Tax Challenges Arising from the Digitalisation of the Economy – Subject to Tax Rule (Pillar Two)

Frequently asked questions on the Pillar Two STTR

1. The STTR is part of Pillar Two. How does it differ from the GloBE rules?

The STTR is an integral part of the consensus on Pillar Two for developing countries. The STTR Report now complements the GloBE rules and is the culmination of the rule-setting work on Pillar Two.

The GloBE Model Rules ensure that large multinational enterprises pay a minimum level of tax on the income arising in each of the jurisdictions where they operate. More specifically, the GloBE Rules provide for a co-ordinated system of taxation that imposes a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate of 15%.

The STTR is a treaty-based rule that applies on a transactional basis to intragroup payments from source States that are subject to low nominal tax rates in the State of the payee. The STTR is based on an understanding that where, under a tax treaty, a source State has ceded taxing rights on certain outbound intragroup payments, it should be able to recover some of those rights where the income in question is taxed (if at all) in the State of the payee (i.e. the residence State) at a rate below 9%.

The STTR applies before the GloBE rules and is creditable in computing the effective tax rate for the IIR and UTPR. It is not limited to members of groups meeting the revenue thresholds applying for the purposes of the GloBE rules.

2. What does the STTR mean for developing countries?

As part of the 2021 October Statement, Inclusive Framework members recognised that the STTR is an integral part of achieving a consensus on Pillar Two for developing countries and agreed that IF jurisdictions applying nominal corporate income tax rates below the STTR minimum rate of nine per cent to items of covered income would implement the STTR in their bilateral tax treaties when requested to do so by Inclusive Framework jurisdictions identified as developing for this purpose[1].

The rule has been developed to cater for the priorities of developing countries. For example, the inclusion of all intragroup service payments within the scope of the rule is important to many developing countries. The STTR also applies before the other rules that form part of Pillar Two, including a qualified domestic minimum top-up tax.

[1] A footnote to the 2021 October Statement provides that for this purpose, "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 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.

3. Is the STTR a minimum standard? Which countries will be required to implement the STTR in their tax treaties?

Inclusive Framework jurisdictions that apply nominal corporate income tax rates below the STTR minimum rate of nine per cent to items of covered income are required to implement the STTR in their bilateral tax treaties when requested to do so by IF jurisdictions identified as developing for this purpose[1]. The IF has agreed a process to assist both jurisdictions within the scope of the commitment and those able to make requests to implement the STTR in their bilateral treaties. This will support the consistent implementation of the STTR.

Jurisdictions that are not within the scope of the commitment, or that are not developing countries for the purpose of the obligation, are free to request implementation of the STTR in their tax treaties if they wish to do so.

4. What's the interplay between the STTR and the OECD work on tax treaties, in particular with the OECD Model Tax Convention?

The STTR was not developed to revisit the current allocation of taxing rights between source and residence States. Rather it is based on an understanding that where, under a tax treaty, a source State has ceded taxing rights on certain outbound payments, it should be able to recover some of those rights where the income in question is taxed (if at all) in the State of the payee (i.e. the residence State) at a rate below 9%.

The STTR has therefore been developed as a standalone treaty article and will not be incorporated into the OECD Model. Likewise, the STTR carries no implications for the allocation of taxing rights or any principles contained in the OECD Model. For example, the STTR does not affect the principles generally governing the taxation of services. The OECD Model Tax Convention provides that services are taxed in accordance with Article 7 and the approach to the taxation of services is described at paragraphs 132-169 of the Commentary to Article 5 of the OECD Model. Countries remain free to negotiate their bilateral treaties on the basis of the OECD, UN and other model tax conventions.

5. What's the interplay between the Pillar Two STTR and the subject to tax rule developed by the UN Committee of Experts on International Cooperation in Tax Matters?

