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Enforcing Secondary Taxing Rights: Subject to Tax Rule in the UN Model Tax Convention

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Abstract

The Global Anti Base Erosion (GloBE) Rules under OECD's Pillar Two recommendations, with a minimum effective tax rate of 15%, are expected to play a significant role to end the 'race to the bottom' in corporate taxation, which is one of the main drivers of profit shifting. However, the thrust of these rules is designed in a manner to give priority to the developed countries. In this light, the Subject to Tax Rule (STTR), which is a treaty-based rule that allows source jurisdictions to impose limited source taxation on certain payments that are taxed below a minimum rate in the country of residence, is of extreme significance for the developing countries. Under Pillar Two, application of STTR is restricted to base eroding payments or mobile income between related parties only, which does not address Base Erosion and Profit Shifting (BEPS) concerns in an entirety. That apart, the withholding tax rate of 9% proposed by the OECD may not result in generation of significant resources for the developing countries. In this light, developing countries keenly expect that the UN Tax Committee should devise an STTR that is simple to operate, has a broad scope covering all payments in a tax treaty and imposes a higher withholding tax closer to 15% to bring meaningful revenues for them. Also, developing countries desire that STTR provisions may be introduced at the earliest so as to speedily implement them through the UN Multilateral Instrument under contemplation. This Policy Brief also examines existing average withholding tax rates on interest and royalty payments in existing tax treaties of 48 South Centre and 52 G-77+China Member States and finds that out of a total of 100 developing countries, only 25 would stand to benefit from the STTR in its restricted form in Pillar Two, further strengthening the need for an improved version formulated by the United Nations.

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Les règles globales anti-érosion de la base d'imposition (GloBE, en anglais) qui s'inscrivent dans le cadre des recommandations du deuxième pilier de l'OCDE et prévoient un taux effectif d'imposition minimum de 15 %, devraient jouer un rôle important pour mettre un terme au "nivellement par le bas" de l'impôt des sociétés, qui est l'un des principaux moteurs du transfert de bénéfices. Toutefois, ces règles visent essentiellement à donner la priorité aux pays développés. À cet égard, la règle de l'assujettissement à l'impôt (STTR, en anglais), qui est une règle conventionnelle permettant aux juridictions d'origine d'imposer de manière limitée certains paiements dont le taux d'imposition est inférieur à un taux minimum dans le pays de résidence, est d'une extrême importance pour les pays en développement. Dans le cadre du deuxième pilier, l'application de la STTR est limitée aux paiements entraînant une érosion de la base d'imposition ou aux revenus mobiles entre parties liées, ce qui ne répond pas entièrement aux préoccupations liées à l'érosion de la base d'imposition et au transfert de bénéfices (BEPS). Par ailleurs, le taux de retenue à la source de 9 % proposé par l'OCDE pourrait ne pas générer de ressources significatives pour les pays en développement. Dans cette optique, les pays en développement attendent avec impatience que le Comité fiscal des Nations Unies élabore une STTR qui soit simple à mettre en œuvre, qui ait un large champ d'application couvrant tous les paiements dans le cadre d'une convention fiscale et qui impose un taux de retenue à la source plus élevée, proche de 15 %, afin de générer des revenus significatifs pour eux. Les pays en développement souhaitent également que les dispositions de la STTR soient introduites le plus rapidement possible afin qu'elles puissent être mises en œuvre par le biais de l'instrument multilatéral des Nations Unies envisagé. Ce Rapport sur les Politiques examine également les taux moyens de retenue à la source sur les paiements d'intérêts et de redevances dans les conventions fiscales existantes de 48 États membres du Centre Sud et de 52 États membres du G-77+Chine et constate que sur un total de 100 pays en développement, seuls 25 pourraient bénéficier de la STTR sous sa forme restreinte dans le deuxième pilier, ce qui renforce encore la nécessité d'une version améliorée formulée par les Nations unies.

