The **BEPS**
Monitoring
Group

THE SUBJECT TO TAX RULE
A COMPARISON OF THE OECD AND UN VERSIONS

This short Briefing by the BEPS Monitoring Group (BMG) analyses and compares the two proposals for modifying tax treaties by inclusion of a Subject to Tax Rule (STTR), one developed by the United Nations Committee of Tax Experts (UNTC), and the other through the OECD/G20 Inclusive Framework on BEPS, as part of the Two Pillar proposals. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It has been drafted by Sol Picciotto, Jeffery Kadet, Mercy Mbithi and Bob Michel.

This report provides an overview, comparison and evaluation of the two proposals, to contribute to better public understanding of this important but technically complex matter. We will be publishing a more detailed analysis in the next two months, and would be happy to provide a draft of this analysis in advance to anyone interested.

13 February 2024

Overview

These proposals have similar aims, but are very different in their design, scope and operational details. Both aim to insert a new provision in existing tax treaties to make it a condition of the acceptance by a contracting state of restrictions on its right to tax income arising in that state, on the recipient of such income being taxed in the other contracting state at a specified minimum rate. Payments of interest, royalties and fees for services are generally deductible when determining the taxable business income of the payor, so they directly reduce the source tax base. Hence, an STTR is important to combat profit shifting and tax base erosion, by restoring the right of states to tax income from activities in their territory that would otherwise be restricted by the treaty, if such income is not taxed at a minimum rate.

The UNTC's STTR is relatively simple and very broad, but it leaves the minimum rate, as well as possible other details, to be agreed between the treaty partners. The Pillar Two STTR

has significant limitations and restrictions, that make it complex and difficult to understand and administer. However, it is complete and ready for adoption on a take-it-or leave it basis, with no need for further negotiations.

We provide here a summary of the provisions of each STTR in tabular form to facilitate comparison. Our longer analysis will examine these in more detail, referring to the specific provisions.

Comparison Table:

	Pillar Two STTR	United Nations STTR
Scope	**Specified categories of income**: interest; royalties; income arising in the jurisdiction for the provision of services; payments for distribution rights; insurance and reinsurance premiums; financial guarantees and other financing fees; and payments for the rights to use equipment	**All income and capital gains** arising in the partner state.
	Payments between **connected** legal persons	**All income** whether paid to a related or unrelated entity
Thresholds	**Income ('materiality') threshold:** Connected recipients with an aggregate annual total of covered income of at least **€1 million** in the jurisdiction, **or €250k** if either jurisdiction has a GDP less than **€40b.**	**None**
	'Mark-Up' threshold The income (other than interest and royalties) must be higher than the direct and indirect costs incurred by the recipient to earn that income, plus 8.5%.	
Collection	**Annual charge in year following** that to which the tax applies, based on tax return	**Deductible directly** from payments **on a current basis**
Minimum rate in recipient country	9%	By Agreement
Rate applicable	Maximum of 9% taking into account tax paid by recipient	Source state's rate (unless otherwise agreed)
Implementation	As a model provision for bilateral negotiations, or may be adopted through a multilateral treaty for easy pairing with willing partner states.	As a model provision for bilateral negotiations, or may be adopted through a multilateral treaty for easy pairing with willing partner states.
	Complete and ready, but on a take-it-or-leave it basis.	Needs agreement on the applicable rate, and possibly other details, between the states concerned.

Both provisions will be available for implementation in similar ways. The OECD has published a report that includes the Pillar Two STTR in the form of a model treaty provision, as well as an extensive commentary; and also a version in a multilateral instrument that states can join, designating the treaties they wish to be covered. The UNTC's STTR has been agreed and is available as a model provision with commentary. It will also be included in the Fast Track Instrument that the UNTC is developing, which would be a UN multilateral convention enabling easy and rapid adoption by willing states of several key provisions of the UN model convention, including its STTR.[1]

Evaluation:

The key divergence is over the right to tax income from services. Pillar Two's STTR would deny the right to tax such income in the country where the income arises unless (i) the payments are to a connected person, *and* (ii) the income exceeds the "mark-up threshold" of 8.5% over direct and indirect costs. The limitation to connected persons means that it will do nothing to limit profit shifting and base erosion by providing services from abroad with little or no physical presence, thus avoiding the tax treaty requirement for a 'permanent establishment'. This is particularly damaging if payments are made for services (digitalised or not) to entities whose income is zero- or low-taxed. This not only affects tax revenues, it also disadvantages local providers of similar services, and discourages genuine inward investment that creates jobs to provide services locally.

However, the Pillar Two STTR does include a targeted anti-avoidance rule to deal with payments that are routed through an intermediary which is subject to tax at a rate above 9%, but makes 'all or substantially all' of such payments to a connected payee, including through 'back-to-back' arrangements with a third party such as a bank. This can used in conjunction with the principal purpose test (Article 29.9 of the model convention) or a limitation on benefits provision where available. Since there is no comparable provision in the UNTC's STTR, countries that prefer that model would also need to apply a principal purpose or limitation on benefits provision in such cases.

