

Implementation of Global Minimum Tax and Hong Kong Minimum Top-Up Tax

Patrick Chu/ Jeffrey Lau

The Organisation for Economic Co-operation and Development (“**OECD**”) announced in July 2021 the international tax reform framework to combat the base erosion and profit shifting (“**BEPS**”) risks arising from digitalization of economy (commonly known as “**BEPS 2.0**”). Hong Kong, together with 130 other territories, has committed to implement the global minimum tax in accordance with Pillar two of the BEPS 2.0 framework.

Following a 3-month consultation exercise concluded in March 2024, the Hong Kong Government gazetted the draft legislation, *the Inland Revenue (Amendment) (Minimum Tax for Multinational Enterprise Groups) Bill 2024* (“**the Bill**”) on 27 December 2024 to implement global minimum tax and a related Hong Kong minimum top-up tax in 2025.

Overview

Global minimum tax ensures that large multinational enterprise (“**MNE**”) groups pay a minimum tax of at least 15 per cent in every jurisdiction in which they operate, thereby reducing the incentive for large MNE groups to shift profits to low or no-tax jurisdictions to reduce tax. In this regard, in-scope MNE groups would need to calculate their effective tax rate (“**ETR**”) for each jurisdiction where they operate. If the ETR of a jurisdiction is below 15 per cent, they pay the top-up tax effectively for the difference between their ETR in that jurisdiction and the 15% minimum rate on certain deemed “excess profits”.

Top-up tax is collected on a priority basis by the low-tax jurisdiction itself that has implemented the Qualified Domestic Minimum Top-up Tax (“**QDMTT**”), or where no QDMTT applies, then by another implementing jurisdiction through the imposition of either:-

- (a) The Income Inclusion Rule (“**IIR**”) which imposes top-up tax on the ultimate parent entity (“**UPE**”) in respect of its low-taxed group entities, in proportion to the ownership interests of the UPE held in those low-taxed entities; or
- (b) The Undertaxed Profits Rule (“**UTPR**”) which serves as a backdrop to IIR to ensure that the residual top-up tax not brought into charge under IIR are collected.

The IIR and UTPR are together referred to as the Global Anti-Base Erosion (“**GloBE**”) rules.

Now, for tomorrow

Implementation in Hong Kong

The Bill seeks to incorporate the detailed terms of the model rules of the GloBE rules promulgated by the OECD into the Inland Revenue Ordinance with limited and necessary adaptations, as well as to introduce Hong Kong minimum top-up tax ("**HKMTT**") which is intended to qualify as a QDMTT.

In-scope MNE groups

GloBE rules and HKMTT are applied to MNE groups with annual consolidated revenue of EUR750 million or above in at least two of the four fiscal years immediately preceding the current fiscal year ("**in-scope MNE groups**").

Charging mechanism of top-up tax

A top-up tax is charged under one of the rules below:

The HKMTT

- The HKMTT imposes top-up tax on low-taxed Hong Kong constituent entities of an in-scope MNE group located or operating in Hong Kong.
- The HKMTT is designed to qualify as a QDMTT so that the top-up tax paid under the HKMTT is creditable against the top-up tax imposed under IIR or UTPR on the low-taxed Hong Kong constituent entities in other jurisdictions (i.e. those which are taxed at an ETR below 15%). This credit mechanism ensures that top-up tax under HKMTT is imposed in priority over the IIR and UTPR, allowing Hong Kong to preserve its taxing right over low-taxed profits derived in Hong Kong.
- Investment entities and insurance investment entities are excluded from the scope of HKMTT to preserve their tax neutrality.
- The HKMTT will apply to a fiscal year beginning on or after 1 January 2025.

