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# Inclusive Framework BEPS Agreement

**The Hong Kong SAR has launched a public consultation on BEPS 2.0 implementation**

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The Hong Kong SAR government published a consultation paper on the BEPS 2.0 implementation in the Hong Kong SAR (Hong Kong) on 21 December 2023. The consultation paper provides an overview of the GloBE Rules under Pillar 2 of BEPS 2.0, sets out the government's proposals on implementing the GloBE Rules and a domestic minimum top-up tax (DMTT) in Hong Kong, and seeks views on certain aspects of the government's proposals and other open issues. The consultation period lasts for three months till 20 March 2024.

## The GloBE Rules and DMTT

The OECD Inclusive Framework on BEPS (IF) published a statement on implementing a two-pillar solution under BEPS 2.0 in October 2021. The key elements under Pillar 2 are: (i) a global minimum tax of 15% on a jurisdictional basis governed by the GloBE Rules, i.e. the Income Inclusion Rule (IIR) and the Undertaxed Profits Rule (UTPR), (ii) the Subject-to-Tax Rule (STTR) and (iii) a DMTT that takes priority over the GloBE Rules for in-scope MNE groups[1].

Under the IIR, the priority taxing right of the low-taxed profits of a foreign subsidiary of an in-scope MNE group is allocated to the ultimate / intermediate parent jurisdictions. However, the subsidiary jurisdiction can preserve its primary taxing right of such low-taxed profits by introducing a DMTT in the jurisdiction as the DMTT will take priority over the IIR.

The interaction between the global minimum tax and DMTT will depend on whether (1) the DMTT is a qualified DMTT (QDMTT) and (2) the QDMTT qualifies for the QDMTT safe harbour[2]:

| Status of the DMTT | Interaction with the global minimum tax / GloBE Rules |
|---|---|
| 1. Not a QDMTT | • DMTT paid is treated as covered tax under the GloBE Rules |
| 2. A QDMTT | • QDMTT paid is credited against the top-up tax payable under the GloBE Rules |
| 3. A QDMTT qualifying for the QDMTT safe harbour | • Top-up taxes under the GloBE Rules in the QDMTT jurisdiction deemed as zero |

Although it is not mandatory for IF members to implement the global minimum tax or DMTT, it is expected that many jurisdictions will implement the IIR and/or DMTT in 2024 or 2025 to protect their taxing rights under Pillar 2. In Hong Kong, the government indicated in the 2023/24 Budget[3] that it plans to implement the global minimum tax and DMTT in Hong Kong from 2025 onwards.

[1] If Hong Kong is going to implement the GloBE Rules from 1 January 2025, the in-scope MNE groups (assuming with a calendar fiscal year end) for 2025 are those with consolidated annual revenue of EUR 750 million or more in at least two of the four years from 2021 to 2024.
[2] For more details about QDMTT and QDMTT safe harbour, please refer to our previous BEPS publication issued in July 2023 in this link.
[3] Please refer to paragraph 200 of the 2023/24 Budget Speech in this link.

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# The Consultation Paper

The government published a consultation paper on 21 December 2023 to gauge stakeholders' views on various issues relating to the implementation of the GloBE Rules and a DMTT in Hong Kong (HKMTT). The STTR under Pillar 2 is not within the scope of the consultation.

## Implementation of the GloBE Rules

There is generally no room for deviating from the internationally agreed GloBE Rules for domestic implementation in Hong Kong. As such, the consultation focused on the legislative approach and administrative framework rather than the technical aspect of the GloBE Rules. The key government proposals contained in the consultation paper include:

### 1. Effective fiscal year

To apply the IIR and UTPR (as well as the HKMTT) to accounting periods commencing **on or after 1 January 2025**.

***KPMG observations:*** *Some jurisdictions that are applying the IIR from 2024 have deferred the adoption of the UTPR for one year till 2025 (taking into consideration that many jurisdictions have not yet put in place the IIR in 2024). Since Hong Kong will only adopt the IIR from 2025, the government's plan is to implement both the IIR and the UTPR from 2025.*

### 2. Legislative approach

- A hybrid legislative approach – to directly incorporate the GloBE Model Rules into the Inland Revenue Ordinance (IRO) as far as practicable with limited adaptations.
- To apply the GloBE Rules in the way that best secures consistency with the OECD's Commentary and Administrative Guidance (AG) that are in force immediately before the enactment.
- Top-up tax charged under the GloBE Rules and the HKMTT will be treated as profits tax.
- Specific provisions may be added to deal with the interaction between the enacted GloBE Rules and the existing provisions of the IRO.

***KPMG observations:*** *One such specific provision may be to clarify that a Hong Kong entity can be subject to profits tax (in the form of top-up tax under the IIR or UTPR) going forward despite the three conditions under the basic charging section of profits tax (i.e. section 14 of the IRO) are not met (e.g. the relevant profits are not from a trade or business carried on in Hong Kong).*

### 3. Definition of Hong Kong resident entity

As there is not a general definition of "Hong Kong resident" in the IRO, a definition of "Hong Kong resident entity" will be introduced for the purposes of the GloBE Rules and HKMTT. In this regard, an entity incorporated / constituted in Hong Kong or an entity incorporated / constituted outside Hong Kong but normally managed or controlled in Hong Kong will be a Hong Kong resident entity. The above definition will apply retrospectively from **1 January 2024** given that some jurisdictions apply the IIR from 2024.

