9 Subject to tax rule

9.1. Overview

566. The GloBE rules focus on the remaining BEPS issues and seek to develop rules that would provide jurisdictions with a right to “tax back” up to the agreed minimum rate where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation. The STTR complements these rules. It is a treaty based rule that specifically targets risks to source jurisdictions posed by BEPS structures relating to intragroup payments which take advantage of low nominal rates of taxation in the other contracting jurisdiction (that is, the jurisdiction of the payee).

567. The STTR is not premised on concerns (such as those addressed under Pillar One, or underlying the inclusion of the Article 12A technical service fees provision in the 2017 UN Model) that the current allocation of taxing rights between jurisdictions needs to be revisited. Rather it is based on the rationale that a source jurisdiction that has ceded taxing rights in the context of an income tax treaty should be able to apply a top up tax to the agreed minimum rate where, as a result of BEPS structures relating to intragroup payments, the income that benefits from treaty protection is not taxed or is taxed at below the minimum rate in the other contracting jurisdiction. Specifically the STTR targets those cross-border structures relating to intragroup payments that exploit certain provisions of the treaty in order to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation. By restoring taxing rights to the source state in these cases, the STTR is designed to help source countries to protect their tax base, notably those with lower administrative capacities.

568. As discussed more fully in section 9.2.3 below, the STTR will therefore apply to certain categories of payments that present a greater risk of base erosion (covered payments). The work so far has entailed consideration of interest, royalties and a defined set of other payments that present BEPS risks because they relate to mobile capital, assets or risk.

569. Although BEPS risks associated with mobile capital, assets and risk may arise in relation to interest, rents, and certain other deductible payments between connected persons, similar concerns may also arise in respect of gains that would otherwise be taxable in the source state and are shifted into the residence jurisdiction in order to escape taxation. These structures may exhibit comparable mobile features to those targeted by covered payments. Further consideration will therefore be given to whether the STTR should also apply to these arrangements. This work will focus on strategies giving rise to a greater risk of base erosion (which, in relation to capital gains, may not be dependent on a connected persons relationship between the parties). Any such rules should minimise the burdens for both tax administrations and taxpayers and avoid double taxation or taxation in excess of economic profit such as taking into account the operation of participation exemption regimes.

570. The STTR does not seek to address broader tax treaty policy questions regarding the allocation of taxing rights between jurisdictions. Jurisdictions legitimately adopt differing positions on these questions, which are a matter for bilateral negotiations. None of the elements making up the design of the STTR –

which has a particular focus on addressing certain base erosion risks in the context of the wider GloBE proposal – either informs or prejudices those broader tax treaty policy positions.

571. Accordingly, the STTR will not be implemented via changes to the Articles of the OECD Model Tax Convention (OECD, 2017[1]) governing the allocation of taxing rights over business profits (Article 7), interest (Article 11) or royalties (Article 12), or the equivalent provisions included in existing treaties, but will be explored through a separate standalone treaty provision codifying the STTR and each of its design elements.

572. As with other elements of Pillar Two, Inclusive Framework members acknowledge the importance of developing rules that meet the objectives set out above while minimising burdens for both tax administrations and taxpayers and avoiding double taxation or taxation in excess of economic profit.

573. Drawing all of this together, work on the STTR will address the following design components:

a. **Applied to payments.** The STTR is a standalone treaty rule and, consistent with the way bilateral tax treaties operate, will apply to payments between residents of two contracting states. This payments-based approach means that the rule will not apply jurisdictional or entity blending, but will instead operate by reference to the tax applicable to an item of income. Consistent with the scope of application of the GloBE proposal, however, it will not apply to payments made to or by individuals.

b. **Applied between connected persons**. The STTR will apply to payments between connected persons. The definition of connected persons is based on the definition of “closely related” persons in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions. Under this test, two persons are treated as “connected” if one has control of the other or both are under the control of the same person or persons. While the test is based on a de facto control relationship, these control requirements are automatically met where one person possesses directly or indirectly more than 50% of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50% of the beneficial interests in both.

c. **Covered payments.** The STTR will apply to a defined set of payments giving rise to base erosion concerns. Further consideration will also be given to whether the STTR should also apply to certain structures that are designed to shift gains from the source to the residence state where they are subject to low nominal rates of taxation.

d. **Excluded entities.** Consistent with the scope of application of the GloBE, the STTR will not apply to certain entities that are outside the scope of the income inclusion and undertaxed payments rules (where certain conditions are met). The entities that are currently envisaged as being excluded from those rules are: investment funds; pension funds; governmental entities (including sovereign wealth funds); international organisations, and non-profit organisations.

e. **Materiality threshold**. In order to ensure that the STTR is both focused on those structures that pose the most material profit shifting risks and simpler to administer and comply with, consideration will be given to a materiality threshold based on one or a combination of the size of the MNE group, a tiered EUR-value of covered payments, and the ratio of covered payments to total expenditures.

f. **Adjusted nominal rate trigger**. The STTR will be triggered when a payment is subject to a nominal tax rate in the payee jurisdiction that is below the minimum rate, after adjusting for certain permanent changes in the tax base that are directly linked to the payment or the entity receiving it. This approach is consistent with the design of a payments-based rule; applying an effective tax rate test to each payment would be prohibitively complex to administer and comply with.

g. **Using a top-up approach.** The effect of the STTR will be to allow the payer jurisdiction to apply a top-up tax to bring the tax on the payment up to an agreed minimum rate and that interacts in a coordinated manner with any existing withholding rate in the treaty. Because the rule applies to the gross amount of the payment, the top-up tax will be limited to avoid excessive taxation.

574. The first five of these components frame the scope of the standalone treaty rule; and the last two determine the conditions under which it applies and the effect of its application. The elements identified above are described in further detail below.

9.2. Scope

575. Consistent with the nature of bilateral tax treaties, the STTR will apply at the entity (person resident in a contracting jurisdiction) level and to individual payments (items of income). Consistent with the overall design of Pillar Two, and subject to further consideration of the risks associated with certain types of capital gains, the STTR will only apply to payments between parties that are under common control and will not apply to payments made to (or by) residents who are individuals.

9.2.1. Connected persons requirement

576. Limiting the scope of the rule to covered payments between connected persons is in line with the policy and purpose of the STTR, as articulated in section 9.1 above. A connected persons requirement ensures that the rule focuses on those cross-border tax planning arrangements that are designed to shift an amount from the source state into a low-tax offshore structure without a corresponding change in the ownership of the underlying profit. An STTR that applied to all covered payments, regardless of the payer's connection with the payee, would push the policy of the rule, contrary to its agreed purpose, away from targeting BEPS risks.

577. Limiting the STTR to payments between connected persons limits the scope of the rule to those transactions which IF members consider raise the most significant BEPS risks. A connected person requirement ensures that there is a sufficient degree of common control between the payer and the payee such that the parties have both the ability to engineer the type of low-tax outcomes covered by the rule and sufficient economic connection to benefit from such profit shifting.

578. On the other hand, expanding the STTR to cover all covered payments, regardless of the degree of connection between the parties, could result in the over-taxation of transactions that do not raise any BEPS concerns. Absent concerns about treaty abuse,[1] payments made by a third party customer for the acquisition of services would not, in isolation, be considered profit-shifting from the payer to the payee jurisdiction in the sense contemplated by the STTR, even if those payments benefitted from low rates of taxation under the domestic laws of the payee jurisdiction. On these facts the payment of services fees to an unrelated party is not the shifting of profit but expenditure incurred in determining the amount of that profit. Limiting the STTR to payments between connected persons guards against the real risk that the imposition of gross-basis taxation may make the supply of those services uneconomic, thereby distorting pricing and purchasing decisions to the detriment of the payer.