IIR

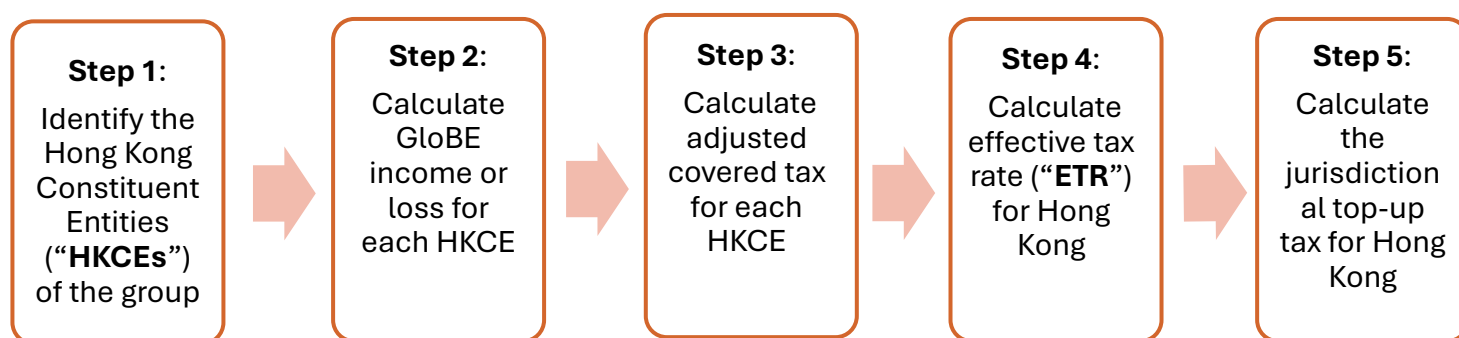
- The IIR imposes top-up tax on the Hong Kong UPEs of in-scope MNE groups headquartered in Hong Kong.
- These Hong Kong UPEs are charged top-up tax in respect of the group entities located in jurisdictions outside Hong Kong that are low-taxed. The top-up tax charged will be based on the ownership interests held by the UPE in those low-taxed entities located outside Hong Kong.
- The IIR will apply in Hong Kong to a fiscal year beginning on or after 1 January 2025.

UTPR

- The UTPR rule is a backdrop to IIR which ensures that the residual top-up tax not brought into charge under IIR will be collected (such as in the case where the group entities are owned by minority interests). In this regard, the residual top-up tax is allocated to other jurisdictions where the group has presence, in proportion to the value of tangible assets and the number of employees in each UTPR jurisdiction.
- Please note that implementation of UTPR in Hong Kong will be deferred to a date to be specified by the government at a later stage.

Calculation of top-up tax under the HKMTT

Top-up tax is calculated on a jurisdictional basis. The following steps are to be taken to calculate the top-up tax payable by an in-scope MNE group in respect of their group entities in Hong Kong:



Step 1 - Identify the HKCEs of the group

HKCEs are Hong Kong tax resident entities of an in-scope MNE group (including permanent establishments) whose financial results are included in the consolidated accounts of the UPE on a line-by-line basis. However, the following types of entities are excluded:

- (a) a governmental entity;
- (b) an international organization;
- (c) a non-profit organization;
- (d) a pension fund;
- (e) an investment fund that is a UPE; and
- (f) a real estate investment vehicle that is a UPE.

A definition of "Hong Kong tax resident entity" is introduced to the Inland Revenue Ordinance by the Bill for general purposes as follows:

- where an entity is a company – the entity is incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong; or
- in any other case – the entity is constituted under the laws of Hong Kong or, if otherwise constituted, normally managed or controlled in Hong Kong.

Calculation of top-up tax under the HKMTT (Continued)

Step 2 - Calculate GloBE income or loss for each HKCE

The GloBE income or loss of each HKCE is determined by making certain adjustments to accounting profit or loss recorded on financial accounts. These adjustments include:

- adding back tax expenses accrued
- removing dividends where the MNE group holds 10% or more of ownership interests in the issuer; or the CE has held full economic ownership of the ownership interest for a period of 12 months or more
- removing gains or losses from fair value changes of an ownership interest
- including adjustments to deal with foreign exchange gains or losses that arise due to differences between the functional currency for accounting and tax purposes;
- removing gains or losses arising from a sale of ownership interest in any entity where the MNE group holds 10% or more of ownership interest at the time of transfer
- removing deductions for illegal payments, fines and penalties greater or equal to EUR50,000.

Step 3 - Calculate adjusted covered tax

The adjusted covered tax for each HKCE is determined by making certain adjustments to the current tax expense recorded on its financial accounts. These adjustments include, for example, excluding taxes that are not related to the GloBE income or loss, and adding back any accrued tax liability that was reported as an ordinary expense instead of income tax expense in the financial account.

