Hong Kong removed from European Union's tax watchlist

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In brief

Following a meeting of the Council of the European Union (EU) on 20 February 2024, Hong Kong was removed from the EU watchlist[1] regarding international tax co-operation. A press release issued on the same date by the Council of the EU confirms that Hong Kong fulfilled its commitments to strengthening tax good governance standard by amending its foreign-sourced income exemption (FSIE) regime[2]. This brings an end to Hong Kong's two-year stint on the watchlist.

The removal of Hong Kong from the EU watchlist is a testament to the Hong Kong SAR (HKSAR) government's commitment to compliance with the international tax standards. It also demonstrates the HKSAR government's dedication to maintaining Hong Kong's status as an attractive and reputable place for business and investment.

In addition to Hong Kong, the EU's external taxation strategy has also prompted legislative changes to the FSIE regime in Malaysia and Singapore. This news flash provides a snapshot of the latest FSIE regimes in these three jurisdictions and our observations thereon.

In detail

Background

In October 2021, Hong Kong was added to the EU watchlist as the EU was concerned that under the then FSIE regime, there could be circumstances under which corporates with no substantial economic activity in Hong Kong would not be subject to tax in respect of certain foreign-sourced passive income (such as interest and royalties), hence leading to situations of 'double non-taxation'.

In response, the HKSAR government enacted legislative amendments in December 2022 to refine and strengthen Hong Kong's FSIE regime against cross-border tax avoidance. Under the refined FSIE regime which came into operation from 1 January 2023, four types of foreign-sourced income, namely (i) dividend, (ii) interest, (iii) intellectual property (IP) income and (iv) disposal gain from the sale of equity interests, are deemed to be sourced from Hong Kong and chargeable to profits tax if the income is received in Hong Kong by a multinational enterprise (MNE) entity carrying on a trade, profession or business in Hong Kong, unless the MNE entity satisfies the relevant exception requirement.

Shortly before the aforesaid legislative amendment was passed by the legislature, the EU updated its guidance to explicitly require an FSIE regime to include capital gains as a general class of income. As a co-operative player in international taxation, the HKSAR government further refined its FSIE regime to expand the scope of covered income to include disposal gain on other types of assets (in addition to equity interests) to align with the latest EU guidance with effect from 1 January 2024. Nonetheless, additional mitigating measures were added to reduce the compliance burden of in-scope MNE entities.

Please refer to our previous news flashes for details of the above changes to Hong Kong's FSIE regime[3].

Hong Kong's removal from the revised EU watchlist

On 20 February 2024, the Council of the EU published the conclusions of its bi-annual review of the EU list of non-cooperative jurisdictions for tax purposes (Annex I – so-called 'blacklist') and the state of play of the cooperation with the EU with respect to commitments taken by cooperative jurisdictions to implement tax good governance principles (Annex II – so-called 'watchlist')[4].

Hong Kong was removed from the updated watchlist, being considered as having fulfilled its commitment by amending its FSIE regime. Hong Kong is now listed among the jurisdictions that cooperate with the EU and have no pending commitments.

The HKSAR government welcomed the EU's recognition of Hong Kong's efforts in aligning its FSIE regime with the relevant requirements, as reflected in its removal from the EU's watchlist. The HKSAR government further stated that it will continue to comply with international tax standards while maintaining Hong Kong's tax competitiveness[5].

Recent changes to the FSIE regime in Malaysia and Singapore

Malaysia

Similar to Hong Kong, foreign-sourced income exemption was originally available to all persons, other than Malaysian-resident companies carrying on a banking, insurance, or sea or air transport business, on income derived from sources outside Malaysia and received in Malaysia.

In response to its inclusion in the EU's watchlist in October 2021, Malaysia amended its FSIE regime. Effective from 1 January 2022, generally, all types of foreign-sourced income received in Malaysia by a resident is subject to tax. Nonetheless, foreign-sourced dividend income received by certain categories of tax residents in Malaysia will continue to be exempt from tax from 1 January 2022 to 31 December 2026 if (i) the dividend is subject to tax in the jurisdiction of origin and the headline tax rate in that jurisdiction is at least 15%; and (ii) the economic substance requirement (ESR) is met.

To align its FSIE regime with the latest EU guidance, Malaysia further expanded the scope of taxable foreign-sourced income received in Malaysia to include gains from the disposal of all types of capital assets from outside Malaysia from 1 January 2024. The Malaysian government has indicated that exemption would be available if the ESR is met. Recently, the Malaysian government announced that unit trusts will be temporarily exempted from tax on foreign-sourced income from 1 January 2024 until 31 December 2026. It is expected that separate legislation will be introduced to give effect to the aforesaid exemptions[6].

Considering that Malaysia has demonstrated tangible progress with the above reforms, it remains on the watchlist and was granted until 31 March 2024 to adapt its legislation as regards the treatment of capital gains.

Singapore

Singapore adopts a territorial basis of taxation where tax is imposed on (i) Singapore-sourced income and (ii) foreign-sourced income received in Singapore, unless a specific exemption applies. Under Singapore's FSIE regime, tax exemption is provided for three types of income, namely dividend, branch profits and service income, provided that the following conditions are met: 'subject to tax' condition; 'foreign headline tax rate of at least 15%' condition; and 'beneficial tax exemption' condition. This means that other foreign-sourced income, such as interest or royalty income, would generally be subject to tax when received in Singapore.

