Multilateral instrument implementing the Pillar Two Subject to Tax Rule opens for signature

5 October 2023

In brief

On 3 October 2023, the OECD Inclusive Framework (IF) announced the conclusion of negotiations on a multilateral instrument (MLI) to implement the Pillar Two Subject to Tax Rule (STTR). The text of the STTR MLI, along with an explanatory statement, high-level summary ('at a glance'), and frequently asked questions (FAQs) can be found on the OECD website. As of 2 October 2023, the MLI is open for signature by all states without reservations. The STTR allows countries to increase taxes on certain cross-border payments (not including dividends) among associated entities under a bilateral tax treaty where the nominal rate in the recipient country is below 9% (adjusted for tax base reductions such as tax exemptions and tax credits). Further details and mechanics of the rule as per the model treaty text and accompanying commentary released 17 July 2023 are discussed in more detail in the previous PwC alert.

The takeaway: The STTR MLI is much narrower in scope than its UN predecessor (UN STTR), which applies in less clearly defined circumstances and leaves much of the content of the provision to be negotiated bilaterally. As a result, parallel STTR universes may emerge. In some cases, the STTR MLI will be implemented and applied by a subset of IF jurisdictions and for a subset of their double tax treaties (currently more than 70 developing IF jurisdictions are entitled to request inclusion of the STTR in their treaties, but it is not clear which countries these are). In other cases, developing countries may seek to implement the UN STTR in a subset of their double tax treaties, but this will require bilateral negotiation and agreement in all cases. Question five of the OECD's FAQs discusses the interplay between the IF's Pillar Two STTR and the UN STTR. It will be important to monitor the decisions of developed and developing countries as they may significantly influence after-tax returns of intra-group international investments.

In detail

The STTR MLI (Annex I)

As part of the October 2021 IF agreement, IF jurisdictions applying nominal corporate income tax rates below the 9% minimum rate (or a lower rate if another provision of a double tax treaty allows it) to interest, royalties, and a

defined set of other payments took on a commitment to implement the STTR in their bilateral tax treaties when requested to do so by IF jurisdictions identified as developing countries for this purpose. The STTR MLI aims to facilitate the implementation of the STTR in existing bilateral tax treaties without the need for more complex/time-consuming bilateral negotiations and amendments to such treaties.

When signing the MLI, IF jurisdictions must clarify to which agreements the treaty applies, which are referred to as 'Covered Tax Agreements.' The treaty text defines 'Covered Tax Agreement' as "an agreement for the avoidance of double taxation with respect to taxes on income" that is "in force between two parties." This is simply every bilateral (or multilateral) double tax treaty in force, which has been notified by both Contracting Jurisdictions as an agreement that they wish to be covered by the STTR MLI.

The STTR MLI does not amend the text, sequencing or numbering of existing provisions in Covered Tax Agreements. Instead, it amends the Covered Tax Agreements to include the STTR and other relevant accompanying provisions as Annexes to the Covered Tax Agreement. Once included in a Covered Tax Agreement, the Annexes form an integral part of the Covered Tax Agreement.

The STTR is included in Annex I to the STTR MLI. Where the STTR is added as an Annex to the Covered Tax Agreement, it will apply after entering into force without reservations. Thus, its application does not require a 'matching exercise' or further steps, apart from the implementation of the STTR MLI. Accordingly, the STTR MLI directly amends existing bilateral tax treaties, functioning like an amending protocol to a single existing bilateral tax treaty. This distinguishes it from the BEPS MLI, which does include reservations and thus requires a matching exercise to determine its application.

Observation: The absence of reservations means that bilateral tax treaty IF counterparties will have to add the STTR whenever two conditions are met: (1) their nominal corporate income tax rates applicable to items of income covered by the STTR are below 9% and (2) they committed themselves to add the STTR to their bilateral tax treaties when requested to do so by IF jurisdictions identified as developing for this purpose.[1] IF jurisdictions can implement the STTR by electing to sign the MLI or by amending bilateral treaties when requested by developing IF jurisdictions. A precise determination of meeting those conditions is therefore vital to anticipate the most likely future reach of the STTR.

Additional rules (remaining Annexes)

In addition to Annex I with the STTR, the STTR MLI contains four Annexes (II-V) regulating additional matters of relevance to the operation of the STTR. Those Annexes (Annex IV and V are optional) are added to Covered Tax Agreements where specified objective conditions are met, summarised as follows.

- Annex II is added if jurisdictions apply a tax computed on any basis other than on a net income basis;
- Annex III is added if countries impose a corporate income tax only at the point of profit distribution (deemed or actual), and not on items of covered income when that income is earned;
- Annex IV is added if jurisdictions choose to include the STTR MLI's specific definition of 'recognised pension fund' for applying the STTR, otherwise the existing treaty definition is used; and
- Annex V, an optional circuit-breaker provision, is added to suspend the STTR when a developing country becomes a developed country (and switches it on in a reverse case).

Signatories to the STTR MLI are required to notify the depository if Annexes II or III are applicable, while Annexes IV and V are optional.

Process of implementation (way forward)

The OECD will be the depositary of the STTR MLI and will support governments in the process of its signature and ratification. The first step is for IF members to sign the STTR MLI. This must then be followed by ratification, acceptance, or approval. The appropriate term and procedure will depend on the domestic legal requirements applicable in each IF jurisdiction. Once the domestic procedures have been completed, an instrument of ratification, acceptance, or approval must then be deposited with the depositary and this is the event which triggers the rule for the entry into force of the MLI. The OECD's high-level summary of the STTR MLI includes a step-by-step roadmap for countries to follow if they wish to sign the STTR MLI.

Articles 11 and 12 of the STTR MLI contain its entry into force and entry into effect provisions. Generally, the STTR MLI will enter into force for a signatory three months following the deposit of its instrument of ratification, acceptance, or approval. Article 12 provides that the STTR MLI will generally have effect in relation to a Covered Tax Agreement from the first day of a fiscal year beginning on or after the expiration of a period of six months following its entry into force for the latter of the Contracting Jurisdictions. Therefore, the earliest the STTR MLI could take effect (assuming deposit of instruments in October 2023) is the first day of a fiscal year starting on or after 1 August 2024 (or 1 January 2025 if the fiscal year follows a calendar year). Tax under the STTR is assessed and levied only following the end of a fiscal year.

Let's talk

For a deeper discussion of how Pillar Two's STTR might affect your business, please contact:

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[1] Developing countries are defined as those with a GNI per capita, calculated using the World Bank Atlas method, of USD 12,535 or less in any of 2019 to be regularly updated. The IF has agreed that this will include a country that meets this requirement in any of 2019, 2020, 2021 or 2022.