

Inclusive Framework BEPS Agreement

A glimpse into the maze: An overview of the draft Pillar 2 legislation in the Hong Kong SAR



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The HKSAR Government published in the Gazette the highly anticipated draft legislation for implementing the global minimum tax (GMT) and Hong Kong minimum top-up tax (HKMTT) in the Hong Kong SAR (Hong Kong) on 27 December 2024.

This publication provides an overview of the draft legislation, highlights the key modifications as compared to the OECD GloBE model rules and share our preliminary observations on the draft legislation.

Structure of the domestic Pillar 2 legislation

The detailed domestic Pillar 2 rules, as set out in the **Inland Revenue (Amendment) (Minimum Tax for Multinational Enterprise Groups) Bill 2024** (the Bill)¹, are organised in the following ways:

- **New Part 4AA on Minimum Tax for Multinational Enterprise Groups** is added to the Inland Revenue Ordinance (IRO) (i.e. a separate part after Part 4 on Profits Tax). Part 4AA consists of **new sections 26AD to 26AH** that cover (1) interpretation of various terms used in this part, (2) an enabling provision of the GloBE rules, (3) charging provisions for top-up tax under the Income Inclusion Rule (IIR), Undertaxed Profits Rule (UTPR) and HKMTT, (4) introduction of Schedules 60 to 63 to the IRO, (5) provisions on the OECD's Administrative Guidance (AG) on the GloBE model rules and (6) the **"main purposes test"**² (in section 26AH) as the general anti-avoidance rule (GAAR) for Pillar 2 purposes.
- **New Schedule 60 on "GloBE Rules"**, which consists of the following three parts:
 - Part 1 – The domestic version of the OECD GloBE model rules (referred to as "the GloBE rules" in the IRO).
 - Part 2 – A list of modifications (mainly related to the UTPR) to the GloBE rules in Part 1.
 - Part 3 – The provisions on the transitional Country-by-Country Reporting (CbCR) Safe Harbour (SH), transitional UTPR SH, permanent Qualified Domestic Minimum Top-up Tax (QDMTT) SH, and Simplified Calculations SH for non-material constituent entities (NMCEs).
- **New Schedule 61 on "HKMTT"**, which consists of the following three parts:
 - Part 1 – Preliminary, mainly interpretation of various terms and stating that the Schedule applies to in-scope MNE groups.
 - Part 2 – The additional provisions for charging the HKMTT on Hong Kong constituent entities (HK CEs).
 - Part 3 – The special rules under HKMTT that apply to standalone joint ventures (JVs) and members of JV groups.
- **New Schedule 62 on "Administration of Top-up Taxes"**, which contains (1) provisions on the HK CE's obligations to file top-up tax return and notice and provide information relevant to the determination of any top-up

¹ The Bill can be accessed via this [link](#) and the Legislative Council brief can be accessed via this [link](#).

² Under the test, if the main purpose, or one of the main purposes, of entering into any arrangements by a person is to avoid any obligations under Part 4AA, the arrangements would be disregarded for the purposes of Part 4AA (including Schedules 60 to 63).

tax liabilities and (2) modifications to various sections in the IRO for their application relating to administration of the top-up taxes.