While Singapore's FSIE regime was assessed by the EU and considered not harmful in 2021, the Singapore government has recently amended its FSIE regime to align the tax treatment of gains from the sale of foreign assets with the latest EU guidance. Specifically, under the newly added section 10L of the Singapore Income Tax Act which came into force on 1 January 2024, gains from the sale or disposal of foreign assets by an entity of a relevant group (which generally refers to an MNE group) that are received in Singapore are treated as income chargeable to tax unless an exception applies[7]. This is notwithstanding such gains would not otherwise be treated as chargeable income (being capital in nature) or would otherwise be exempt from income tax.

Our observation: *The legislative changes in Hong Kong, Malaysia and Singapore all reflect the increasing global focus on addressing international tax avoidance. While recent changes to the FSIE regime in these three jurisdictions were prompted by the EU's latest guidance, the exact coverage and non-taxation conditions of each FSIE regime were subject to negotiation and mutual agreement between the jurisdiction concerned and the EU. In comparison, Hong Kong's FSIE regime appears to provide for a wider scope of non-taxation and relief:*

- *foreign-sourced dividend and interest derived from, or incidental to, the business of a regulated financial entity, or the profit-producing activities of a taxpayer benefitting from an existing preferential tax regime are excluded from the FSIE regime;*
- *non-IP disposal gains accrued to an entity that is a trader (as defined) are also excluded from the scope of the FSIE regime if the gains are derived from, or incidental to, the entity's business as a trader;*
- *offshore interest income remains non-taxable if the ESR is met;*
- *participation requirement is available as an alternative to ESR for non-taxable treatment for dividends and equity interest disposal gains; and*
- *intra-group transfer relief is available which would defer any tax that may be chargeable on any type of disposal gain if the asset concerned is transferred between associated entities.*

Nonetheless, to provide additional clarity to covered taxpayers in relation to ESR, we hope that the IRD will consider the pragmatic approach adopted by its counterpart in Singapore. While the tax authorities of both jurisdictions will assess the ESR at the entity level, the Inland Revenue Authority of Singapore provides the option of allowing the ESR of a special purpose vehicle (SPV) to be tested at its holding company level if the holding entity: (i) has effective control over the SPV; (ii) derives economic benefits from the activities carried out by the SPV; and (iii) defines the core investment strategies that the SPV implements[8]*.*

This is a welcome approach as it is more closely aligned with the commercial reality that the holding entity is generally where the substance resides and SPVs are typically formed to ring-fence investment risks and do not have employees or significant expenditure on their own.

The takeaway

The removal of Hong Kong from the watchlist is the culmination of a significant effort by the HKSAR government to address the EU's concerns over the past couple of years. This positive development also underscores the HKSAR government's commitment to supporting global cooperation in combatting tax avoidance. The refined FSIE regime is not expected to have adverse impact on the tax competitiveness of Hong Kong as the city's focus has always been on attracting and anchoring substantive economic activities in Hong Kong.

If you have questions or need more information on how the recent changes to Hong Kong's FSIE regime would impact your business, we are pleased to discuss with you further and help you to navigate the new regime.

Endnotes

1. Officially, *State of play of the cooperation with the EU with respect to commitments taken by cooperative jurisdictions to implement tax good governance principles*, or 'state of play document' in short.

2. The press release of the Council of the EU can be accessed via this link: https://www.consilium.europa.eu/en/press/press-releases/2024/02/20/taxation-bahamas-belize-seychelles-and-turks-and-caicos-islands-removed-from-the-eu-list-of-non-cooperative-jurisdictions-for-tax-purposes/

3. The news flashes can be accessed from our dedicated FSIE webpage via this link: https://www.pwccn.com/en/services/tax/fsie.html

4. The updates to the EU blacklist and watchlist are as follows:

   Annex I – The blacklist
   - Jurisdictions removed: The Bahamas, Belize, Seychelles and The Turks and Caicos Islands

   Annex II – The watchlist
   - Jurisdictions removed: Albania, Aruba, Botswana, Dominica, Hong Kong and Israel
   - Jurisdictions moved from the blacklist: Belize and Seychelles

   The revised EU blacklist and watchlist can be accessed via this link: https://www.consilium.europa.eu/media/70365/st06776-en24.pdf

5. The press release can be accessed via this link: https://www.ird.gov.hk/eng/ppr/archives/24022001.htm

6. Pending further details, it is now unclear whether exemption by meeting the ESR will be confined to disposal of capital assets other than IP assets. Under the FSIE regimes in both Hong Kong and Singapore, foreign-sourced disposal gains in relation to IP assets will

be excluded from taxation to the extent that the nexus approach developed by the Organisation for Economic Co-operation and Development (OECD) is complied with. The nexus approach was adopted by the OECD as a minimum standard for assessing whether a jurisdiction's preferential tax regime for IP constitutes harmful tax practices.

7. Foreign-sourced disposal gains from the sale or disposal of a foreign asset, not being an IP asset, will not be brought to tax if the entity has adequate economic substance in the basis period in which the sale or disposal occurs. For gains from the sale or disposal of qualifying foreign IP assets as defined, the OECD's nexus approach will be used to determine the extent of such gains that will not be taxable when received in Singapore.

   For further details of the key provisions of Singapore's section 10L, please refer to our previous news flash (which was prepared based on the draft amendment bill published in September 2023 and enacted by the Singapore Parliament in October 2023 unamended):
   https://www.pwchk.com/en/hk-tax-news/2023q4/hongkongtax-news-oct2023-15.pdf

8. The guidance can be accessed via this link:
   https://www.iras.gov.sg/media/docs/default-source/e-tax/tax-treatment-of-gains-or-losses-from-the-sale-of-foreign-assets.pdf

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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