Inclusive Framework BEPS Agreement

The Subject to Tax Rule and its potential application in the Hong Kong SAR

Policy Perspectives Update – the Hong Kong SAR

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On 17 July 2023, the OECD published a document setting out the model treaty Article and Commentary on the Subject to Tax Rule (STTR). For a brief overview of the STTR, please refer to our previously issued Hong Kong BEPS Publication.

In this Hong Kong BEPS Publication, we discuss the STTR in more details and set out our observations on the potential application of the STTR in the Hong Kong SAR (Hong Kong).

The Subject to Tax Rule

The STTR is a treaty-based rule which allows the source (or payor) state to impose additional tax on several categories of outbound intragroup payments when such payments are subject to **a nominal tax rate below 9%** in the residence (or payee) state. The STTR takes priority over the GloBE Rules. Taxes imposed under the STTR will be treated as Covered Taxes in computing the effective tax rate for GloBE Rules purpose.

The STTR will be implemented through a multilateral instrument (MLI) (to be open for signature from 2 October 2023) or bilateral renegotiation of the treaties. The key elements of the STTR are summarised below.

Scope — connected persons and exclusions

The STTR only covers payments between “connected persons”. Two persons are regarded as connected if one has control of the other or both are under the control of the same person(s). The control test is met when there is a direct or indirect ownership of more than 50% or a de facto control based in all relevant facts and circumstances.

There is targeted anti-avoidance rule to deal with two types of abuse, namely (1) the interposition of an unconnected person between two connected persons and (2) the routing of a payment of covered income through a high-tax connected person onto a low-tax connected person. Annex A of the STTR document contains examples to illustrate this rule.

The STTR does not apply where the recipient is: (1) a recognised pension fund, (2) a non-profit organisation, (3) certain investment funds, (4) an insurance company, (5) certain widely held entities or arrangements that achieve a single level of taxation (at either the entity or interest holder level) and (6) certain holding vehicles owned by an excluded recipient, etc.

The investment fund exclusion is subject to conditions, including the fund must be professionally managed and designed to invest funds obtained from unconnected persons, and the fund or its managers must be regulated.

The exclusion for regulated insurance companies applies to the extent the covered income is derived from assets held for the purpose of meeting policyholder liabilities.

For the exclusion for widely held entities or arrangements to apply, the entity or arrangement must either hold predominantly immovable property (e.g. a widely held REIT) or be subject (at either the entity or interest holder level) to tax of at least 9% in its residence state.

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Covered income

The STTR only applies when the taxing right of the source state is limited under the following treaty articles: Business Profits (Article 7), Interest (Article 11), Royalties (Article 12) and Other Income (Article 21). This means international shipping and air transport income (Article 8) are not within the scope of the STTR.
In particular, the STTR applies to the following types of "covered income":

1. interest;
2. royalties;
3. payments for the use of, or the right to use, distribution rights in respect of a product or service;
4. insurance and reinsurance premiums;
5. fees to provide a financial guarantee or other financing fees;
6. rent or any other payment for the use of, or the right to use, industrial, commercial or scientific equipment; and
7. income received in consideration for the provision of services.

There are specific exclusions in relation to shipping income – i.e. (1) rental income from leasing of ships to be used in international transportation on a bare boat charter basis and (2) income derived by a person whose tax liability in respect of that income is determined by reference to a tonnage tax regime are not regarded as covered income. There is no exclusion similar to (1) above for aircraft leasing income.

The provisions of the Business Profits Article instead of the STTR would apply where the covered income is effective connected with or attributable to a permanent establishment (PE) in the source state via which the payee carries on business in that state.