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Se espera que las Normas Globales contra la Erosión de la Base Imponible (GloBE, por sus siglas en inglés), en el marco de las recomendaciones del Segundo Pilar de la OCDE, con una tasa impositiva efectiva mínima del 15%, desempeñen un papel importante para

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poner fin a la "carrera a la baja" en el impuesto de sociedades, que es uno de los principales motores del traslado de beneficios. Sin embargo, la idea central de estas normas es dar prioridad a los países desarrollados. En este sentido, la norma de sujeción a impuestos (STTR, por sus siglas en inglés), que es una norma basada en un tratado que permite a las jurisdicciones de origen imponer impuestos limitados en origen sobre determinados pagos cuando dichos pagos no están sujetos a un tipo impositivo mínimo en el país de residencia, es de extrema importancia para los países en desarrollo. En el marco del segundo pilar, la aplicación de la STTR se limita únicamente a los pagos que erosionan la base imponible o a los ingresos móviles entre partes vinculadas, lo que no aborda en su totalidad las problemáticas relacionadas con la Erosión de la Base y el Traslado de Beneficios (BEPS). Por otra parte, el impuesto de retención del 9% propuesto por la OCDE puede no generar recursos significativos para los países en desarrollo. En este sentido, los países en desarrollo esperan que el Comité Fiscal de la ONU elabore una STTR que sea fácil de aplicar, que tenga un alcance amplio que cubra todos los pagos en un tratado fiscal y que imponga una tasa de retención más alta, cercana al 15%, para obtener ingresos significativos para dichos países. Asimismo, los países en desarrollo desean que las disposiciones de la STTR se introduzcan lo antes posible para poder aplicarlas rápidamente a través del Instrumento Multilateral de la ONU que se está contemplando. Este Informe sobre Políticas también examina las tasas medios de retención en origen sobre los pagos de intereses y cánones en los convenios fiscales vigentes de 48 Estados miembros del Centro Sur y 52 del G-77+China y concluye que, de un total de 100 países en desarrollo, sólo 25 podrían beneficiarse de la STTR en su forma restringida del Segundo Pilar, lo que refuerza aún más la necesidad de una versión mejorada formulada por las Naciones Unidas.

Introduction

The Organisation for Economic Co-operation and Development (OECD)/Group of Twenty (G20) Inclusive Framework on Base Erosion and Profit Shifting (BEPS) is preparing a "Two Pillar Solution" to address the tax challenges arising from the digitalization of the economy. Pillar One seeks to carry out a formulaic reallocation of 25% of residual profits that the largest Multinational Enterprises (MNEs) make in jurisdictions where they get revenues.[1] Those jurisdictions, referred to as "market" jurisdictions, would then have a taxing right, known as Amount A, over those profits.

Pillar Two on the other hand seeks to institute a global minimum effective corporate tax rate of 15%, which must be paid by the MNE for the revenues derived from each jurisdiction where it operates. Pillar Two has two components – the Global Anti Base Erosion (GLoBE) rules and the Subject to Tax Rule (STTR). The GLoBE Model rules[2] were released in December 2021 followed by an accompanying Commentary. The STTR continues to be negotiated.

Dissatisfied with the structure of the STTR at present in Pillar Two, chiefly its narrow and restrictive scope, the developing countries decided to create a better version through the United Nations (UN) mechanisms. In April 2022, the developing country Members of the UN Tax Committee (UNTC) introduced the STTR as an issue to be included into the Committee's four-year workplan.[3] Despite opposition from the developed country Members, the effort was successful and it was included in the workstream of the Subcommittee on the Update of the United Nations Model Double Taxation Convention between Developed and Developing Countries. The Subcommittee will now prepare its own version of the STTR.

Section I of this Policy Brief briefly outlines why the STTR was introduced in Pillar Two and its key features. Section II outlines what are its limitations and the present state of negotiations. Section III carries out an analysis of whether the STTR is beneficial for developing countries, given the existing withholding rates in the tax treaties of the Member States of the South Centre and the Group of 77 (G-77)+China. The data shows that the STTR is of minimal benefit for these countries and it explains why this led to the push for an improved version through the UN Tax Committee. Section IV describes the possible design features of such an STTR.

