HONG KONG

"BEPS 2.0" and the Future of Intra-Group Financing in Hong Kong

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Abstract

Under Hong Kong's territorial tax system, only interest income that is derived from Hong Kong (or deemed as such) can generally be within the scope of Hong Kong Profits Tax. Hong Kong companies that lend overseas are in some cases not subject to Hong Kong Profits Tax on interest receipts.

Under new proposals made by the Organisation for Economic Co-operation and Development ("OECD"), Hong Kong's approach to taxing interest could come under increasing pressure. The denial of foreign interest deduction or the blocking of treaty access for interest withholding tax relief are among the potential implications of these new proposals.

Multinational groups should be considering now what to do if such rules were to be enacted, including contingency plans looking at bringing such payments within the Hong Kong tax net and a consideration of the Hong Kong Corporate Treasury Centre ("CTC") regime for qualifying entities. With indications that the Hong Kong Government is planning to enhance the CTC regime, if this is effectively handled, it could in fact create new opportunities to attract global investment through Hong Kong as a financing and treasury hub.

Introduction

In what are potentially some of the most fundamental changes to international taxation since the Base Erosion and Profit Shifting ("BEPS") project began, in February 2019, the OECD released a new proposal that aimed to create a level playing field for global taxation, in the form of a public consultation document entitled "Addressing the Tax Challenges of the Digitalisation of the Economy".[1] In May 2019, the Programme of Work, built on the public consultation document, was issued.[2]

While somewhat confusingly referencing the digitalisation of the economy as a follow-up to the 2015 BEPS Action 1 Report, many of the proposed rules contained in the consultation document and Programme of Work are not directly tied to digital or digitalisation at all. Given the potential far-reaching impact of the proposal to all businesses with cross-border activities, it is commonly referred to as a second BEPS, or "BEPS 2.0".

Specifically, the first half of the BEPS 2.0 proposal, Pillar One, looks at the implications of the digitalisation of the economy and how tax systems may need to adapt to keep up.[3] The remainder of the paper, Pillar Two, looks at broad proposals to effectively introduce a global "minimum tax", which will be the focus of this article.

The new global anti-base erosion ("GloBE") proposals under Pillar Two aim to prevent the shifting of profits to jurisdictions where they are subject to no or very low taxation. At the time of writing, the OECD has also just released its public consultation document on GloBE – Pillar Two.[4] This article explores the Pillar Two proposals and, in particular, the impact they may have for Hong Kong intra-group financing structures.

Global Anti-Base Erosion Proposals

All the various GloBE proposals in effect have a simple goal, which is to ensure that income and payments are subject to a "minimum" amount of tax. While it is currently not clear what this minimum tax would look like, this clearly represents a significant development in the field of international taxation.

Jurisdictions such as Hong Kong, which operate a "source"-based taxation regime, will need to pay particular attention, due to the approach that involves only subjecting profits to tax when they have a local "source". This could lead to situations where not all profits are subject to tax, particularly "passive" profits, such as some forms of interest income, which often do not require material operations in order to be derived.

Historically, many of the BEPS proposals have focused on ensuring fair taxing rights between jurisdictions, by ensuring that profits are allocated between jurisdictions in an equitable way. Primarily, this has been through looking at commercial and economic substance, but has also included ensuring that inconsistencies between tax systems do not give rise to results such as cross-border tax deductions but the non-inclusion of income, or that double deductions are not generated on a single expense.

It remains, however, that there are a number of jurisdictions around the world where fairly allocated profits are not subject to tax (or are taxed at a low rate) under domestic legislation. It appears that the OECD, under views expressed by member states, is stepping up its proposals to tackle what it considers to be risks in this area.

If such proposals are implemented by jurisdictions, they could apply under two main mechanisms (which could potentially operate in various ways):

- Income inclusion rule – a rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate below a specified minimum rate; and

- Tax on base eroding payments – a rule that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to tax treaties, for certain payments, unless that payment was subject to tax at or above a specified minimum rate.

The intention of the proposals is presumably to ensure that taxpayers and jurisdictions alike are no longer caught in a "race to the bottom". While the practical impact of any such proposals remains to be seen, if implemented effectively, these rules should raise the bottom threshold from zero tax to a minimum (as yet undecided) rate.

