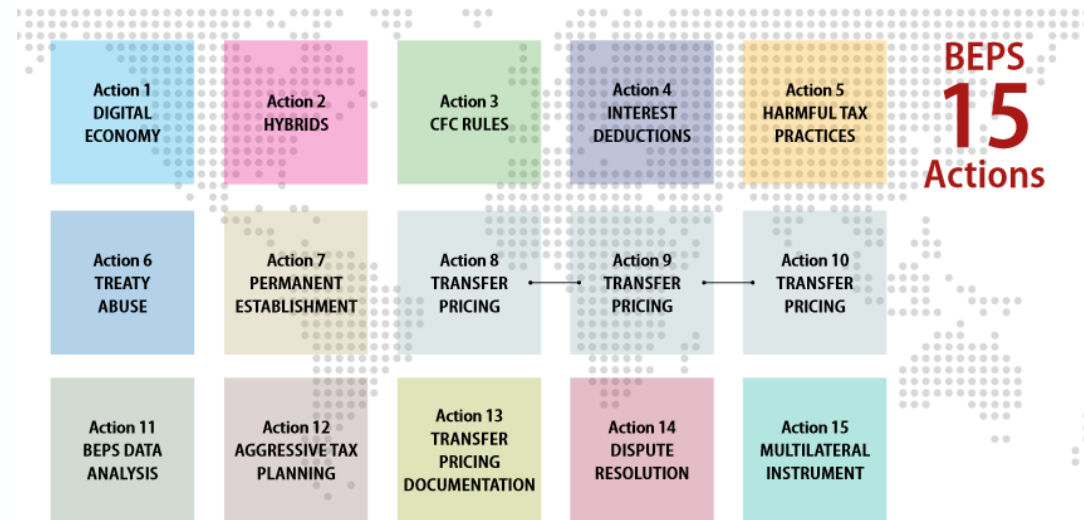
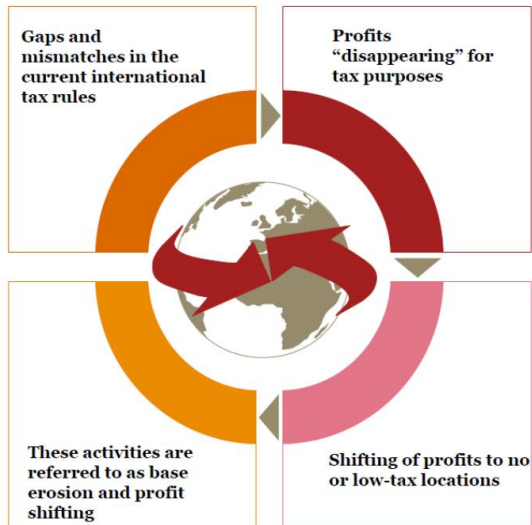


BEPS 1.0 and 2.0: An Overview

- OECD (2021, my emphasis) observes:
 - BEPS refers to *tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties*. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.
 - The OECD/G20 Inclusive Framework on BEPS brings together 140 countries and jurisdictions to collaborate on the implementation of the BEPS Package.
 - The *BEPS package provides 15 Actions that equip governments with the domestic and international instruments needed to tackle tax avoidance*. Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.
 - BEPS 1.0 largely deals with shortcomings of rules initially developed in the 1920s (e.g. source, residence, permanent establishment, etc. as per OECD's Model Tax Convention).

BEPS 1.0 and 2.0: An Overview (2)

Background



BEPS 1.0 and 2.0: An Overview – 15 Actions (3)

1. *Address the challenges of the digital economy;*
2. Neutralize the effects of hybrid mismatch arrangements;
3. Strengthen the controlled foreign company (CFC) rules;
4. Limit base erosion via interest deductions and other financial payments;
5. Counter harmful tax practices more effectively, taking into account transparency and substance;
6. Prevent treaty abuse;
7. Prevent the artificial avoidance of permanent establishment status;
8. (8, 9, and 10) Assure that transfer pricing outcomes are in line with value creation regarding intangibles, risks and capital, and other high-risk transactions;
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it;
12. Require taxpayers to disclose their aggressive tax planning arrangements;
13. Re-examine transfer pricing documentation;
14. Make dispute resolution mechanisms more effective;
15. Develop a multilateral instrument to enable interested countries to implement measures developed in the course of the BEPS work and amend bilateral tax treaties.

