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# EU – HONG KONG ENGAGEMENT FORUM

**Policy Brief**

## *EU, OECD and Hong Kong: Building a transparent and fair tax environment through international cooperation*

### The EU standard of tax good governance

In May 2016, the Economic and Financial Affairs Council (ECOFIN)[1] of the Council of the European Union (EU) agreed to implement the principles of good governance in tax issues with third countries. The introduction of the EU standard aims to enhance transparency and fairness in tax matters, which help combating cross-border tax avoidance and evasion under the globalized and digitized economy. The EU standard of tax good governance covers three criteria:

***Transparency:*** *The jurisdiction must comply with international standards on information exchange such as exchange of information on request and automatic exchange of information.*

***Fair tax competition:*** *The jurisdiction must not have any harmful tax practices or regimes without anti-BEPS measures.*

***Tackling Base Erosion Profit Shifting (BEPS):*** *The jurisdiction must commit and effectively implement the standards developed by the OECD/G20.*

The standard is used as a reference to determine whether a non-EU country should be included in the **list of non-cooperative jurisdictions for tax purposes (Annex I of the ECOFIN Council Conclusion, often incorrectly referred as 'the blacklist'**[2]. Listed countries are subject to a number of defensive measures by the EU such as denial of deductions of outgoing payments, subjection to controlled foreign corporation (CFC) rules (which prevent companies from moving profits to offshore structures), increased withholding taxes, and increased audits. Another group of jurisdictions which do not yet comply with the EU standards but have committed to

[1] ECOFIN is composed of the Ministers (or State Secretaries) of Economic Affairs of the Member States of the EU and responsible for EU policy in three main areas: economic policy, taxation issues and the regulation of financial services.
[2] Prof. Irma Johanna Mosquera Valderrama, The EU standard of tax good governance vis-a-vis non-EU countries including developing countries, Leiden Law Blog, 31 January, 2022

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amending its tax law with a given deadline in order to meet the standards are included in a second Annex to the Conclusions, which is often referred as a 'grey list'

### Inclusion of Hong Kong in EU's watchlist on tax cooperation

Hong Kong has been mentioned as a cooperative jurisdiction for tax purposes, working towards implementation of relevant tax reforms, since October 5, 2021, when the jurisdiction was added to Annex II of the *Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purpose*s. The EU considers that aspects of Hong Kong's territorial tax system may facilitate tax avoidance or other tax practices regarded as harmful[3]. At the moment, Hong Kong does not tax foreign sourced passive incomes, such as dividends, interest and royalties of a company registered in Hong Kong under territorial tax system. Multinational companies find this tax practice attractive as setting up a regional office in Hong Kong can reduce their corporate income tax (CIT) obligations through diverting their overseas income to Hong Kong. However, the EU considers that the non-taxation of certain foreign sourced passive incomes of businesses set up in Hong Kong without substantial local economic activity could potentially lead to situations of "double non-taxation", base erosion and profit shifting. Hong Kong has committed to reform its tax system according to EU expectations by 31 December 2022. Doing so would ensure that there is no risk for the jurisdiction to be moved to Annex I[4].

In 2017 and 2018, Hong Kong was included in Annex II. Hong Kong has also taken important steps to amend tax regulation to improve its tax environment and increase financial transparency such as amending its preferential tax regimes and accessing the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Hong Kong was excluded from the list when this process was completed.

### Impacts of Hong Kong's taxation amendment in regards to the EU's requirements and BEPS 2.0

In response, the Government of the Hong Kong Special Administrative Region (HKSAR) has agreed to make changes and committed vis-à-vis the EU to amend the Inland Revenue Ordinance (Chapter 112 of the Hong

[3] Council of the EU, Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes , Brussels, 05 October 2021
[4] Arendse Huld, Hong Kong Added to EU Watchlist on Non-Cooperative Tax Jurisdictions, China Briefing, 12 October 2021

Kong laws) by the end of 2022 and implement relevant measures from 1 January 2023. The HKSAR government also reiterated that continuing to adopt the territorial source principle of taxation with a simple, certain and low-tax regime is a key to maintaining the competitiveness of Hong Kong's business environment. The relevant measures will mainly target companies without local economic activity and avoiding paying tax on passive income through Hong Kong. Individual taxpayers will not be affected[5].

Meanwhile, Hong Kong has signed up to the two-pillars solution agreed within the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS 2.0)[6]. 137 countries and jurisdictions including Hong Kong are implementing actions to help address tax avoidance, improve the coherence of international tax rules, ensure a more transparent tax environment and address the tax challenges arising from digitalisation of the economy. Pillar 2 in particular aims to ensure that multinational enterprises (MNEs) pay a fair share of tax based on profit allocation and global minimum taxation. Large MNEs with annual revenue of over €750 million will be subject to a minimum corporate tax rate of 15%. This global corporate tax rate should be effective in 2023. The 15 % tax rate is slightly lower than Hong Kong's CIT rate of 16.5%. However, through income exclusion and tax exemption, many companies are currently eligible to pay CIT rates below the 15% tax rate agreed under Pillar 2. MNEs may therefore be required to pay the difference to reach the 15 % minimum rate[7].

## Building a transparent and fair tax environment through international cooperation

Globalization and digitalization stimulates cross-border business activities. It is hard to ensure a fair tax environment as companies can easily register in a jurisdiction with a tax regime favorable to them. This practice may lead to tax avoidance and unfairness as SMEs have less resources to do the same. Meanwhile, governments would receive less tax as companies tend to move to jurisdictions with lower tax rates. A robust, efficient and fair business tax framework would support the post-COVID-19 recovery and sustainable development. Seeing the problems, the European Union and OECD are facilitating changes to boost tax transparency and cement the coherence of international tax rules under the globalized economy. The list of non-cooperative jurisdictions for tax purposes is a good example to see how the EU is monitoring the tax system of non-EU countries. On the other hand, OECD's BEPS 2.0 can ensure an internationally agreed minimum tax rate.

[5] HKSAR Government responds to inclusion of Hong Kong in EU's watchlist on tax co-operation, Hong Kong, 5 October 2021
[6] Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 October 2021 - OECD
[7] Lewis Lu and John Timpany, The impact of BEPS on tax incentives in Hong Kong SAR, International tax review, 1 December 2021

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Building an internationally fair tax environment through 'tax good governance' practices is the trend. As part of the global community, the HKSAR government has all along been demonstrating active tax cooperation with the EU and OECD to preserve its reputation as an international financial centre, enhance its tax transparency and support the combating of cross-border tax evasion. The effective mechanisms of the HKSAR government such as Comprehensive Double Taxation Agreements / Arrangements (DTAs) and Tax Information Exchange Agreements (TIEAs) help reduce double taxation caused by overlapping tax jurisdictions and exchange tax information to avoid tax avoidance, or tax evasion situations. They can be a good reference to other jurisdictions on how to maintain competitiveness of Hong Kong's business environment and meet international standards at the same time.

In its press release, the HKSAR government highlights its application of the territorial source principle of taxation, which is seen as a tax incentive to attract overseas business and investment. However, any amendments on tax legislations should meet international standards. Continuous engagement and discussion among the HKSAR government, international organizations, industries and academia are needed to explore new and effective measures to boost Hong Kong's economy and enhance its competitiveness.

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