KPMG

Pillar Two: Subject to Tax Rule

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Summary

The Subject to Tax Rule ("STTR") is a tax treaty-based rule that allows for the levying of additional tax on several categories of connected party payments when such payments are not subject to an adjusted nominal tax rate of at least 9% in the country of residence of the recipient. Specifically, the STTR allows source countries to recover the right to tax certain payments when the domestic rights to tax such payments may have been limited or ceded pursuant to other provisions of the treaty, such as business profits, interest, royalties or other income article. The STTR, if adopted into an income tax treaty, permits source countries to apply their domestic law taxing provisions to bring the nominal corporate income tax rate up to a maximum of 9%. It may be implemented through modifications to bilateral tax treaties via a multilateral instrument (to be open for signature from October 2, 2023) or through bilateral renegotiation of the treaties.

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

The STTR is an integral part of the Pillar Two solution. Its application has priority over the top-up mechanism of the Globe anti-Base Erosion ("GloBE") rules and any STTR tax is creditable under those rules.

KPMG observation: It remains to be seen how many jurisdictions will be determined to have nominal corporate income tax below 9% to an in-scope payment, and how many of the world's 3000+ bilateral tax treaties will be updated for the STTR.

The key elements of the STTR are scope, covered income, adjusted nominal tax rate, excluded persons, mark-up threshold, materiality threshold, how they are levied and administered, and potential targeted anti-avoidance rules. There is also a coordination rule providing that the STTR is effectively turned off, and the business profits article would apply to the covered income, when the enterprise carries on a business in the source state through a permanent establishment (PE) and the covered income is interest or royalty that is connected with, or in the case of other covered income to extent attributable to, the PE. Further, when additional tax is allowed under the STTR, an accompanying modification to the relief from double tax article would make it clear that the country of residence is not obligated to provide an exemption or credit with regards to the additional tax.

Scope — connected persons and exclusions

The STTR covers payments between connected persons. There is a 50% control test, which states that two parties are connected if both entities are under control of the same person either directly or indirectly. In addition, two parties may be connected if the facts and circumstances are such that there is a relationship of control. The STTR will not apply when the payment is made by an individual or the recipient of the payment is an individual, a recognized pension fund, a non-profit organization, a State or part of a State, the central bank, certain other persons, entities, agencies or authorities whose principal purpose is performing a government function and that do not carry on a trade or business, an international organization, certain investment funds and arrangements, or entities owned, directly or indirectly, by certain excluded recipients.

An investment fund exclusion covers professionally managed entities or arrangements designed to invest funds obtained from unrelated persons. The investments must be made for the purpose of generating investment income or providing protection against an event. The arrangement or its managers must be regulated. An insurance company that is regulated as such may be deemed to be excluded with regards to covered income that is derived from assets held to meet policy holder liabilities. A further exclusion covers widely held entities or arrangements subject to a tax regime achieving a single level of taxation (entity or interest holder level). This must either hold predominantly immovable property or be subject entity or interest holder level) to tax of at least 9%.

The STTR includes an anti-avoidance provision aimed at preventing the insertion of intermediaries when all or substantially all of a covered income payment to an intermediary is paid, directly or indirectly, to certain connected payee(s) during a 365 days period that includes the date of the original payment to the intermediary, and it is reasonable to conclude that the payment by the intermediary would not have occurred in the absence of the original payment.

Covered income

The STTR applies to payments of covered income. Covered income encompasses:

- Interest and royalties,
- Payments in consideration for the use of, or the right to use, distribution rights in respect of a product or service,
- Insurance and reinsurance premiums,
- Fees to provide a financial guarantee, or other financing fees,
- Rent or any other payment for the use of, or the right to use, industrial commercial or scientific equipment, and
- Income received in consideration for the provision of services.

However, special carve-outs from the definition of covered income apply to payments related to ships used in international shipping and income of persons who may be subject to taxes determined by reference to tonnage of a ship. Further, the STTR does not apply to income from profits from international shipping or air transport.

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

The guidance generally follows the definition of interest consistent with the OECD Model, and for other payments establishes that the source of payments is determined based on the residence of the payor. However, if the payment is borne by a PE in a Contracting State, it is sourced to the country of the PE.

Nominal and STTR tax rates

The ability of the source country to impose tax under the STTR, and the rate of tax, depends on the "adjusted nominal rate" of tax imposed on the covered income in the residence country.

The adjusted nominal rate is determined by taking the statutory rate applicable in the residence country to the item of covered income in the hands of the person deriving the income and modifying for any preferential adjustment. The adjusted nominal rate may be a low rate as applied to a particular category of income or to the person receiving the income (e.g., for persons located in a special economic zone). Special approaches for determining the statutory rate are set out when progressive CIT rates apply, or when tax is applied to equity rather than net income.

The preferential adjustments include exemptions/exclusions from income, deductions without a corresponding payment (e.g., super deductions), or tax credits referable to income (other than foreign tax credits). These must be permanent reductions in the amount of tax payable, although remittance regimes will be caught when tax is not paid within 3 years. The preferential adjustment must either be directly linked to the covered income (i.e., result from the specific local tax law characterization of the payment) or arise under a preferential regime designed to attract geographically mobile income.

Note that in certain cases where the covered income is treated as attributable to a PE in a third jurisdiction by both the contracting state of residence of the enterprise and the jurisdiction of the PE, then the adjusted nominal rate may be determined by reference to the rate and preferential adjustments in the PE jurisdiction if that would produce a higher rate than in the jurisdiction where the enterprise is resident.

For purposes of the STTR provision, the relevant taxes taken into account for the analysis include covered taxes under the treaty and any tax on net income. The addition of any tax on net income is intended to encompass income taxes that are covered taxes under the GloBE rules.

The STTR gives the source country the right to recover taxing rights over the covered income only if the adjusted nominal rate imposed on the covered income is less than 9%. If the adjusted nominal rate is less than 9%, the STTR applies and rate of tax that the source country may impose on the covered income must be determined, referred to as the "specified rate." The maximum specified rate equals 9% less the sum of the adjusted nominal rate on the covered income and withholding tax (if any) on the covered income permitted under any other provision of the treaty. Further, when the withholding tax permitted is equal to or exceeds the specified rate then the STTR is turned off as it would not provide any additional taxing rights over the covered income.

Covered income exceeds costs in earning that income

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

Materiality threshold

For purposes of reducing the administrative burden, the STTR only applies if the total sum of covered income paid in a fiscal year exceeds € 1 million or €250,000 if the size of the smaller of the payer or payee jurisdiction has a GDP of less than €40 billion.

Taxes levied

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

What MNEs need to do?

MNEs should consider whether they have transactions that fall within the scope of the STTR rules. If they have covered payments that, after considering the impact of the preferential adjustment rule, have a nominal tax rate less than 9%, they should determine whether the source country is a developing IF member. If so, it is critical to closely monitor developments related to the STTR, including which countries will sign the MLI on October 2, 2023, and after.

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