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OUTCOME OF PROCEEDINGS

From: General Secretariat of the Council
To: Code of Conduct Group (Business Taxation)
Subject: Hong Kong's Foreign source income (FSIE) regime (HK009)
– Final description and assessment

STANDSTILL REVIEW PROCESS (SEPTEMBER 2021)

Hong Kong committed to reform its FSIE regime within a timeline that will permit adoption of the necessary legislation by the end of 2022. Hong Kong also committed not to availing of any grandfathering, as requested by the COCG.

The Code of Conduct Group meeting of 21 September 2021 acknowledged the commitment of Hong Kong. This conclusion was endorsed by the ECOFIN Council on 5 October 2021.

Annex 1: Assessment of the HK009 regime

Assessment of the HK009 regime (standstill)**Assessment of FSIE regime**

	1a	1b	2a	2b	3	4	5
Hong Kong – Foreign Source Income Exemption	V	V	V	V	V	X	X

V: Harmful; X not harmful

Gateway criterion – Significantly lower level of taxation

“Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code”

The general profits tax rate in Hong Kong is 16.5%.

As the Code of Conduct looks at the effects that tax legislation may have on the location of business activities in general terms, a full tax exemption may be regarded as a reason for businesses to establish in one jurisdiction over another. In this sense, these provisions are relevant for the Code.

The Code of Conduct uses a broad term (‘tax measures’) to describe what should be assessed under its criteria. This definition is not limited to specific pieces of legislation nor does it define what is intended as a ‘tax measure’. In the specific case of Hong Kong, it is relevant to take into account the general tax system, in order to understand whether the legislation provides for a significantly lower level of taxation. This is the case in Hong Kong, as in certain circumstances income from foreign source can be exempted from taxation.

The provisions are therefore potentially harmful and should be evaluated under the Code.

Criteria 1 and 2 – Targeting non-residents and Ring-fencing

“whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”

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Since 1940, Hong Kong levies a profits tax on a territorial basis. Under Section 14 of the Inland Revenue Ordinance (IRO), such a profits tax is charged on every person, whether tax resident in Hong Kong or not, carrying on a trade, profession or business in Hong Kong in respect of profits arising in, or derived from, Hong Kong from such trade, profession or business. There is no distinction between active and passive income. As a result, any profit considered as being sourced outside Hong Kong is not chargeable to profits tax.

The source of profits is to be determined by reference to where profit producing activities have been undertaken, having regard to the totality of facts and circumstances of each case. Generally, a trade, profession or business is regarded as being carried on in Hong Kong if activities are undertaken in Hong Kong for profit with a certain degree of continuity. Depending on the nature of the business, the activities may also be intermittent with long intervals of quiescence in between. As developed by case law, the broad guiding principle is that one looks at the operations which produced the relevant profits and where these operations took place.

Hong Kong has six preferential regimes providing for tax concessions or exemptions under specific conditions. These regimes have been assessed by the OECD FHTP and the COCG as not harmful.

According to Hong Kong, for the three years of assessment 2015-2016 to 2017-2018, on average:

- 14,000 corporations have claimed their foreign source exemption for all or part of their income declared in Hong Kong; on average, this accounts for about 6% of the total number of corporations whose tax liability has been assessed by the Hong Kong tax authorities – Inland Revenue Department (IRD);
- the proportion of foreign sourced profits claimed compared to total profits reported by all assessed corporations is about 57%; specifically, about 80% of the exemption claims relate to dividend and interest income.

Based on the above, we propose a tick (‘V’ – harmful) for criterion 1.a and 2.a as well as for criterion 1.b and 2.b.

Criterion 3 – Substance:

“whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages”

There are specific conditions for the economic substance of the preferential tax regimes mentioned above. Indeed, the IRO requires taxpayers who benefit from any of the six preferential regimes of Hong Kong to carry on core income generating activities (CIGAs) in Hong Kong by employing an adequate number of full-time qualified employees and incurring an adequate amount of operating expenditures in Hong Kong. Failing such substantial activity requirements renders the taxpayer ineligible for the benefit provided by the regime.

However, these rules do not apply outside the six preferential tax regimes. Considering that foreign-sourced income is a general feature and therefore permeates the tax system of Hong Kong, the benefit of exemption is granted widely without a requirement for complying with CIGAs.

The issue of double non-taxation would generally be tackled by the anti-avoidance provisions in the IRO. Under Sections 61 and 61A of the IRO, where a taxpayer has entered into a transaction with the principal purpose of disguising its profits as foreign sourced outside Hong Kong and thus escaping from the profits tax charge, the IRD may consider invoking the anti-avoidance provisions to disregard the transaction and assess the profits as Hong Kong sourced accordingly. In this regard, whether the person has achieved double non-taxation in other tax jurisdictions is one of the factors for consideration.

While there are general anti-avoidance rules in place, these are general and not targeted to tackle the specific risks of double non-taxation and lack of substantial activities in Hong Kong in relation to income exempt from profits tax in Hong Kong.

In light of the above, we propose a tick (“V” – harmful) for criterion 3.

Criterion 4 – Internationally accepted principles:

“whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD”

In Hong Kong, a non-resident person will be regarded as having a permanent establishment (PE) in Hong Kong if the presence of the non-resident person in Hong Kong satisfies:

- the definition of PE in the relevant Double Taxation Agreement (DTA); or
- where the non-resident taxpayer is resident in a non-DTA territory, the definition of PE in the IRO.

In the latter case, Part 3 of Schedule 17G of the IRO provides for a PE definition which is modelled after Article 5 of the OECD Model Convention, as updated in 2017. In case of conflict between the IRO rule and a tax treaty, Hong Kong has confirmed that the court would give prevalence to the tax treaty.

In 2018 Hong Kong codified their transfer pricing rules in line with the OECD standard on BEPS. The transfer pricing rules require a multinational enterprise to compute its profits from transactions with associated persons in accordance with the arm’s length principle or if the enterprise is a non-resident person, to attribute profits to its PE in Hong Kong in accordance with the separate enterprises principle. After the ascertainment or attribution of profits, the broad guiding principle (as described above) would be applied to determine whether and, if so, the extent to which such profits are sourced from Hong Kong.

Finally, while Hong Kong signed the OECD Multilateral Instrument (MLI), its entry into force in respect of Hong Kong will depend on China’s decision to extend its application.

In light of the above, we propose a cross (“X” – harmful) for criterion 4.

Criterion 5 - Transparency:

“whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”

All conditions necessary for granting the tax benefits under the FSIE regime in Hong Kong are clearly laid down in the legislation.

Therefore, we propose a cross (“X” – not harmful) for criterion 5.

Overall Assessment

In light of the analysis above, Hong Kong’s FSIE regime is considered harmful under criterion 2.1.
