International Tax News Flash
Hong Kong

BEPS 2.0 Pillar Two Global Anti-Base Erosion Model Rules and other international tax developments

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Issue 1

In brief

Just before the end of 2021, the Organisation for Economic Co-operation and Development (OECD) and European Commission (EC) released several documents in relation to the tackling of international tax avoidance.

Further to its October 8, 2021 *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*[1], the OECD released the long-awaited BEPS 2.0 Pillar Two Global Anti-Base Erosion (GloBE) Model Rules (Model Rules)[2] on December 20, 2021 to assist in the implementation of a landmark reform to the international tax system, which will ensure that Multinational Enterprises (MNEs) will be subject to a minimum tax rate of 15% from 2023.

These Model Rules, covering the Income Inclusion Rule (IIR) and Undertaxed Payment Rule (UTPR) (collectively 'GloBE Rules') are the first of three expected sets of guidance: (i) the Model Rules; (ii) an explanatory Commentary expected in early 2022; and (iii) a more detailed Implementation Framework, which may not be published before 2023.

Two days after the release of the Model Rules, on December 22, 2021, the EC published its *Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union* ('Draft EU Directive on Pillar Two')[3] aimed at implementing the Model Rules in the EU Member States.

On the same day, the EC published its *Proposal for a Council Directive laying down the rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU* (Draft EU Directive on Shell Entities)[4] to provide indicators of minimum substance for undertakings in Member States and rules regarding the tax treatment of those undertakings that do not meet the indicators.

In detail

Model Rules

The Model Rules, which provide governments a precise template for taking forward the GloBE Rules, were released together with a summary, *The Pillar Two Rules in a Nutshell*[5]; a set of fact sheets, *Overview of the Key Operating Provisions of the GloBE Rules*[6]; and a set of frequently asked questions[7].

The GloBE Rules apply a system of top-up taxes that brings the total amount of taxes paid on an MNE's excess profit in a jurisdiction up to the minimum. The OECD summarises the steps in determining the top-up tax liability for an in-scope MNE as follows:

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Step 1 – Constituent entities within scope: Identify groups within scope and the location of each constituent entity within the group

Step 2 – GloBE Income: Determine the GloBE income of each constituent entity

Step 3 – Covered taxes: Determine the taxes attributable to the GloBE income of a constituent entity

Step 4 – Effective tax rate (ETR) and top-up tax: Calculate the ETR of all constituent entities located in the same jurisdiction and determine the resulting top-up tax

Step 5 – IIR and UTPR: Impose top-up tax under IIR or UTPR in accordance with the agreed rule order

The key points under each step are set out below:

Step 1 – Constituent entities within scope

Scope: The scope is clarified to cover MNEs with annual global consolidated revenues reaching EUR750m for at least two of the last four fiscal years immediately preceding the tested fiscal year (with some transitional rules for single entities on becoming groups).

Excluded entities: A constituent entity is generally an entity included in the MNE group and a permanent establishment thereof, but does not include an excluded entity, which covers government entities, international organisations, non-profit organisations, pension funds and, where they are ultimate parent entities, investment funds and real estate investment vehicles. The definition is extended to also cover 95%-owned entities of the above excluded entities that hold assets or invest funds, or only carry out ancillary activities, and those that mostly derive income excluded from the calculation of GloBE income. Other investment entities are subject to special rules which treat them separately from other entities in a jurisdiction, with elections for them to be treated as transparent or to apply a taxable distribution methodology.

Step 2 – GloBE income

GloBE income or loss: GloBE income or loss, which needs to be determined for each constituent entity, is calculated using the financial accounting net income or loss as a starting point, with a number of required or elective adjustments, including for instance excluded dividends, excluded equity gain or loss, policy disallowed expenses, non-arm's length intra-group transactions, and excluded international shipping income. Elections are provided to permit stock-based compensation to be accounted for under the relevant income tax rules. An election is also provided to allow the application of the 'realisation principle' in respect of assets and liabilities that are subject to fair value or impairment accounting.

Our observations: *There appears to be quite a number of adjustments required in arriving at the GloBE income for each constituent entity, which may pose practical compliance challenges to MNEs. On the other hand, the availability of an election to adopt the realisation principle may be good news to certain MNEs in the real estate or financial services sector as this might help resolve some concerns over the treatment of unrealised gains.*

Allocation to permanent establishments and flow-through entities: Rules for allocating GloBE income or loss between a permanent establishment and the main entity, or to owners of a flow-through entity, are available to ensure an appropriate allocation generally in line with the applicable local tax rules.

