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

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Summary:
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 was seen, the STTR in Pillar Two has been restricted so it can 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.

Key words: Developing countries, global minimum tax, subject to tax rule

1. Introduction

The OECD/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 a portion of residual profits that the largest Multinational Enterprises (MNEs) make in jurisdictions in which they have consumers but may lack permanent establishments.[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 the accompanying Commentary. The STTR continues to be negotiated.

Dissatisfied with the structure of the STTR at present in Pillar Two, the developing countries decided to create a better version through the United Nations. In

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

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 the 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 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.

2. 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 US 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, UK, 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

[3] 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

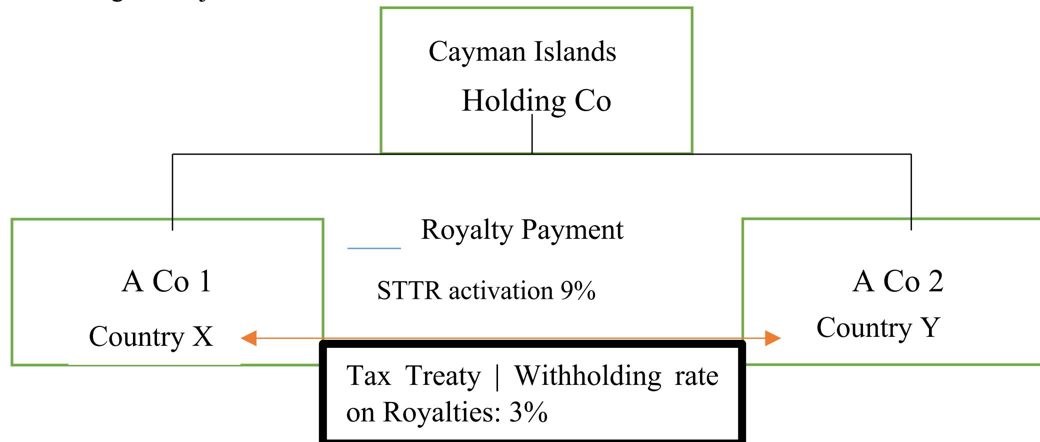
[4] Monica Victor, "Addressing Developing Countries' Tax Challenges of the Digitalization of the Economy", Tax Cooperation Policy Brief, No. 10 (Geneva, South Centre, 2019). Available from https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/

[5] https://www.southcentre.int/research-paper-156-1-june-2022/

[6] https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf

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 can be explained through an example below in Figure 1.

Figure 1: Functioning of Subject to Tax Rule



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%.

3. 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 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, 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 interest and royalties, and a few service payments. The developing countries through the G-24 had demanded the inclusion of all service fees and capital gains.[10]

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 and is unjustifiable. A base eroding payment should be taxed regardless of whether it generates a high or low return.

4. 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 Group of 77 + 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.

[7] https://www.southcentre.int/tax-cooperation-policy-brief-23-11-february-2022/

[8]

[9] https://www.southcentre.int/wp-content/uploads/2021/10/SC-Statement-on-IF-Two-Pillar-Solution-13-Oct-2021.pdf

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

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%).

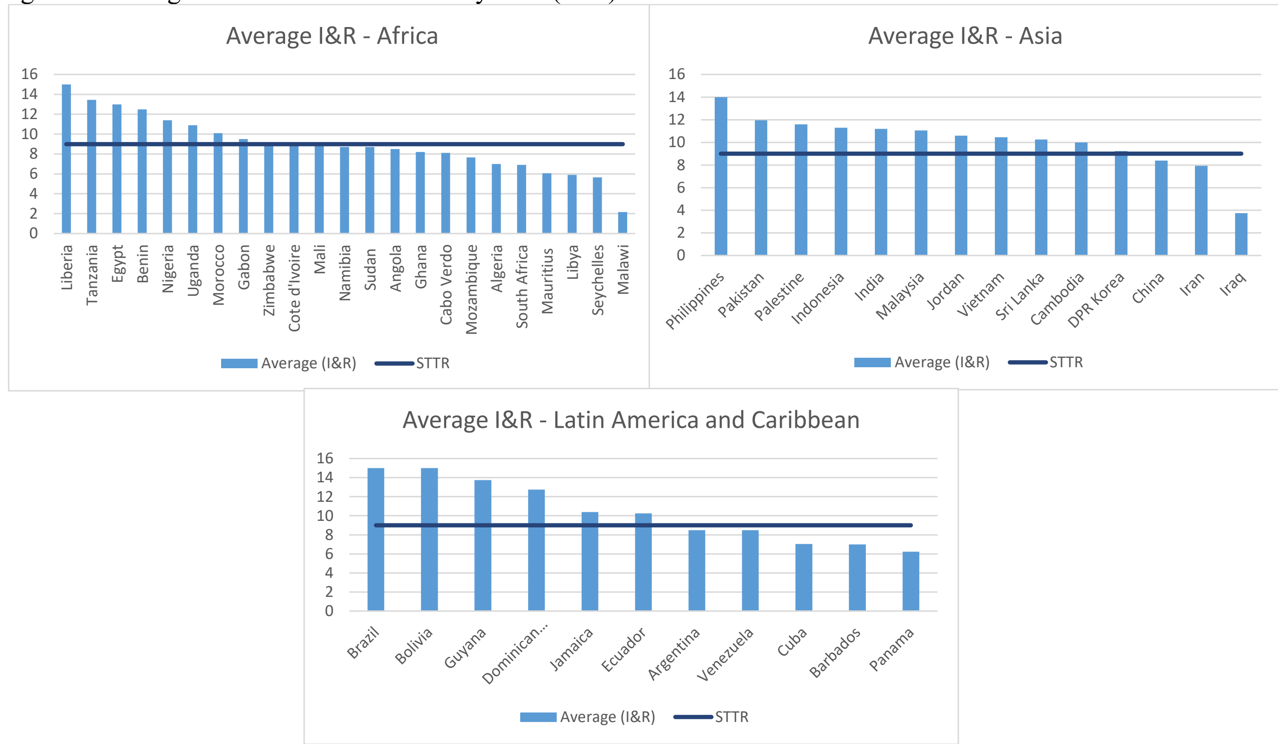
Table 1: Average rate for interest and royalties (I&R) per region