- **New Schedule 63 on “OECD GloBE Rules Guidance”**, which consists of the following two parts:
 - Part 1 – a table listing out the reference documents issued by the OECD on the GloBE model rules up to the end of 2024 and their respective effective dates in Hong Kong – i.e. the Consolidated Commentary, Illustrative Examples and the four tranches of AG³, all of which will apply **to a fiscal year begins on or after 1 January 2025**.
 - Part 2 – a table that links the specific guidance in the OECD reference documents to the corresponding articles in the GloBE rules.
- **Other consequential changes to the IRO** include:
 - New section 2(9) - which defines an entity as **a tax resident in Hong Kong** if it is (1) incorporated in Hong Kong / constituted under the laws of Hong Kong or (2) incorporated or constituted outside Hong Kong but normally managed or controlled in Hong Kong. The definition applies from **1 January 2024**.
 - New section 16(2L) - which specifies that any IIR or UTPR top-up tax paid in a foreign jurisdiction is **not** tax deductible.
 - New section 50(11) - which specifies that any IIR or UTPR top-up tax payable in a foreign jurisdiction is **not** allowed as credit.
 - New section 25A – which specifies that reimbursement for UTPR top-up tax or HKMTT made by a CE to a designated paying entity within an MNE group must **not** be taken into account of either entity for the purposes of profits tax.
 - New sections 80O to 80R and amended sections 82 and 82A – which contain the penal provisions for various non-compliance/offences by Part 4AA entities⁴, service providers, directors of Part 4AA entities/service providers.
- **A change unrelated to Pillar 2** - The Bill also contains a correction to section 14IM of the IRO in relation to the concessionary tax regime for aircraft leasing – i.e. the aggregate amount of the other income and trading receipts arising in or derived from Hong Kong that are attributable to the lease income (i.e. E in the formula in section 14IM) should be added to (instead of subtracted from) the net payments of finance charges or interest in relation to a funding lease of an aircraft in determining the assessable profits for a year of assessment.

KPMG observations:

- *There are concerns about introducing the “main purposes test” as the GAAR for Pillar 2 purposes, particularly given that the threshold for triggering the rule under the main purposes test (i.e. one of the main purposes) is lower than that under the existing GAAR in section 61A (i.e. the sole or dominant purpose) and there is no grandfathering for pre-regime transactions.*
- *It is also noteworthy and controversial that proceedings in respect of Pillar 2 offences may be brought by the later of (1) the expiry of 2 years from the day on which the offence was discovered by the Commissioner and (2) the expiry of 6 years after the day on which the offence was committed.*

Key modifications to the OECD GloBE model rules

The GloBE rules in Part 1 of Schedule 60 largely mirror the OECD GloBE model rules, with the following key modifications (please note the below is not a complete list of modifications made):

³ The four tranches of AG are: (1) AG1 issued in February 2023, (2) AG2 issued in July 2023, (3) AG3 issued in December 2023 and (4) AG4 issued in June 2024.

⁴ Part 4AA entity means a HK constituent entity, a HK standalone JV or a HK member of a JV group, or a Part 4AA stateless entity of an MNE group.

