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Brian J. Arnold*

Earth to OECD: You Must Be Joking – The Subject to Tax Rule of Pillar Two

In this article, the author examines the implications of the Subject to Tax Rule (STTR) of the OECD's Pillar Two for developing countries. He argues that the STTR is unreasonably complex, and will not be advantageous for developing countries. Accordingly, developing countries should be very cautious in adopting the STTR.

1. Introduction

The Pillar Two global minimum tax package of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) (the Inclusive Framework) is rapidly becoming a reality, with many countries enacting domestic legislation to implement the measures effective 1 January 2024. Pillar Two consists of the following three top-up taxes: (i) an IIR top-up tax to allow countries to top up the foreign taxes on the foreign-source income of the controlled foreign corporations (CFCs) and permanent establishments (PEs) of their resident multinational enterprises (MNEs) to 15%; (ii) a UTPR top-up tax to allow countries to tax the profits of an MNE that are not subject to the IIR top-up tax; and (iii) the Subject to Tax Rule (STTR) that is intended to allow developing countries to impose a top-up tax on certain low-taxed payments to connected non-residents.[1] The detailed Model Treaty provisions for the STTR (the STTR Model Rule and Commentary)[2] and the Multilateral Convention to implement the STTR (the STTR Multilateral Convention)[3] were issued only recently, i.e. in July and October 2023, respectively. Although the STTR was part of the Pillar Two package from the beginning, it was the last part to be finalized.

The thesis of this article is that the proposed STTR, which is intended to be compensation to developing countries for agreeing to enact Pillar Two, is an unreasonably complex provision that is unlikely to benefit developing countries much, if at all.

The article begins with a brief discussion of the development of the STTR from a measure to complement a proposed base-eroding payments rule to the final stand-alone treaty provision that restores taxing rights on specified low-taxed payments to connected persons (*see* section 2.). This scrutiny of the background to the STTR is followed by a discussion of whether the rationale advanced by the OECD for the STTR is justified and what the process used to develop the STTR reveals about its nature and rationale (*see* sections 3. and 4.). The article then provides a reasonably detailed, but not comprehensive, description and analysis of the provisions of the STTR Model Rule and a brief overview of the STTR Multilateral Convention to implement the STTR (*see* sections 5., 6., 7., 8., 9., 10. and 11.). This description forms the basis for an assessment of the implications of the STTR for developing countries, the countries that it is explicitly intended to benefit (*see* section 12.). The author's analysis concludes not only that the STTR will not achieve its stated objectives, but also suggests that it has been deliberately designed so that it will not benefit developing countries (*see* section 13.).

At the outset, a note of caution is appropriate. The STTR is very complex.[4] Although this article tries to explain some of the technical details of the STTR and its relationship with other provisions of any tax treaty to which the STTR is added, the technical details should not obscure the more important issue, which is whether the STTR will provide any significant benefits to developing countries.

2. Background

The background to the development of the STTR begins with the 2015 BEPS Action 1 Report on the tax challenges for the international tax system posed by the digitalization of the economy.[5] Despite the importance of the issue, that Report failed to recommend any solution for taxing large MNEs on their profits from digital goods and ser-

* **Senior Adviser, Canadian Tax Foundation, Toronto, Canada. The author can be contacted at barnold@execulink.com.**

1. Only STTR is an acronym. IIR and UTPR were originally acronyms for "Income Inclusion Rule" and "Undertaxed Payments Rule" respectively, but those taxes were detached from any income or undertaxed payments as Pillar Two was developed. Nevertheless, the letters IIR and UTPR were retained as the names for the two taxes despite lacking any meaning.
2. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Subject to Tax Rule (Pillar Two)*, OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS, (OECD 6 July 2023), Primary Sources IBFD, also available at www.oecd-ilibrary.org/docserver/9afd6856-en.pdf?expires=1704709767&id=id&accname=guest&checksum=7800397029E94803BD6FCA1F264C545F (accessed 8 Jan. 2024) [hereinafter the *STTR Model Rule and Commentary*].
3. OECD, *Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule* (2 Oct. 2023), Treaties & Models IBFD, also available at www.oecd.org/tax/beps/multilateral-convention-to-facilitate-the-implementation-of-the-pillar-two-subject-to-tax-rule.htm (accessed 8 Jan. 2024) [hereinafter the *STTR Multilateral Convention*], adopted by the OECD/G20 Inclusive Framework on BEPS on 15 September 2023, and opened for signature on 2 October 2023.
4. With not even a hint of irony, OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 states that the rule "takes the form of a conventional treaty article in order to make it easier to read and interpret and to analyse its interaction with other treaty provisions". It seems more likely, in the author's opinion, that the STTR was designed in its current form, which is far from a conventional treaty article, to disguise its complexity.
5. OECD, *Action 1 Final Report 2015 – Addressing the Tax Challenges of the Digital Economy* (OECD 2015), Primary Sources IBFD [hereinafter the *Action 1 Final Report* (2015)].

