Hong Kong Tax Alert

4 November 2024
2024 Issue No. 15

Government refines its legislative approach to Pillar Two

In a recent paper submitted to the Legislative Council Panel on Financial Affairs (the Paper), the Government has summarized its responses to the views received on its earlier consultation paper on the implementation of the global minimum tax and the Hong Kong minimum top-up tax (HKMTT) in Hong Kong[1].

Having regard to the feedback received, the Government indicates that it will refine certain features of the legislation for the implementation of the global minimum tax (referred to below as "top-up tax") and the HKMTT, including the following:

(a) Implement the Income Inclusion Rule (IIR) and the HKMTT from 2025, while the Undertaxed Profits Rule (UTPR) will be implemented later subject to further studies, having regard to the implementation timelines of other jurisdictions. The legislation, to be enacted in 2025 with retrospective effect from 1 January 2025, will be contained in a separate part of the Inland Revenue Ordinance (IRO);

(b) Introduce a definition of "Hong Kong resident entity" into the IRO for general purposes, instead of the previous proposal that the definition be only applicable to the top-up tax and the HKMTT;

(c) Exclude investment entities and insurance investment entities from the scope of the HKMTT to preserve tax neutrality for these entities;

(d) Exclude the general anti-avoidance provisions contained in sections 61 and 61A of the IRO from being applicable to the top-up tax and the HKMTT. Instead, a main purpose test would be included as a general anti-avoidance provision in the top-up tax and the HKMTT legislation;

(e) Set the time limit for raising a tax assessment under the GloBE rules to be six years from the later of (i) the end of the fiscal year or (ii) the time when the non-assessment or under-assessment has come to the knowledge of the assessor; and

(f) Explore administrative arrangements for a "clean exit" where a constituent entity (CE) subject to the joint and several liabilities of the top-up tax under the UTPR and the HKMTT of a multinational enterprise (MNE) group leaves the group, i.e., after leaving the group, subject to the satisfaction of specified conditions, the CE could be released from the joint and several liabilities. Such administrative arrangements would undoubtedly facilitate MNE groups undertaking merger and acquisition transactions.

The Government also indicates that generally the respondents supported the implementation of the HKMTT that would qualify as a Qualified Domestic Minimum Top-up Tax (QDMTT) under the Global Anti-Base Erosion (GloBE) rules such that in-scope MNE groups may benefit from the QDMTT safe harbor. Where the QDMTT safe harbor is applicable, the top-up tax payable by these MNE groups under the GloBE rules in Hong Kong would be deemed to be zero.

For the full responses of the Government to the views received on major issues, Appendix B to the Paper is reproduced in full in the Appendix to this alert.

Clients who have any questions on how the refined legislative approach could impact their top-up tax and HKMTT planning can contact their tax executives.

[1] The outcome of the consultation can be retrieved from:
https://www.legco.gov.hk/yr2024/english/panels/fa/papers/facb1-1409-1-e.pdf

Commentary

We welcome the deferral of the timeline for implementing the UTPR in Hong Kong. This would help Hong Kong maintain its tax competitiveness vis-à-vis its competitors.

Equally welcome is the exclusion of investment entities and insurance investment entities from the scope of the HKMTT. This would ensure the status of Hong Kong as an international financial center would not be undermined.

The definition of "Hong Kong resident entity", presumably to be included in section 2 of the IRO, for the general purposes of the IRO would apparently not change the practical effect that the definition will only have application to the top-up tax and HKMTT for determining the location of a CE, without affecting the tax liabilities or other obligations of such defined entities under the existing provisions of the IRO.

Nevertheless, given that such a definitional approach is acceptable to the Organisation of Economic Co-operation and Development (OECD), hopefully the concern that other jurisdictions may still dispute the definition as invalid would only be academic.

The introduction of a "main purpose test" as a general anti-avoidance provision in the top-up tax and the HKMTT legislation may however still create uncertainty for MNE groups planning their financial affairs and transactions.

Indeed, the determination of the top-up tax is very much based on the exhaustive accounting-centric Model Rules promulgated by the OECD without a general anti-avoidance provision. As such, some jurisdictions possibly including some of our competitors may choose not to overlay their top-up tax and domestic minimum tax legislation with a general anti-avoidance provision.

To provide more tax certainty and maintain the tax competitiveness of Hong Kong, the Government may need to further consider the pros or cons of introducing the "main purpose test" provision in the proposed legislation.