Income Inclusion Rule

The proposed income inclusion rules may act in a similar manner to a Controlled Foreign Company ("CFC") type rule, to bring into tax for a shareholder a proportionate share of income in a corporation that is not subject to a minimum rate.

A switch-over rule for tax treaties would also be explored, which would allow a residence jurisdiction to switch from an exemption to a credit method, where the profits attributable to a permanent establishment ("PE") or derived from an immovable property that is not part of a PE are subject to an effective rate below the minimum rate.

There are a number of significant complications involved in any such proposals, as the Programme of Work concedes, including the potential for complex tax compliance and unintended consequences due to mis-matches between how a parent and a subsidiary jurisdiction may calculate their income and effective tax rates.

The Programme of Work also mentions various options and issues that need to be explored, including, for instance, the possible use and effect of carve-outs for regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance-based carve-outs, noting, however, that such carve-outs would undermine the policy intent and effectiveness of the proposal.

The rules would be implemented by way of changes to domestic legislation and tax treaties. Given the way in which many territories already follow CFC rules, plus the potential for complications and mis-matches arising if not all territories introduce the rules, this leaves some significant design problems with the proposal that need to be addressed.

The November public consultation document therefore specifically seeks comments on three technical design aspects: 1) the use of financial accounts as a starting point for determining the tax base and different mechanisms in order to address timing differences; 2) the extent to which a multinational group can combine high-tax and low-tax income from different sources in determining the effective blended tax rate; and 3) stakeholders' experience with and views on carve-outs and thresholds.

Tax on Base Eroding Payments

The proposal regarding a tax on base eroding payments complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. There are two proposed rules under consideration:

- Undertaxed payments rule – a rule that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate; and

- Subject to tax rule – a rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income, where the payment is not subject to tax at a minimum rate. This rule applies to both related party and unrelated party payments.

It would seem likely that any undertaxed payments rules may not look too dissimilar to "anti-hybrid" rules which have been introduced in a number of jurisdictions in recent years and require only domestic law changes. Such rules generally look to either bring into tax a payment, or deny deduction on a payment, where there is a mis-match in treatment (e.g., leading to a tax deduction) but no inclusion regarding the tax of the corresponding income.

Furthermore, given the wide uptake of the Multilateral Instrument ("MLI") by 90 jurisdictions[5] (including Hong Kong, represented by China) there seems to be a ready platform through which to implement a potential "subject to tax rule" through the modification of treaty benefits via the MLI, which was designed to be an efficient way to introduce such treaty changes on a broad base of jurisdictions.

For these reasons, while there is still work to be done in clarifying exactly how the proposals would operate, the implementation of any such base eroding payments rules may be closer than one might think. It should also be borne in mind that the OECD and G20 have committed to reaching a resolution regarding these issues by the end of 2020, with political pressure mounting to do so as soon as possible.

The next sections focus on the potential impact the "income inclusion rule" and "tax on base eroding payments" rules could have on Hong Kong financing structures and what steps multinational groups should be thinking about taking now.

Impact on Hong Kong Lending

As a key global financial hub, Hong Kong is responsible for providing financing to innumerable investments around the globe that provide value, growth, and jobs to local economies.

As previously mentioned, Hong Kong operates a "source"-based taxation system, which generally only subjects to Hong Kong Profits Tax the profits that arise as part of a Hong Kong trade, profession, or business, and when such profits are sourced in Hong Kong. Hong Kong incorporated companies generally (although not always) have a trade or business in Hong Kong, and so the first leg of the above test would be satisfied, although many overseas incorporated entities also carry on a Hong Kong trade or business either directly or through other persons. Accordingly, in the discussion below, we refer to Hong Kong businesses, which may be carried on by a Hong Kong or a non-Hong Kong company (or a non-corporate entity).

The determination of the taxability of interest income under Hong Kong tax law is relatively complex. Apart from two tests (i.e., provision of credit test and operations test), which apply to different types of situations, there is also a deeming provision that treats the interest income and relevant profits arising through or from the carrying on in Hong Kong of an intra-group financing business as taxable.

Putting the deeming provision aside, with either of the above two tests, there is, under Hong Kong domestic legislation, a clear and legitimate result that interest may be regarded as sourced from outside Hong Kong and hence be excluded from Hong Kong Profits Tax, even though the Hong Kong tax authorities are increasingly taking a more stringent practical approach to offshore claims. It is also quite likely that Hong Kong businesses would not be subject to any foreign taxes (other than withholding tax) on the interest income either (e.g., if it does not have a foreign PE).

