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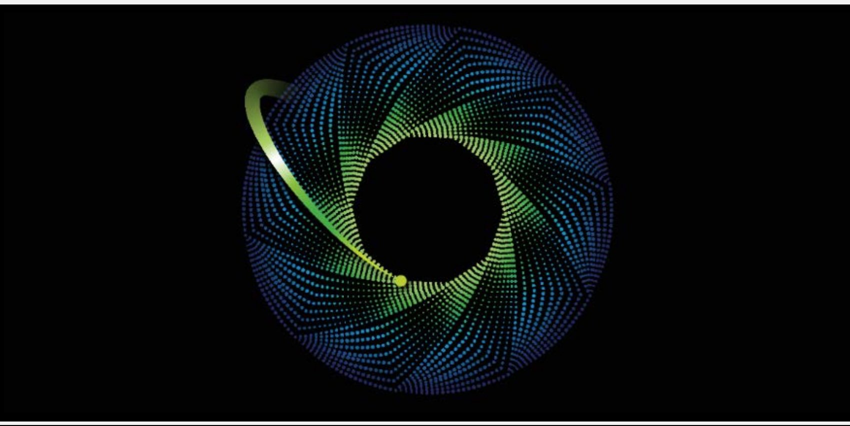

Hong Kong Tax Newsflash
Hong Kong in EU watchlist on tax cooperation due to territorial source regime

On 5 October 2021, the European Commission officially announced updates to the European Union (EU) list of non-cooperative tax jurisdictions and the inclusion of Hong Kong in the EU watchlist[1] on tax cooperation.

As a result of the foreign source income exemption regimes review, the EU considers that Hong Kong's territorial source tax regime is harmful. The EU has granted until 31 December 2022 for Hong Kong to amend its regime and Hong Kong has confirmed it will do so. As a result of Hong Kong's willingness to respond to the EU's concerns, defensive measures by the EU will be suspended subject to the passing of those amendments.

Review of territorial source regime

Based on EU's guidance[2], foreign source income exemption regimes that apply on a territorial basis are not inherently problematic. However, the EU is concerned where such regimes create situations of double-non taxation. In particular, they are concerned with the non-taxation of passive income in the form of interest or royalties where the income recipient has no substantial economic activity.

Hong Kong's response

Hong Kong has announced that it will amend its tax law by 31 December 2022 with the revised rules taking effect on 1 January 2023. According to the Hong Kong government, the proposed legislative amendments will only target corporations with no substantial economic activity in Hong Kong receiving passive income that is not chargeable to tax in Hong Kong. However, Hong Kong will continue to adopt the territorial source principle of taxation.

The EU will monitor the measures implemented by Hong Kong to comply with its commitments. If the issue is not resolved by 31 December 2022, Hong Kong will be put on the EU "blacklist" where certain defensive measures may be applied by the EU member states e.g. non-deductibility of costs, controlled foreign company rules, withholding tax measures etc.

Our observation

The timeline for Hong Kong to amend its territorial source tax regime coincides with that of the BEPS 2.0 Pillar Two project (Pillar Two) i.e. 1 January 2023.

For taxpayers with consolidated revenues over EUR750 million the impact of Pillar Two is likely to be far more significant than the impact of the territorial regime revisions in response to the EU concerns. As their effective tax rate as a whole will be required to be at least 15%. Accordingly, while revisions to Hong Kong's territorial regime will be of interest, the focus of these taxpayers should remain on Pillar Two and Hong Kong's potential introduction of a domestic minimum tax.

However, groups with consolidated revenue of less than EUR750 million that have implemented intellectual property planning or financing structures involving the receipt of offshore interest income will need to understand the impact on their current structures and consider making adjustments in order preserve their current tax profile.

[1] *The state of play with respect to commitments taken by cooperative jurisdictions to implement tax good governance principles (Annex II)*

[2] *Guidance on foreign source income exemption regimes dated 15 October 2019*

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