Furthermore, the extension of the time limit for raising a tax assessment under the GloBE rules to six years after the under-assessment or non-assessment has come to the knowledge of the assessor seems to be too long or indefinite and would create undue tax uncertainty.

It appears that the time limit in such cases could be reduced to say six months after the under-assessment or non-assessment has come to the knowledge of the assessor, subject to the overall condition that in no case can the assessment be issued ten years after the fiscal year in question. The ten-year is the time limit for raising an assessment for tax evasion cases under the existing provision of the IRO.

Another point is that the Government proposes to designate the top-up tax and the HKMTT as part of the "profits tax" under the IRO. It is considered that such a designation would enable any dispute on the top-up tax and the HKMTT with other jurisdictions to be resolved under an applicable tax treaty.

However, given that the imposition of the top-up tax and the HKMTT was not envisaged when Hong Kong's existing tax treaties were concluded, it remains to be seen whether any such disputes could be resolved through the dispute mechanism of a tax treaty.

Appendix - Summary of the views on the major relevant issues received and the Government's responses

Item	Summary of the views	The Government's responses
(A) General		
1	The implementation of the UTPR should be deferred for at least one year. This approach aligns with the practice adopted by some jurisdictions, which have opted to postpone the implementation of the UTPR to a later date.	The suggestion is accepted. The UTPR will be implemented in Hong Kong on a date to be specified by the Secretary for Financial Services and the Treasury at a later stage. The Government will consider all relevant factors, including the position of in-scope MNE groups operating in Hong Kong after the implementation of the IIR and HKMTT, as well as the practice of other jurisdictions before deciding on the timeline for the implementation of the UTPR.
2	While most respondents supported incorporating the GloBE rules and the rules for implementing HKMTT (HKMTT rules) into the IRO, a few expressed concerns about treating them as profits tax and suggested that the GloBE rules and HKMTT rules should be legislated under a separate Ordinance as the GloBE and HKMTT regimes are significantly different from the existing profits tax.	Since the top-up tax payable under the GloBE rules or HKMTT regime is an income tax by nature, we maintain that it should be more appropriate to provide for such tax under the IRO, of which the purpose is to impose tax on, among others, earnings and profits. By treating the top-up tax as a profits tax, various existing tax administration mechanisms, such as tax collection, handling of objections and appeals, etc., could be applied to the top-up tax. In-scope MNE groups could also ride on the mechanisms under Hong Kong's comprehensive avoidance of double taxation agreements or arrangements (CDTAs) for resolving any cross-border disputes in relation to their top-up tax liabilities in Hong Kong and jurisdictions of the CDTAs concerned. Given the distinctive nature of the top-up tax, relevant rules will be added under a new Part of the IRO which is separate from the rules for normal profits tax under Part 4. We will also review all existing references to profits tax under the IRO to ensure that the relevant rules will have no application to the normal profits tax.
3	It is unclear whether defining the term "Hong Kong resident entity" only for the purposes of the GloBE rules and HKMTT rules with effect from 1 January 2024 would be acceptable to the OECD since the definition will not generally apply to the IRO and will take effect before the GloBE rules and HKMTT rules come into operation.	Having consulted the OECD, we will introduce a definition for "Hong Kong resident entity" for the general purposes of the IRO. This aligns with the approach commonly adopted by other jurisdictions in defining "tax resident" in their separate tax laws. The definition will take effect retrospectively from 1 January 2024, such that an entity that falls within the definition can be regarded as located in Hong Kong throughout the fiscal year 2024.
(B) Calculation of effective tax rate		
4	A qualified refundable tax credit (QRTC) regime should be introduced, or the existing tax incentives should be replaced with QRTCs as the existing tax incentives, which have the effect of reducing the ETR, may no longer provide benefits to in-scope MNE groups after the implementation of the GloBE rules and HKMTT.	Under the GloBE rules, a QRTC is a tax credit so designed that it must be refundable in cash or cash equivalents within four years from the year in which the constituent entity satisfies the conditions for receiving the credit. Given that a QRTC regime involves not only a reduction of tax payable but also a cash outlay, there will be major policy and financial implications to the Government. Due consideration should also be given to various factors, including the policy objective of introducing a QRTC regime for specific activities or industries, the scope of qualifying activities for QRTC purposes, cost of administration and the risk of abuse. The Government needs to carefully consider the feasibility of introducing a QRTC regime when implementing the global minimum tax and the HKMTT.