BEPS 1.0 and 2.0: An Overview (4)

- Collectively through the OECD/G20 Inclusive Framework on BEPS, around 140 countries and jurisdictions are implementing 15 Actions to tackle tax avoidance, improve the coherence of international tax rules, ensure a more transparent tax environment, and address the tax challenges arising from the digitalisation of the economy
- The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ('MLI') allows governments to modify existing bilateral tax treaties in a synchronised and efficient manner to implement the tax treaty measures developed during the BEPS Project, without the need to expend resources renegotiating each treaty bilaterally
- In November 2016, over 100 jurisdictions concluded negotiations on the MLI. It covers covers 96 jurisdictions and entered into force on 1 July 2018
- The MLI's goal, overall, is to allow participating jurisdictions to swiftly & efficiently adopt supplemental or substitute provisions without having to re-negotiate each bilateral treaty separately.



BEPS 1.0 and 2.0: An Overview (5)

The BEPS timeline



BEPS 2.0: Developments with Action 1


- **Action 1: Tax Challenges Arising from Digitalisation: BEPS 2.0 – timeline of key developments**
- October 2015: Addressing the Tax Challenges of the Digital Economy
- March 2018: Delivery of the Interim Report
- January 2019: Delivery of Policy Note
- February-March 2019: Public Consultation
- May 2019: Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy
- November 2019: Public Consultation - Secretariat Proposal for a 'Unified Approach' under Pillar One
- December 2019: Public Consultation - Global Anti-Base Erosion (GloBE) Proposal under Pillar Two
- January 2020: Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy
- October 2020: Delivery of the Reports on the Blueprints of Pillars One and Two
- October-December 2020: Public Consultation - Reports on the Pillars One and Two Blueprints.



BEPS 2.0: Developments with Action 1 (2)

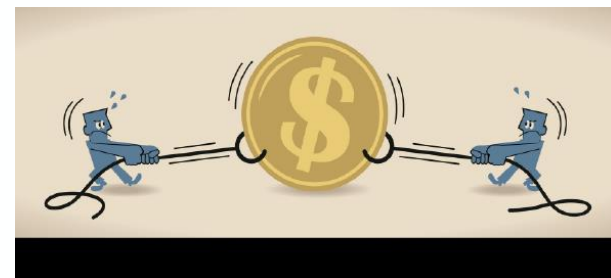
- January 2021: Public Consultation Meetings - Reports on the Pillars One and Two Blueprints
- July 2021: Statement on a Two–Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy
- *October 2021: Final statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* – 136 member jurisdictions of IF agreed, representing over 94% of global GDP
- October-November 2021: detailed implementation plan being developed
- During 2022: more details on Amount B in Pillar One and multilateral instrument developed to be adopted by signatories through domestic legislation
- During 2023: implementation of Pillar One and Pillar Two
- Around 2030: review of Pillar One including potential reduction of scope threshold
- **Pillar Two** could be called: *Base Erosion and **Activity** Shifting*, as it focusses on reducing the ‘race to the bottom’
- *Pillar One has taken more of the headlines but Pillar Two will arguably have more impact globally.*

BEPS 2.0: Pillar One (3)

- **Pillar One** – seeks to reallocate taxing rights to give market jurisdictions the right to tax a share of the profits of large and profitable MNEs, regardless of physical presence
 - Taxing rights on more than \$US125 billion of profits expected to be reallocated
 - *Scope*: Global turnover of over EU20 billion and profitability over 10% of profits before tax (PBT)/revenue. Will include the largest and most profitable MNE groups (around 100-110 MNE groups expected to be included globally)
 - *Exclusions*: extractives and regulated financial services
 - *Nexus*: new special purpose nexus (for Amount A) where an in-scope MNE derives revenue greater than EU 1 million or greater than EU 250,000 in smaller jurisdictions (with less than EU 40 billion in GDP)
 - *Amount A*: New taxing right that allocates 25% of profits in excess of 10% of revenue to market jurisdictions based on a formula, not the arm's-length principle
 - *Quantum of reallocation*: taxing rights on 25% of profit greater than 10% PBT/revenue to be reallocated to market jurisdictions where customers and users are located
 - *Unilateral measures*: multilateral convention will require removal of all digital services taxes (DSTs) and similar measures, and commitment to not introduce them in the future.
- 