The specified rate and preferential adjustments

- The STTR tax imposed by the source state = **Gross amount of covered income x Specified rate**
- Specified rate = **9% - Tax rate applied to the covered income in the residence state - Withholding tax rate in the source state allowed under the applicable tax treaty**
- The applicable tax rate in the residence state is either the general statutory rate for corporate income tax (CIT) or the reduced statutory rate (if the covered income or the recipient is subject to a special reduced rate). In addition, the tax rate shall take into account the effect of certain **preferential adjustments** that **permanently** reduce the amount of tax payable in the residence state (e.g. an exemption or exclusion from income and a deduction from tax base).
- Where the withholding tax (WHT) rate permitted under the applicable tax treaty exceeds the difference between 9% and the residence state tax rate, the specified rate is effectively reduced to zero and no STTR tax applies.
- Where progressive CIT rates or a general exemption / exclusion of a portion of net income apply, a weighted averaging approach may be adopted in determining the applicable tax rate of the covered income.
- Special rules for determining the applicable tax rate apply where the covered income is attributable to the payee's PE situated in a third jurisdiction.

Mark-up threshold

Except for interest and royalties, the STTR does not apply when there is a limited return – i.e. when the gross amount of covered income is less than the costs incurred that are directly or indirectly attributable to earning the income plus **a mark-up of 8.5%** on those costs.

All income derived under a single contractual arrangement with respect to the same category of covered income and all related direct / indirectly costs during a fiscal year should be aggregated to determine the mark-up on costs.

All income derived from more than one contractual arrangement or category of covered income and all related direct / indirect costs during a fiscal year should be aggregated to determine if the income is so interrelated that an aggregate analysis is more reliable.

Special rule for service fee income applies where the costs of earning such income include costs from transactions with a connected person that is a resident of a third jurisdiction.

The mark-up threshold does not apply where the targeted anti-avoidance rule under the STTR applies to the covered income.

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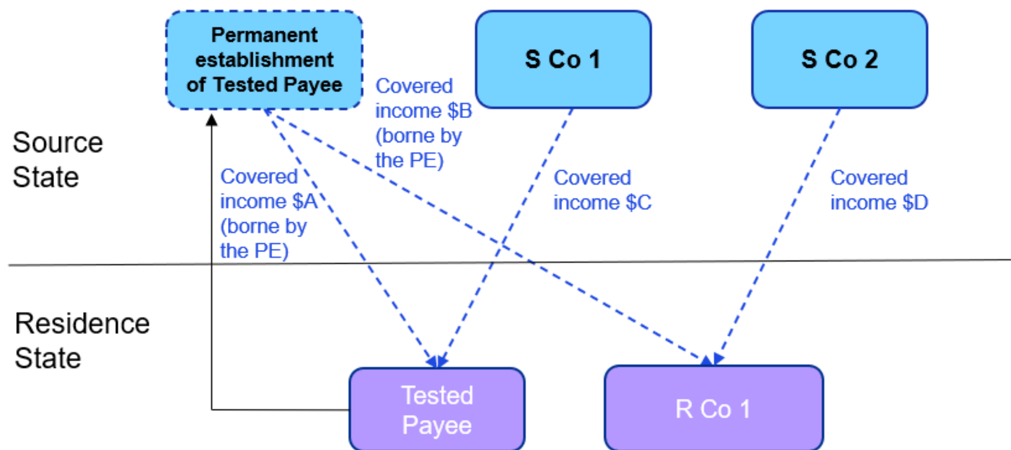
Materiality threshold

The STTR only applies if the total gross amount of all categories of covered income paid from the source state in a fiscal year is equal to or greater than EUR1 million or EUR250,000 (if the GDP of the source state or the residence state (whichever is the smaller one) is less than EUR40 billion). The diagram below illustrates the operation of the materiality threshold.



Notes:
1. R Co 1, S Co 1 and S Co 2 are connected to the Tested Payee
2. S Co 1 and S Co 2 are a resident of the Source State
3. Tested Payee and R Co 1 are a resident of the Residence State

In the above example, the STTR only applies if covered income $A + $B + $C + $D is equal to or greater than EUR1 million / EUR 250,000 in a fiscal year, depending on the GDP of the Source State and Residence State.

No relief for double taxation

The STTR document also contains model provisions to be added to the Article on Elimination of Double Taxation in a tax treaty. The effect of these provisions is to (1) disapply the exemption method in cases it would not have applied in the absence of the STTR (under the exemption method of relief) and (2) disallow a foreign tax credit for the STTR tax paid (under the credit method of relief). This means that **no double tax relief** would be available for any STTR tax paid.