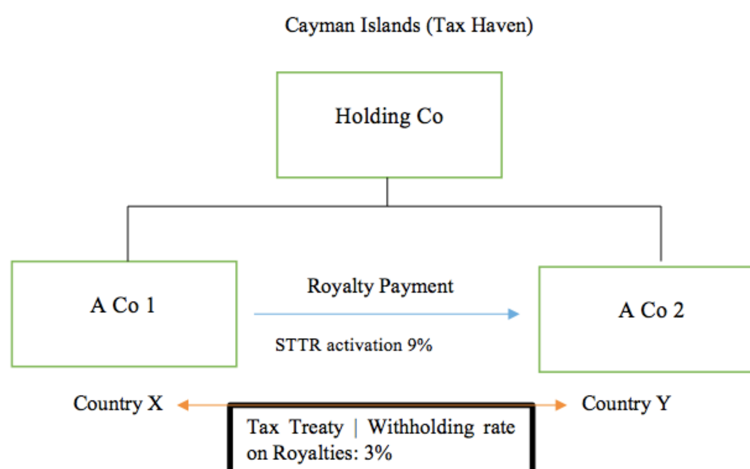
I. Genesis of the Subject to Tax Rule in Pillar Two

Pillar Two initially consisted mainly of the GLoBE rules, which in turn consisted of the Income Inclusion Rule (IIR) and the Under Taxed Payments Rule (UTPR). These were largely modelled on United States domestic law, specifically the US Tax Cuts and Jobs Act (TCJA) of 2017.[4] The IIR and UTPR were replicas of the Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT), respectively. The design of the rules meant that the undertaxed profits of the subsidiary, known as the Constituent Entity (CE), would be first taxed by the jurisdiction of the Ultimate Parent Entity (UPE). In practice these would be the developed countries such as the US, United Kingdom, France, Germany, etc where the big tech companies are headquartered.[5] If the UPE jurisdiction refused to collect the tax, which is most unlikely, then the second "chance" would be given to an intermediate jurisdiction, which in the case of big tech firms would typically be tax havens like Ireland or the Netherlands. Only if they refused, would the source jurisdictions finally be given the "chance" through the UTPR.

The design of such a blatantly one-sided set of rules meant to further enrich the developed countries was unacceptable to the developing countries. Accordingly, they pushed for what was eventually known as the Subject to Tax Rule. The idea was to ensure that certain payments between tax treaty partners were taxed at a minimum effective rate, which was later agreed upon at 9%.[6]

The STTR in Pillar Two is designed as a transaction-based rule, applying to certain categories of payments and between related parties. So far, the categories cover interest, royalties, and certain service fees. It is "activated" when such a payment is not taxed at an adjusted nominal rate of 9% in the recipient jurisdiction, and functions as a top-up tax. While this may seem abstract, its functioning

Figure 1: Functioning of Subject to Tax Rule



can be explained through an example in Figure 1.

In Figure 1, Country X, a developing country and Country Y, a developed country, both members of the Inclusive Framework, have a tax treaty. The withholding rate on royalties in this treaty is 3%. Country Y has a nominal corporate income tax rate on royalties of 2%.

If both X and Y adopt Pillar Two, then X can request Y to implement the STTR into its tax treaty, since the tax rate in Y on a covered payment (royalties) is 3% + 2% = 5%, which is below the STTR rate of 9%. The result of this will be that if A Co 1 in X makes a royalty payment to a related party such as A Co 2 in Y, and if the payment is above a certain "materiality threshold" (meaning it is a significant sum), then the STTR would be activated to bring the withholding tax rate to the top-up, which would be (9%-5% = 4%). It would have the practical effect of modifying the treaty to ensure the royalty payment transaction is taxed at 9%.