Item	Summary of the views	The Government's responses
(C) Design of the HKMTT		
5	To preserve tax neutrality for investment funds and their asset holding vehicles, investment entities and insurance investment entities should be excluded from the scope of the HKMTT.	Having regard to the practice adopted by other jurisdictions, we agree to exclude investment entities and insurance investment entities from the scope of HKMTT.
(D) Simplification and safe harbours		
6	Hong Kong should provide the transitional UTPR safe harbour as transitional relief to the UPE jurisdiction of a foreign-headquartered MNE group with corporate income tax rate of at least 20%.	We will include the transitional UTPR safe harbour in our legislation.
(E) Tax compliance and administration		
7	The top-up tax liability of a constituent entity under the joint and several liability should be limited to its allocable share of the top-up tax attributable to a partially-owned constituent entity.	Under the default allocation mechanism for top-up tax under the UTPR and the HKMTT, each constituent entity will only be liable for its share of top-up tax. Joint and several liability will only be applied when the MNE group chooses to dis-apply the default allocation mechanism and designate one or more than one constituent entities to pay the top-up tax, and that the designated paying entity does not pay the top-up tax payable. In such case, all Hong Kong constituent entities of the group will be jointly and severally liable for the whole amount of the top-up tax payable of the group. The group should internally coordinate the arrangement among its members. In any case, an in-scope MNE group is free to adopt the default allocation mechanism instead of appointing designated paying entity or entities if the group has concern on the potential joint and several liability.
8	A "clean exit" mechanism should be implemented for a constituent entity of an in-scope MNE group that intends to leave the group, where the group has elected to dis-apply the default allocation mechanism for top-up tax under the UTPR and the HKMTT.	We agree to explore administrative arrangements for allowing "clean exit" of constituent entities subject to the satisfaction of specified conditions.
9	The designation of one or more than one paying entity for the top-up tax under the UTPR and the HKMTT regimes should be allowed to be made on a year-by-year basis.	We agree to enable the annual election.
10	The payment due date of the top-up tax should be extended from two weeks to one month from the date of the notice of assessment.	We agree to extend the payment due date to one month after the expiry of the return filing deadline or the date of the notice of assessment, whichever is the later.
11	A constituent entity should be allowed to object to a top-up tax assessment within two months from the date of the notice of assessment.	We agree to extend the objection period to two months after the date of the notice of assessment.
12	A limitation period for raising assessments under the GloBE rules as distinct from the normal six-year time limit under section 60 of the IRO should be provided, having regard to the possible need for re-calculating an in-scope MNE group's top-up tax payable for a previous fiscal year, for example where there is a decrease in the group's adjusted covered taxes for the year concerned in a jurisdiction outside Hong Kong (cf. Article 4.6.1 of the GloBE rules).	We share the view that a different limitation period for raising assessments under the GloBE rules is justified for ensuring the consistent implementation of such rules. As IRD may not be timely informed of the adjustments initiated by other jurisdictions, we suggest the time limit for issuing a top-up tax assessment be set as six years from (a) the end of the fiscal year or (b) the time when the non-assessment or underassessment has come to the assessor's knowledge, whichever is the later.

Item	Summary of the views	The Government's responses
13	The general anti-avoidance provisions (i.e. sections 61 and 61A of the IRO) should not be applied to the GloBE and HKMTT regimes because they were not designed for the said regimes and, if Hong Kong introduces its own anti-avoidance provisions, transactions entered into prior to 1 January 2025 should be grandfathered.	We agree that sections 61 and 61A of the IRO should not apply in the context of the GloBE and HKMTT regimes. These provisions were specifically enacted to tackle tax avoidance within the current framework of the IRO. Given the global consensus approach of the GloBE rules and QDMTT, it appears more appropriate to address any avoidance arrangements in relation to top-up tax liability by way of specific provisions or guidance promulgated by the OECD. To maintain the integrity of the GloBE and HKMTT regimes, we will introduce the main purpose test as a general anti-avoidance rule for the regimes. As objective evaluation of all relevant facts and circumstances is required for the application of the main purpose test, a general grandfathering of all transactions entered into before the GloBE and HKMTT regimes come into operation may not be appropriate.
14	Clear penalty abatement rules should be provided for the initial transitional years and no penalty should be imposed in the situation of a good faith misunderstanding of the GloBE rules.	The existing penalty mechanism under the IRO calls for an evaluation of all relevant circumstances surrounding the taxpayer's wrongdoing to determine whether the required mental element of the offence concerned (e.g. without reasonable excuse) can be established. The IRD will adopt the same approach in formulating the penalty provisions in relation to the GloBE rules and HKMTT rules. The IRD will set out in its guidance that the factors mentioned in the OECD's guidance on transitional penalty relief will be taken into account when considering whether penal action is to be taken against a wrongdoing in relation to the GloBE rules or HKMTT rules.
15	The penalty imposed on service providers should be lowered/refrained from if they have no reasonable basis to doubt the information provided to it.	Currently, a service provider only commits an offence in relation to the filing of a tax return if the wrongdoing falls within the description under section 80K(2), (3) or (4) of the IRO and the maximum penalty would be a fine at level 3. We suggest adopting a similar approach for a service provider's wrongdoing in relation to the filing of top-up tax return or notification.
(F) Others		
16	Further administrative guidance (AG) issued by the OECD should be implemented through subsidiary legislation.	We will incorporate future additional AG into the IRO through subsidiary legislation.
17	The IRD should provide its own guidance on the implementation of the GloBE rules and HKMTT rules.	The IRD will publish its own guidance on the implementation issues that are of common interest to in-scope MNE groups on its website.