BEPS 2.0: Pillar One (4)

- *Tax certainty*: dispute prevention and dispute resolution mechanisms for Amount A and related issues in a mandatory and binding manner. There will also be a effective binding dispute resolution mechanism for developing countries (for those countries eligible for deferral of Action 14 peer review and that have no/low levels of mutual agreement procedure (MAP) disputes, subject to review)
- *Amount B*: the application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined. Focus is to be on needs of low capacity countries, with work to be completed by end of 2022
- *Administration*: tax compliance to be streamlined (this includes filing obligations) and allowance for in-scope MNEs to manage the process through a single entity
- *Other*: revenue sourcing, tax base determination, market and distribution profits safe harbour, limited segmentation and elimination of double taxation, all as yet to be finalised.



BEPS 2.0: Pillar Two (5)

- **Pillar Two** – seeks to put a floor on tax competition, through introduction of a global effective minimum corporate tax rate (ETR) of 15%
- Around \$US150 billion in additional tax revenues globally per year expected
- *Design*: GloBE, Income Inclusion Rule (IIR) and Undertaxed Payment Rule (UTPR) and treaty-based Subject to Tax Rule (STTR) require further refinement
- *Status*: GloBE rules are a common approach:
 - They are not required to be adopted, but if a country so chooses to adopt, it must implement consistently
 - Must accept the application of these rules if they are applied by other member jurisdictions (this includes the rule order and safe harbours provisions)
- *Scope*: EU 750 million revenue threshold, but countries can implement the IIR below this threshold on MNEs headquartered in their country
- *Out of scope*: government entities, international organisations, non-profit organisations, pension funds and investment funds
- *Exclusions*: international shipping income

BEPS 2.0: Pillar Two: (6)

- *ETR calculation*: Top-up tax, with an ETR test calculated on a jurisdictional basis, using a common definition of covered taxes and tax base determined by reference to accounting income (with some agreed adjustments)
- *Minimum rate*: for IIR and UTPR is 15%
- *Carve-out and de minimis exclusion*:
 - Formulaic substance-based carve out will exclude the amount of income that is 5% of the carrying value of *tangible assets* and *payroll* (this will have a 10 year transitional period)
 - De minimis exclusion will apply to jurisdictions where the MNE has revenues less than EU10 million and profits less than EU1 million
- *GILTI*: consideration is to be given as to what conditions will allow the (US) GILTI regime to co-exist with the GloBE rules to ensure a level playing field
- *Simplification*: to ensure targeting and avoid disproportionate administrative and compliance costs, the implementation will include safe harbours and other mechanisms.



BEPS 2.0: Pillar Two (7)

- *Subject to Tax Rule*: Minimum rate to be 9%
- Where members apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and other sets of payments (as defined), the STTR will need to be implemented via their bilateral treaties with developing member countries when requested to do so
- For these purposes a developing country is defined as those with GNI per capita, calculated using the World Bank Atlas method, of US\$12,535 or less in 2019 (but updated regularly)
- The taxing right will be limited to the difference between the minimum rate (9%) and the tax rate applied on the payment.