The Pillar Two STTR represents a negotiated solution between the 142 jurisdictions comprised in the inter-governmental Inclusive Framework, operating on a full consensus basis. In contrast, the UN STTR was developed members of the UN Committee of Experts on International Cooperation in Tax Matters, serving in their personal capacity. The decisions of the UN Committee are made by simple majority.

In terms of substance, the Pillar Two STTR applies to defined categories of payments, including payments for services, made between connected companies where the relevant income is subject to a nominal tax rate below the minimum rate of 9%. It contains some exclusions and limitations to ensure the rule is appropriately targeted. Where it applies, it provides an additional taxing right up to 9%. The approach to the administration of the rule is also codified in the provision to limit the compliance and administrative burdens.

The UN STTR applies in less clearly defined circumstances and leaves much of the content of the provision to be negotiated bilaterally. It applies: to payments between all persons (including individuals) and its application is not limited to payments made to connected persons); to all types income (including, for example, employment income and pensions); without specification of the tax rate to which the income is subjected; and without limitation upon the additional tax that a source jurisdiction may charge, which is left to domestic law. The UN provision less prescriptively defines the computation of tax rate that is the trigger for its application. It also does not provide for any exclusions from the rule or features that would target its application (i.e. no materiality threshold or exclusion for income that result in a mark-up on costs of certain percentage) and leaves the exclusion of payments to pension funds, investment vehicles, real estate investment vehicles and other persons to bilateral negotiation. The UN STTR provision does not specify an approach to the administration of the rule. The commentaries accompanying the UN STTR are shorter and less comprehensive than those accompanying the Pillar Two STTR. These features might not be acceptable to jurisdictions that would prefer to implement a more targeted and defined rule.

Importantly, as part of the 2021 October Statement, IF jurisdictions have committed to implement the Pillar Two STTR in their existing tax treaties when certain conditions are met (i.e. IF jurisdictions that apply nominal corporate income tax rates below the STTR minimum rate of 9% to items of covered income are required to implement the STTR in their bilateral tax treaties when requested to do so by IF jurisdictions identified as developing for this purpose[1]). Therefore, unlike the UN STTR which requires bilateral negotiation and agreement, the Pillar Two STTR will be implemented in tax treaties where that commitment applies.

6. Who (i.e. which taxpayers) will be subject to the STTR?

The STTR applies to payments between connected companies. For the purposes of the rule, “connected” follows the approach taken in Article 5(8) of the OECD Model (Article 5(9) of the UN Model) and includes circumstances whereby one person has control of another, or both are under control of the same person or persons. It therefore applies to intragroup payments of income covered by the rule.

The STTR does not apply to payments made by individuals. Other persons are also excluded from the rule, including recognised pension funds, non-profit organisations, the Contracting States and their political subdivisions, international organisations, certain investment vehicles and persons owned by those persons listed above.

7. The Pillar Two Blueprint and the 2021 October Statement envisaged an STTR scope that comprised “interest, royalties and a defined set of other payments”. What’s the scope in the final version of the rule?

In the Pillar Two Blueprint, the STTR scope considered as covered income interest, royalties and a defined set of other payments (which included franchise fees or other payment for the use of or right to use intangibles in combination with services; insurance or reinsurance premium; guarantee, brokerage or financing fees; rents or any other payments for the use of or the right to use moveable property; amounts paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services).

Seven categories of income constitute covered income in the final version of the STTR. Those are:

(i) interest;
(ii) royalties;
(iii) payments made in consideration for the use of, or the right to use, distribution rights in respect of a product or service;
(iv) insurance and reinsurance premiums;
(v) fees to provide a financial guarantee, or other financing fees;
(vi) rent or any other payment for the use of, or the right to use, industrial, commercial or scientific equipment; and
(vii) any income received in consideration for the provision of services.

Under the scope in the STTR model provision, and in contrast for example to Article 12A of the UN Model which applies to "fees for technical services" delineation is no longer required and the STTR applies to all intra-group services.

8. How will we ensure that the STTR is effectively targeted and does not create undue impediments to business activities?

Three important features of the STTR ensure that its application is targeted and does not create undue impediments to business activities:

- A mark-up threshold, in paragraph 9 of the STTR model provision, excludes from the scope of the STTR some items of covered income that result in a mark-up on costs of 8.5% or less in the hands of the person deriving that income; and,
- A materiality threshold, in paragraph 12 of the STTR model provision, sets out a threshold test, below which the STTR will not apply. The threshold considers the total amount of covered income paid by persons in a source jurisdiction that are connected to persons in a residence jurisdiction. It also takes into account covered income borne by permanent establishments in that source jurisdiction.
- An ex post annualised charge approach to the administration of the additional taxing right, which provides for assessment and payment after the end of the fiscal year in which the taxpayer derives the payments of covered income.

9. What is the effect of having a mark-up threshold at 8.5%?

A mark-up threshold, which will exclude from the application of the STTR covered income from transactions that result in a mark-up on costs of 8.5% or less in the hands of the person deriving that income, focuses the rule on payments where the tax at risk and incentives to seek low tax outcomes are more material, as well as mitigating the potential for excessive taxation. Instead of performing a transfer pricing analysis of the various functions, assets and risks borne by the parties to the transaction in order to assess eligibility, the mark-up threshold provides for a mechanical approach that focuses on numerical indicators.

This feature of the rule was developed to balance the broad scope of covered payments, and especially the inclusion of all intragroup services taxable on a gross basis, with considerations of proportionality and administrability.

The mark-up threshold applies to the items of covered income contained at subdivisions (iii) to (vii) of subparagraph a) of paragraph 4, and not to the items of covered income found in subdivisions (i) and (ii) (i.e. interest or royalties).

10. How will the STTR be administered?

The STTR will be administered following an ex post annualised charge approach. That approach, which is codified in paragraph 14 of the STTR model provision, ensures that the tax chargeable in accordance with the STTR for a fiscal year is determined following the end of that fiscal year and is not be levied until it is so determined.

The approach to the submission of a tax return containing relevant information and the collection of tax due under the STTR is important because applying some core components of the STTR requires information that commonly will not be available at the point a payment of covered income is made. These include: whether the mark-up threshold in paragraph 9 applies; whether covered income qualifies for a preferential adjustment for the purposes of the tax rate test; whether the value of payments of covered income exceeds for a relevant fiscal year the materiality threshold in paragraph 12; and whether the STTR applies to a payment of covered income where the alternative provisions catering for taxes imposed on an alternative basis or at the point of a profit distribution apply.

The ex post annualised charge will operate by way of self-assessment. The approach will limit compliance burdens by ensuring that a self-assessment of liability under the STTR is not required whenever there is a cross-border payment of covered income to a connected person. Instead, under the ex post annualised charge approach, a resident of a Contracting State will only be required to submit a tax return where, following the end of a fiscal year, it has a liability to tax under the STTR.

11. How will the STTR be introduced in existing tax treaties? How does the STTR multilateral instrument differ from the BEPS Multilateral Instrument?

A new multilateral instrument has been developed to facilitate the implementation of the STTR in existing tax treaties and will be open for signature from 2 October 2023. IF jurisdictions will be able to use that instrument to swiftly implement the STTR in all their relevant tax treaties. Alternatively, IF jurisdictions that wish to do so will be able to implement the STTR in a given tax treaty through bilateral negotiations.

The coverage of the multilateral instrument on the STTR and the BEPS Multilateral Instrument will differ: the multilateral instrument on the STTR is likely to be used by a subset of IF jurisdictions (those within the commitment to implement the STTR) and for a subset of their tax treaties.

The functioning of the multilateral instrument on the STTR and the BEPS Multilateral Instrument also differ: the STTR will be implemented in all treaties covered under the multilateral instrument on the STTR and that instrument will amend those treaties by including annexes containing the STTR and accompanying provisions.

For more information, please visit: https://oe.cd/sttr-mli.