Administration

STTR taxes are levied after the end of the fiscal year in which they arise under an **ex-post annualised charge approach**. This approach ensures the STTR for a fiscal year is only determined, and can only be levied, following the end of that fiscal year. It operates by way of self-assessment and the payee is only required to submit a tax return in the source state if it has a liability to tax under the STTR.

In addition, a certification system can be put in place under which a payee of a covered income could obtain a certificate confirming that it is not liable to tax under the STTR and does not need to submit a tax return (e.g. it is an excluded entity).

Hong Kong business considerations

Observations on the potential application of the STTR in Hong Kong

We discuss below some issues related to the potential application of the STTR in Hong Kong:

- Similar to those treaty-related BEPS measures under BEPS 1.0, an MLI will be developed for members of the Inclusive Framework (IF) on BEPS to sign up to incorporate the STTR into bilateral tax treaties. For Hong Kong to be a party to the MLI on the STTR, the Mainland China will first need to become a signatory of the MLI and then extend its application to Hong Kong.

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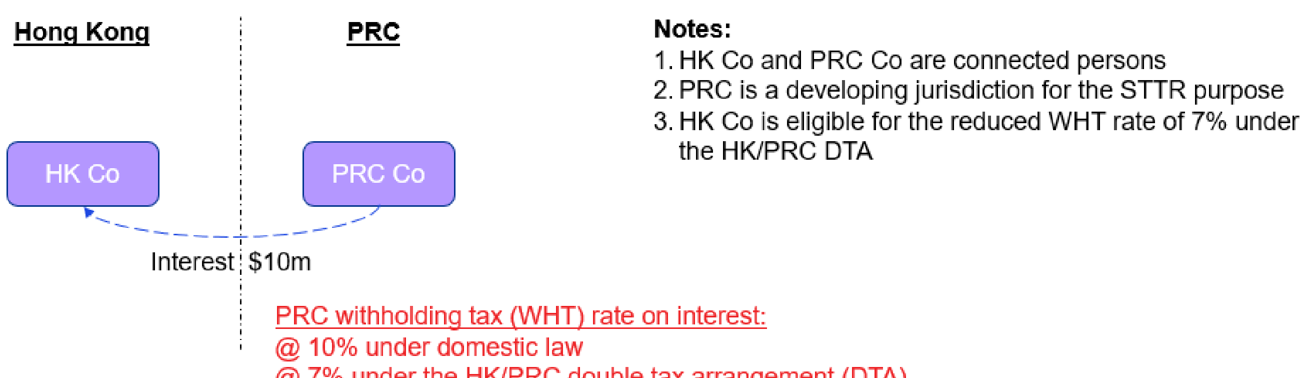
- Based on the October 2021 Statement issued by the IF, members of the IF are **required** to adopt the STTR in their tax treaties with **developing countries**[1] when being requested to do so. Currently, Hong Kong has tax treaties with 15 jurisdictions[2] which are regarded as a developing country for the STTR purpose. These jurisdictions can require Hong Kong to adopt the STTR in the relevant tax treaties either via the MLI or bilateral treaty negotiation.
- As Hong Kong is not a developing country for the STTR purpose, a treaty partner of Hong Kong could refuse to update its tax treaty with Hong Kong even if being requested by Hong Kong.

- Special attention should be paid to the potential impact of the STTR on service fees derived by a Hong Kong company from a group company in a treaty jurisdiction that is a developing country (e.g. the PRC). In the absence of the STTR, such service fees should not be taxable in the PRC if the Hong Kong company does not have a PE in the PRC. Under the STTR, such service fees could be subject to a STTR tax in the PRC if it is regarded as offshore sourced and not taxable in Hong Kong and the STTR is incorporated into the double tax arrangement between Hong Kong and the PRC.

Illustrative examples

The two examples below illustrate the potential operation of the STTR in Hong Kong.