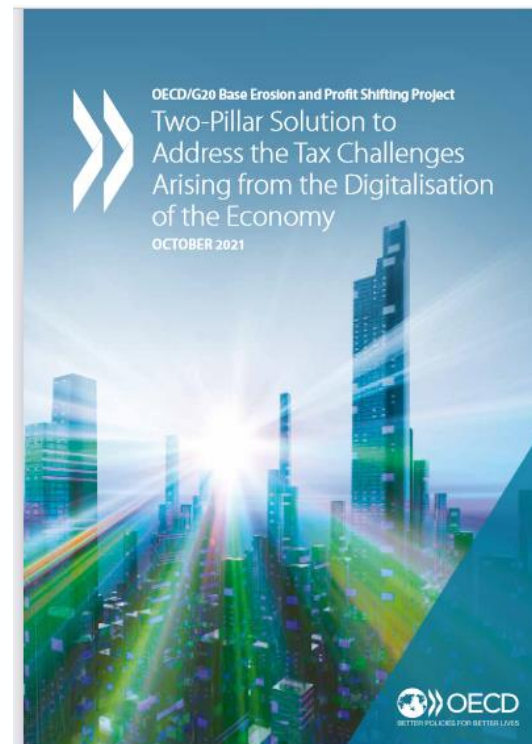


BEPS 2.0: Pillar One - implementation plan (8)

- *Amount A*: to be implemented via a multilateral convention (MLC), with domestic ratification and law changes with the intention that it comes into effect in 2023
- *MLC*: to facilitate consistent implementation for all jurisdictions regardless of whether a tax treaty exists, together with an Explanatory Statement (ES):
 - MLC will include rules to determine and allocate Amount A and eliminate double taxation; simplified administration processes; exchange of information process; processes for dispute prevention and resolution; as well as addressing interactions with existing and future bilateral tax treaties
 - The Tax Force on the Digital Economy (TFDE) will clarify and define the features of Amount A (specifically elimination of double taxation, marketing and distribution profits safe harbour) and develop its content. The TFDE is to conclude the text in early 2022 for the MLC signing ceremony scheduled for mid-2022
- *DSTs*: MLC will require their removal and a commitment not to introduce DSTs (or other similar measures). A detailed definition is to be developed as part of the MLC and ES
- *Domestic law changes*: TFDE to develop model rules and commentary by early 2022
- *Amount B*: WP6/Forum on Tax Administration's (FTA) MAP Forum to conclude work by end of 2022.

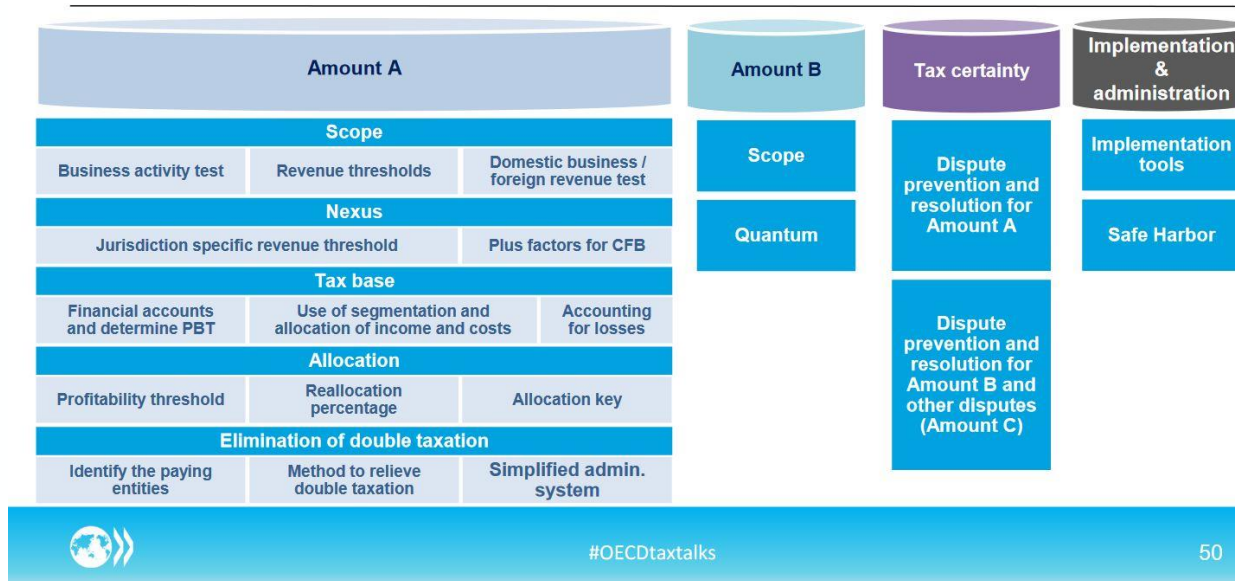
BEPS 2.0: Pillar Two - implementation plan (9)

