OECD releases Pillar Two STTR

19 July 2023

In brief

On 17 July 2023 the OECD Inclusive Framework (IF) released a report with model treaty text to give effect to the Subject-to-Tax-Rule (STTR), together with an accompanying commentary explaining the purpose and operation of the STTR. The OECD Secretariat also published a summary of the STTR, titled "The Subject to Tax Rule in a Nutshell," to assist in understanding the STTR model provisions.

The STTR is a treaty-based rule that allows source countries to impose an additional tax liability on certain intra-group payments in case the recipient is subject to a nominal corporate tax rate of less than 9% (adjusted for tax base reductions such as tax exemptions and tax credits). A wide range of payments between connected persons are targeted by the rule, including interest, royalties and service fees, with the notable exclusion of dividends. The STTR takes priority over the GloBE Rules and is creditable as a covered tax. Its implementation by countries is planned to start in October 2023 via a multilateral instrument (to allow for multiple bilateral tax treaties to be changed at the same time). IF members have committed to adopt the STTR when requested by other IF members that are developing countries.[1]

The takeaway: The STTR is an important part of the narrative of how the Two-Pillar Project tilts towards developing countries. But the price is high: there would be a significant increase in complexity of tax treaties for taxpayers and tax authorities. While the STTR may prove to be effective in allowing source countries to recover taxing rights in certain circumstances, it achieves this objective by requiring meticulous analysis of a broad spectrum of direct and indirect intra-group cross border payments, including items of income that were traditionally subject to exclusive residence taxation (e.g., services). Taxpayers should monitor the upcoming implementation of the STTR in treaties involving developing countries, including by way of a multilateral instrument in October 2023. Because the additional source tax is levied on the basis of gross income and the basis for the elimination of double taxation is net income, the STTR has the potential to increase the cost of capital for business.

In detail

STTR mechanism

The STTR is designed to expand source taxing rights otherwise granted by a tax treaty to the residence state, where the residence state exercises its taxing rights at a nominal rate below 9%. This additional taxing right is intended to be calculated as a top-up to the agreed 9% rate. As such the STTR specified rate is equal to the difference between 9% and the nominal rate applied in the resident State (as defined for STTR purposes), further reduced by any source taxation already allocated to the source jurisdiction in accordance with other articles of the

treaty. The maximum tax liability that may be levied under the STTR is determined by multiplying the STTR specified rate by the gross amount of covered income.

Observation: Even though the maximum STTR liability is calculated by reference to the gross amount of covered income, there is no requirement for the source country to exercise that taxing right in full or to levy taxation on a gross basis.

Objective scope (covered income)

Paragraph 4 of the STTR lists seven categories of income that constitute "covered income" for its purposes: (1) interest; (2) royalties; (3) payments for distribution rights for a product or service; (4) insurance or reinsurance premiums; (5) payments of guarantee or financing fees; (6) rental payments for industrial, commercial or scientific equipment; and (7) payments for services. Subparagraph b) modifies the list by excluding from its scope any income derived (a) from renting or using a ship transporting passengers or cargo without a crew or master; or (b) from a person whose tax liability in respect of that income is determined by reference to the tonnage of a ship.

Observation: Notably, the covered income does not include dividends. Instead it focuses on a broad spectrum of payments that reduce the tax base in source countries by their tax deductibility. This implies that the STTR targets both usually passive (e.g., interest, royalties) and active (e.g., payments for services) income as long as it can be broadly qualified as base eroding. It thus favors intra-group financing by equity rather than debt. Covered income also encompasses items that are generally not taxed by source States because exclusive taxing rights are attributed to resident States under Art. 7(1) of the OECD Model Convention; (i.e., services' fees and payments for the use of, or the right to use, distribution rights.)

Personal scope, exclusions and thresholds

The scope of the STTR covers transactions between connected persons. Entities are considered connected on the basis of a control relationship. Additionally, a deeming rule provides that persons will be connected in case of direct or indirect participation of more than 50% or based on facts and circumstances.

That being said, the STTR does not apply when the recipient falls into the following categories: individuals; non-profit organisations; states and government entities fulfilling a government function; international organisations; investment funds meeting specific conditions, including pension funds; or holding vehicles that are wholly, or almost wholly owned by an excluded recipient.

