The British Chamber of Commerce in Hong Kong
香港英商會

Mr Christopher Hui Ching Yu, JP
Secretary for Financial Services and the Treasury
Financial Services and the Treasury Bureau
24/F West Wing
Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

23 March 2022

Dear Secretary,

BEPS2.0 in Hong Kong

Following on from our previous support for the letter by the Australian Chamber of Commerce early last year, we would like to thank the Government for its efforts on this international initiative so far. We were pleased to note in the Budget Speech from the Financial Secretary on 23 February that Hong Kong will be preserving the unique advantages of its tax regime in terms of 'transparency' and 'simplicity', not only will that maintain the territorial source principle of taxation, it is also likely to minimise the compliance burden on multinational enterprises.

Within the Chamber, we have set up a small working group to consider this important initiative. This submission sets out a number of the issues raised by the working group for your further consideration. We would request an early opportunity to meet with you and your colleagues (virtually) to discuss.

1. EU grey list

The Chamber understands that the Government's current intention is to address the legislative amendments resulting from the EU's concerns about foreign income exclusions and those resulting from the BEPS initiative separately.

Although the scope of the two projects and the filing positions they concern are not identical, there is substantial overlap. A holistic approach to the changes is crucial to ensure that the changes take full advantage of any concessions that are available under the two regimes and that any changes are mutually compatible.

One example of this is considering the introduction of a participation exemption for substantial shareholdings. Such a regime is common in the EU and is expressly permitted by the BEPS rules. While many companies currently rely on the offshore sourcing rules to prevent dividends and gains on disposal of subsidiaries from being taxable, amending the law to provide a clear exemption should meet the requirements of both BEPS and the EU, and provide greater certainty to taxpayers.

Another example would be to consider the availability of deductible expenditure. While a complete exemption from tax can be problematic for the EU, the subject to tax rules and the minimum tax

info@britcham.com
+852 2824 2211
Room 1201, Emperor Group Centre,
288 Hennessy Road, Wan Chai,
Hong Kong
www.britcham.com

rules, the availability of deductions, especially when these are charged to the profit and loss account or represent a timing difference, is generally more acceptable. We have noted below in this regard the current restrictive nature of Hong Kong's deductions for interest payable.

Our concern is that if the legislative amendments to address the BEPS rules and the EU grey list consist largely of restrictions on the ability to make the claims which currently make Hong Kong's tax system attractive, without implementing changes to make the system as competitive as it can be within the confines of the new rules, Hong Kong's competitiveness from a tax perspective may start to decline.

2. Consequential amendments

The current proposals put forward by the Government mainly concern the implementation of a domestic minimum tax. The principle aim of this is to protect Hong Kong's tax base by giving Hong Kong the right to tax income that would otherwise, as a result the GloBE rules, be taxed overseas. This is a sensible measure, especially if it assists in ensuring Hong Kong qualifies for the safe harbour provisions within the rules.

However, we note that taken in isolation, the net effect of this can only be to increase tax for large multinationals operating in Hong Kong. It will significantly reduce the attractiveness of many of the incentives the Government has recently introduced. It will also require affected companies to prepare two sets of tax computations, paying tax on whichever gives the higher number. We also note that a minimum tax does not appear to be effective in defending against overseas tax charges raised under the subject to tax rules, which a significant number of treaty partners in the region, including Mainland China, have the ability to impose on Hong Kong.

In order to remain attractive to international business, the Chamber encourages consideration of how to revise current incentives and tax treatments to remain competitive and in line with the GloBE provisions. Some examples include:

a) Research and development incentives: Hong Kong currently provides a double or triple deduction on certain qualifying research and development expenditure. Although there are provisions for a clawback of this in certain circumstances, in many cases this incentive gives rise to a permanent benefit. Under the GloBE rules, this may no longer be beneficial but the rules allow a deduction for long-term timing differences in respect of research and development costs which large multinationals may find such an approach more attractive than a permanent deduction.

b) Shareholding exemptions: As noted above, the GloBE rules do allow for exemptions from dividend income from shares held for more than a year or in which the ownee has a significant interest and gains on disposals of shares in which the owner has a significant interest. Although many groups are able to achieve something similar on the basis the returns are either offshore sourced or capital in nature, there does seem to be a chance to to extend the current exemptions to make it clear that income falling within the definition of

Excluded Dividends and Excluded Net Equity Gain is outside the scope of tax. We note that such a provision would also be consistent with many EU tax systems.

c) Interest deductibility: Hong Kong's rules on deduction of interest to related parties are currently very strict by global standards. Historically, this has not been of too much concern as interest receivable has also frequently been offshore sourced and also exempted from tax. However, the ability to continue to claim such exemptions is questionable following the introduction of the subject to tax rules, the global minimum tax and measures to address the EU's concerns over foreign sourced income exclusions. Given the greater amounts of income falling within the tax net, consideration should be given to reducing the restrictions on interest deductibility.

d) Group relief or tax consolidation: The GloBE rules use jurisdictional blending on the assumption that related entities within the same jurisdiction are acting together. This offsetting of group assets and liabilities for GloBE purposes differs from the rigid entity-by-entity approach imposed by Hong Kong's domestic tax legislation. Introducing a provision in Hong Kong to allow related companies to offset profit and losses arising in different entities within the group would help to reduce the potential for misalignment between the two sets of rules. Such rules are common in many jurisdictions and can be achieved either by allowing a loss in one entity to be transferred to another profitable entity in the group or by filing a single tax return for the group of companies within Hong Kong. It is also important that any substance requirements applied either for treaty claims or for access to other incentives reflect the commercial reality that substance is maintained on a group rather than an entity-by-entity level.