However, if the withholding rate in the treaty was higher, such as 5%, then the difference would be [9% - (2% + 5%) = 2%] and the STTR rate would be 2%. In this manner the STTR would function as a top-up to ensure that the covered payments in the treaty are always taxed at 9%.

One of the implications of this, however, is that the STTR is of no use in treaties where the withholding rate equals or exceeds 9%.

II. Design Limitations of the STTR

The original goal was to have a broad and simple to operate rule, but what now exists is a severely constricted - and as a result - highly complex rule with limited efficacy. The key limitations are outlined below.

Rate

As will be explored in Section III, the low rate of 9% means the STTR is of minimal use for most developing countries, who typically have higher withholding rates on the covered payments in their tax treaties. Since the withholding rate would affect the effective tax rate (ETR), it had to be kept a few percentage points lower than the overall Pillar Two rate of 15%. The developing countries had demanded a higher rate for the latter, ranging from 20% - 25%[7], and further research continues to confirm that the 15% rate will bring minimal additional revenues to developing countries.[8] As stated by the South Centre, "Had the minimum rate been between 20 - 25%, the STTR rate could have been at a more appropriate 10-15%, in line with the withholding rates in many developing country tax treaties."[9]

Scope

The single most important issue is the scope. At present, this is restricted to interests and royalties, and a few service payments. The developing countries through the Group of Twenty-four (G-24) had demanded the inclusion of all service fees and capital gains.[10]

The GloBE rules already include portfolio gains or losses in the tax base. Practically, this means that capital gains will be taxed by the residence country if the source country does not tax it up to 10%. Thus, the principle has been accepted that capital gains should be taxed at a minimum rate. However, this is only partially applied and only for the benefit of residence jurisdictions, which are mainly developed countries. The principle should be comprehensively applied across Pillar Two so that both the GloBE rules and STTR include capital gains. In this manner the developing countries will also be able to benefit as the STTR comes first in the rule order, hence giving the first right of taxation to the source countries which are mainly developing countries.

Related Parties / Connected Persons

The restriction of its application only to related parties has no rationale, as a base eroding payment can take place even with unrelated parties. For example, the Income Inclusion Rule taxes income from unrelated parties, and the same is provided for in BEPS Action 4 (thin

capitalization) and other Actions.

Further, the administration of the 'connected persons' test may be onerous. The Pillar Two Blueprint prescribes a) *de facto* control b) groups of persons and c) deeming rule tests which will be difficult to administer for tax administrations. These will require additional anti-abuse rules which are resource intensive and increase complexity.

The STTR at present also does not apply to payments to individuals.

Low Return Exclusion

The Pillar Two blueprint also proposes that payments that generate a "low return" should be excluded from the STTR, known as the "low return exclusion". This is yet another unnecessary restriction of the scope. A base eroding payment should be taxed regardless of whether it generates a high or low return.

Generally, base erosion concerns have been found in relation to payments made for management services (human resource services, strategic guidance services, marketing services, training services, legal services, etc.). The concerns regarding base erosion exist on account of no or low taxation in the state of residence, regardless of the mark-up charged by the service provider in rendering these services.

III. Impact Assessment of Pillar Two STTR on Developing Countries

The relevance of STTR for developing countries depends on the existing rates of withholding taxes in their bilateral tax treaties for covered payments such as interest and royalties. However, as will be shown, most developing countries already have withholding rates on interest and royalties that are on average higher than 9%. The methodology is briefly described below.

Methodology

The "average rate" as used in this study refers at a country level to the average of the rates applied on interest payments with all the tax treaty partners of the country, the average of the rates applied on royalty payments with all the partners, and thus the average of the rates on both interest and royalties in the country's tax treaties. Data on withholding tax rates was collected from the TaxNotes tax treaties database. Analysis is made for the South Centre's member countries and Members of the G77 + China, where data is available.