579. The connected persons test is consistent with other design features of the STTR such as the definition of covered payments, which focuses on certain categories of transactions involving an intragroup transfer of risk, assets or capital and which are difficult to price from a transfer pricing perspective[2]. It is also in line with the operation of the other GloBE rules such as those applied to Orphan Entities.

Practical and administrative concerns

580. A STTR that did not incorporate a connected persons requirement could be difficult to apply and could lead to volatile and unpredictable outcomes for taxpayers due to the fact that the payer may not have

the information necessary to determine whether (and to what extent) the rule will apply and would not have the ability to control its liability for any withholding tax under the rule.

Documentation requirements

581. In order to comply with the STTR the payer needs to know, prior to making the payment, whether the payment is subject to tax above the minimum rate in the hands of the counterparty. While in certain cases it may be relatively simple for a payer to know whether the payee is subject to a nominal rate of tax on a payment, there are likely to be a number of situations where the nominal rate of taxation on a payment is not obvious.[3] These challenges are more significant in the case of payments to unrelated parties where it may be difficult for the payer to obtain the information necessary to comply with the rule but also because the compliance and economic incentives of the payer and payee may not be aligned.

582. Even if it were possible to address some of these concerns – for example by requiring the payee to communicate to the payer, whenever a payment was made, whether that payment was subject to tax at above the minimum rate – this would involve documentation requirements that do not currently exist for most service contracts. And it is not clear to what extent the payer can or should be able to rely on information provided by a payee located in a different jurisdiction. An alternative would be for the payer to withhold on all payments and require the payee to file for a refund. However this would impose a significant additional tax burden on cross-border supplies of services and would be contrary to the policy behind the STTR which focuses on defined transactions that give rise to significant BEPS concerns.

Inability of payer to control risk

583. While, as discussed further below, there may be a number of domestic mechanisms that the source state could use to levy the tax provided for under the STTR, in most cases it is expected that the compliance and payment obligations are likely to fall, as least in part, on the local payer. Furthermore in situations where the parties are independent persons acting at arms-length with divergent economic interests, then the payee may seek to shift the additional cost of tax payable in the source state onto the payer in the form of a tax indemnity or gross-up. This is commonly the case, for example, in relation to third-party lending transactions. Therefore, particularly in the case of payments between unconnected parties, the economic and compliance burden of the tax falls on the local payer.

584. The risk of the payer being exposed to unexpected liabilities pursuant to the operation of the STTR will be exacerbated in cases where the payer and payee have divergent interests and are not under common control. For example, the payer would not necessarily know (or expect to be notified) that the underlying IP licensed from a third party has been shifted into a low tax preferential regime. The payer could not protect itself from the resulting change in the tax treatment of license payments without inserting onerous provisions into the service agreement that restricted the counterparty's right to manage its own IP.

9.2.2. Definition of Connected Persons

Connected Persons

"Two persons shall be "connected persons" if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

In any case, a person or enterprise shall be considered to be connected to another person if:

(a) one possesses directly or indirectly more than 50% of the beneficial interest in the other (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or

(b) if another person possesses directly or indirectly more than 50% of the beneficial interest (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person.".

585. The definition of connected persons adopts (with the necessary adaptations) the approach taken in the definition of "closely related" persons and enterprises in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions, for the purposes of applying the independent agent and anti-fragmentation provisions in those Articles[4]. This rule is based on a de facto control test but includes a back-up rule that deems there to be control where there is a direct or indirect participation of 50% or more. This test is the same as control test used for Orphan Entities in Section 8.3 above which, in turn, is similar to the control test used in consolidated accounting.

586. As set out in Section 8.3, the connected persons test looks to the facts and circumstances between the parties in the context of its other arrangements and seeks to determine whether the person has sufficient power over the entity to affect that person's investment return in that entity. The test takes into account a broad range of factors affecting control which ensure that, in practice, a controlling investor in a company cannot sever a connection with an entity by putting in place arrangements that are designed to retain control but shift ownership of the equity into the hands of others. The connected persons test also extends to joint venture interests. The connected persons test applies to groups of controlling persons. The controlling persons requirement means that shares in an entity that are held by members of the shareholder's family or received as part of a spin-off of a business to controlling shareholders will generally remain under common control even if that entity is no longer consolidated with the group. The de facto test is supplemented by a deeming rule that treats one person as connected to another where the first person holds directly or indirectly more than 50% of the beneficial interest in the second person. The deemed control test means that a majority shareholder does not fall outside the scope of the rule simply because it is de-consolidated for other reasons. Together these three elements of the connected persons test (de facto control, groups of persons and deeming rules) ensure that two parties to arrangement that have a significant economic connection and the ability to structure arrangements between them to the advantage of one or the other are likely to fall within the scope of the connected persons test.

587. Whilst the de facto control test provides a robust defence against arrangements designed to shift the ownership of equity in order to reduce participation to minority levels, consideration will be given during the development of the detailed rules to supplementing the control test with mechanical anti-abuse rules targeting conduit structures designed to circumvent the connected persons condition. For example, an MNE might enter into back-to-back arrangements through which payments of covered income are routed through one or more intermediate unconnected person(s) with the prima facie result that the connection between each payer and payee is severed. Purpose-based general anti-abuse rules, such as the principal purpose test codified in Article 29(9) of the OECD and UN Model Tax Conventions, offer an effective remedy to such arrangements, but the Models and their Commentaries include a number of mechanical anti-abuse rules that may be used in addition to those general rules to target particular arrangements (such as the anti-contract splitting rule provided in paragraph 52 of the Commentary on Article 5 of the OECD Model) and these can be attractive especially to tax administrations that may have limited capacity to resource more fact-intensive approaches. Such mechanical provisions, however, require more detailed drafting to ensure that they effectively describe and remedy the targeted abuse, without being too widely-drawn, and risk adding complexity to the design of the rules. The further technical work in this area will therefore balance these considerations with a view to designing rules that are appropriately focused and administrable.

9.2.3. Categories of covered payments

588. As outlined in section 9.1 above, the STTR will apply to a defined list of payments. Work so far has entailed consideration of interest,[5] royalties and a defined set of other payments designed to capture categories of payments that present BEPS risks because they exhibit features such as being susceptible to transfer pricing abuse or uncertainty and arise in respect of mobile risk, ownership of assets, or capital. The rule will include a definitive list of the categories of payment to which it will apply. Further work is required to refine this list to ensure that the rule is targeted and effective without giving rise to undue compliance burdens for taxpayers and the outcomes from this work will be incorporated into the development of a model provision.

Interest and royalties

589. The STTR will apply to payments of interest and royalties.

Other covered payments

590. Other payments are considered to present a greater BEPS risk if the value of the payment is primarily compensation for mobile factors such as capital, assets, or risks that are owned or assumed by the person entitled to the payment. Conversely, payments present a lower risk from a BEPS perspective where their value is primarily linked to functions performed by the person entitled to the payment. Whilst the latter type of payment may, in certain cases, be equally difficult to price from a transfer pricing perspective they might not be expected to give rise to the same base-eroding opportunities as payments that are primarily compensation for the provision of capital, assets or risk. This is because the functions performed by personnel are less mobile than the ownership or assumption of capital, assets and risk and therefore less susceptible to BEPS strategies.

591. In addition to payments of interest and royalties, the STTR would therefore apply to the following categories of payments primarily based on these mobile features:

a. A franchise fee or other payment for the use of or right to use intangibles in combination with services;

b. Insurance or reinsurance premium;

c. A guarantee, brokerage or financing fee;

d. Rent or any other payment for the use of or the right to use moveable property;

e. An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

592. These payments were identified by applying the principles set out above and aim at providing jurisdictions with a tool to deal with arrangements that are designed to shift profit to low tax structures within the group. These tax structures have been previously identified by their tax administrations. Each of these categories of payment is described in further detail below.

593. None of these categories apply to payments forming part of the income of a permanent establishment in the source state or for the use of an asset that forms part of the business property of a permanent establishment in the source state. This is because the source state has an existing and prior taxing right over the profits of the permanent establishment under Article 7. This would be codified in the text of the STTR.

594. A payment that does not fall in the categories (a) to (e) listed above would not be covered by the STTR. In addition, the STTR will not apply to payments falling within those categories where the payment generates a low return (see below the section on the exclusion of low-return payments).

595. Defining the list of covered payments by reference to the components that generate value and providing an exclusion based on the return generated for the payee ensures that the STTR targets relevant payments that are likely to present BEPS risk offers a number of advantages:

- it is relatively simple;
- the inclusion of payments the value of which derives from a significant asset is in line with the inclusion of royalties in the scope of covered payments;
- the inclusion of payments the value of which derives from a significant risk is in line with the fact that the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised;
- the exclusion for low-return payments whose compensation, when expressed on a cost-plus basis, does not exceed a certain margin limits the risk of taxation in excess of economic profits if the rule applies as a withholding tax on the gross amount of the payment made;
- the exclusion for low-return payments is in line with the simplified approach provided in Chapter 7 of the OECD Transfer Pricing Guidelines (OECD, 2017[2]) as available for low-value adding services;
- the exclusion for low-return payments could leave the possibility for taxpayers and tax administrations to prove on an ex-post basis that the payment did or did not generate a low-return on costs, which is likely to facilitate the administration of the rule.

596. In developing the detailed rules, further work will be undertaken on the definition and delineation of each of the categories of payment included in the list. This will include an examination of the extent to which management fees and payments for knowledge-based technical services are covered.

(a) A franchise fee or other payment for the use of or right to use intangibles in combination with services

597. Under a franchise arrangement, one member of an MNE Group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee (a "franchise fee").[6] The franchisor may have developed intangible assets (e.g. trademark, know-how) that it licenses to the franchisee together with additional services in return for a fee, such as a percentage of the franchisee's revenue.

598. Other similar arrangements could give rise to payments for the "use or right to use intangibles in combination with services". Such payments could, for instance, be made for the right to use a technology owned by a connected person that provides services to the payer based on the use of that technology. Another example is a payment for the use of software where the provider also provides ancillary support such as technical support, customisation and maintenance which is performed by the same connected person. The payer could pay a single fee for both the use of the software and the related services.

599. If related intragroup services can be rendered by a connected person that benefits from a low-tax regime, an MNE Group could organise its structure so that the ownership of such an intangible asset is transferred to such a low-tax connected person, which would then license the asset and render combined services in exchange for a single fee, which could generate a high return.

600. Where the payment is made under a mixed contract and includes a royalties[7] element, the contract may be able to be broken down into its constituent parts (i.e. royalty + payment for a service). In this case, the STTR will only apply to the constituent parts that are in scope of the rule.[8] Assuming that the payment can be broken down into a royalty and a payment for a service, the following will apply:

- Where the treaty allocates a source state taxing right over royalties, both the existing treaty provision and the STTR will apply to the royalty component and the source state will be permitted to tax the royalty element at the higher of the existing treaty rate or the top-up rate. This is consistent with the ordering rule described in Section 9.3.2 below.

- The remainder of the payment (the services element) will be in the scope of the STTR if it is, viewed in isolation, itself a covered payment that is not a low-return payment.

(b) Insurance or reinsurance premium

601. Insurance or reinsurance premiums are payments made in exchange for covering a risk that would otherwise be borne by the insured person. Through the insurance/reinsurance, the assumption of the insured risk is transferred to the insurer, so that if the risk materialises the insured person does not bear the financial consequences of that risk. Risks can therefore be transferred from one connected person to another through this arrangement. If the risk does not materialise, the insurance or reinsurance premium can generate a high return. Insurance or reinsurance services rendered by connected persons such as captive insurance tend to be more profitable than other insurance or reinsurance services. Furthermore, it can be hard to find comparable unrelated transactions to test whether the pricing of these transactions meets the arm’s length principle.

602. In the situation where the insurance premium would form part of the taxable profits of a permanent establishment located in the source jurisdiction, these premiums would be taxable in the source jurisdiction and the STTR would not apply to them. The UN Model Tax Convention, for instance, provides that an insurance enterprise shall be deemed to have a permanent establishment in the state where it collects premiums or insures risks situated therein through a person.[9] An exception, however, is provided for reinsurance premiums. In this situation, the existence of a PE can be avoided by providing reinsurance services to local (possibly connected) insurers instead of insurance services directly to final customers. The STTR could apply to such reinsurance premiums if the other conditions to apply the rule are met.

(c) A guarantee, brokerage or financing fee

- Guarantee fee

603. A guarantee is a legally binding commitment of the guarantor to assume an obligation of the guaranteed debtor if the debtor defaults on that obligation. In an MNE Group context, a related party guarantor may provide a guarantee on a loan taken out by a connected person from an unrelated lender. By providing an explicit guarantee the guarantor is exposed to additional risk as it is legally committed to pay if the borrower defaults. While the guarantor can suffer a loss in case the risk materialises, the guarantee fee can generate a high return if the borrower does not default on its obligation. The risks assumed by the guarantor may be shifted into a low tax jurisdiction provided the guarantor has the financial capacity to assume the risk. .

- Brokerage fees

604. A broker acts as an intermediary to facilitate a transaction, in exchange for a commission or a brokerage fee. An underlying component of this transaction is the access to and use of an intangible asset (for instance the client and the supplier list). When a broker acts on behalf of connected persons, the development of the client or supplier list consisting of connected persons may not have required significant efforts. The broker may have been transferred such an intangible asset and benefit from a low-tax regime.

605. It may be difficult to find reliable comparable transactions to the intragroup brokerage service that is rendered, which makes it difficult to test whether the pricing of the intragroup transactions meets the arm’s length principle. When the brokerage fee is a percentage of the underlying transaction (and not based on the costs of the service provider), the transaction may also generate a high return.

- Financing fees

606. When a company borrows money, either through a loan or a bond, it usually incurs financing fees. These are fees paid by the borrower to intermediaries or persons involved in arranging the financing. If a connected person was involved in arranging the financing, it could also charge intragroup financing fees.

607. It may be difficult to find reliable comparable transactions to the financing fee, which makes it difficult to test whether the pricing of the intragroup transactions meets the arm's length principle. When the financing fee is a percentage of the underlying transaction (and not based on the costs of the service provider), the transaction may also generate a high return.

(d) Rent or any other payment for the use of right to use moveable property

608. This category covers leasing or rental payments for moveable property and would apply, for instance, where such moveable property is held by a connected person that benefits from a low-tax regime and is used by another connected person. The ownership of such moveable property can be transferred within the group while it may be hard to find reliable comparable transactions for the use of such moveable property when it is relatively unique and essential to the business of the lessor. For instance, a company operating in the extractives sector could transfer the ownership of a drilling rig to a low-tax affiliate which would lease this property to other connected persons and receive a rent. When the rent is not based on the costs of the low-tax affiliates, the transaction may generate a high return.