e) Group restructurings: In order not to deter groups of companies from carrying out commercially driven group restructuring, gains arising from group restructuring may be excluded the ETR calculation provided that a tax deferral/ exemption is available under the domestic law. Currently, Hong Kong is lacking such a relief for restructurings and the gain will only be exempted to the extent it can be shown to be offshore sourced or capital in nature. To align with international tax practice, we recommend the government consider providing a similar local tax exemption/ deferral in Hong Kong.

f) Unrealized gains: Profits are only subject to Hong Kong profits tax once realized. The OECD has also accepted in the latest GloBE rules that an election may be made to ensure that unrealized gains do not form part of the ETR calculations until they are crystallised. The Chamber considers it important that any domestic minimum top up tax retains the principle that gains should not be taxed until realized.

Perhaps most radically, the need to do a domestic tax calculation at all under the GloBE rules could be questioned. By taxing large multinational enterprises directly based solely on GloBE principles, Hong Kong would be going a long way towards automatically achieving the lowest tax rate possible under the new rules. It would simplify compliance and potentially, by being a direct tax on profits rather than a top up tax, also address concerns about the application of the subject to tax rules. By focusing incentives on those adjustments allowed by the GloBE rules (substantial shareholdings,

depreciation allowances, research and development timing differences, etc.), Hong Kong could fully realign its taxation of large multinationals to remain attractive in the new era.

3. Administrative approach of the IRD

When discussing the attractiveness of Hong Kong as a place to do business, several of our members cited the approach of the tax authorities as an important factor. Concerns were raised that the IRD's administrative approach could sometimes run counter to the perception of attractiveness generated by Hong Kong's relatively simple and low-taxed regime.

Members provided examples where simple and advantageous tax rules were interpreted or administered against taxpayers, sometimes potentially beyond the technical requirements or policy intent of the rules.

We respectfully submit that shifting the IRD's administrative stance towards a slightly more business-friendly approach would enhance Hong Kong's attractiveness for foreign investment. This might entail setting a "tone at the top" for assessors to align with, and certain specific examples could be considered:

a) Tax residence certificates: The current process for obtaining a tax residence certificate imposes requirements well beyond demonstrating residence of an entity. Often these requirements extend further than those required under double tax treaties, and sometimes the requirements run counter to Hong Kong's legislated territorial system. For example, several members cited examples of assessors requiring proof that an entity derived Hong Kong sourced income before the entity could qualify for a tax residence certificate, thus conflating the concepts of residence and source. We appreciate that Hong Kong should not facilitate treaty shopping, but respectfully suggest that the administrative practice surrounding tax residence certificates extends beyond what is required and creates an adverse perception of the administration. In addition to using tax residence certificates for treaty entitlement purposes, some jurisdictions also request such certificates for local non-treaty requirements. We recommend revamping and simplifying the application and approval mechanisms for the issuance of tax residence certificates. Finally, we note that the treaty shopping concerns should be obviated in the future under Pillar two and a domestic minimum tax regime (for those entities within relevant groups), and the introduction of these rules may provide an ideal time to revisit the requirements for issuing tax residence certificates more broadly.

b) Literal versus purposive interpretations of the law: A perception exists that the administration sometimes adopts an overly literal interpretation of the law, which can sometimes run counter to the commonly understood intention of the Ordinance. For example, an issue has arisen for multinational groups conducting corporate reorganisations, with stamp duty costs potentially being imposed despite a legislated concession aimed at eliminating stamp duty for certain intra-group transfers. The administrative approach has

involved declining the stamp duty relief for groups that trace their common ownership through an entity such as an LLC, on the basis that the entity's ownership structure might not conform to the Hong Kong standard, notwithstanding that the entity's economic interests are 100% owned within the group.

c) Aggressive approach to offshore income claims: Under Hong Kong's territorial regime a fine line can arise between income that is sourced in Hong Kong versus income sourced outside Hong Kong. A wide-held perception is that the IRD has toughened its stance on "offshore claims" in recent years, with some multinationals questioning the plausibility of sustaining such a claim.

d) A focus on documentation that can sometimes overtake the underlying principles: A perception exists that the IRD requests far more extensive documentation in tax queries than many other peer jurisdictions. This requirement places a significant resource burden on multinationals. It is likely to further erode the perception of Hong Kong's attractiveness when combined with an occasional unwillingness of assessors to discuss the technical merits of a case without first obtaining all requested documents, even if such documents are merely ancillary to the issues at stake.

The Chamber very much appreciates the considerable effort of the Government on this matter. It would be our pleasure to discuss these issues in this letter in further details with you or your team.

Yours Sincerely,

Ivor Morris and Jesse Kavanagh

Co-Chairs of BEPS 2.0 Working Group

The British Chamber of Commerce in Hong Kong

Cc: Mr Stephen Lo Yip Kwong, Principal Assistant Secretary for Financial Services and the Treasury (R2)

info@britcham.com
+852 2824 2211
Room 1201, Emperor Group Centre,
288 Hennessy Road, Wan Chai,
Hong Kong
www.britcham.com