Results

Table 1 shows the average rate for interest and royalties for South Centre member countries and others G77+China countries. South Centre member countries globally already have an average rate of 9.6%, which is higher than the STTR rate. At the regional level, the average rate for South Centre members from Africa is 9%, and for members from Asia and Latin America and the Caribbean (LAC) respectively it is 10.1% and 10.4%.

Thus, for the South Centre's members the low STTR rate is of no use since the current withholding rates on average exceed 9%. For other members of the G77+China the average rate is 8.8%, lesser than the STTR rate by 0.02 percentage points which is quite insignificant. At a regional level for the G77+China countries the average rate for African countries is 8.7% and for Asian countries it is 8.9%, which is almost the STTR rate. Only the Middle Eastern countries have an average rate which is significantly lesser than the STTR, by 2.7 percentage points (6.3%).

Figure 2 shows the average rate for I&R by country and region for the South Centre's members. For African countries, out of 23, 7 countries have an average rate of 10% and above, 9 countries an average rate between 8% and 9%, 4 countries an average rate between 6% and 7%, and 3 countries with an average rate less than 6% (5.8%-2%).

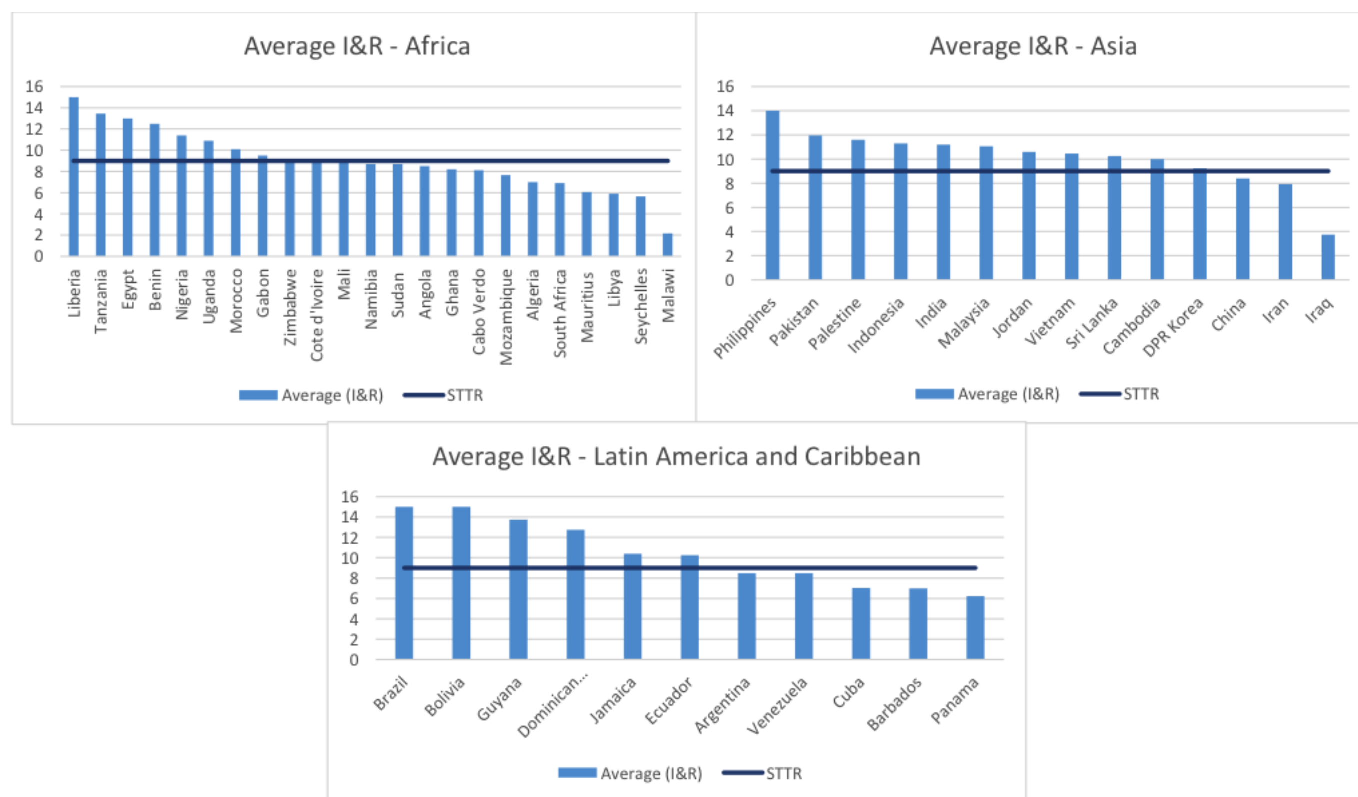
As per the data, the STTR's current rate will be of no use for at least 16 out of 23 African countries, which represents 70% of the total. Countries such as Liberia, Tanzania,

