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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

Hong Kong's Responses to BEPS 2.0 and its Inclusion in EU's "Greylist" of Non-Cooperative Tax Jurisdictions

Throughout recent years, we have witnessed huge international collaborative efforts to combat tax avoidance. In response to addressing the base erosion and profit shifting ("BEPS 2.0"), the global minimum tax was agreed in October 2021 between over 130 jurisdictions who are members of the Organisation for Economic Cooperation and Development (OECD)/G20 inclusive framework. On the other hand, the European Union ("EU") has added Hong Kong to its "greylist" of non-cooperative tax jurisdiction[1] on 12 October 2021 due to Hong Kong's absence of taxation of certain passive income. It would thus be inevitable that the Hong Kong tax system may experience quite some changes in response to these global efforts.

The fundamentals of the Hong Kong tax system

Hong Kong adopts a territorial source of taxation, and only a person carrying on a trade or business in Hong Kong would be subject to tax on its Hong Kong sourced income. Hong Kong's tax system is known for its simplicity and transparency, with the current corporation profits tax rate levied at a competitive 16.5% on assessable profits. Income such as offshore income or certain passive income would not be subject to tax in Hong Kong.

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[1] *The EU list of non-cooperative jurisdictions for tax purposes consists of two types of jurisdictions: (i) those that appear in Annex I, i.e., on the blacklist which have failed to take "meaningful" action on the basis of the EU's criteria, and (ii) those that are listed in Annex II, i.e., on the greylist/watchlist which comprises countries committed to improving their (according to the EU) harmful tax regimes.*

What is BEPS 2.0?

BEPS is an initiative of the OECD to address tax planning strategies used by multinational enterprises ("MNEs") that exploit the difference in tax regimes between jurisdictions to effectively avoid paying tax.

The BEPS 2.0 package targets large MNE groups meeting certain criteria and consists of two pillars. The first pillar targets MNE groups with global turnover above 20 billion Euros and profitability above 10%, and distributes the taxing rights in respect of a certain portion of the residual profit (which is defined as profit in excess of 10% of revenue) of these enterprises to the market jurisdictions. The second pillar is the implementation of the global minimum effective tax rate, which targets MNE groups with global turnover above 750 million Euros. If the effective tax rate of an MNE group in a jurisdiction is below 15%, its parent or subsidiary companies will be required to pay a top-up tax with respect to the shortfall in their own located jurisdiction.

Please refer to our August 2021 Tax Newsletter for details.

EU's greylist

The Council of the European Union announced in October 2021 that it would include Hong Kong in Annex II on the Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes[2], which is commonly referred to as the greylist or watchlist. The EU is concerned that corporations with no substantial economic activity in Hong Kong would not be subject to tax in Hong Kong on certain offshore passive income (such as interest and royalties), and considered the non-taxation of these foreign sourced passive income in Hong Kong might lead to instances of double non-taxation.

The fundamental elements of the Hong Kong tax system have thus rendered it to be considered harmful, being regarded as cross-border tax evasion, leading to potential double non-taxation under Hong Kong's territorial source concept for some taxpayers.

Potential shake-up in the Hong Kong tax system

Hong Kong Government believes the initiation of BEPS 2.0 would reduce the effectiveness for tax jurisdictions to introduce tax exemption or extremely low preferential tax rate to increase their competitiveness in the future, and Hong Kong would thus be able to reinforce its competitive advantages under a more level playing field in terms of taxation.

The Financial Secretary announced in the 2022-23 budget delivered on 23 February 2022 that a domestic minimum top-up tax would be proposed to ensure that the effective tax rates of

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[2] EU Council keeps Hong Kong "Grey Listed" in its February 2022 update of the greylist. The list now contains twenty-six jurisdictions, which have been allotted deadlines for (i) implementing the automatic exchange of information; or (ii) achieving membership of the Global Forum on transparency and exchange of information for tax purposes; or (iii) adapting their legislation; or (iv) implementing the Country-by-Country Reporting (CbCR) minimum standard (BEPS Action 13).

multinational enterprises reach the global minimum effective tax rate of 15% commencing from 2024-25. A delicate balance will be struck between safeguarding Hong Kong's taxing rights and maintaining its competitive positioning for foreign investments.

In this regard, the Government is planning to submit a legislative proposal to the Legislative Council during the second half of 2022 to implement the global minimum tax rate and other relevant requirements in accordance with the international consensus, but at the same time reaffirmed that the advantages of the Hong Kong tax regime in terms of its simplicity, certainty, transparency and the territorial source principle of taxation would be maintained.

With respect to the EU's greylist, to comply with EU standards, the Hong Kong Government has agreed to cooperate with and has committed to the EU to amend the Inland Revenue Ordinance by the end of 2022 and implement the relevant measures in 2023 so that the EU could remove Hong Kong from the greylist and avoid being moved to the blacklist. According to the Government, the proposed legislative amendments will only target corporations with no substantial economic activity in Hong Kong that make use of passive income to evade tax across a border. Individual taxpayers will not be affected.

The Government reiterated that Hong Kong will continue to adopt the territorial source principle of taxation and will uphold the low-tax regime to maintain the competitiveness of Hong Kong's business environment.

While we will need to see how the Hong Kong Government could strike a balance to satisfy the different stakeholders with respect to the Hong Kong tax system, Hong Kong taxpayers should keep abreast of developments and be prepared for potential changes in the tax filing positions or tax compliance requirements.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Provide tax expert witness services at Courts
- Act as tax advisor on transfer pricing and tax compliance reviews for IPO applications
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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