The Pillar Two STTR's restriction to specified categories of income raises significant doubt about its scope. In particular: (i) payments for the use of software may not be covered as royalties, since this STTR does not resolve the disagreements over the interpretation of article 12; and (ii) payments for automated digital services (e.g. supplied through artificial intelligence) may be argued to fall outside the definition of services, since it does not specifically refer to services supplied by non-humans.

The 9% rate in the Pillar Two STTR is both the minimum that the residence state should apply, and the maximum that can be applied at source. It is set at 60% of the 15% minimum rate specified for the Pillar Two global minimum tax (the GloBE). Hence, parent or conduit jurisdictions would have the right, under the GloBE, to apply an additional top-up tax of up to 6% on profits that have been shifted out of the source country. The rationale some suggested for the STTR's lower rate was that it applies to gross payments rather than net profits. However, the Pillar Two STTR does not apply unless the income exceeds the mark-up

---

[1] In addition to this STTR, the UN Fast Track Instrument currently proposes to include treaty provisions for pension funds, gains in relation to natural resources and offshore indirect capital gains, fees for technical services, income from automated digital services, arbitration, capital gains from the value of immoveable property, and services permanent establishments.

threshold based on costs. This is similar to the substance-based income exclusion carved out in the GloBE, which specifies the 'excess profits' on which top-up tax can be applied. The mark-up threshold means that the STTR applies only if there is income in excess of a normal return on expenses, so it acts like a top-up tax on excess income, just as the GloBE does. Yet the STTR's cap at 9% on the gross payment can in many circumstances be significantly lower than the GloBE's minimum net rate of 15% on income in excess of the expenses attributable to the substance-based income exclusion.

The UNTC STTR's broad base, and lack of either a 'materiality threshold' or a 'mark-up threshold' protects much more effectively the right to tax at source income derived from that country. Thus, it would be more beneficial even if the agreed minimum rate were only 9%.

Clearly, the UNTC version is far more beneficial for taxation at source. It is also administratively much simpler, and applies to current payments, rather than in the succeeding tax year, and requiring a tax return that could require some auditing. Its only disadvantage is that its adoption relies on the agreement of the states concerned. The Pillar Two provision has the advantage that those Inclusive Framework members which apply a rate of less than 9% to the categories of covered income have made a commitment to agree to accept the provision in their treaties with developing countries.[2] It also aims to resolve, through its complex and detailed rules, issues that might otherwise need to be dealt with by negotiations between treaty partners.

In our view, the Pillar Two STTR is unsuitable for developing countries, due to its very restricted scope and great complexity. Adopting this version of the STTR would entail accepting continuing erosion of their tax base through payments that fall outside its scope, notably:

(i) payments to unrelated persons,

(ii) income that does not exceed the mark-up threshold,

(iii) income below the materiality threshold, and likely also

(iv) all payments for the use of software.

They should instead aim to safeguard their source taxation rights through appropriate measures in domestic law, and by ensuring that all their treaties include the UNTC's STTR, through bilateral negotiations and by joining the UN's FTI when it becomes available (including its STTR Protocol).

Conclusion:

All countries should immediately review the operation of all their existing treaties to identify any that are facilitating erosion of their tax base through payments that are low-taxed in the recipient jurisdiction. These should be considered for renegotiation or cancellation. For developing countries considering new tax treaties, the inclusion of the UN STTR should be a non-negotiable element.

---

[2] Developing countries are defined as those with a gross national income per capita, using the World Bank Atlas method, of USD12,535 in 2019, to be regularly updated; this includes all but High-Income countries. If a country subsequently becomes a High-Income country the STTR would continue to apply, unless the treaty partner has opted for Annex V of the MLI.

Countries should also consider introducing measures into their domestic law to deny deductions for payments that are made to jurisdictions where the income is low-taxed. Greater use could and should be made of anti-abuse provisions in domestic law, in conjunction with the Principal Purpose Test that should by now be included in all tax treaties, as it was a minimum commitment in phase one of the BEPS project. This can justify the denial of treaty benefits to entities that are not genuinely carrying out activities that generate the relevant income.

Sources

Inclusive Framework on BEPS (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Subject to Tax Rule (Pillar Two),* OECD.

OECD (2023), Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule.

UN Department of Economic and Social Affairs (2023), *United Nations Model Double Taxation Convention STTR*. "Co-Coordinators' Report: Proposal for the inclusion of a general "subject to tax" rule in the United Nations Model Double Taxation Convention between Developed and Developing Countries." Document E/C.18/2023/CRP.12.

UN Committee of Experts on International Cooperation in Tax Matters, "Possible Fast Track Instrument", Annex I of "Taxation issues related to the digitalized and globalized economy", Co-Coordinators Report, United Nations Doc. E/C.18/2023/CRP.40, 2 October 2023.

Picciotto, S., Kadet, J. M., Michel, B. (2024), 'A Tale of Two STTRs', *Tax Notes International*, March.