1. Modifications listed in Part 2 of Schedule 60 – which mainly include (1) additional provisions necessary for implementing the UTPR in Hong Kong (e.g. allocating the UTPR top-up tax among HK CEs and specifying that UTPR adjustment will take the form of additional cash tax in the current year) and (2) consequential changes resulting from the omission of Article 8.1 (Filing obligations) of the GloBE model rules and replacing the article with the administrative provisions in Part 2 of Schedule 62.
2. Modifications embedded in the GloBE rules to reflect the guidance in the AG published, including modifications to:
 - define **investment-related entity** as **an investment entity or an insurance investment entity** and replace “investment entity” with “investment-related entity” in various articles, including Articles 5.1.3 (Determination of effective tax rate (ETR)), 5.5.4 (De minimis exclusion), 5.6.2 (Minority-owned CEs), 7.4 (ETR computation for investment-related entities) and 7.6 (Taxable distribution method election) *(as stated in AG1)*,
 - include “restricted tier one capital” (in addition to “additional tier one capital”) in Article 3.2.10 *(as stated in AG1)*,
 - include “marketable transferrable tax credits” (in addition to qualified refundable tax credits) in Articles 3.2.4 and 4.1.3 *(as stated in AG2)*, and
 - add “impairment losses” in Article 5.3.5 for determining the average carrying value of Eligible Tangible Assets for the purposes of the substance-based income exclusion (SBIE) *(as stated in AG2)*.
3. Modifications to address practical difficulties of applying the GloBE rules – e.g. the modified definitions of “Portfolio shareholding” and “Short-term portfolio shareholding” with the effect that:
 - in the case of Excluded dividends, the 10% threshold on Ownership interests for Portfolio Shareholding is determined with reference to the **vesting date** of the distribution, which is defined as **the earlier of the date of distribution and the date on which the CE becomes entitled to the distribution**, and
 - in the case of Excluded equity gain or loss, the 10% threshold on Ownership interests for Portfolio shareholding is tested at the end of the relevant fiscal year.
4. Other modifications – these include modifications to rationalise the GloBE model rules, modifications relating to optional provisions, minor textual changes for providing greater clarity and other miscellaneous changes, such as:
 - Article 5.1.3 – in addition to investment entities and insurance investment entities, minority-owned CEs in a jurisdiction are also excluded from the ETR computation of the other CEs in the jurisdiction as they are subject to a separate ETR computation.
 - Article 7.1.1(a)(ii) – to take into account covered taxes paid by “other entities that are part of the tax transparent structure” in addition to those paid by the Ultimate Parent Entity (UPE) that is a flow-through entity.
 - Article 9.3.5 – adopting the optional provisions in this article which means that if Hong Kong is the reference jurisdiction, (1) the UTPR exclusion does not apply during the initial phase of international activity of an MNE group, (2) the UTPR top-up tax calculated for low-taxed CEs in Hong Kong will be deemed as zero and (3) any UTPR top-up tax calculated for low-taxed CEs outside Hong Kong will be collected by Hong Kong.
 - Minor textual changes to Articles 3.2.5(b)&(c), 4.3.3, 4.5.4, 7.3.2, 7.3.7, etc. to provide greater clarity without substantive changes to their content.
 - Changes are also made to Article 4.4.2(a) (i.e. removing “Disallowed Accrual” from the article) and Articles 7.4.5 and 7.4.6 (i.e. removing the provisions that limit an MNE group’s pick-up on an investment-related entity’s top-up tax and SBIE amount to the amounts referable to the MNE group’s allocable share of the investment-related entity’s GloBE Income).
 - In addition, the following articles are omitted:

Articles	Subject matters	Reason for omission
2.4.2	Carry-forward of UTPR top-up tax to succeeding fiscal years	No carry-forward of UTPR top-up tax
8.1	Filing obligations	Replaced by Part 2 of Schedule 62

8.3	Administrative guidance	Replaced by section 26AF of the IRO
9.4	Transitional relief for filing obligations	Replaced by Part 2 of Schedule 62

KPMG observations: Some of the AGs have substantially changed the GloBE model rules, such as AG1 modifying Article 4.1.5 (i.e. Additional Current Top-up Tax for a jurisdiction in a fiscal year with a GloBE loss) and AG2 modifying Article 5.3.4 (i.e. SBIE amount for assets held for lease). However, no modifications are made in the GloBE rules to reflect these changes brought by the AGs. Instead, notes are added after these articles to refer to the relevant AG. Although section 26AD(2) in Part 4AA states that a note in Part 4AA or Schedules 60 to 63 is provided for information only and has no legislative effect, the four tranches of AG are incorporated in Schedule 63 as subsidiary legislation and therefore are part of the Pillar 2 law.

Transitional and permanent safe harbours

Hong Kong will provide the (1) CbCR SH, (2) UTPR SH, (3) QDMTT SH and (4) Simplified Calculations SH for NMCEs under its Pillar 2 regime. The provisions on these SHs are in line with the Consolidated Commentary and the relevant AG. For more details of these SHs, please refer to Annex A of the Consolidated Commentary issued by the OECD in April 2024.

In particular, the provisions on the CbCR SH have incorporated the guidance included in the Consolidated Commentary and AG3 relating to the qualified financial statements, qualified CbC report, treatment of purchase price accounting adjustments, the anti-avoidance rule on hybrid arbitrage arrangements (which applies to transactions entered into after **15 December 2022**) and the “once-out, always out” approach, etc.