Step 4 - Calculate ETR for Hong Kong

ETR is calculated on a jurisdictional basis and is equal to the sum of the adjusted covered taxes of each HKCE (step 3 above refers) for the fiscal year divided by the net GloBE income i.e. sum of GloBE income or loss of all HKCE (step 2 above refers) as follows:

$$ETR = \frac{\text{Aggregated Adjusted Covered Tax of all HKCE}}{\text{Net GloBE income of all HKCE}}$$

Calculation of top-up tax (Continued)

Step 5 - Calculate the jurisdictional top-up tax for Hong Kong

The top-up tax payable is calculated by multiplying the top-up tax percentage by the excess profit:

$$\text{Top-up tax} = \text{Top-up tax percentage} \times \text{Excess profit}$$

The top-up tax percentage is calculated by subtracting the jurisdictional ETR (see step 4 above) from the 15% minimum rate.

Excess profit is calculated by subtracting net GloBE income by Substance Based Income Exclusion (“**SBIE**”) amount.

$$\text{Excess profit} = \text{Net GloBE income} - \text{SBIE amount}$$

The SBIE amount is the sum of the following for each HKCE:

- 5%* of eligible payroll costs of eligible employees who perform activities for the MNE group.
- 5%* of the carrying value of eligible tangible assets.
(Certain assets are however specifically excluded from SBIE calculation, including property held for investment, sale or lease)

*The percentages used in the SBIE are higher during a transition period. The percentages start at 10% for payroll and 8% for tangible assets, reducing to the normal rates of 5% over the 10-year transition period.

Payment of top-up tax

The top-up tax is allocated among and charged as HKMTT to each HKCE in proportion to each entity’s GloBE income. The group may designate one or more than one HKCE to pay the HKMTT for the group.

The HKMTT paid will be creditable against top-up tax imposed under IIR or UTPR in another jurisdiction (if any) in respect of the HKCEs.

Safe Harbours

The Bill introduces all the safe harbours developed by the OECD to relieve in-scope MNE groups from performing full GloBE calculations when certain conditions are met. These are summarized below:

Safe harbors	Salient points
<p><i>Transitional country-by-country reporting (“CbCR”) safe harbor</i></p>	<ul style="list-style-type: none">• The top-up tax of an in-scope MNE groups in a particular jurisdiction will be deemed to be zero if the group can satisfy one of the following tests for a fiscal year computed using data from the group’s qualified CbCR:<ul style="list-style-type: none">(i) De minimis test - The group reports total revenue of less than EUR 10 million and profit (loss) before income tax of less than EUR 1 million in such jurisdiction for the fiscal year; or(ii) Simplified ETR test - The group has a simplified ETR that is equal to or greater than the transition rate in such jurisdiction for the fiscal year. The transition rate is 16% for a fiscal year beginning in 2025 and 17% for a fiscal year beginning in 2026; or(iii) Routine profit test - The group’s profit (loss) before income tax in such jurisdiction is equal to or less than the SBIE amount.• This transitional CbCR safe harbor only applies to a fiscal year during the transition period. The transition period means all of the fiscal years beginning on or before 31 December 2026 and ending on or before 30 June 2028.• The above tests are computed using data from a qualified CbCR i.e. a CbCR complied with data drawn from the group consolidated statement or from the individual entity accounts, provided they are prepared using an acceptable financial standards.• If an in-scope MNE group qualifies for transitional safe-harbor in a fiscal year but has <u>not</u> applied the transitional CbCR safe harbor for that fiscal year, the group cannot qualify for the safe harbor in respect of that jurisdiction for a subsequent fiscal year. In other words, this safe harbor adopts a “once out, always out” approach.

Safe Harbours (Continued)