(e) An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

609. This category is aimed at covering agency and intermediary services such as marketing agency, procurement or other centralised intermediary services when their value primarily derives from the use of an intangible asset, such as a client list or a supplier list.

610. The payments covered by this category may either be paid to the intermediary (for instance in the case of a commission paid to a sales agent for the sales made to the customers that it introduced to the intragroup seller) or retained by the intermediary (for instance in the case of a procurement fee that is incorporated in the price of the products that are purchased on behalf of the other affiliates).[10] This difference in payment terms does not affect the characterisation of such payments as being covered by the STTR.

611. One of the underlying components of these payments is the access to and use of an intangible asset (e.g. client list or supplier list). When the related intermediary functions are mobile, an MNE Group could organise its structure so that the ownership of such an intangible asset is transferred to a low-tax connected person, which would then be entitled to the intermediary fee, which could generate a high return.

612. Other marketing agency, procurement and other intermediary services may primarily derive their value from functions performed, for example for market research. These services would be expected to generate a low-return and would be covered by the exclusion for low-return payments (see below).

Exclusion for low return payments

613. Although payments for the listed categories of covered payments, by their nature, present prima facie risks of base-erosion and profit-shifting, the STTR is designed to be targeted and to minimise administrative and compliance burdens. The rule will therefore provide an exclusion for payments falling within those categories where the payment generates a low return (low-return payments). A payment is a low-return payment where it is calculated by reference to the costs incurred by the payee in earning the payment[11], or can be calculated on a cost plus basis, and where the margin is no higher than an agreed percentage.

614. When combined with a materiality threshold as described later in this Section, this exclusion will ensure that the STTR is focused on cross-border tax planning structures that take advantage of particular low tax outcomes in the residence jurisdiction in order to shift material amounts of profit from the source to the residence jurisdiction.

615. The effect of the exclusion for low-return payments is to focus the STTR only on those payments that generate a high return. Activities that produce a low-return for the payee are the least likely to present a risk of base erosion for the payer jurisdiction. The STTR will not apply when the taxpayer demonstrates that payments generate a low return (i.e. when the mark-up of costs incurred by the payee is below a fixed percentage). This mark-up test will be applied independently of whether the transfer pricing method applied is a cost-plus method, or another method the result of which produces an equivalent mark-up on costs. The application of the mark-up test for the purposes of the low-return payments exclusion does not, however, displace or influence the normal requirement to apply the transfer pricing rules, as for any other intragroup payments, including the principles that govern the choice and the application of an appropriate transfer pricing methodology.

616. This limitation is generally expected to exclude payments that had already been subjected to a transfer pricing benchmarking analysis and would be consistent with existing transfer pricing safe-harbours used by Inclusive Framework members. In designing the detailed rules that will codify the STTR, further technical work will be undertaken to identify the circumstances under which this limitation would apply – including the determination of the cost base and mark-up percentage – and potential simplifications to the design of this rule component.

9.2.4. Excluded entities

617. For the purposes of the income inclusion and undertaxed payments rules, and where certain conditions are met, it is proposed that the following entities will not be treated as Constituent Entities of an MNE Group (and will therefore be excluded from the scope of those rules: investment funds, pension funds, governmental entities (including sovereign wealth funds), international organisations, and non-profit organisations. Consistent with the exclusion of these entities from the scope of the income inclusion and undertaxed payments rules the same exclusion could apply for the purposes of the STTR.

618. These excluded entities all have a particular purpose and status under the laws of the jurisdiction in which they are created or established. This status is likely to result in the entity not being exposed to domestic income tax in order to preserve a specific intended policy outcome under the laws of that jurisdiction. The domestic tax outcome may, for example, be designed to ensure a single layer of taxation on vehicles used by investors (e.g. funds) or on retirement plans used by employees, or because the entity is carrying out governmental or quasi-governmental functions. The tax policy objectives of the domestic tax exemption for these types of entities are neither inconsistent with the tax policy objectives of the GloBE rules nor create a competitive distortion that would undermine the tax policy objectives of the GloBE proposal. Subjecting the income of such entities to tax under the GloBE rules would undermine the policy objectives that the domestic jurisdiction is seeking to achieve by granting the exemption without furthering the tax policy objectives of the GloBE rules.

619. Similar considerations apply in the context of bilateral tax treaties and this is recognised in the OECD Model and Commentaries.

a. Paragraphs 22 to 48 of the Commentary on Article 1 address issues relating to collective investment vehicles and, recognising that under domestic law such arrangements may enjoy exemption from tax, be taxed on a reduced base (often reduced to nil) by being granted deductions for distributions to investors, or be taxed at special low rates, generally seek to clarify their entitlement to treaty benefits as persons who are liable to tax and the beneficial owners of their income.

b. In 2017, Article 4(1) of the Model was revised to expressly include a “recognised pension fund”, which may be conditionally exempt from tax under domestic law, in the definition of a resident liable to tax and prima facie entitled to treaty benefits.

c. Paragraphs 49 to 53 of the Commentary on Article 1, and paragraph 8.5 of the Commentary on Article 4, discuss the treaty entitlement of entities set-up and wholly-owned by a state or its political subdivisions, including sovereign wealth funds, and note that these entities often enjoy exemption from tax and paragraph 8.11 of the Commentary on Article 4 considers similar issues in relation to charities and other organisations that may be exempted from tax.

620. Many states include provisions in, or interpret and apply, their bilateral tax treaties to treat these entities as residents. Those treaties may also include provisions to grant the benefit of exemptions from or reductions in source taxation of these entities, notwithstanding that they may be exempt in their state of residence, in recognition of the principles outlined above. In such cases, applying the subject to tax test to such entities would therefore run contrary to that policy objective.

621. Jurisdictions are, of course, free to determine their response to these issues in their bilateral negotiations and may, as is recognised in paragraph 8.12 of the Commentary on Article 4, take the view that entities that are exempt from tax under domestic law do not qualify as residents prima facie entitled to benefits or, as is recognised in paragraph 8.9 of the Commentary on Article 4, choose to omit the reference to a “recognised pension fund” in Article 4(1). In relation to the application of the principle of sovereign immunity to governmental entities, paragraph 52 of the Commentary on Article 1 notes that most states would not extend this to business activities carried on by such entities.

622. Consideration of these exclusions in the context of the STTR will be updated as the discussions develop further on sectoral carve-outs in relation to the broader GloBE rules, with the option to align the treatment of these entities.

9.2.5. Materiality threshold

623. In the absence of a threshold or filter an MNE would be required to identify and compute the adjusted nominal tax rate for every covered payment made to connected persons in each separate payee jurisdiction. For a large MNE this could be thousands of payments for which there is no distinct line item in the financial statements. As far as the tax policy context permits, and in line with aims of the wider Pillar, the design of the STTR should seek to minimise such compliance burdens. Moreover, the STTR is intended to serve as a tool to discourage MNEs from structuring themselves in a way designed to exploit the allocation of taxing rights under a treaty in order to make base-eroding payments that benefit from low tax outcomes in the other contracting jurisdiction. MNEs are unlikely to incur the costs of structuring themselves in this way unless the result would secure material tax advantages. A threshold or filter could exclude these de minimis outcomes from the scope of the rule.

624. Similar materiality considerations can underlie the allocation of audit resources by tax administrations to cases where the tax at risk best justifies costly interventions. For this reason, tax administrations build such thresholds into their domestic regimes including, for example, excluding small and medium sized enterprises from the scope of transfer pricing legislation or applying safe harbours for intra-group payments falling below a de minimis value. Chapter B.4.5.2 of the UN Transfer Pricing Manual sets out two safe harbours that may be used by tax authorities – a safe harbour for low-value services that are unconnected to an Associated enterprise’s main business activity; and a minor expenses safe harbour – and notes as a rationale that the administrative costs and compliance costs may be disproportionate to the tax at stake.

625. One way of addressing these compliance and administration considerations would be to include a materiality threshold, below which the STTR would not apply, as part of the detailed rules underpinning the operation of the Rule. This approach would also provide greater tax certainty. However, it must also

be recognised that what is a materially significant risk can vary between small and large jurisdictions. And that the administration of a threshold test itself might introduce complexity and cost, especially for tax administrations with lower capacity.

626. There are a number of possible approaches to the design of a materiality threshold, which could be used in isolation or in combination, and three approaches are discussed below. The choice of an approach will be informed by views on the levels at which MNEs are likely to enter into structuring arrangements to take advantage of low tax outcomes and the appropriate allocation of tax administrations' resources to risk.

Threshold based on the size of the MNE

627. The income inclusion and undertaxed payments rules apply to MNE Groups that meet the EUR 750m threshold adopted by the Inclusive Framework under BEPS Action 13 (Country by Country Reporting). As a standalone treaty rule the STTR does not need to be limited to groups meeting that size threshold, but there are merits in considering a threshold based on the size of the MNE Group.

628. A threshold based on the size of an MNE Group is easy to administer and apply, especially in the context of a payments-based rule, because it does not rely on information that might not be available at the point of payment or during the period in which a payment is made. This clearly has advantages for both tax administrations and taxpayers. Although a size threshold applying for the purposes of the STTR does not need to align with the EUR 750m threshold applying for the purposes of the GloBE, it should not be set too low in recognition of the lower risk of material base-eroding payments in smaller groups. It seems clear, for example, that micro, small and medium sized enterprises (SMEs)[12] should be excluded from the scope of the rule. A number of jurisdictions provide exclusions for SMEs in their domestic transfer pricing and other rules, on similar materiality grounds.

629. The STTR focuses on a defined set of cross-border payments between connected persons other than individuals and is therefore addressing particular risks arising in an MNE Group context. A threshold based on the characteristics of an MNE Group would therefore be consistent with this focus and would serve to target the rule on those MNE Groups most likely and best equipped to enter into BEPS structures taking advantage of low-tax outcomes.

Threshold based on a tiered value of covered payments made to connected persons in other contracting state

630. Because the STTR focuses on particular categories of cross-border, connected-person payments giving rise to greater BEPS risks, the materiality threshold could be set by reference to the value of such payments in a year. Where the EUR-value of covered payments made to connected persons in the other contracting jurisdiction exceeded a fixed amount in a year, the STTR would apply. The test would apply to all covered payments irrespective of the tax treatment. Such a threshold could be tiered by reference to GDP, with a lower threshold amount for smaller economies, in a way that recognises that what is considered a significant risk can vary between small and large jurisdictions, and be informed by existing safe-harbour regimes. For example, the United Nations Transfer Pricing Manual discusses safe harbours for "minor expenses" and example 20 alludes to a $750,000 threshold.

631. An approach that relies on the value of payments in a year raises administrative and compliance questions, where the total value of payments in a year is not known and cannot be established at the point a particular payment is made. To address this, the determination of whether the threshold is crossed for a particular year could be made on the basis of the average value of covered payments to [connected persons in] the other contracting jurisdiction in the preceding three years. Where that average exceeds the threshold, the STTR would apply to all such payments in the current year. Such an approach may, however, result in both over- and under-withholding – where (although the threshold is crossed according

to the three year average) payments in a year ultimately fall below the threshold, or vice versa – and give rise to concerns about excessive contingent withholding and potential delayed repayment. Administrative approaches to minimising or eliminating these issues, including applying the top-up tax on an ex-post basis in the form of an annualised charge are discussed further in Section 9.3.4 below. Alternatively, the STTR could apply prospectively to subsequent payments once the level of payments in a period has crossed the threshold.

Threshold based on a ratio

632. Under this approach, the STTR will not apply where the total amount of covered payments the payer had made (or was expected to make) to any connected persons in the other contracting jurisdiction over the course of the payer's financial year, expressed as a proportion of total expenditures, were below a certain ratio. Building off a risk assessment concept, the threshold could be designed to measure whether the payer makes a sufficient amount of covered payments (as defined above) during the relevant period to connected persons in the other contracting jurisdiction to justify further intervention by the source jurisdiction and allow an efficient allocation of a jurisdiction's tax administration's resources to risk. The threshold is intended to focus the operation of the STTR by excluding from its scope those connected person arrangements that would not typically be expected to give rise to BEPS concerns. As with the EUR-value approach described above, this materiality test would capture all covered payments and apply irrespective of the tax treatment of each specific payment in the payee jurisdiction.

633. The threshold would be met when (i) the total amount of covered payments the payer had made (or was expected to make) to [any connected persons in] the other contracting jurisdiction over (ii) the payer's total expenditures except cost of goods exceeded a certain percentage. In order to be able to compute this ratio at the time when the payment is made, both the payments and expenditures taken into account could be an average calculated across the preceding three years. This raises similar administrative and compliance considerations as the EUR-value approach discussed above, and potential remedies are discussed in Section 9.3.4 below. Again, the STTR could apply prospectively to subsequent payments once the ratio of payments in a period has crossed the threshold.

634. Both the EUR-value and ratio approaches could also include an anti-fragmentation rule that prevented the MNE splitting payments under the same arrangement between multiple payers in the source state to avoid reaching the threshold.

Further technical work

635. Balancing these considerations, the Inclusive Framework will take forward further technical work on the design of a materiality threshold within a framework that will explore:

- an MNE size threshold;
- a tiered EUR-value payments threshold; and
- a ratio-based threshold,

which could be applied in isolation or combination.

636. The evaluation of these approaches will be informed by views on the levels at which MNEs are likely to enter into structuring arrangements to take advantage of low tax outcomes and the appropriate allocation of a tax administration's resources to risk. It will also recognise that a threshold would be intended to both simplify the operation of the STTR and focus its application on a risk-assessment basis, by excluding from its scope those connected person arrangements that would not typically be expected to give rise to audit concerns. Such a threshold should operate as an administrable filter to determine whether the STTR should apply in a particular case given the policy objectives of the rule that should be

straightforward for taxpayers and tax administrations to apply and avoid giving rise to undue compliance and administration costs.

9.3. Operation and effect

9.3.1. Subject to Tax Rule applies on a nominal basis

637. The STTR will be triggered where a covered payment is subject to a nominal tax rate in the payee jurisdiction that is below an agreed minimum rate, after adjusting for certain permanent changes in the tax base. A rule that sought to establish the effective tax rate on a particular payment or transaction (after taking into account relevant deductions) would be prohibitively complex both from an administrative and compliance perspective. Focusing on a nominal tax rate test makes the rule simpler to apply, particularly in the context of the other mechanics of the rule discussed further below (such as top-up withholding).

638. Using an effective tax rate test in the context of a withholding tax measure would be particularly difficult as an effective tax rate test measures the tax imposed on an entity's net income over a defined accounting period and it would not be possible to establish the effective tax rate in the payee jurisdiction at the time when a payment is made (and the withholding tax would need to be levied). A nominal tax rate test is easier for tax administrations to administer (particularly those with low capacity) and is more in line with the policy goal of the STTR to focus on specific low-tax outcomes in respect of specific payments.

639. Because the STTR is a treaty rule, the taxes that will be taken in account for the purposes of applying the nominal rate test will be those that are covered taxes for the purposes of the treaty, as defined in the treaty in provisions equivalent to Article 2 of the OECD Model Tax Convention (OECD, 2017[1]). These covered taxes may not align with the taxes that are covered taxes for the purposes of the GloBE, but this is consistent with the nature of bilateral tax treaties which include rules setting the scope of their application (e.g. to defined persons and taxes).

Nominal test applies on a payments basis

640. A rule that looked only to the statutory rate applied to a payment, however, and did not take account of specific provisions that alter the amount of the payment that is brought within the charge to tax, might fail to capture cases in which a payment is subject to low levels of taxation and leave countries exposed to BEPS risks. Such an approach would not, therefore, offer a credible response to targeting the base-erosion concerns that underpin the STTR. To balance these considerations, the determination of the adjusted nominal rate would start with the statutory rate applicable to the counterparty in the payee jurisdiction and adjust this by reference to any preferential rate or special exemptions, exclusions, reductions or expansions that are linked directly to the payment or the entity receiving it. Multiplying the actual tax rate on the payment by the proportion of the payment that is subject to tax in the payee jurisdiction would produce the adjusted nominal rate. For example, where a company in State X receives foreign source royalty income, State X might

(a) apply a preferential tax rate to that royalty payment;

(b) exclude a certain percentage of the royalty payment from taxation;

(c) apply tax at a low rate, but to an amount that is greater than the income;

(d) allow resident companies a deduction for deemed expenditure associated with payments of that character that is in addition to or calculated independently of the payee's actual expenditure.

In all these cases this approach would calculate the rate of tax on the payment by reference to the proportion of the payment that is subject to tax after taking into account the exclusion or deduction from the payment.

641. An adjusted nominal rate determined along these lines would, for example, apply to low or zero rate jurisdictions; payments to a territorial regime where such payments are not brought into account as income in the residence state; payments eligible for a preferential tax regime and regimes that provided for a full or partial exclusion from income.

No adjustment for general deductions against the tax base

642. This approach would not, however, take into account deductions from the tax base that were not directly linked to the item of income or category of payee. For example, adjustments such as super-deductions for certain categories of expenditure or notional interest or dividend deductions and other unilateral downward adjustments of profit would, therefore, not be covered by the STTR. And deductions, in computing profits of the payee, for costs that represent actual business expenditures incurred should not give rise to an adjustment of the nominal tax rate. Taking these types of general deductions from the tax base into account would raise prohibitive challenges from a design perspective, such as how to allocate the reduction in the tax base to particular payments, and would add another layer of complexity and controversy to the application of the rule. It would also raise questions about what account should be taken of the non-deductibility of certain expenditure, such as whether the nominal rate needed to be adjusted upwards to take account of the fact that some interest expenses might be non-deductible.

Tax base calculated otherwise than by reference to income

643. In developing the detailed rules that will codify and govern the operation of the adjusted nominal tax rate test, further work will be undertaken on the design of mechanisms that ensure that the test applies appropriately in relation to jurisdictions that calculate their tax base other than by reference to a resident's income. These mechanisms will be informed by, and could draw upon with suitable adaptations, the solutions developed for the purposes of the IIR and UTPR. For example the Zakat levied on corporations by the Kingdom of Saudi Arabia is a tax on both income and equity. The Zakat is levied at 2.5% but since it is imposed on income and equity it results in a higher effective rate. Equally certain members of the Inclusive Framework have income tax regimes that impose an income tax on a corporation when the corporation's income is distributed to its shareholders, rather than when it is earned. The statutory tax rates in these jurisdictions may equal or exceed the agreed minimum rate of tax, thereby ensuring that ultimately the income is not subject to a low rate of tax. Absent a distribution, however, the income is not subject to tax in the year it is earned. The design of a nominal tax rate test mechanism would need to be adjusted in these cases to reflect to specific features of these countries regimes. For example, for jurisdictions with a corporate tax base that is not calculated by reference to income, the payee may be able to certify that, notwithstanding the low nominal rate, the average tax burden on all income of the payee over an agreed period was in excess on the minimum rate.

Practical considerations

644. Subject to the application of a materiality threshold, as discussed in section 9.2.5 above, which would serve to remove the obligation in cases below that threshold, taxpayers, withholding agents and tax administrations will need to establish the adjusted nominal tax rate for all covered payments in determining whether the STTR applies and, where it does, the rate of top-up tax to be applied to the covered payment. If the primary mechanism for applying the STTR were to be an interim withholding tax at the point of payment, it is particularly important that this information is ascertainable by the payer, or a withholding agent, at that time, to determine whether and at what rate the withholding tax should be applied. Whilst information on the nominal tax rates, and details of special regimes, applying to categories of income in particular jurisdictions is generally available – either in material published by the relevant tax administration, or from third party sources – further work will be undertaken on how best to administer this in light of the specificities of each jurisdiction's tax regime.

No adjustment for exemption or credit under treaty elimination article

645. Under paragraph 1 of Article 23 A of the OECD Model, the residence jurisdiction is obliged to exempt an item of income from tax where the source jurisdiction is permitted to tax that item of income in accordance with the treaty. This treaty exemption is, prima facie, an exemption, exclusion, or reduction in the tax base that is linked directly to the payment or the entity receiving it. But taking the treaty exemption into account for the purposes of computing the adjusted nominal rate would produce outcomes that go beyond the intended functioning of the STTR, which is not to reallocate taxing rights between jurisdictions but to allow source jurisdictions to apply a top-up tax to covered payments that are subject to low nominal rates in the residence jurisdiction. This is illustrated by example 9.3.1A.

646. In order to address this issue, the entitlement to an exemption under provisions equivalent to Article 23 A of the OECD Model will not be taken into account when computing the adjusted nominal rate for the purposes of the STTR.

647. To the extent that similar considerations could arise in respect of the residence jurisdiction's obligation under paragraph 1 of Article 23 B and paragraph 2 of Article 23 B to provide a credit against its own tax on an item of income for the tax paid on that income in the source jurisdiction, the entitlement to credit under those provisions will also be disregarded when computing the adjusted nominal rate for the purposes of the STTR.

648. Disregarding the entitlement to exemption or credit under the elimination article in a tax treaty in this way for the purposes of computing the adjusted nominal rate raises questions about the interaction between the source jurisdiction's right to apply a top-up tax under the subject to tax test and the residence jurisdiction's obligation to provide relief by exemption or credit for that top-up tax. These questions are addressed in Section 9.3.3 below. In developing the detailed rules, further technical work will be undertaken in the Inclusive Framework on these two interlinked issues and the precise interaction with the residence jurisdiction's obligations under the elimination of double taxation provisions of tax treaties.

Setting nominal tax rate

649. Given that the nominal tax rate trigger applies to the gross amount of the payment, on a transaction by transaction basis and does not allow for blending, the STTR might, in certain cases, give rise to the risk of over-taxation. This over-taxation could arise, for example, where a covered payment is made to an entity that is subject to tax at a nil rate but which has incurred expenses in deriving that income. In this case, applying the minimum ETR determined under the income inclusion and undertaxed payments rules to the gross amount of the payment when computing the top-up rate to be applied to that payment under the STTR would give rise to an effective tax rate above that minimum rate and could even give rise to taxation in excess of economic profit. In order to limit this risk of over-taxation, Inclusive Framework members could decide to limit both the trigger rate and the amount of top-up tax under the STTR to a rate that is lower than the minimum ETR under the income inclusion and undertaxed payments rules.

9.3.2. Top-up to a minimum rate

650. The effect of the rule will be to allow the source jurisdiction to tax the gross amount of the payment up to an agreed minimum rate. That is, the payer jurisdiction would be able to impose a withholding tax on the covered payment at a rate that was equal to the difference between the minimum rate provided for under the STTR and the adjusted nominal tax rate applicable to the covered payment in the payee jurisdiction. As noted above, in order to mitigate this risk of over-taxation, it may be appropriate to limit both the trigger rate and the amount of top-up tax under the STTR to a rate that is lower than the minimum ETR set under the income inclusion and undertaxed payments rule. Having a lower trigger and top-up rate under the STTR would limit the risk of over-taxation and be intended to arrive at a net tax burden that is (after taking into account any tax levied on the gross amount of the payment) equal, or at least broadly similar,

to the minimum effective rate under the income inclusion and undertaxed payments rules. To address this and conform with the broader GloBE objective of avoiding double and excessive taxation, the top-up rate could be set at a rate that is lower than the minimum rate agreed for the income inclusion and undertaxed payments rules.

651. In general, no top-up tax would be imposed in circumstances in which the relevant treaty already provided for source taxation on the covered payment. But the treaty rule would include provision for applying top-up tax where the existing allocation of taxing rights was less favourable to the payer jurisdiction (for example, where the treaty provides for a low rate – say 5% – on the gross payment and the top-up mechanism would result in increased taxing rights). This will take the form of an ordering rule in the relevant provisions, the effect of which will be to allow the payer jurisdiction to apply the higher of the rate agreed in the treaty or the top-up rate provided for under the STTR.

9.3.3. Interaction with treaty elimination articles

652. This Section deals with a technical feature of the STTR that will need to be incorporated as part of the final design, in order to avoid unintended outcomes resulting from the interaction with other treaty provisions.

653. As discussed in Section 9.3.1 above, the computation of the adjusted nominal rate (and therefore the amount of top-up required to bring that rate up to the agreed minimum rate) will not take account of the obligation to provide exemption or credit in the residence jurisdiction under the elimination of double taxation provisions in a tax treaty between the payer and payee jurisdictions. This avoids an unintended reallocation of taxing rights between the jurisdictions that would go beyond the intended effect of the STTR. But questions also arise about the interaction between the source jurisdiction's right to apply a top-up tax under the STTR and the residence jurisdiction's obligation, under the elimination of double taxation provisions of a tax treaty, to provide relief by way of exemption or credit in those circumstances.

654. Under paragraph 1 of Article 23 A of the OECD Model, the residence jurisdiction is obliged to exempt an item of income where the source jurisdiction is permitted to tax that item of income in accordance with the treaty. Where the conditions are met for the STTR to apply, the source jurisdiction will be permitted, in accordance with the treaty, to apply a top-up tax and the residence jurisdiction will then be obliged under the provisions of the elimination article to exempt that income from tax. Even where that obligation is not taken into account for the purposes of determining the adjusted nominal rate, and therefore does not increase the top-up tax that can be applied in the source jurisdiction, the residence jurisdiction will nevertheless be deprived of its taxing right. The result of this will be that only the source jurisdiction will tax the affected payment; and only at the top-up rate. This effect can be illustrated by adapting example 9.3.1A in Annex A – see example 9.3.3A in Annex A.

655. This outcome can be considered to be at odds with the intended effect of the STTR, which is not to reallocate taxing rights away from the residence jurisdiction but to permit the source jurisdiction to apply a top-up tax to covered payments that are subject to low nominal rates in the residence jurisdiction, in order to bring the tax on those payments up to an agreed minimum rate.

656. Similar considerations arise where the residence jurisdiction is obliged to provide a credit under paragraph 1 of Article 23 B or paragraph 2 of Article 23 A of the OECD Model. Even where that credit is not taken into account in computing the adjusted nominal rate for the purposes of the STTR, the residence jurisdiction's taxing right is reduced by the credit it is obliged to give for the top-up tax applied in the source jurisdiction. This is illustrated by example 9.3.3B in Annex A.

657. In order to avoid these outcomes, the residence jurisdiction's obligation to provide exemption or credit under the elimination of double taxation provisions of a tax treaty could be switched-off where the source jurisdiction is only exercising a taxing right in accordance with the treaty because it is applying a top-up tax in accordance with the STTR. The effect of this approach is illustrated by example 9.3.3C in

Annex A. There would then be no reallocation of taxing rights away from the residence jurisdiction and, given the limitation imposed on the source jurisdiction to only apply a top-up to the agreed minimum rate, concerns about unrelieved double taxation might be minimal.

658. This approach could, however, result in a cliff-edge where a covered payment to which the STTR applies is subject to an existing source jurisdiction taxing right under the terms of the treaty at a rate above the top-up rate. This is illustrated in Example 9.3.3D in Annex A.

659. Although this outcome does not disturb the position obtaining before the STTR came into contemplation, it does mean that the combined residence and source taxation of a covered payment in respect of which all the conditions for the STTR to apply are met will be lower than it would be if the rule had applied to produce a top-up tax. To avoid this outcome, without depriving the source jurisdiction of its bilaterally agreed right to tax the income at a rate above the top-up, the residence jurisdiction's obligation to provide relief by way of exemption or credit would be proportionately limited. The effect of this will bring the combined rate in the residence and source jurisdictions up to the agreed minimum rate under the STTR (assumed to be 7.5%). This is illustrated in example 9.3.3E in Annex A.

660. In developing the detailed rules, further technical work will be undertaken in the Inclusive Framework on the precise interaction with the residence jurisdiction's obligations under the elimination of double taxation provisions of tax treaties in a range of scenarios, including where the treaty includes source taxation rights that are not conditioned upon the application of the STTR.

9.3.4. Administrative considerations

661. The STTR is intended to address remaining BEPS risks by restoring to source jurisdictions a limited right to apply a top-up tax to a defined set of connected person payments resulting in low tax outcomes in the other contracting jurisdiction, in order to bring the tax on those payments up to an agreed minimum rate. Because this top-up tax will be applied to the gross amount of the payment it may be appropriate, as discussed in Section 9.3.2 above, to limit both the trigger rate and the amount of top-up tax under the STTR to a rate that is lower than the minimum ETR set under the income inclusion and undertaxed payments rules, in order to limit the risk of over-taxation and arrive at a net tax burden that is equal, or at least broadly similar, to the minimum effective rate under the income inclusion and undertaxed payments rules.

662. However, although such an approach will mitigate the risk of covered payments ultimately being over-taxed, there remains a risk of temporary over-taxation if the source jurisdiction applies contingent withholding taxes at higher rates at the point of payment and requires the recipient entities to file claims for treaty relief and repayment after the year-end. Paragraph 109 of the Commentary on Article 1 of the OECD Model notes that jurisdictions are not prevented by the treaty from adopting this approach, but observes that delay in making refunds can result in a direct cost to taxpayers and that it is extremely important that refunds are made expeditiously. The Commentary goes on to say that, in order to ensure the expeditious implementation of benefits under a treaty, it is highly preferable for source jurisdictions to automatically limit the tax they levy in accordance with the relevant provisions of the treaty. In the context of the STTR, this would mean limiting the tax applied at the point of payment to the top-up rate.

663. Consistent with these aims, consideration will be given to administrative approaches facilitating as far as possible the application of the STTR in a way that: ideally, allows the tax applied to covered payments to be limited to the top-up tax that is due after computing the adjusted nominal rate and applying the materiality threshold; and in any event minimises the need for and delay in obtaining refunds of contingent withholding taxes in excess of the top-up.