**Views are sought on the above proposed definition and its retrospective application from 1 January 2024.**

***KPMG observations:*** *The tax residency of an entity will affect the application of the GloBE Rules in various aspects (e.g. it determines the location of a constituent entity (CE) for the purposes of computing the jurisdictional blended ETR and ascertaining where top-up tax has to be paid).*

### 4. Open issues for domestic implementation

- To only apply the IIR to Hong Kong headquartered MNE groups that meet the consolidated revenue threshold.
- To adopt the Euro threshold instead of an equivalent Hong Kong dollar threshold for applying the GloBE Rules to avoid annual rebasing of the threshold to Euro.
- To charge the UTPR top-up tax in the form of an additional cash tax instead of a denial of a deduction without any carry-forward of UTPR top-up tax.
- To allocate the UTPR top-up tax among Hong Kong CEs based on their respective number of employees and value of tangible assets by default. This default allocation mechanism will be disapplied if an in-scope MNE group designates one or more Hong Kong CEs to pay the UTPR top-up tax.

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**Views are sought on the above proposed UTPR adjustment approach as well as the proposed UTPR top-up tax allocation and payment mechanism.**

***KPMG observations:***

- *In cases where a UTPR adjustment (in the form of a denied deduction or an equivalent adjustment) is insufficient to produce an additional cash tax expense equal to the UTPR top-up tax chargeable in the current year (e.g. when a Hong Kong CE is in a loss position or does not have sufficient deductions available for denial), the GloBE Rules Commentary suggests that the UTPR jurisdiction should consider imposing the adjustment in priority on other CEs that will result in an immediate additional cash tax expense in the current year. The Commentary also seems to suggest that a carry-forward of such UTPR top-up tax payable by means of a reduction of tax losses that are carried forward indefinitely (such that additional cash tax expenses will be incurred over time) is also acceptable.*

- *UTPR top-up tax allocated to the Hong Kong CEs under the above proposed allocation mechanism may be disproportionate to the profits derived by those CEs. For example, an investment holding company with limited number of employees and tangible assets may derive significant dividends and/or interest income whereas a group service company with lots of employees may only derive a cost-plus service fee from group companies.*

### 5. Other views sought

The consultation paper also **seeks views on whether there are any uncertainties in the (i) calculation of the effective tax rate, (ii) calculation of the GloBE top-up tax and (iii) operation of the transitional rules** that could be clarified in the Inland Revenue Department (IRD)'s administrative guidance.

## Design and implementation of the HKMTT

The OECD's July 2023 AG specified (i) two mandatory variations and a few permitted optional variations in the design of a QDMTT and (ii) three additional standards that must be met for a QDMTT to qualify for the QDMTT safe harbour[2]. Certain flexibilities are also allowed for the local administration of the DMTT in a jurisdiction. Below are the key government proposals on the design and administration of the HKMTT:

- The HKMTT will be so designed to enable it to qualify as a QDMTT and the QDMTT safe harbour.
- Both Hong Kong and foreign headquartered in-scope MNE groups will be subject to the HKMTT.
- The HKMTT will be imposed on the whole amount of the total top-up tax computed in respect of all Hong Kong CEs under the GloBE Rules, irrespective of the ownership interest held in the CEs by the parent entities.
- Joint ventures (JVs) and JV subsidiaries held by an in-scope MNE group will be subject to the HKMTT and the HKMTT attributable to such JVs and their JV subsidiaries will be directly imposed on the JVs and JV subsidiaries instead of being allocated to other Hong Kong CEs of the group.
- To require the use of the local financial accounting standard for computing the HKMTT when the specified conditions are met[4]. This means MNE groups will not be given an option to choose which accounting standard to use.
- To allocate the HKMTT payable among Hong Kong CEs based on the ratio of the GloBE income of the Hong Kong CE to the aggregate GloBE income of all Hong Kong CEs of the group by default. This default allocation mechanism will be disapplied if the group designates one or more Hong Kong CEs to pay the HKMTT.
- To allow an exclusion from the HKMTT for in-scope MNE groups that are in the initial phase of international activity[5] but limit its application to groups where no parent entity is required to apply a Qualified IIR with respect to Hong Kong CEs of the group.