Table 1: Average rate for interest and royalties (I&R) per region

South Centre member countries			**G77+China member countries**	
Region	Average (I&R)		Region	Average (I&R)
Africa	9.0		Africa	8.7
Asia	10.1		Asia	8.9
Latin America and Caribbean	10.4		Latin America and Caribbean	9.8
Average for all South Centre Members	**9.6**		Middle East	6.3
			Oceania	10.5
			Average for all G-77+China Members	**8.8**

Source: Authors with TaxNotes data

Figure 2: Average tax rate for interest and royalties (I&R) for South Centre member countries in %



Source: Authors with TaxNotes data

Egypt, Benin, Nigeria, Uganda, Morocco, Gabon, Zimbabwe, Cote d'Ivoire and Mali will not gain any benefits from the STTR as it stands now. Countries that may have a slight gain from the STTR could be Malawi, Seychelles, Libya and Mauritius. For Asian countries, 12 out of a total of 14 countries, which is 86%, will not benefit from the STTR.

However, for Latin America and the Caribbean the results are different where out of 11 countries at least 6 (54%) will not clearly benefit from the STTR, implying the other 46% may stand to benefit. Argentina and Venezuela's rates are close to 9%, but Cuba, Barbados and Panama have rates which are much lower.

Figure 3 (in the next page) shows the average rate for I&R for other G77+China countries per country and region. For African countries, out of 21, 8 already have an average rate of 10% and above, 8 others have a rate between 8% and 9% and 5 have a rate less than 6% (between 5% and 4%). The STTR rate will not be of use for at least 12 African members of the G77, which represent 57% of African countries covered. In this group are countries such as Cameroon, Kenya, the Gambia, Senegal, Chad, Democratic Republic of the Congo, Guinea Bissau, Tunisia, Lesotho and Rwanda.

For Asian countries 1/3rd of the countries are already above the STTR rate and another 1/3rd already have a rate of 8%. Half of the countries in LAC region have an average rate above the STTR, and 3 countries out of the remaining 4 countries have an average rate of almost 9%.

Thus, the overall assessment for South Centre member countries and other developing country members of the G77+China shows that the STTR in Pillar Two will be of minimal benefit for most developing countries.