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

Figure 1 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, Egypt, Benin, Nigeria, Uganda and 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.

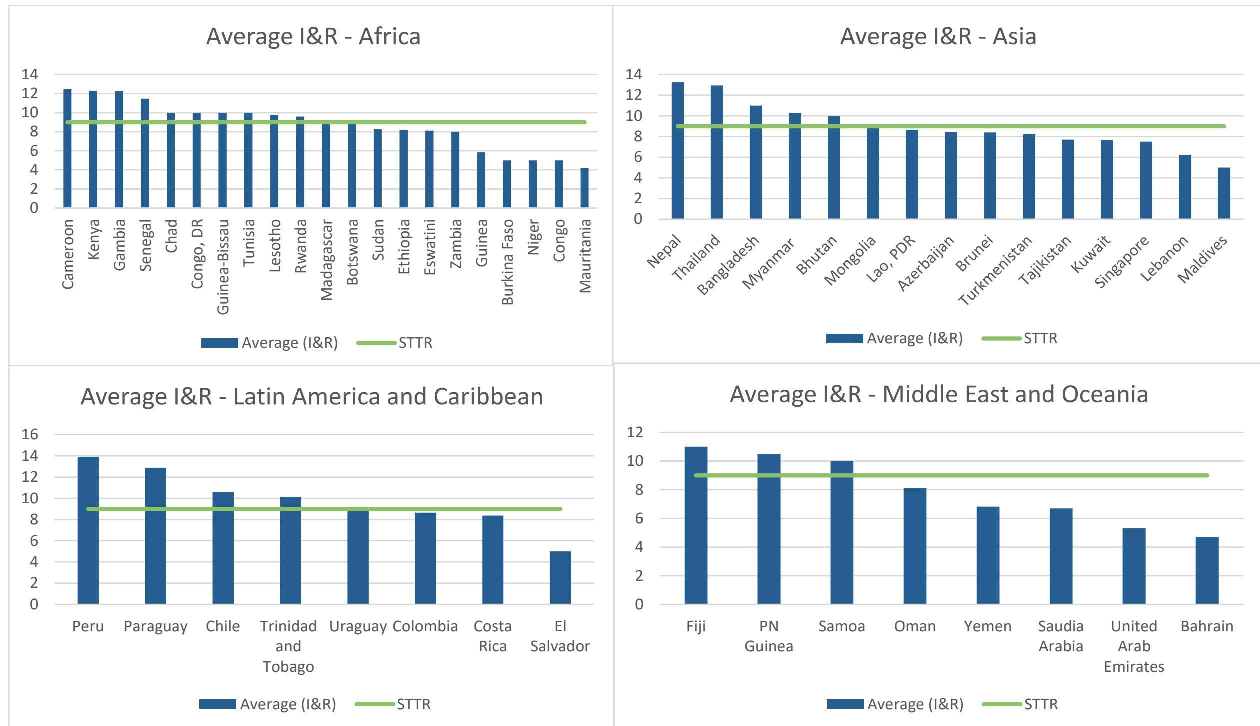
Figure 1: Average tax rate for interest and royalties (I&R) for South Center member countries in %



Source: Authors

Figure 2 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, DR 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 almost 9%.

Figure 2: Average tax rate for interest and royalties (I&R) for other developing countries member of the Group of 77 + China



Source: Authors

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.

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

This 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, 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

[11] 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] https://www.southcentre.int/tax-cooperation-policy-brief-15-june-2021/

additional important article for wide dissemination through the UN MLI.

The development of a UN MLI would provide a great fillip to the UN Model Tax Convention (UN MTC) and be of much help to the developing 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.

6. 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 was seen, the STTR in Pillar Two has been restricted so it can 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.