**Views are sought on the above proposed scope and allocation mechanism of the HKMTT, the adoption of the local financial accounting standard rule and the QDMTT safe harbour, and whether the switch-off mechanism under the QDMTT safe harbour should be adopted.**

***KPMG observations:*** *The consultation paper does not discuss the option of only applying the HKMTT to in-scope MNE groups where all the CEs located in Hong Kong are 100% owned by the Ultimate Parent Entity (UPE) or a Partially-Owned Parent Entity for the entire fiscal year and not applying the HKMTT to JVs, JV subsidiaries and partially owned CEs. This is probably due to adopting such option will render the HKMTT not qualifying for the QDMTT safe harbour and cause a loss of tax revenue for Hong Kong.*

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[4] The two specified conditions are: (i) all CEs located in Hong Kong have financial accounts based on the local financial accounting standard and (ii) all of them are required to keep/use such accounts under the domestic corporate/tax law or such accounts are subject to an external financial audit.

[5] Please refer to Article 9.3 of the GloBE Rules that deals with a similar exclusion from the UTPR in the initial phase of international activity.

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## Adoption of other safe harbours

Other than the permanent QDMTT safe harbour, the consultation paper also discusses (i) the transitional Country-by-Country Report (CbCR) safe harbour, (ii) the transitional UTPR safe harbour (which is not applicable to Hong Kong) and (iii) the permanent Simplified calculation safe harbour. The government **seeks views on its proposal to adopt the CbCR safe harbour** and indicates that it will consider adopting the simplified calculation safe harbour after the OECD releases the AG on it.

## The tax compliance and administration framework

The consultation paper **seeks views on the below proposed tax compliance and administration framework**:

- An electronic platform will be developed for account registration, submission of notifications and returns and communications with the IRD. A service provider can be engaged to furnish a top-up tax notification or a top-up tax return through the platform.
- An in-scope MNE group:
  - will need to file an annual top-up tax notification on its obligation of filing top-up tax return within **six months** after the end of the fiscal year;
  - will need to file **a single top-up tax return** for the purposes of the GloBE Rules and HKMTT no later than **15 months** after the end of the fiscal year (extended to **18 months** in the first / transitional year); and
  - can designate one Hong Kong CE to be the Designated Local Entity for filing top-up tax notifications and top-up tax returns.
- The same "assessment first audit later" approach will be adopted for top-up tax.
- No provisional top-up tax will be charged.
- The top-up tax under the IIR will be charged on the UPE. For top-up tax under the UTPR or HKMTT, an in-scope MNE group can designate one or more Hong Kong CEs as the paying entities but in such case, all Hong Kong CEs will be jointly and severally liable for the whole amount of the top-up tax payable.
- Top-up tax payments made by a paying entity on behalf of other Hong Kong CEs will not be allowed as deductions for profits tax purpose whereas reimbursement of such tax payments received by the paying entity will not be treated as receipts for profits tax purpose.
- The existing administrative provisions in the IRO relating to anti-avoidance, objection and appeal, tax collection, record keeping and penalties (including penalties for service providers), etc. will apply.
- The existing approach of allowing a taxpayer to make representations before imposing an administrative penalty under section 82A will apply and the reasonable measures for complying with the GloBE Rules discussed by the OECD in respect of transitional penalty relief will be taken into account by the IRD in considering whether there is any reasonable excuse for non-compliance.

***KPMG observations:** The government's proposal of allowing an in-scope MNE group to designate one or more Hong Kong CEs to be the **paying entities** of the QDMTT / UTPR top-up tax allocated to different Hong Kong CEs is welcomed. However, clarifications on (i) whether such top-up tax will be regarded as the income tax of the paying entities or the other Hong Kong CEs to which the top-up tax is originally allocated and (ii) how this interacts with foreign tax credit (FTC) claim will be helpful – e.g. in situation where a Hong Kong CE derives offshore interest income that is tax exempt in Hong Kong under the foreign-sourced income exemption regime, has paid foreign withholding tax (WHT) on the interest income in the source state having a tax treaty with Hong Kong, and is allocated a top-up tax under the QDMTT (at least partly because of the tax-exempt interest income) but such top-up tax is paid by another Hong Kong CE on its behalf.*

## Mandatory e-filing of profits tax returns

The government also takes the opportunity of this BEPS 2.0 consultation to **seek views on its plan to launch the first phase of mandatory e-filing of profits tax returns.** The government proposes to require all Hong Kong CEs of MNE groups that are within the scope of Pillar 2 to e-file their profits tax returns for a year of assessment commencing on or after 1 April 2025 (i.e. from year of assessment 2025/26). This is on the basis that these groups will already need to file their CbCRs and top-up tax returns electronically.

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## The next step

Businesses in Hong Kong impacted by Pillar 2 should take the opportunity of the public consultation to express any views and/or concerns they may have on the implementation of the GloBE Rules and the HKMTT in Hong Kong. Other than the specific issues set out in the consultation paper, considerations should also be given to whether any further clarifications are required on the interpretation and application of any particular provisions of the GloBE Rules or comments set out in the OECD's AG to facilitate compliance by businesses.

As the next step, the government plans to develop the Pillar 2 legislative proposal for submission to the Legislative Council in the second half of 2024. In-scope businesses should closely monitor the Pillar 2 legislative status in Hong Kong as it may impact the accounting for Pillar 2 taxes in their financial accounts (e.g. the new pre-regime disclosure requirement) under Hong Kong Accounting Standard 12 on Income Taxes.

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