Step 3 – Covered taxes

Covered taxes: Covered taxes include any tax on an entity's income or profits (including tax on distributed profits) and any taxes imposed in lieu of a generally applicable income tax (including tax on retained earnings and corporate equity). Certain covered taxes may need to be allocated to other constituent entities, for example controlled foreign company taxes, distribution taxes (e.g. dividend withholding taxes), and taxes in respect of permanent establishments or other flow-through entities.

Adjusted covered taxes and deferred taxes: Adjusted covered taxes are computed starting with the current tax expense as per the financial accounts, adding tax accruals in profit before tax per the accounts plus/minus deferred tax expense/credit per the accounts (recast at 15% if deferred tax items have been booked at a higher statutory rate). Additional adjustments include tax on income that is excluded from the computation of GloBE income and taxes with respect to uncertain tax position. A deferred tax liability which is not expected to reverse within five years can be disclaimed, otherwise a recalculation will be required (potentially adding additional top-up tax in the current year by reference to a preceding taxable year), with certain exceptions. Transition rules are available to allow certain existing deferred tax assets and liabilities to be taken into account in determining the ETR in transition year. Deferred tax assets or liabilities in respect of assets (other than inventory) transferred

between constituent entities after November 30, 2021 and before the commencement of a transition year shall be based on the disposing entity's carrying value.

GloBE loss election: A GloBE loss election can be made for a jurisdiction, with certain exceptions, in lieu of applying the deferred tax accounting rules. Upon making such an election, a GloBE loss deferred tax asset is established for carryforward and utilisation in subsequent years.

Our observations: *The inclusion of provisions addressing the treatment of deferred taxes and losses should be good news to MNEs. However, the rules on deferred taxes are complex and further clarification will be needed, which will hopefully be available in the Commentary to be issued.*

Step 4 – ETR and Top-up tax

ETR: For each jurisdiction, the ETR is calculated as the adjusted covered taxes of all constituent entities divided by net GloBE income (excluding those of investment entities). Where the ETR is below the minimum rate of 15%, a top-up tax must be calculated.

Top-up tax: The jurisdictional top-up tax amount is the difference between the minimum rate of 15% and the ETR applied to an amount of excess profit equal to net GloBE income minus the substance-based income exclusion for that jurisdiction. The de minimis exclusion treats this top-up tax amount as zero if, averaging the current and two prior years, the GloBE revenue is less than EUR10m and GloBE income is less than EUR1m (or a loss). The top-up tax is reduced by any applicable qualified domestic minimum top-up tax, and allocated to constituent entities in the low-tax jurisdiction that have GloBE income. Safe harbour rules will be developed to provide an election for a zero top-up tax amount in certain other cases as part of the Implementation Framework.

Our observations: *While a qualified domestic minimum tax is not regarded as a covered tax, it will be credited against any top-up tax liability. Certain jurisdictions, for example Spain, have already announced the introduction of a domestic minimum tax in response to Pillar Two. It is understood that the Hong Kong SAR government is also considering such a measure. Details, however, have yet to be released.*

Substance-based income exclusion: MNEs will get a carve-out on GloBE income for 5% of the carrying value of their tangible assets and payroll, with a transition period of ten years that offers an exclusion of 8% of tangible assets and 10% of payroll in 2023, gradually declining to 5% in 2033. Eligible payroll costs cover 'employee compensation expenditures (including salaries, wages, and other expenditures that provide a direct and separate personal benefit to the employee, such as health insurance and pension contributions), payroll and employment taxes, and employer social security contributions'. Eligible tangible assets include items located in a jurisdiction, like property, plant, equipment, natural resources, a lessee's right to use tangible assets, and certain government licenses, including ones to exploit natural resources. The carve-out does not apply to properties that are held for sale, lease or investment, or tangible assets that are used to generate exclude international shipping income (such as ships and other maritime equipment).

Step 5 – IIR and UTPR

Parent entity applying IIR: The ultimate parent entity (UPE) is primarily responsible for applying IIR as the collection mechanism for the top-up tax. However, if the UPE jurisdiction does not apply IIR or another qualified IIR, or the UPE is an excluded entity, then responsibility falls to the next highest level intermediate parent entity that has a controlling ownership interest, and so on down the chain. If the MNE group includes a sufficiently partially-owned parent entity (POPE) (i.e. where more than 20% interest is held outside the group), the obligation to apply the IIR is wholly or partly pushed down to this POPE or a POPE further down the chain. There is an offset mechanism to ensure there is no double counting.

