

Hong Kong Tax Alert

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EU concluded that Hong Kong's offshore income exemption regime as regards passive income is harmful

To avoid getting blacklisted, the HKSAR Government has committed to amend or impose additional conditions by the end of 2022 before such passive income could be claimed as being offshore sourced in Hong Kong

Background

In October 2019, the European Union (EU), via its Code of Conduct Group (COCG), published a "Guidance on foreign source income exemption regimes" (the Guidance). The Guidance sets out the guidelines to assess whether a particular foreign sourced income exemption regime (FSIE regime) is harmful¹.

The Guidance acknowledges that FSIE regimes, or regimes that charge corporate tax on a territorial basis are not in themselves problematic. However, problems arise when such regimes not only prevent double taxation, but also create situations of double-non taxation. Specifically, the EU is concerned about FSIE regimes that:

- ▶ exclude foreign source passive income (e.g. dividends, interest and royalties) from taxation without any conditions or safeguards, as this can result in ring-fencing and a lack of economic substance (e.g. a non-resident setting up shell companies in other jurisdictions to receive the relevant income so as to achieve double non-taxation);
- ▶ exclude foreign source active income from taxation that do not align with the international tax principles (e.g., adopting a definition of Permanent Establishment not in line with the Organisation for Economic Cooperation and Development's (OECD) Model Tax Convention).

As Hong Kong operates a territorial system of taxation which does not generally impose tax on offshore profits, the EU, upon publishing the Guidance, also selected Hong Kong's FSIE regime for review and assessment.

1. <https://data.consilium.europa.eu/doc/document/ST-13075-2019-INIT/en/pdf>

EU's FSIE assessment on Hong Kong

The EU recently completed its review and concluded that the FSIE regime of Hong Kong is harmful insofar as foreign source passive income is concerned. Specifically, the EU is concerned that corporates with no substantial economic activity in Hong Kong are not subject to tax in respect of certain offshore passive income (such as interest and royalties), hence leading to circumstances of double non-taxation.

Apparently, as Hong Kong has since July 2018 already adopted in its domestic tax legislation the definitions of Permanent Establishment contained in the latest 2017 OECD Model Tax Convention, its territorial source regime in respect of active income (e.g., trading and service income) passed the EU's FSIE assessment on Hong Kong.

The EU's FSIE assessment is part of an on-going effort of the EU to identify and list jurisdiction(s) that pose challenges to the tax bases of EU member states. The EU list of non-cooperative jurisdictions for tax purposes, first published in 2017, comprised of two annexes: Annex I (the so-called "blacklist") and Annex II (the so-called "gray list").

A jurisdiction which has been assessed by the EU as having a harmful tax regime would be invited to make a commitment to either abolish or amend that regime before a prescribed deadline. A jurisdiction that has made sufficient commitments to reform its tax policies would be placed on the gray list until it has executed all of its commitments. On the other hand, a jurisdiction that has not made sufficient commitments in response to the EU's concerns or fails to meet the EU's criteria by the required deadline would be placed on the blacklist.

HKSAR Government's response to the EU's FSIE assessment on Hong Kong²

In its response to the EU's FSIE assessment on Hong Kong, the HKSAR Government stresses that Hong Kong will continue to adopt the territorial source principle of taxation in respect of both passive and active income. As such, the current thinking is that Hong Kong would not abolish its territorial source regime.

Instead, to avoid being blacklisted which may result in punitive measures being imposed on Hong Kong businesses by EU member states³, Hong Kong has committed to amend or impose additional conditions, in line with the Guidance, by the end of 2022 before the relevant passive income could be claimed as being offshore sourced in Hong Kong.

As a result of this commitment, Hong Kong is now being listed on Annex II of the EU council conclusions endorsed on 5 October 2021⁴.

While the Guidance permits jurisdictions with FSIE regimes that are considered harmful to continue excluding certain types of passive income from taxation, they need to impose one or more of the following additional safeguard measures:

- I. implement adequate substance requirements for the entities concerned in line with EU standards;
- II. have robust anti-abuse rules in place;
- III. remove any administrative discretion in determining the income to be excluded from taxation.

It appears that the HKSAR Government may wish to adopt safeguard measure (i) above as it indicates that the proposed legislative amendments will merely target corporations with no substantial economic activity in Hong Kong, and make use of passive income to evade tax across a border.

The HKSAR Government further states that it will consult the stakeholders on the specific contents of the legislative amendments and strive to minimize the compliance burden of corporates.

Implications for Hong Kong

Unlike the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) 2.0 which will only affect large in-scope multinational enterprises, the impending changes as a result of the EU's FSIE assessment on Hong Kong will affect all taxpayers in Hong Kong, regardless of their industries and sizes.

While the Guidance has already prescribed the options that Hong Kong could adopt to remedy the features considered harmful by the EU, implementing any of these options with such a tight deadline is a challenge for both the HKSAR Government and taxpayers.

It is to be hoped that the HKSAR Government will set out the pros and cons of the available options and gauge the views of the stakeholders concerned before finalizing its response to the EU's FSIE assessment on Hong Kong.

Taxpayers should closely monitor the development in this regard and assess how the changes would impact their current operations or tax strategies. Professional tax advice should be sought where necessary.

2. <https://www.ird.gov.hk/eng/ppr/archives/21100501.htm>

3. While EU member states have broad discretion on the type and scope of defensive measures they apply in the tax area depending on their national tax systems, there is a certain degree of coordination. In December 2019, the EU issued "Guidance on the coordination of defensive measures" inviting all EU member states to adopt at least one of the four specific legislative measures against jurisdictions on the blacklist:

- ▶ non-deductibility of costs incurred in a listed jurisdiction;
- ▶ controlled foreign company rules, to limit artificial deferral of tax to offshore, low-taxed entities;
- ▶ withholding tax measures, to tackle improper exemptions or refunds; or
- ▶ limitation of the participation exemption on shareholder dividends.

4. <https://www.consilium.europa.eu/media/52208/st12519-en21.pdf>

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