Hong Kong commits to amend its tax system by 2022 as EU puts it on 'greylist' for not taxing foreign source income

October 5, 2021
Issue 9

In brief

The Council of the European Union (EU) added various jurisdictions, including Hong Kong, to *Annex II to the Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes*, commonly known as the 'greylist', with effect from October 5, 2021, following a review of their foreign source income exemption regimes. These jurisdictions have until December 31, 2022 to make necessary changes to their legislation in order to avoid being moved to the blacklist.

It is understood that the HKSAR government has been working closely with the EU to understand and address their concerns about Hong Kong's territorial basis of taxation. The government sent a letter to the Code of Conduct Group (COCG) on June 24, 2021 committing to amend Hong Kong's tax system by December 31, 2022 with the amended system taking effect on January 1, 2023 with no grandfathering arrangement.

In detail

The Council of the EU started releasing its list of non-cooperative jurisdictions for tax purposes in December 2017 as part of its initiative to improve international tax governance. The list, which is updated twice a year from 2020, is a tool to tackle tax fraud or evasion, tax avoidance and money laundering. The list of non-cooperative jurisdictions for tax purposes (i.e. Annex I to the Council conclusions), commonly known as the 'blacklist', sets out non-EU jurisdictions that encourage abusive tax practices, which erode EU member states' corporate tax revenues. Annex II to the Council conclusions, entitled 'State of play of the cooperation with the EU with respect to commitments taken by cooperative jurisdictions to implement tax good governance principles', and commonly known as the 'greylist' or 'watchlist', contains jurisdictions that do not yet comply with all international tax standards but have committed to reform by an agreed timeline. Once a jurisdiction meets all its commitments, it is removed from the greylist; otherwise, it will be moved to the blacklist (the consequences of which are various sanctions by EU member states, including for instance higher withholding taxes on payments to blacklisted jurisdictions).

On October 5, 2021, the Council of the EU updated Annex I and Annex II as follows[1]:

Annex I (Blacklist)
Jurisdictions removed (and moved to Annex II): Anguilla, Dominica and Seychelles

Annex II (Greylist)
Jurisdictions added (apart from the three moved from Annex I): Costa Rica, Hong Kong, Malaysia, North Macedonia, Qatar and Uruguay
Jurisdictions removed: Australia, Eswatini and Maldives

The updates to the Annexes were in part prompted by the review of foreign source income exemption regimes by the COCG, invited by the EU Economic and Financial Affairs Council (ECOFIN), which commenced in December 2019. 13 jurisdictions[2], including amongst others Hong Kong, Malaysia and Singapore, were identified as having foreign source income exemption regimes with harmful features. While the COCG does not view a territorial tax regime as necessarily problematic, it considers that problems arise when such regimes create situations of double non-taxation.

Based on the guidance agreed by the COCG on the approach to assess foreign source income exemption regimes, passive foreign source income (which is intended to be the primary focus of the review) that is fully exempt without clear conditions (e.g. explicit link to some real activity in the jurisdiction) is considered harmful. Accordingly, one remedial option, if the passive income exemption is to be retained, is to implement adequate substance requirements to the entities concerned in line with the EU's Code of Conduct (Business Taxation), have robust anti-abuse rules in place and remove any administrative discretion.

As regards active income, the COCG appears to suggest that if the exemption is for income attributable to a foreign permanent establishment, defined in line with the OECD Model Tax Convention, that might be acceptable as the taxing right would be allocated to the source jurisdiction.

It could be argued that territoriality has been the fundamental basis of taxation in Hong Kong for more than 70 years and that the exclusion (not exemption) of offshore income from tax is part of this regime rather than a concession. In fact, substance requirements (to deal with passive offshore income) are in concept incompatible with the current source principles in Hong Kong. Having said that, a blended approach of 'bright-line' tests and substance could be a potential solution to be considered. There are other possible solutions, the pros and cons of each of which need to be considered carefully.

This is in fact not the first time that Hong Kong is added to the greylist. Hong Kong was included in the first EU greylist released in December 2017, when the HKSAR government committed to implementing automatic exchange of financial account information by 2019, signing and ratifying the Multilateral Convention or having in place a network to exchange agreements covering all EU members states by 2018, and amending or abolishing the identified harmful tax regimes by 2018. The city was removed from the greylist in March 2019 after having undertaken actions with respect to the commitments. In light of the new requirements imposed by the EU, it is understood that the HKSAR government has been having close dialogues with the ECOFIN in order to find mutually agreeable ways for Hong Kong to meet its commitments.

The takeaway

Hong Kong will have to make changes to its territorial tax system in order to comply with the EU's requirements and be removed from the greylist. Taxpayers with offshore claims should keep a close eye on the details to be released by the HKSAR government and be prepared for potential changes in their tax position.

The latest developments in the international tax landscape, including the EU review and the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting 2.0 project, have brought about significant challenges to Hong Kong's simple tax system. As noted by the HKSAR government, Hong Kong will actively comply with international standards while striving to maintain the key advantages of Hong Kong's tax regime in terms of simplicity, certainty and fairness. Meanwhile, the government will need to consider non-tax measures in order to improve the business environment and competitiveness of Hong Kong.

Endnotes

1. The revised lists can be accessed via this link: https://www.consilium.europa.eu/media/52208/st12519-en21.pdf

2. These comprise (i) nine jurisdictions that are either developed or developing jurisdictions with a finance centre – Costa Rica, Hong Kong, Malaysia, Nauru, Panama, Qatar, Singapore, Uruguay and Samoa; and (ii) four jurisdictions that do not have a financial centre – Botswana, Maldives, Namibia and Eswatini.

Let's talk

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