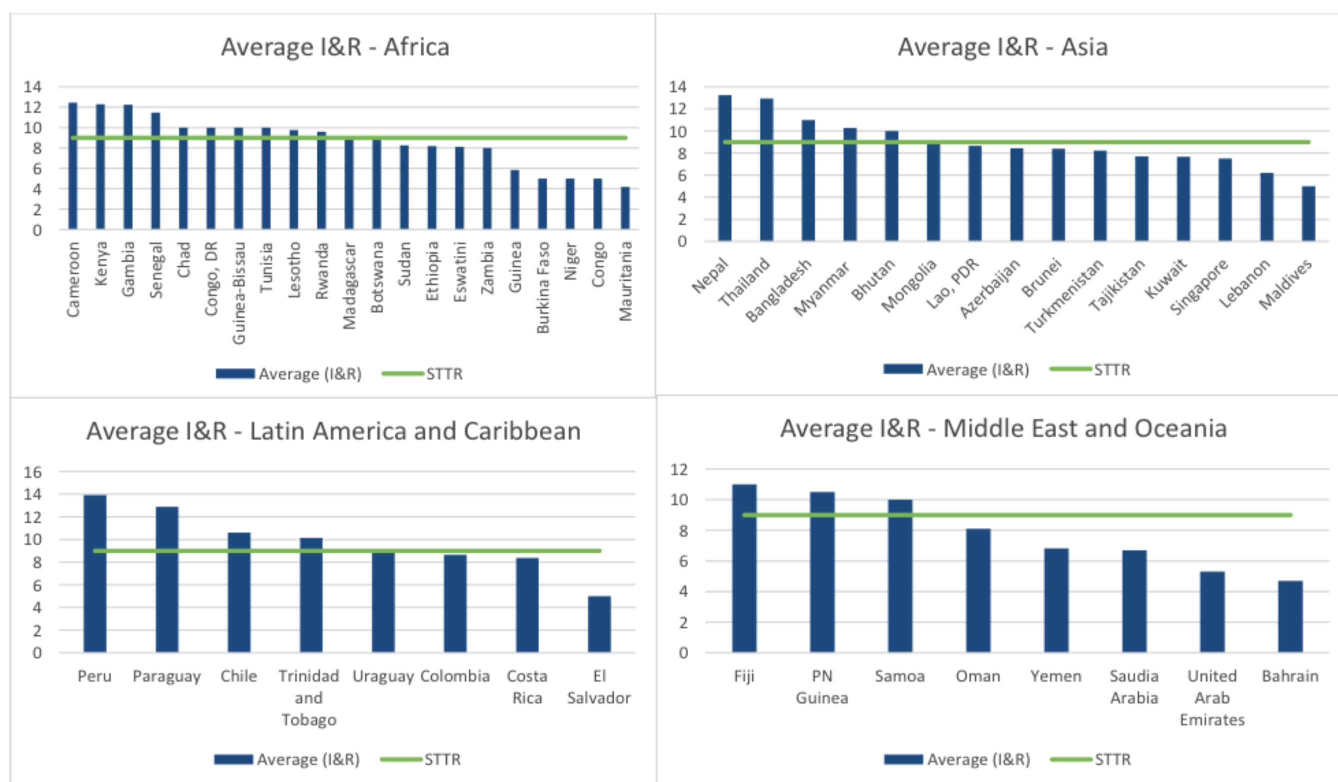
IV. Subject to Tax Rule in the UN Model Convention – A New Beginning

This conclusion led to the push to design an improved version through the UN Tax Committee. As mentioned, in April 2022, the decision was taken for the UN Tax Committee's Subcommittee on the Update of the United Nations Model Double Taxation Convention between Developed and Developing Countries to begin working on a Subject to Tax Rule.

An equally important decision in the April session was for the Subcommittee on Taxation Issues Related to the Digitalized and Globalized Economy to begin working on a UN Multilateral Instrument (MLI).[11] The concept of a UN MLI was first put forth by the South Centre and would be a means to incorporate the beneficial provisions of the UN Model Tax Convention (UN MTC), particularly Article 12B, into multiple existing bilateral tax treaties without the need for their individual renegotiation.[12] The Subcommittee recognized that in addition to Articles 12A and 12B, the STTR could be an additional important article for wide dissemination through the UN MLI.

The development of a UN MLI would provide a great fillip to the UN MTC and be of much help to the develop-

Figure 3: Average tax rate for interest and royalties (I&R) for other developing country members of the Group of 77 + China



Source: Authors with TaxNotes data

ing countries in updating and renegotiating their bilateral tax treaties. Including an STTR provision would provide a powerful anti-abuse rule and ensure that the source country can exercise their secondary taxing right when the residence jurisdiction refuses to exercise its primary taxing right.