In situations in which the parent company of the Hong Kong business is located in a jurisdiction that implements the income inclusion rule, the parent company would be required to bring the interest income to tax in its own jurisdiction, where the interest income has not been subject to an effective rate of tax above a minimum rate.

Second, from the perspective of the borrower, there may be an interest deduction on the interest paid, depending on its domestic law. There may also be a reduction or elimination of any borrower jurisdiction interest withholding tax under any relevant tax treaty with Hong Kong.

Under the proposed tax on base eroding payments rules, such arrangements would be at risk of facing the denial of tax deduction for the interest payment and/or the denial of the tax treaty reduction in regard to interest withholding tax. This could have material impacts on the tax efficiency of such structures and groups should be considering what to do now.

The Way Forward

As the proposals are still at the consultation stage, it may still be too soon to enact wholesale restructuring. However, groups should definitely be assessing the potential implications of the proposals for their existing arrangements and begin exploring contingency plans, so as to be ready for any changes that may have short lead times.

It could be that, given the relatively low Hong Kong Profits Tax rate of 16.5 per cent, subjecting interest income to Hong Kong tax may still have overall efficient results; for instance, if this satisfies any new rules in order to allow for interest deductions and access to treaties for the borrower. Care would need to be taken for existing structures, however, as it may not be as simple as just including the interest as taxable in the latest tax returns. Justification as to why the treatment of interest has changed under any restructuring plan would be required, so as not to undermine historical positions.

Hong Kong introduced legislation in 2016 to allow for a special concessionary rate of 8.25 per cent for qualifying CTCs in Hong Kong. Briefly, an entity that is centrally managed and controlled in Hong Kong, which derives qualifying profits from carrying on an intra-group financing business, providing corporate treasury services, or carrying out corporate treasury transactions, subject to meeting certain other conditions, would be entitled to the concessionary tax rate. If this rate were to satisfy any new "minimum" tax rate, or if carve-outs for BEPS Action 5 compliant regimes are allowed, then this may also be an efficient solution. We note that moving to the CTC regime should automatically result in interest being deemed as Hong Kong sourced, regardless of any prior arrangements. The issue with looking to CTC however, is that CTC rules, as they currently stand, entail a number of practical issues that have so far resulted in relatively little uptake in setting up such CTCs by businesses. For instance, a qualifying CTC cannot undertake any other activity or needs to satisfy a safe harbour rule if it does, and the rules for deducting interest expenses paid to associated corporations by a CTC are also relatively restrictive. There are also onerous consequences whereby, if tests are failed for a particular year, the entity is not only denied access to the regime for the failed year, but for the subsequent year as well. These, among other issues, increase uncertainty and reduce the attractiveness of the regime. The Hong Kong Government seems to be aware of the ineffectiveness of the current CTC rules (it has been announced in the 2019/20 Budget as an item that will be further considered), but the community has yet to see the exact Government proposals intended to resolve these issues and make the regime more practical, while remaining BEPS compliant.

Although it may be a reasonable assumption that the Hong Kong Government would seek to amend the rate if it were to be below the "minimum tax", it may not be possible to act quickly enough, given the need for them to be promulgated by the Legislative Council. Consideration could be given to building in flexibility to the legislation, to allow for much more agile changes to take place in regard to the CTC regime in this respect.

One thing is clear, however: With the timeline to which the OECD and G20 is working and the increased speed at which new tax legislation could now be introduced in a post-BEPS world, the time to be thinking about "BEPS 2.0" is now.

While we are aware that the Hong Kong Government is closely following the developments of BEPS 2.0, we urge them to consider it alongside a possible revamp of the CTC regime. If this can be done, then it could finally lead to an increased demand for the CTC regime from Hong Kong businesses looking to fund overseas operations, as well as from Chinese or foreign multinationals looking to use Hong Kong as a financing and treasury hub.

Endnotes

1. 13 February 2019: https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf

2. 29 May 2019: https://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

3. See also the public consultation document issued on 9 October 2019 for Pillar One: http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

4. 8 November 2019: https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

5. 30 October 2019: https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf T