Pillar 2: Subject to Tax Rule

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The STTR is a tax treaty-based rule which allows for the levying of additional tax on several categories of connected party payments. Specifically, the STTR relaxes the tax treaty restrictions which would otherwise apply on source jurisdiction taxation on the listed payments. This permits countries to apply their domestic law taxing provisions to bring the nominal corporate income tax rate up to a minimum of 9 percent. It will be implemented through modifications to bilateral tax treaties via a multilateral instrument (to be open for signature from 2 October 2023) or through bilateral renegotiation of the treaties.

The new Inclusive Framework (IF) document sets out a design for the STTR provision and commentary on its operation. It does not deal with the specifics of how the STTR will be rolled out to treaties. Back in the October 2021 IF Statement, IF jurisdictions, that apply nominal CIT rates below 9 percent to in-scope payments, committed to bring the STTR into their bilateral treaties with developing IF members when requested to do so.

Observation: it remains to be seen how many jurisdictions are determined to apply rates below 9 percent, and how many treaties are requested to be updated for STTR. Time will tell what proportion of the world's 3000+ bilateral tax treaties get updated for STTR.

The key elements of the STTR are scope, covered income, nominal tax rate, mark-up threshold, materiality threshold, how they are levied and administered and potential targeted anti-avoidance rules. These are dealt with in turn.

Scope — connected persons and exclusions

The STTR covers payments between connected persons. There is a 50 percent control test which states that two parties are connected if both entities are under control of the same person either directly or indirectly. In addition two parties may be connected if the facts and circumstances are such that there is a relationship of control.

There is an anti-avoidance provision aimed at the prevention of the insertion of intermediaries where all or substantially all of a payment to the intermediary is paid as a related payment and it is reasonable to conclude that the related payment would not have occurred in the absence of the original payment

The STTR will not apply where the recipient of the payment is an individual, a non-profit organization, a State or part of a State, an international organization, certain investment funds and arrangement, and a holding vehicle which is owned by an excluded recipient.

The investment fund exclusion covers professionally managed entities or arrangements designed to invest funds obtained from unconnected persons. The investments must be made for the purpose of generating investment income or providing protection against an event. The arrangement or its managers must be regulated. A further exclusion covers widely held entities or arrangements subject to a tax regime achieving a single level of taxation (entity or interest holder level). This must either hold predominantly immovable property or be subject (entity or interest holder level) to tax of at least 9 percent.

Covered income

The STTR applies to:

- Interest and royalties
- Payments in consideration for the use of, or the right to use, distribution rights in respect of a product or service

- Insurance and reinsurance premiums
- Fees to provide a financial guarantee or other financing fees
- Rent or any other payment for the use of, or the right to use, industrial commercial or scientific equipment
- Income received in consideration of the provision of services.
- There are specific exclusions in relation to shipping ad air transport is also excluded

Observation: particularly notable is the inclusion of a broad spectrum of service payments in scope. Typically, tax treaties do not provide for the application of withholding taxes to cross-border service payments. As such, the inclusion of service payments in the scope of STTR could facilitate increased application of source country taxation to cross-border service payments in future.

Guidance is set out on the determination of the source of payments. This includes a rule deeming a payment to be sourced in the country of a permanent establishment, where the payment liability is borne by the latter.

Nominal tax rates and preferential adjustments

The STTR looks to the nominal tax rate rather than the effective tax rate to determine whether the 9 percent threshold is met. However, this is specifically an 'adjusted' nominal tax rate.

- STTR tax is calculated as the gross amount of covered income multiplied by the 'specified rate';
- The 'specified rate' is 9 percent minus the adjusted nominal rate, and a further adjustment for withholding tax permitting to be applied under the treaty;
- The adjusted nominal rate is determined by taking the statutory rate, applicable in the residence country to the item of covered income in the hands of the person deriving the income, and modifying for any preferential adjustment;
- The 'statutory' rate might thus be a low rate, applied to a particular category of income, or to the person receiving the income, in view of their status (e.g., located in a special economic zone);
- Special approaches for determining the statutory rate are set out where progressive CIT rates apply, or where tax is applied to equity rather than net income;
- The preferential adjustments that can be modified for include exemptions/exclusions from income, deductions calculated on the basis of an income amount without a corresponding payment, or tax credits referable to income (other than foreign tax credits). These must be permanent (rather than temporary) reductions in the amount of tax payable (albeit remittance regimes will be caught where tax is not paid within 3 years). Furthermore, the preferential adjustment must either be directly linked to the covered income (i.e., result from the specific local tax law characterisation of the payment) or arise under a preferential regime designed to attract geographically mobile income;
- As noted, the specified rate can be further reduced to the extent that the treaty allows withholding tax to be applied to the payment. Where the withholding tax permitted exceeds the specified rate, then the latter is effectively reduced to zero and no STTR tax applies.

Covered income exceeds costs in earning that income

Except for interest and royalties, the STTR does not apply if the income is less than the costs incurred attributable to earning the income plus a mark-up of 8.5 percent on those costs. This is subject to certain qualifications.

Materiality threshold

The STTR only applies if the total sum of Covered Income paid in a fiscal year exceeds € 1 million or €250,000 if the size of the smaller of the payer or payee jurisdiction has a GDP of less than €40 billion.

Taxes levied

STTR taxes are levied after the end of the year in which they arise, under an ex-post annualised charge approach. This can be coupled with a certification system, under which a non-resident could obtain a certificate confirming that it is not liable to tax under the STTR and does not need to submit a tax return.

What MNEs need to do?

MNEs need to analyse their structures and payments to determine whether, including the impact of the preferential adjustment rule, the nominal tax rate on covered income payments is less than 9%. If so, regard should be given to changing the arrangements between the parties.

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