Safe harbors	Salient points
Transitional UTPR safe harbor	<ul style="list-style-type: none"> • The UTPR top-up tax for the jurisdiction of the UPE will be deemed to be zero if the nominal corporate income tax rate of the jurisdiction is at least 20%. • This transitional UTPR safe harbor only applies to a fiscal year during the transition period that begins on or before 31 December 2025 and ends on or before 31 December 2026.
QDMTT safe harbor	<ul style="list-style-type: none"> • This is applicable when charging top-up tax to constituent entities of group companies in a jurisdiction outside Hong Kong under IIR or UTPR. • Where that jurisdiction outside Hong Kong has introduced a QDMTT, and that QDMTT meets additional requirements on top of those required to become “qualified” as QDMTT, any foreign top-up tax is deemed to be zero in that jurisdiction. Hence, no top-up tax calculation will be required in Hong Kong for the MNE group in respect of that jurisdiction.
Simplified calculations safe harbor for non-material constituent entities (“NMCEs”)	<ul style="list-style-type: none"> • This safe harbor applies to charging of top-up tax in jurisdictions outside Hong Kong where NMCEs are located. • NMCEs are entities that are not consolidated in the UPE’s consolidated financial statements solely on size or materiality grounds but are still considered a “constituent entity” for GloBE rule purposes. • Under this safe harbor, top-up tax for the jurisdiction in respect of the NMCEs there will be deemed to be zero if one of the following tests is met calculated using information on a qualified CbCR: <ul style="list-style-type: none"> (i) De minimis test - The group reports total revenue of less than EUR 10 million and profit (loss) before income tax of less than EUR 1 million in such jurisdiction for the fiscal year; or (ii) Simplified ETR test – the ETR in that jurisdiction is at least 15%; or (iii) Routine profit test – the GloBE profit does not exceed the SBIE in that jurisdiction.

Tax compliance and administration

HKCEs of in-scope MNE groups will be subject to the below compliance requirements in Hong Kong:

	Main information to report	Entity responsible	Due date	Penalty for non-compliance
Filing of top-up tax return	<ul style="list-style-type: none"> Information required in the standardized GloBE Information Return (“GIR”) developed by OECD. HKCEs of an in-scope MNE group will be relieved from the obligation to file the GIR information if such information is filed in a jurisdiction that will be able to exchange GIR information with Hong Kong under a qualifying competent authority agreement 	<ul style="list-style-type: none"> Each HKCE; or One designated entity to file for the group such that other HKCE are relieved of the obligation to file. 	<ul style="list-style-type: none"> Within 15 months after the last day of the reporting fiscal year. Extended to 18 months for the first year that the MNE group is subject to (i) the GloBE rules in Hong Kong or other jurisdictions; or (ii) the HKMTT. 	<ul style="list-style-type: none"> A fine of HKD10,000 and a further fine of treble the top-up tax undercharged. Officers and directors of the corporation may also be liable on conviction to the penalties.
Filing of top-up tax notification	<ul style="list-style-type: none"> Notifying the Inland Revenue Department (“IRD”) that an MNE group has come within scope of the global minimum tax and HKMTT. The entity and jurisdiction from which Hong Kong will receive the GIR, if any. 	<ul style="list-style-type: none"> Each HKCE; or One designated entity to file for the group such that other HKCE are relieved of the obligation to file. 	<ul style="list-style-type: none"> Within 6 months after the last day of the reporting year. 	<ul style="list-style-type: none"> Same as that for top-up tax return

Tax compliance and administration (Continued)

	Main information to report	Entity responsible	Due date	Penalty for non-compliance
Payment of top-up tax	<ul style="list-style-type: none">N/A	<ul style="list-style-type: none">HKMTT top-up tax and UTPR top-up tax are by default allocated among the HKCEs, and each HKCE will be liable for its share of the top-up tax.However, a group is allowed to designate one or more HKCEs to pay HKMTT top-up tax or UTPR top-up tax. However, if the designated HKCE does not pay the top-up tax, the HKCEs will be jointly and severally liable for the whole amount of top-up tax.IIR top-up tax is payable by the parent entity.	<ul style="list-style-type: none">Within one month after the expiry of the return filing deadline or the date of notice of assessment, whichever is later.	<ul style="list-style-type: none">Existing provisions on tax in default under the Inland Revenue Ordinance will apply.

Forward Planning

The GloBE rules and HKMTT are complex new rules which will no doubt pose significant challenges to taxpayers from a compliance perspective. Large MNE groups should immediately assess the impact of the upcoming implementation of GloBE rules and HKMTT, and whether they may qualify for any of the safe harbors. They should also review whether their current accounting systems and processes are capable of generating required data for top-up return filing.

If you would like to have more information regarding the matter, please contact:

Patrick Chu
Principal of Tax and Transfer Pricing Leader
+852 2152 2712
patrickchu@bakertilly.hk

Jeffrey Lau
Senior Manager- Tax and Transfer Pricing
+852 2152 2636
jeffreylau@bakertilly.hk