KPMG observations:

- *The CbCR SH and Simplified Calculations SH for NMCEs are relevant to Hong Kong’s administration of both the IIR/UTPR and HKMTT whereas the QDMTT SH and UTPR SH are relevant to Hong Kong’s administration of the IIR/UTPR only.*
- *The Bill includes the following noteworthy provisions on the CbCR SH: (1) the revenue of a CE of an MNE group that is held for sale and that is not already included in the group’s total revenue for the jurisdiction reported in its qualified CbC report must be added back to the total revenue, (2) for a CE that is not included in an MNE group’s consolidated financial statements solely due to size or materiality grounds, the qualified financial statements means the financial accounts of the CE that are used for preparing the group’s CbC report, (3) for computing the SBIE amount for a jurisdiction under the routine profits test, the payroll costs and tangible assets of a CE may only be taken into account if the CE is recorded as a resident of that jurisdiction in the qualified CbC report and is located in that jurisdiction for the purposes of the GloBE rules, and (4) an investment-related entity and its CE-owner(s) of an MNE group would be regarded as being located in a jurisdiction where it is resident for the purposes of the MNE group’s qualified CbC report.*

Key features of the HKMTT

Below are some key features of the HKMTT specified in the Bill:

- HKMTT is intended to be a QDMTT that has QDMTT SH status (including transitional qualified status).
- The **Local Financial Accounting Standard (FAS) Rule** will be adopted – which means that the financial accounting net income or loss of a HK CE of an MNE group for HKMTT purposes **must** be determined based on the local accounting standard if all the three specified conditions⁵ are met. In this regard, local accounting standard means **the IFRS or HKFRS**.
- All CEs, standalone JVs, members of JV Groups and non-wholly owned CEs of an in-scope MNE group that are located in Hong Kong will be subject to the full amount of HKMTT regardless of the ownership interest of the parent entities in them.

⁵ The three conditions are: (i) each HK CE has financial accounts prepared based on the local accounting standard, (2) the accounting period of each HK CE’s financial accounts is the same as the fiscal year of the consolidated financial statements of the UPE of the MNE group and (3) each HK CE is required to prepare or use such financial accounts for determining its liability to tax in Hong Kong or to comply with any other law in Hong Kong or such financial accounts are subject to external financial audit.

- For a HK standalone JV or a HK member of a JV Group (i.e. a HK JV entity) of an MNE group, the HKMTT **may be charged on the HK JV entity directly or a HK CE of the group** at the election of the HK JV entity and with the consent of the HK CE. There is also **a relief for double taxation** in cases where an entity is (1) a HK JV entity of two MNE groups or (2) a HK JV entity of one MNE group and a HK CE of another MNE group, and that HKMTT is chargeable on the entity in respect of both MNE groups. In the former case, the HKMTT chargeable on the entity in respect of each of the MNE groups will be reduced by 50%.
- The HKMTT will also apply to stateless CEs of an MNE group that are created in Hong Kong or are a PE with a place of business in Hong Kong. These entities are subject to separate ETR and top-up tax calculations for HKMTT purposes.
- Adoption of the **two mandatory variations** specified in the commentary on QDMTT in the Consolidated Commentary – i.e. (1) no reallocation of covered taxes of a foreign Main Entity allocable to a Hong Kong permanent establishment (PE) to the Hong Kong PE and (2) Hong Kong currency must be used for HKMTT computation when the local accounting standard is required to be adopted under the Local FAS Rule and all HK CEs use Hong Kong currency as their functional currency, except where an MNE group makes a 5-year election⁶ to use the presentation currency of the consolidated financial statements of the UPE instead.
- The HKMTT does **not** apply to (1) **investment-related entities** (i.e. the Switch-off Rule will apply with respect to these entities) and (2) MNE groups in the initial phase of international activity if none of the HK CE(s) of the groups is held (directly or indirectly) by a parent entity subject to a qualified IIR (i.e. option two in the OECD's guidance on QDMTT SH which will not trigger the Switch-off Rule).
- If the HKMTT is applicable to a HK CE of an MNE group in a fiscal year earlier than the fiscal year in which the group first becomes subject to a qualified IIR or qualified UTPR of a foreign jurisdiction, the Transition Year for the HK CE for HKMTT purposes will be refreshed to align with that for the MNE group for GloBE rules purposes, and the tax attributes will be reset and the transitional rules in Articles 9.1.1 and 9.1.2 will be applied accordingly.