Allocation of top-up tax: The jurisdictional top-up tax is allocated to constituent entities in the jurisdiction according to their contributions to aggregate GloBE income so that the IIR is then applied to the relevant parent entity's allocable share according to the ownership interest.

UTPR: Where there is remaining top-up tax after the IIR has been applied, such that the UTPR backstop kicks in, the adjustment or additional cash tax expense can be achieved in the manner each jurisdiction decides, e.g. denial of a deduction, an additional tax, a reduction in any allowance for equity, or deemed income (reversing a related party expense). The total UTPR amount is allocated among implementing jurisdictions under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction. Note that under this formula, there is no requirement that an entity in a UTPR jurisdiction actually makes deductible payments to a low-taxed affiliate.

Our observations: *The determination of the parent entity applying IIR can be a complex exercise for MNEs with split ownership structures.*

Other special rules

There are additional rules that deal with corporate restructurings and holding structures, and tax neutrality and distribution systems. The rules regarding joint ventures appear to deviate from those set out in the 2020 Blueprint and clarifications may be needed.

Administration

Each constituent entity (or a designated local entity for the jurisdiction) will have 18 months for the first transitional year, and then 15 months to file a standardised GloBE Information Return in its jurisdiction unless it notifies the tax administration there that the UPE (or designated filing entity for the group) has filed such a return in a jurisdiction that has an information sharing agreement in place with that first jurisdiction.

What's next?

An explanatory Commentary, which will provide more background and examples, is expected to be released early this year, together with details on how co-existence with the US Global Intangible Low-Taxed Income (GILTI) rules will be addressed, followed by a more detailed Implementation Framework focused on the administrative, compliance and coordination issues of the rules which may not be published before 2023. However, a public consultation event on the Implementation Framework will be held in February 2022 and on the Subject to Tax Rule (STTR) in March 2022, according to the press release of the OECD of December 20, 2021[8]. The model provision for the STTR, together with a multilateral instrument for its implementation, is expected to be released in the early part of 2022.

Draft EU Directive on Pillar Two

The Draft EU Directive on Pillar Two[9] closely follows the OECD Model Rules, but departs from them 'with some necessary adjustments, to guarantee conformity with the EU law'. The major key differences are:

- An extension of the IIR to 'large-scale' purely domestic groups whose consolidated revenues exceed the same threshold under the Model Rules, but transitional rules provide for a zero-rate application of the top-up tax due for the first five years of application of the rule – this extension was put in place 'to avoid any risk of discrimination between cross-border and domestic situations'

- An extension of the application of the IIR by a parent entity to the low-taxed constituent entities located in the same member state (including the parent entity)

The draft directive will need to be unanimously approved by all 27 Member States in order to be adopted. If successfully adopted, Member States shall then implement the rules into their national systems by December 31, 2022 and apply the related implementing provisions starting from January 1, 2023 (for the IIR) and January 1, 2024 (for the UTPR).

Draft EU Directive on Shell Entities

The proposal stems from a European Parliament move to counter the misuse of shell entities, in addition to more general requests from some Member States, business and civil society to deal with tax avoidance. Based on feedback from respondents on a public consultation undertaken during the summer of 2021, the EC has noted that entities can be set up with low economic substance for valid reasons and that the proposed directive is designed only for entities set up for the purposes of tax avoidance and evasion and that do not perform any actual economic activity.

The provisions in the proposed directive[10] apply to all entities, regardless of their legal form, that are engaged in an economic activity and that are considered to be tax resident and eligible to receive a tax residency certificate in a Member State. It also captures legal arrangements, such as partnerships, that are deemed residents for tax purposes in a member state. There are some exclusions, such as a company with a listed transferable security, and a regulated financial undertaking.