Example 1



In the above example, whether (1) the STTR applies and (2) HK Co requires to pay a STTR tax would depend on the tax rate applicable to the interest income in Hong Kong as shown in the table below:

Tax rate applicable to the interest income in HK	The STTR impact
1. Tax @ 16.5%	The STTR does **not** apply as the HK tax rate is ≥ 9%
2. Tax @ 8.25%	The **STTR applies** (as the HK tax rate is < 9%) But **no STTR tax**: Specified rate = 9% - 8.25% (HK tax rate) - 7% (PRC WHT rate) < 0%
3. Tax @ 0% (i.e. being offshore sourced and not deemed as taxable under the foreign-sourced income exemption regime)	The **STTR applies** and the specified rate = 9% - 7% = 2% HK Co requires to pay **a STTR tax of $0.2m** (i.e. $10m x 2%)

[1] For the STTR purpose, developing countries are defined as those with GNI per capita of USD 12,535 or less in 2019, calculated using the World Bank Atlas method and to be updated regularly.
[2] The 15 jurisdictions that are regarded as a developing country under the STTR are: Belarus, Cambodia, Mainland China, Georgia, India, Indonesia, Malaysia, Mauritius, Mexico, Pakistan, Russia, Serbia, South Africa, Thailand and Vietnam.

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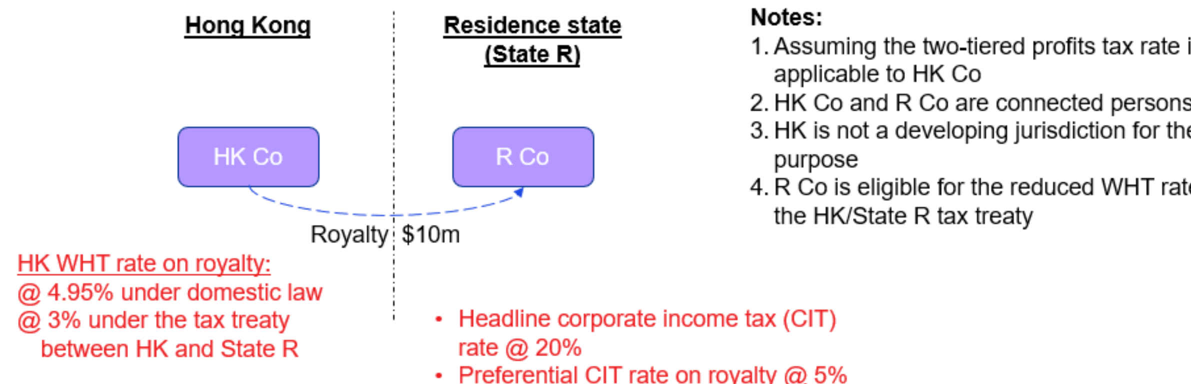
Example 2



In the above example, the specified rate on the royalty income is 1% (i.e. 9% - 5% - 3%). However, R Co is required to pay a STTR tax of $0.1m (i.e. $10m x 1%) in Hong Kong only if Hong Kong requests to incorporate the STTR in its tax treaty with State R and State R agrees to do so.

In addition, foreign tax credit is only available to R Co on the Hong Kong WHT tax paid on the royalty (i.e. $0.3m) but not the additional STTR tax (i.e. $0.1m).

In some Hong Kong tax treaties, the WHT rate on royalty specified in the treaty (e.g. 5%) is higher than the domestic WHT tax rate of 4.95% (if it is taken as 4.95% instead of 16.5%). Apparently, the STTR does not call for a comparison between the domestic WHT rate and the treaty WHT rate and that the specified rate would be reduced by the rate specified in the relevant tax treaty even though it is higher than the domestic rate. Further OECD guidance on this would be relevant to Hong Kong.

Issues for considerations

Business groups in Hong Kong with cross-border intragroup payments should consider whether such payments are within the scope of the STTR, whether the source states of the payments are a developing country as defined under the STTR, and if any exclusions apply.

Other issues that may need to be considered include determining the nature of the covered income (e.g. interest vs service fee and royalty vs service fee) and ascertaining the amounts of direct and indirect costs for the mark-up threshold purpose (and whether a transfer pricing analysis is necessary).

Affected business groups should review their cross-border group structures and intragroup payment arrangements, assess the potential impact of the STTR, and consider possible restructuring where necessary.

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