Below are suggestions for an improved version of the STTR that can be introduced in the UN MTC. The underlying design principle is that the rule must be simple to operate and have a broad scope, consistent with the logic that any payment can be potentially base eroding.

Rate

The UN Model Articles themselves do not prescribe rates, leaving it to bilateral negotiations. However, the Commentaries do suggest rates. Accordingly, a minimum rate of 15% can be prescribed, which would be far more beneficial for developing countries.

Scope

The STTR should apply to all payments covered in the relevant tax treaty. Further, it should apply to all persons irrespective of their relationship, including individuals. There must be no low-return exclusion. It can continue to function as a simple transaction-based rule.

Nominal Tax Rate Disclosure

The STTR should also encourage service contracts between parties (related or unrelated) to require disclosure of information related to the nominal tax rate to help taxpayers in enforcing the withholding. This can also strengthen calls for transparency on the tax havens.

Application through Tax Treaties

The STTR can be designed either as a stand-alone new Article in the UN Model Tax Convention, or as an addition to an existing Article. One option could be to add it to Article 29 (Entitlement of Benefits) with wording that states that where income is not effectively subject to tax in the residence State, it shall be taxable by the source State in accordance with its domestic legislation.

The dissemination of the STTR can be facilitated through the UN MLI.

Conclusion

The global minimum tax is a welcome move to end the ‘race to the bottom’ in corporate taxation. However, in Pillar Two, the GLoBE rules give priority to the developed countries, and it is mainly the Subject to Tax Rule (STTR) that will benefit developing countries by enforcing the secondary taxing right in tax treaties. As we have seen, the STTR in Pillar Two has been restricted so it cannot effectively fulfil its desired objective. For this reason, the ongoing work on an STTR in the UN Tax Committee is welcome news for developing countries. Such a rule should be simple to operate, have a broad scope covering all payments in a tax treaty and impose a higher withholding tax closer to 15% to bring real revenue benefits for developing countries. It can be more widely disseminated

into existing tax treaties through a UN Multilateral Instrument, which is also being developed by the UN Tax Committee.

Endnotes:

[1] See https://www.taxnotes.com/tax-notes-today-international/base-erosion-and-profit-shifting-beps/amount-rules-dont-work-intended-unilever-tells-oecd/2022/08/29/7dzb1.

[2] See https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[3] See https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2022-03/CRP.2%20UN%20Model%20Coordinators%20Report%20march18pab.pdf.

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[5] *Vladimir Starkov and Alexis Jin,* ***A Tough Call? Comparing Tax Revenues to Be Raised by Developing Countries from the Amount A and the UN Model Treaty Article 12B Regimes****,* Research Paper, No. 156 (Geneva, South Centre, 2022). Available from https://www.southcentre.int/research-paper-156-1-june-2022/.

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[7] Sebastien Babou Diasso, "Global Minimum Tax Rate: Detached from Developing Country Realities", Tax Cooperation Policy Brief, No. 23 (Geneva, South Centre, 2022). Available from https://www.southcentre.int/tax-cooperation-policy-brief-23-11-february-2022/.

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[10] See https://www.g24.org/wp-content/uploads/2022/03/Comments-of-the-G24-on-the-IF-July-Statement.pdf.

[11] See https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2022-03/CRP.6%20Digitalized%20and%20Globalized%20Economy.pdf.

[12] Radhakishan Rawal, "Conceptualizing a UN Multilateral Instrument", Tax Cooperation Policy Brief, No. 15 (Geneva, South Centre, 2021). Available from https://www.southcentre.int/tax-cooperation-policy-brief-15-june-2021/.

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Efforts to reform international cooperation in tax matters are exhibiting a distinct acceleration. The direction of change must recognize and incorporate innovations in developing country policies and approaches, otherwise the outcomes will obstruct practical paths to development.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

***** The views contained in the policy briefs are personal to the authors and do not represent the institutional views of the South Centre or its Member States.**

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