Hong Kong office

Jasmine Lee, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888   Fax: +852 2868 4432

Non-financial Services

Wilson Cheng
Tax Leader for Hong Kong and Macau
+852 2846 9066
wilson.cheng@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

Jacqueline Chow
+852 2629 3122
jacqueline.chow@hk.ey.com

Ryan Dhillon
+852 3752 4703
ryan.dhillon@hk.ey.com

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

Ada Ma
+852 2849 9391
ada.ma@hk.ey.com

Jennifer Kam
+852 2846 9755
jennifer.kam@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

Leo Wong
+852 2849 9165
leo.wong@hk.ey.com

Ricky Tam
+852 2629 3752
ricky.tam@hk.ey.com

Susan Kwong
+852 2629 3117
susan.tm.kwong@hk.ey.com

China Tax Services

Ivan Chan
+852 2629 3828
ivan.chan@hk.ey.com

Becky Lai
+852 2629 3188
becky.lai@hk.ey.com

Payroll Operate

Vincent Hu
+852 3752 4885
vincent-wh.hu@hk.ey.com

Accounting Compliance and Reporting

Linda Liu
+86 21 2228 2801
linda-sy.liu@cn.ey.com

Cecilia Feng
+852 2846 9735
cecilia.feng@hk.ey.com

International Tax and Transaction Services

International Tax Services

Winnie Kwan
+852 2629 3211
winnie.yw.kwan@ey.com

Transfer Pricing Services

Sangeeth Aiyappa
+852 2629 3989
sangeeth.aiyappa@hk.ey.com

Martin Richter
+852 2629 3938
martin.richter@hk.ey.com

Kenny Wei
+852 2629 3941
kenny.wei@hk.ey.com

Transaction Tax Services

Jane Hui
+852 2629 3836
jane.hui@hk.ey.com

Jasmine Tian
+852 2629 3738
jasmine.tian@ey.com

Emma Campbell
+852 2629 1714
emma.ef.campbell@ey.com

People Advisory Services

William Cheung
+852 2629 3025
william.cheung@hk.ey.com

Christina Li
+852 2629 3664
christina.li@hk.ey.com

Emily Chan
+852 2629 3250
emily-my.chan@hk.ey.com

Winnie Walker
+852 2629 3693
winnie.walker@hk.ey.com

Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

Ming Lam
+852 2849 9265
ming.lam@hk.ey.com

Sunny Liu
+852 2846 9883
sunny.liu@hk.ey.com

Helen Mok
+852 2849 9279
helen.mok@hk.ey.com

Customer Tax Operations and Reporting Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

Francis Tang
+852 2629 3618
francis-ks.tang@hk.ey.com

US Tax Services

Camelia Ho
+852 2849 9150
camelia.ho@hk.ey.com

International Tax and Transaction Services

International Tax Services

Sophie Lindsay
+852 3189 4589
sophie.lindsay@hk.ey.com

Stuart Cioccarelli
+852 2675 2896
stuart.cioccarelli@hk.ey.com

Maggie Mang
+852 3471 2759
maggie.mang@hk.ey.com

Transfer Pricing Services

Ka Lok Chu
+852 2629 3044
kalok.chu@hk.ey.com

Justin Kyte
+852 2629 3880
justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

Tax Technology and Transformation Services

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

Asia-Pacific Tax Center

Tax Technology and Transformation Services

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton
+852 3471 2783
jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
+852 9736 3038
edvard.rinck@hk.ey.com

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