KPMG observations:

- *It should be noted that under the Local FAS Rule, no option is given to an MNE group to choose which accounting standard is to be used – i.e. an MNE group must use the HKFRS or IFRS if the specified conditions under the Local FAS Rule are met.*
- *The Bill does not exclude securitisation entities from the scope of the HKMTT (which is allowed under AG4).*

Tax compliance and administration

The Pillar 2 compliance requirements in the Bill have incorporated the government's proposed changes to the originally proposed tax administration framework based on the feedback received during the BEPS consultation⁷, with certain further modifications. The table below summarises the key compliance requirements and administration measures of the GloBE rules and HKMTT.

Key aspects of tax administration	Compliance requirements / Administrative measures
1. Filing of top-up tax notification	<ul style="list-style-type: none"> • Each HK CE to file an annual notification relating to the obligation of filing top-up tax return in a prescribed form and manner within six months after the end of the reporting fiscal year. • An MNE group can appoint a HK CE (i.e. designated local entity) to file the top-up tax notification so as to relieve all other HK CEs from their filing obligation. • The designated local entity will need to be appointed annually. It should either be the UPE or a CE in Hong Kong.
2. Filing of top-up tax return	<ul style="list-style-type: none"> • Each HK CE to file a single top-up tax return (containing a GloBE Information Return (GIR)) for the purposes of the GloBE rules and HKMTT in a prescribed manner and form no later than 15 months (18

⁶ The 5-year election can only be made if one or more HK CEs of the MNE group do not use Hong Kong currency as their functional currency.

⁷ For more details, please refer to our *Hong Kong BEPS Publication, November 2024* in this [link](#).

Key aspects of tax administration

Compliance requirements / Administrative measures

	<p>months for the Transition Year) after the end of the reporting fiscal year.</p> <ul style="list-style-type: none"> An MNE group can appoint a HK CE (i.e. designated local entity or designated filing entity) to file the top-up tax return so as to relieve all other HK CEs from their filing obligation. HK CEs will be relieved from the obligation to file the GIR if such return is filed in a foreign jurisdiction that will be able to exchange GIR information with Hong Kong under a qualifying competent authority agreement.
3. Assessment and payment of top-up tax	<ul style="list-style-type: none"> A notice of assessment (NOA) will be issued based on the information declared upon the filing of the top-up tax return. No provisional top-up tax will be charged. The payment due date will be (i) one month after the expiry of the top-up tax return filing deadline or (ii) the date of the NOA, whichever is the later.
4. Appointment of designated paying entity	<ul style="list-style-type: none"> An MNE group may, by an election in writing, appoint one or more HK CE as the designated paying entity for payment of HKMTT or UTPR top-up tax. The election is an annual election and is irrevocable. If a designated paying entity defaults in paying any HKMTT or UTPR top-up tax for a fiscal year (taxable year), all linked entities become jointly and severally liable for the total amount of the HKMTT or UTPR top-up tax that is not paid. A linked entity is an entity that (i) is a HK CE of the assessed group when the notice demanding for payment of the unpaid tax is issued by the Commissioner and (ii) was at any time in the taxable year a HK CE of the assessed group.
5. Objection period	<ul style="list-style-type: none"> Two months after the issuance date of the NOA.
6. Limitation period for raising additional assessments on top-up tax	<ul style="list-style-type: none"> Six years after (i) the end of the fiscal year or (ii) the time when the non-assessment or under-assessment has come to the assessor's knowledge⁸, whichever is the later.
7. Record keeping requirements	<ul style="list-style-type: none"> To retain sufficient records of transactions, acts or operations relevant to the computation of top-up tax liability for at least 12 years after the completion of such transactions, acts or operations.
8. Application of GAAR	<ul style="list-style-type: none"> Sections 61, 61A and 61B do not apply (as the "main purposes test" is introduced in section 26AH).
9. Penalty for non-compliance	<ul style="list-style-type: none"> Sections 80O to 80R are added and sections 82 and 82A are amended to provide for penal provisions for various non-compliance/offences by Part 4AA entities, service providers, directors of Part 4AA entities/service providers. These panel provisions are largely modelled on the existing panel provisions for late/incorrect filing of profits tax return and/or CbC report.

