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Inclusive Framework BEPS Agreement

The Multilateral Convention on the Subject to Tax Rule is open for signature

Policy Perspectives Update – the Hong Kong SAR

The Multilateral Convention on the Subject to Tax Rule is open for signature

On 3 October 2023, the OECD announced that the **Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule** is open for signature as of 2 October 2023. For more details about the scope and operation of the Subject to Tax Rule (STTR) and its potential application in the Hong Kong SAR (Hong Kong), please refer to our previously issued Hong Kong BEPS Publication.

It remains to be seen whether Hong Kong would sign up for the Multilateral Convention (through the Chinese Mainland), how many treaty partners of Hong Kong would seek to update their tax treaties with Hong Kong to incorporate the STTR, and whether Hong Kong would seek to adopt the STTR in its tax treaties to impose additional tax on royalties and equipment rentals paid from Hong Kong to low-taxed jurisdictions.

The Multilateral Convention on STTR

The STTR is a treaty-based rule which allows the source (or payor) state to impose additional tax on several categories of **cross-border intragroup payments** when such payments are subject to **a nominal corporate income tax rate of below 9%** in the residence (or payee) state. To facilitate jurisdictions to efficiently implement the STTR in existing bilateral tax treaties without the need to re-negotiate/update each treaty individually, the OECD announced the release of the following documents on 3 October 2023:

- Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule (the STTR MLI);
- Explanatory Statement of the STTR MLI;
- STTR MLI at a glance; and
- Frequently Asked Questions.

The STTR MLI contains five annexes for inclusion in a Covered Tax Agreement (i.e. a bilateral tax treaty covered by the STTR MLI) to implement the STTR. **Annex I covers the main provisions of the STTR** whereas Annexes II to V contain additional STTR provisions that are applicable to specific circumstances (see more detailed discussion below).

Separately, the OECD published a report in July 2023 setting out the model treaty provisions and the detailed Commentary of the STTR (the STTR Report).

Key updates in the STTR MLI as compared to the STTR Report

The more significant changes to the model STTR provisions as reflected in the STTR MLI as compared to the STTR Report are:

- Instead of amending Article 23 on Elimination of Double Taxation in the OECD Model Tax Convention, a new paragraph has been added to the model STTR provisions (i.e. paragraph 15 of Article 1 in Annex 1) to specify that the residence state does not have any obligations to provide a double tax relief (by means of an income exemption or a tax credit) in respect of the STTR tax to the resident payee.

- A new paragraph has been added to the model STTR provisions (i.e. paragraph 2 of Article 2 in Annex 1) to make it clear that the STTR will not affect the application of any other provisions of a tax treaty that deny a treaty benefit where an item of income is not subject to a certain level of taxation in a contracting jurisdiction (e.g. a provision that denies a reduced treaty withholding tax rate on an item of income when the income is tax exempt in the residence state of the payee).

- In addition to Annex I, the STTR MLI contains the following annexes for inclusion in a Covered Tax Agreement where applicable:

  - **Annex II – Taxes computed on an alternative basis**, which contains provisions required to be included in a tax treaty for determining the nominal tax rate in the residence state of the payee when that jurisdiction imposes tax on an item of covered income other than on a net income basis.

  - **Annex III – Taxes imposed at the point of distribution**, which contains provisions required to be included in a tax treaty for determining the nominal tax rate in the residence state of the payee when that jurisdiction does not impose tax on an item of covered income when the income is earned, but at the point of profit distribution.

  - **Annex IV – Recognised pension fund (optional)**, which jurisdictions may choose to include to provide a uniform definition of the term "recognised pension fund" for the purpose of excluding such pensions funds or schemes from the application of the STTR when the Covered Tax Agreement does not include a definition of the term.

  - **Annex V – Circuit-breaker provision (optional)**, which jurisdictions may choose to include to (1) suspend the application of the STTR when a jurisdiction previously regarded as a developing country ceases to be a developing county as defined for a period of five consecutive years and (2) reactivate the application of the STTR when such jurisdiction becomes a developing country as defined again.

Inclusion of the STTR in existing bilateral tax treaties

The STTR can be incorporated into existing bilateral tax treaties through either the STTR MLI or re-negotiation of the treaties.

To update an existing tax treaty via the STTR MLI, both Contracting Jurisdictions to the treaty must first become a Party to the STTR MLI (i.e. signs the Multilateral Convention and goes through the ratification procedures required for the Convention to enter into force domestically). A tax treaty will become a Covered Tax Agreement when each Party to the Multilateral Convention has made a notification to the OECD Depository listing the treaty as an agreement to be covered by the STTR MLI. Articles 11 and 12 of the STTR MLI contain provisions that govern the entry into force of the STTR MLI in general, the entry into force of the STTR MLI for a particular signatory jurisdiction and the entry into effect of the provisions in the STTR MLI with respect to a Covered Tax Agreement.

According to the Statement issued by the Inclusive Framework on BEPS (IF) in October 2021, IF member jurisdictions are committed to incorporating the STTR into their bilateral tax treaties when being requested by developing jurisdictions[1] to do so.

It remains to be seen how many jurisdictions will sign up for the STTR MLI, how many jurisdictions are determined as having a nominal tax rate of below 9% on the covered income and how many tax treaties will be updated to incorporate the STTR. In this regard, further guidance from the OECD on the process to assess whether the nominal tax rate (subject to any necessary adjustments) applicable to an item of covered income is less than 9% in a jurisdiction would be helpful.

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[1] Developing countries are defined as those with GNI per capital of USD 12,535 or less in 2019.

Hong Kong SAR considerations

We discuss below some specific issues for Hong Kong SAR on adopting the STTR MLI:

- As Hong Kong SAR is not a sovereign state, for Hong Kong to be a Party to the STTR MLI, the Chinese Mainland will first need to become a Party to the STTR MLI and then extend its application to Hong Kong. It remains to be seen whether the Chinese Mainland and Hong Kong SAR would sign up for the STTR MLI.

- Currently, Hong Kong SAR has signed tax treaties with 16 jurisdictions[2] which are regarded as a developing country for the STTR purpose. It has yet to be seen whether these developing jurisdictions would require Hong Kong to include the STTR in their tax treaties with Hong Kong.

- As Hong Kong SAR 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. In addition, since Hong Kong does not impose withholding tax on the majority of covered income (e.g. interest, insurance and reinsurance premiums, fees for provision of financial guarantee and service fees) under its domestic tax law, no additional tax can be imposed by Hong Kong under the STTR even if the rule is incorporated into a Hong Kong tax treaty unless the domestic tax law was changed.

[2] The 16 jurisdictions that are regarded as a developing country under the STTR are: Bangladesh, Belarus, Cambodia, Mainland China, Georgia, India, Indonesia, Malaysia, Mauritius, Mexico, Pakistan, Russia, Serbia, South Africa, Thailand and Vietnam.

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