A seven-step 'Minimum Substance Test' is used to determine whether an entity should be regarded as a 'shell' giving rise to various consequences. Without going into the technical details, the substance test essentially involves the consideration of certain 'gateway' criteria (i.e. geographic mobility, cross-border activities, outsourcing of administration), various indicators (i.e. premises, active EU bank account and qualified, tax resident director(s) or staff), grounds for rebuttal of presumption based on

the indicators due to additional facts and circumstances and exemption for lack of tax motives. The consequences associated with being regarded as a 'shell' entity include the inability to obtain a tax residency certificate and denial of tax benefits (participation exemption under the Parent-Subsidiary Directive, or exemption from withholding tax under the Interest and Royalty Directive. The new rules would only apply to EU Member States, but could also indirectly impact group entities outside the EU, e.g. when a subsidiary in a Member State levies a withholding tax on an interest payment to a 'shell entity' in another Member State, which would probably lead to an overall increase of the tax burden for the group).

Once adopted, the proposed directive should be transposed into national law by the Member States before June 30, 2023 to come into effect from January 1, 2024. Given the EC's packed legislative agenda for 2022 and the significant time required to consider the BEPS 2.0 rules, this appears to be an ambitious timeline.

The takeaway

While the Model Rules provide more clarity on the implementation of Pillar Two, they are complex and pose challenges to governments in terms of implementation into domestic law and overall administration, as well as to affected MNEs in terms of compliance. The seventeen pages of new defined terms demonstrate the novelty of these rules, especially around the calculation of the tax base derived from financial accounting numbers. Furthermore, the jurisdictional and entity level (as opposed to business unit) calculations may not be straightforward, as many taxpayers' IT systems are not configured to collect data in the manner described in the Model Rules.

The potential impact of some of these provisions will need detailed consideration. Affected MNEs should keep a close eye on further details coming up, including the explanatory Commentary and the Implementation Framework. Those MNEs with parent entities located in the EU will also need to monitor the developments of the relevant EU directive.

Meanwhile, affected MNEs should start considering how they should organise for compliance. For this exercise, modelling will also be pivotal. Indeed, the treatment of historical losses and other tax assets (especially those existing on or before November 30, 2021), the use of incentives and preferential tax regimes, the impact of the inclusion of certain deferred taxes under taxes covered, and the application of the substance based carve-out are only some of the elements that require specific attention when modelling the impact of the Model Rules.

The stated timeline for Pillar Two remains ambitious, with enactment in late 2022 (perhaps even before the Implementation Framework is fully published) and an effective date of January 1, 2023 (with UTPR coming into effect in 2024). Governments around the world, including the Hong Kong SAR government, will face challenges clearing this through their legislative processes, drafting regulations, designing forms and systems in order to meet the timeline.

The Hong Kong SAR government has on various occasions shared the overall direction of Hong Kong's response to BEPS 2.0 based on recommendations of the Advisory Panel on BEPS 2.0, including the likelihood of applying the full GloBE Rules to in-scope MNEs with ETR below the global minimum rate, and the possibility of introducing a domestic minimum tax. The Advisory Panel also recommends that specific amendment proposal should be formulated with a view to protecting Hong Kong's taxing rights and minimising the compliance burden of businesses operating in Hong Kong. Given the availability of the Model Rules, we look forward to more details being released by the government soon.

Amid the challenges brought about by BEPS 2.0, MNEs with entities in EU Member States will have an even heavier compliance burden if and when the Draft EU Directive on Shell Entities is adopted.

Endnotes

1. Our news flash on the October Statement can be accessed via this link: https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-oct2021-4.pdf

2. The OECD's publication, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, can be accessed via this link: https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf

3. The Draft EU Directive on Pillar Two can be accessed via this link: https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf

4. The Draft EU Directive on Shell Entities can be accessed via this link: https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_565_1_EN_ACT_part1_v7.pdf

5. The summary can be accessed via this link: https://www.oecd.org/tax/beps/pillar-two-model-rules-in-a-nutshell.pdf

6. The fact sheets can be accessed via this link: https://www.oecd.org/tax/beps/pillar-two-GloBE-rules-fact-sheets.pdf

7. The frequently asked questions can be accessed via this link: https://www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf

8. The OECD's press release can be accessed via this link: https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm

9. For details of the Draft EU Directive on Pillar Two, please refer to the *PwC Global Tax Policy Alert, 22 December 2021*, which can be accessed via this link: https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-ecs-directive-proposal-o-pillar-two-15-min-tax-rate-in-the-eu.pdf

10. For details of the Draft EU Directive on Shell Entities, please refer to the *PwC Global Tax Policy Alert, 23 December 2021*, which can be accessed via this link: https://www.pwc.com/gr/en/pwc-ec-draft-directive-to-prevent-the-misuse-of-shell-entities.pdf

Let's talk

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