- GloBE rules along with accompanying commentary are to be developed by the end of November 2021. These rules will define the scope and mechanics of the IIR and UPTR, including rules for determining the ETR, the formulaic substance-based carve out, various administrative provisions and transitional rules
- A model treaty provision to give effect to the STTR is to be developed by the end of November 2021
- A multilateral instrument (MLI) will be developed by mid 2022 to facilitate the implementation of the STTR for relevant bilateral treaties
- An implementation framework will be developed by the end of 2022 to facilitate the coordinated implementation of the GloBE rules
- More information is available on the OECD's website:
<https://www.oecd.org/tax/beps/beps-actions/action1/>



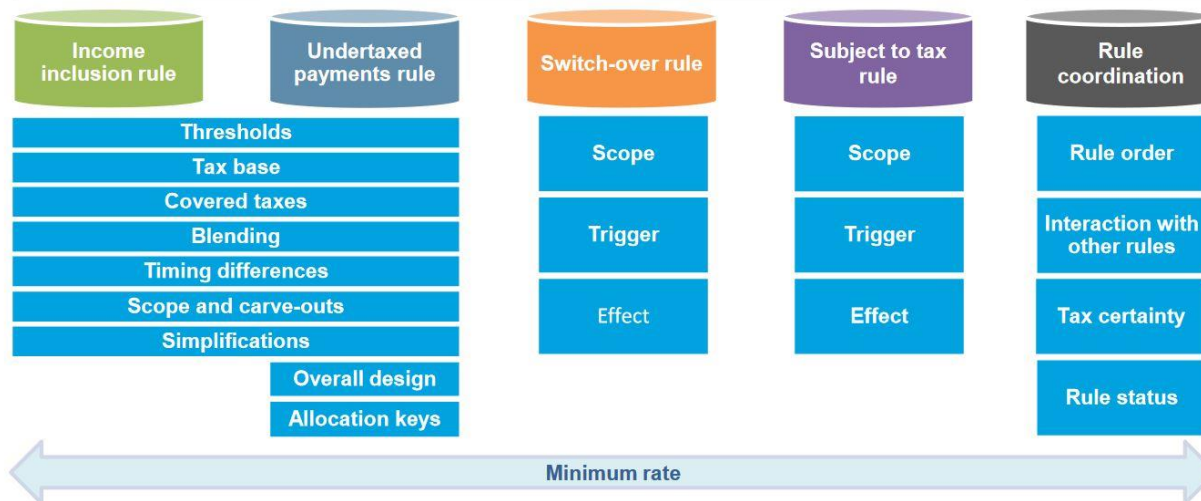
BEPS 2.0: the components (10)

Pillar 1 – Unified approach



BEPS 2.0: the components (11)

Pillar 2 – GloBE proposal



HKSAR's approach to BEPS

- HKSAR received a largely compliant report from the Global Forum on Transparency and Exchange of Information in its Peer Review in 2013, but with areas for improvement
- Enacted legislation in 2013, after much debate, to enable HKSAR to conclude Tax Information Exchange Agreements (TIEAs)
- Negotiated in 2014 an in-substance and final inter-governmental agreement (IGA) under US's Foreign Account Tax Compliance Act (FATCA) 2010
- Became a signatory through the Peoples Republic of China (PRC) signing the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) on 27/08/13 – entered into force on 1/02/16
- Automatic Exchange of Information (AEOI) introduced by amendment to HKSAR's Inland Revenue Ordinance (IRO) in 2016
- BEPS 1.0 - accepted invitation, as “Hong Kong, China”, in June 2016 to be an Associate on the BEPS initiatives. This requires HKSAR to facilitate 15 BEPS Actions, as relevant, & work globally
- Consultation on BEPS commenced later in 2016: proposed to introduce draft legislation for first half 2017.