⁸ An example is a decrease in the adjusted covered tax amount in a foreign jurisdiction for a previous year due to a post-filing adjustment, triggering the need for re-calculating the top-up tax payable by the MNE group in that jurisdiction for that previous year.

Key aspects of tax administration

Compliance requirements / Administrative measures

10. A HK CE that is not a corporation or is a PE
- For a HK CE that is not a corporation (e.g. a partnership), the obligations on tax filing and payment of tax, etc. as well as certain panel provisions will apply to a person who acts for the HK CE or is responsible for the management of the HK CE, with certain modifications.
 - For a HK CE that is a PE of a Main Entity, the obligations on tax filing and payment of tax, etc. as well as certain panel provisions will apply to the Main Entity, with certain modifications.

KPMG observations:

- *Regarding filing of top-up tax return, there is a provision in the Bill that allows an assessor to require, by a notice in writing, any entity or PE (subject entity) that forms part of an MNE group to file a top-up tax return, regardless of whether the MNE group is an in-scope MNE group. When such notice is issued, the burden is on the subject entity to satisfy the assessor that such filing is not required (either because the MNE group is not in-scope or the top-up tax return has already been filed).*
- *Regarding the joint and several liability for top-up tax in default, the definition of “linked entity” above means that the following entities would not assume the joint and several liability of the unpaid top-up tax: (1) an entity that was a HK CE of the MNE group concerned in the taxable year but has left the group at the time the notice demanding for payment of the unpaid top-up tax is issued and (2) an entity that was not a HK CE of the MNE group concerned in the taxable year but is part of the group when the notice is issued.*
- *Similar to the proposed time limit for bringing proceedings in respect of Pillar 2 offences in section 80R, the proposed time limit for raising additional top-up tax assessments is controversial.*

The next step

The release of the draft Pillar 2 legislation represents a significant step towards the implementation of the GMT and HKMTT regimes in Hong Kong, making these regimes tangible and imminent for in-scope MNE groups operating in Hong Kong. The Bill will be introduced into the Legislative Council for scrutiny on 8 January 2025. In-scope MNE groups should take this opportunity to raise any concerns or submit any suggestions they may have on the Bill.

Given that both regimes will take effect in Hong Kong for **fiscal years beginning on or after 1 January 2025**, in-scope MNE groups should get themselves familiar with these complex and novel rules as soon as possible. They should also plan ahead for the additional disclosure required in the financial statements under IAS 12 and the additional compliance burden relating to Pillar 2 reporting obligations in the forthcoming years.

As the next step, we look forward to the timely issuance of IRD’s guidance on the interpretation and application of the GloBE rules on various common issues. These include, but not limited to, what are regarded as “ancillary income outside an MNE group’s ordinary activities”, treatment of mobile tangible assets and employees, the transitional rules for pre-regime deferred tax attributes and applicability of the transitional simplified jurisdictional reporting framework for the GloBE/HKMTT top-up tax return.

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