664. Further technical work will be undertaken in the Inclusive Framework on administrative approaches that could deliver these aims. This will include work on:

- applying the top-up tax as an ex-post annualised charge;
- a certification system providing for reduced rates of withholding tax; and
- the application of contingent withholding taxes set at a level that would generally result in an annual ex-post balancing payment by the taxpayer (rather than a repayment).

Each of these approaches is briefly discussed in the remainder of this section.

Ex-post annualised charge

665. An advantage of applying the top-up tax as an ex-post annualised charge would be that both the taxpayer and tax administration would know at the point the charge is applied: the value of covered payments subject to adjusted nominal tax rates below the agreed minimum rate made in the relevant period; and that the materiality threshold had been crossed for that period. As well as addressing the risk of temporary over-taxation in the form of contingent withholding taxes, this approach would increase tax certainty. But it does give rise to administrative questions, particularly in relation to the person to whom the charge would be applied. Two possible approaches seem to present themselves. The first would be to apply the annualised charge to the non-resident payee.[13] The second would be a charge on the resident payor[14]. Adopting the first approach might be seen as less of a departure from withholding taxes, because the incidence of the tax is applied to the same legal person (the payee). It might also fit better with the income inclusion and undertaxed payments rules, because the top-up tax applied under the STTR will be included in the ETR of the payee (whereas a charge on the payor might require an allocation of the top-up tax to the payee). And imposing the charge on the recipient of the income might be less likely to give rise to issues about ability to pay. But this approach raises an obvious compliance issue, by requiring collection from a non-resident taxpayer. One potential remedy is domestic law collection machinery permitting the tax administration to serve a notice on companies within the same control group as the non-resident taxpayer.[15]

Certification system

666. Some jurisdictions operate administrative easements that allow non-resident taxpayers whose local source income is subject to withholding taxes in that jurisdiction to apply for certificates limiting the rate at which those withholding taxes are applied to that income. The effect of the granting of such certificates is that the withholding tax burden is reduced to a level that is commensurate with the expected final liability to local taxes in the source jurisdiction and therefore the need for the taxpayer to claim a refund after filing a return in that jurisdiction is reduced. The source jurisdiction may grant the certificate, and set the appropriate rate of withholding tax, when satisfied that the taxpayer's circumstances are likely to result in a final liability that is below the amount produced by applying withholding taxes at the full domestic rate to the gross amount of the income sourced in that jurisdiction. In the context of the STTR, such a system could allow taxpayers to apply for a reduction to zero in respect of income that is not covered income for the purposes of the STTR and a reduction to a rate that is limited to the agreed minimum rate or the top-up tax rate (net of the adjusted nominal rate) in respect of income that is covered income for the purposes of the STTR (provided that the income is not subject to an existing source jurisdiction taxing right at higher rates under the applicable treaty). The effect of the granting of a certificate in this context would be to reduce or eliminate the scope for income to be subject to excessive contingent withholding taxes, with the resulting need for repayment claims, as a result of the inclusion of the STTR in the applicable treaty. It would be important to design the information and evidential requirements associated with the making of applications for such certificates in a way that minimises the associated compliance and administrative burdens and provides for an efficient and timely process.

Low interim withholding with balancing payment

667. An alternative, or extension, to the certification system described above is to design, as part of the detailed rules codifying and supporting the application of the STTR, a system providing for the application of withholding taxes at rates that would generally result in an annual ex-post balancing payment by the taxpayer to the tax administration (rather than a repayment). In setting the appropriate rate for particular categories of covered income, the top-up tax could first be computed by reference to the known agreed minimum rate and the adjusted nominal rate for that category of income in the relevant residence jurisdiction (drawing upon the database discussed in section 9.3.1 or other publicly available sources); the amount of withholding tax applied to the income could then be set at an agreed proportion of the top-up tax to produce a rate of withholding tax that would result in an annual balancing payment to the tax administration. Such an approach would balance the revenue flow concerns of tax administrations with the cash flow concerns of businesses and is facilitated by the greater predictability of liabilities based on ascertainable nominal rates of taxation. It would also minimise the cash flow impact on business of the application of the resulting low rate of withholding tax to income that, on an ex-post examination of the facts, is determined not be within the scope of the STTR.

References

OECD (2017), *Model Tax Convention on Income and on Capital*, OECD Publisher, Paris, https://doi.org/10.1787/mtc_cond-2017-en. [1]

OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, https://doi.org/10.1787/tpg-2017-en. [2]

Notes

[1] An MNE Group may arrange to provide services to its customers through a subsidiary that is resident in a contracting state which has a tax treaty with the state where that customer is located (the source state). Where a principal purpose of that arrangement is to take advantage of the tax treaty between the two jurisdictions then, under the measures agreed in Action 6, the source state will not be required to extend treaty benefits to any covered payment made under that arrangement.

[2] The STTR does not, of course, displace the requirement to apply transfer pricing rules to the covered payments between connected persons to which the rule applies.

[3] There are a number of reasons why a payment could be subject to no or little tax in the counterparty jurisdiction. The payment may have a different character under the laws of the payee jurisdiction which means that it is not treated as income for tax purposes. The payee could have a special tax status or be eligible for special tax treatment in respect of the payments (e.g. because the payment is subject to tax under a preferential tax regime). The payee jurisdiction may impose tax at progressive rates and the payee may be eligible for an exclusion or lower rate on small amounts of income or the payee may be eligible for a lower rate of tax on income from certain sources or based on the way the payment is treated (i.e. whether it is remitted to the jurisdiction of the payer).

[4] It is noteworthy that the same approach – a two component rule with a de facto control test and deemed control above a 50% participation level – is also adopted in paragraph 6 of the alternative fees for technical services article provided for in paragraph 26 of the Commentary on Article 12A of the 2017 UN Model Tax Convention. A similar control test could also be applied in the context of rules for addressing the profit shifting risks raised by orphan entities in the context of the undertaxed payments rule.

[5] Further consideration could be given to the treatment of interest payments on intra-group regulatory capital or other regulated financing instruments where the imposition of withholding taxes could give rise to a significant risk of over-taxation making such funding arrangements uneconomic on an after-tax basis.

[6] See Paragraph 6.100 of the OECD Transfer Pricing Guidelines (OECD, 2017[2]): "One situation where transactions involving transfers of intangibles or rights in intangibles may be combined with other transactions involves a business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee."

[7] As defined in the relevant treaty.

[8] See Paragraph 6.100 of the OECD Transfer Pricing Guidelines (OECD, 2017[2]) in relation to the breakdown of the constituent parts of a business franchise arrangement: "If the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both."

[9] See Article 5(6) of the UN Model Tax Convention: "Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person."

[10] See paragraph 7.15 of the OECD Transfer Pricing Guidelines (OECD, 2017[2]).

[11] When the service provider is acting only as an agent or intermediary, the cost base will include only those costs incurred by the intermediary in performing its agency function. For example, the cost base of a company acting as a procurement agent and incurring costs for the purchase of goods on behalf of connected companies would not include the costs of those goods.

[12] SME is not a term defined at the international level, but there are existing examples of definitions. For instances SMEs are defined in the EU recommendation 2003/361. The main factors determining whether an enterprise is an SME under that approach are staff headcount and either turnover or balance sheet total. The size thresholds for SMEs are a staff headcount below 250 and either turnover below or equal to EUR 50m or a balance sheet total below or equal to EUR 43m.

[13] An approach taken in the United Kingdom's offshore receipts of intangible property (ORIP) regime.

[14] An approach taken in the United States' base erosion and anti-abuse tax (BEAT).

[15] Such collection machinery is available under UK domestic law and applies in relation to the ORIP regime there.

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