HKSAR's approach to BEPS (2)

- HKSAR in 2017 made a priority for it to meet the four agreed BEPS minimum standards:
 - Harmful tax practices & spontaneous EOI on certain tax rulings (Action 5);
 - Model tax treaty provisions to prevent treaty abuse (Action 6);
 - CbC reporting (Action 13); and
 - Improvements to cross border tax dispute resolution (Action 14)
- Implemented the MLI in February 2018 via an amendment to the IRO (no ratification instrument to OECD)
- Launched a Country by Country (CbC) reporting portal in March 2018, with first AEOI occurring later that year using the Common Reporting Standard (CRS)
- Implemented new transfer pricing legislation in July 2018 via an amendment to the IRO
- *BEPS 2.0* – set up an advisory panel in June 2020 to assess the impact and make recommendations to the HKSAR Government
- HKSAR announced it was **fully committed** to implementing BEPS 2.0 in February 2021 but it will ensure the advantages of HKSAR's tax regime are maintained, namely:
 - *maintain the simplicity, certainty and fairness of the regime;*
 - *minimize the compliance burden for affected enterprises; and*
 - *continue to improve the business environment and competitiveness*

Implications of BEPS 2.0 for HKSAR

- *Should HKSAR agree to facilitate the implementation of BEPS 2.0?:*
- Will facilitate avoiding a proliferation of unilateral tax measures by countries (such as DSTs)
- Will reduce, if not eliminate, harmful tax competition and preserve incentives for real economic activity
- More tax will be paid in more countries with a fairer allocation of taxing rights, including countries where consumers and the underlying economic activity resides
- A 'fair share' of tax will be paid by MNEs
- *Impact for HKSAR:*
- Only affects relatively few HKSAR businesses and not any SMEs
- Statutory tax rate 16.5% exceeds the minimum ETR of 15%, but there is some concern if the ETR is less than 15% - here the IIR may operate
- Will need to look at all of its bilateral treaties to ensure they meet the STTR minimum rate (especially on passive income such as dividends, interest & royalties).

Implications of BEPS 2.0 for HKSAR (2)

- *What is HKSAR's approach to date?:*
- Continue with its territorial source principle of taxation (but, after consulting, it is likely to change the territorial source rules for passive income by end of 2022 so as to come off the EU's 'grey list')
- Set up the *Advisory Panel on BEPS 2.0* on 11 June 2020 (Chaired by Secretary for Financial Services and the Treasury, with bureaucrats and private sector members), with a specific Terms of Reference:
 1. *To review the possible impact of the latest requirements under BEPS 2.0 on the competitiveness of Hong Kong's business environment.*
 2. *To advise the Financial Secretary on strategies and measures to facilitate the sustainable development of Hong Kong as an international financial, trading and business centre in light of the changing international tax landscape.*
- Due to report when the BEPS 2.0 details are finalised by OECD – likely to be by December 2021 for some details and for others during 2022
- *Expected to implement BEPS 2.0 according to international consensus*, provided HKSAR can maintain its competitiveness, can keep compliance burdens low and can improve the overall business environment.

Implications of BEPS 2.0 for Hong Kong (3)

- HKSAR supported BEPS 1.0, such as by signing the MLI, but it has not yet deposited an instrument of ratification (neither has the PRC): does this suggest a lack of real commitment?
- Have yet to see the recommendations of the Advisory Panel on BEPS 2.0 – unlikely to recommend changes to HKSAR's tax regime unless the finalised BEPS 2.0 supports HKSAR's ideals and/or it is facing undue international pressure to conform
- Some changes to passive income under STTR are expected; it may need to review its profits regime (if ETRs less than 15%); and may need to review areas of exempt income (depending on carve outs)
- Some MNEs are expected to experience heavier tax burdens, extra compliance costs and potentially more tax disputes
- Likely to affect HKSAR's popularity as a global financial hub
- However, ultimately any effective change it will depend largely on the approach taken by PRC in terms of ratification and deposit of relevant instrument(s).





Thank you!
Questions and Comments