Moreover, the STTR will only apply if the total sum of covered income arising in the source country and paid to connected persons in the resident State surpasses a materiality threshold of EUR 250,000 or EUR 1 million per year (depending on whether the GDP of the country involved is above or below EUR 40 billion).[2]

Furthermore, except for interest and royalties, the STTR only applies in the case of covered income received by the recipient which exceeds the relevant costs incurred in the earning of the income <u>plus</u> a mark-up of 8.5% (i.e., limited BEPS risk). Indirect costs are also relevant for the calculation and its attribution to covered income can be established by any reasonable approach.

Nominal rate

The nominal rate applicable in the resident State is relevant to determine the STTR specified rate. While in most cases the relevant nominal rate may correspond to the general statutory rate, a number of circumstances may require an adjustment to the nominal rate, including where:

- a special statutory rate applies to certain categories of income or for taxpayers meeting certain conditions;
- the statutory rate is graduated according to the amount of income;
- the tax is covered under the relevant double tax treaty (DTT) but is levied on an alternative tax base (e.g. a tax levied on assets or equity rather than on net income); and
- a taxpayer benefits from "preferential adjustments" in the resident State, which result in a permanent reduction in the amount of covered income subject to tax. This includes exemptions, certain deductions from the tax base and certain tax credits (excluding foreign tax credits) that are directly linked to an item of covered income as opposed to the taxpayer.

Observation: Although the focus on the nominal tax rate aims to simplify the operation of the STTR, the further qualifications on relying on it removes much of the simplification.

Elimination of double taxation

In the absence of any adjustment, the STTR could trigger an obligation for the resident State to apply the exemption method or to provide credit for the tax paid at source. However, the STTR is not intended to have an effect on the allocation of taxing rights. To reflect this, additional provisions have been added to the article on eliminating double taxation to preserve the resident State position prior to the application of the STTR. For example, if a treaty ordinarily allows source taxation at 2.5% and the residence state levies its tax at 4%, the credit ordinarily granted by the residence state is 2.5% against that 4%. The introduction of the STTR top up of 2.5% (i.e., now 5% in the source country) would not require additional credit to be granted in the residence state.

Observation: The report notes that this provision has no effect on the relief mechanisms that may be available under domestic law, nor does it disturb the treatment of the STTR as a covered tax for GloBE purposes.

Targeted anti-avoidance rule

Paragraph 11 of the STTR contains a complex targeted anti-avoidance rule (TAAR). This applies either in the case of a payment routed via a high-tax connected person; or in the case when a payment is made to a non-connected intermediary which then makes a payment to a final payee who is connected to the first payor. Under certain circumstances and if it is reasonable to conclude that the intermediary would not have made the related payments in the absence of the original payment, the TAAR allows the intermediary to be disregarded in the transaction flow for purposes of determining the tax rate for the STTR. However, if Contracting States have the Principal Purpose Test and the Limitation on Benefits articles in force under their DTTs and consider them sufficient to address situations covered by the TAAR, they are free to omit the TAAR.

Observation: The TAAR operates mechanically (regardless of the tax avoidance intention of the payor of the covered income to obtain a tax benefit contrary to the relevant DTT provisions). Therefore, the TAAR does not necessarily target only abusive transactions. Additionally, one of the main conditions for applying the TAAR ("the intermediary would not have made the related payments in the absence of the original payment") corresponds to the exception relating to beneficial owner (BO) under Articles 10-12 (namely that this provision only applies if the intermediary is the BO, not if the final recipient is). However, the actual language used creates confusion between the concept of BO and the terms of the TAAR, thereby creating the risk that the tax authorities will by analogy apply the TAAR to identify BOs beyond the scope of application of the STTR.

PwC’s Tax Readiness Webcast: The current state of the OECD's two-pillar solution

While there is uncertainty around Pillar One (both on the timeline and on whether a critical mass is achievable), many countries have begun implementing Pillar Two, and the OECD IF continues to release substantive guidance in key areas. Join our CPE-eligible webcast for the latest updates on the OECD's two-pillar solution.

July 27, 2023 from 11:00 AM – 12:00 PM ET

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Let’s talk

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

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[1] Defined as countries with a Gross National Income per capita of USD 12,535 or less in 2019 to be regularly updated.
[2] The threshold is similar to that used to determine the nexus with a jurisdiction under Amount A of Pillar 1.