vices derived from countries without the need for any physical presence in those countries.[6] The BEPS Action 1 Report indicated that the OECD would continue to work on the problem and, in the interim, countries could adopt withholding taxes on payments for digital services, a substantial economic presence threshold, or an excise tax on payments for Digital Services Taxes (DSTs) on a temporary basis.[7] In response, several countries, including some developed countries, did exactly what the BEPS Action 1 Report suggested, with many countries enacting DSTs at widely differing rates on a broad range of digital services. These DSTs were simple and easy to administer, and they quickly began to proliferate.[8] The United States and US MNEs were adamantly opposed to DSTs as non-creditable gross-based taxes and the United States threatened to impose trade sanctions against any countries imposing a DST on US companies.

With this intense pressure from the United States, the OECD, through the Inclusive Framework, which had been established in 2016 to implement the minimum standards adopted by the BEPS Project, started to work with considerable urgency on a multilateral solution to stop the proliferation of unilateral measures, especially DSTs. The proposed solution advanced tentatively by the OECD, apparently without any serious consideration of alternatives, was a two-pillar solution. On 23 January 2019, the Inclusive Framework issued a short three-page Policy Note as part of its work on the tax challenges of the digital economy.[9] The Policy Note was the first public announcement of a two-pillar solution for the tax issues raised by the digital economy – Pillar One, to provide revised nexus and profit allocation rules for the world's largest and most profitable MNEs, and Pillar Two, a global minimum tax, to deal with the "remaining BEPS challenges". Neither pillar was limited to primarily digitalized businesses and both were to be explored on a without-prejudice basis.[10] With regard to Pillar Two, the Policy Note mentioned "an income inclusion rule and a tax on base eroding payments" to deal with profit shifting to entities in low- or no-tax jurisdictions. A subject to tax rule was not mentioned at all.

In February 2019, the Inclusive Framework issued a Public Consultation Document[11] on the proposed two-pillar solution to solicit views from interested parties. This document suggested that the STTR would complement the base-eroding payments rule, which would deny treaty benefits for a wide range of payments, including payments covered by articles 7, 9, 10, 11 to 13 and 21 of the OECD Model, that were not subject to a minimum level of tax in the residence country.[12] It raised the possibility that the STTR would be limited to payments to related parties, except with regard to payments covered by articles 11 to 13 of the OECD Model.

Following the public consultation, in May 2019, the Inclusive Framework agreed to a Programme of Work (the Work Programme) with regard to the two-pillar solution.[13] Under this Work Programme, the Inclusive Framework agreed to explore the following four rules: (i) an income inclusion rule; (ii) a switch-over rule; (iii) an undertaxed payment rule; and (iv) a subject to tax rule.[14] Originally, the STTR was intended to limit treaty benefits or impose withholding tax at source where an item of income was not subject to a minimum tax rate.[15] It was regarded as a complement to the base-eroding payments rule. The STTR was seen as focused primarily on interest and royalties but the Work Programme alluded to the possibility of dealing with other payments, as suggested in the February 2019 Consultation Document,[16] and extending the STTR to payments of interest and royalties to unrelated persons.[17] Responsibility for the work on the STTR was allocated to the OECD's Working Party 1 on the OECD Model and Working Party 11 on Aggressive Tax Planning.

In November 2019, the Inclusive Framework issued another Public Consultation Document on Pillar Two dealing with design and technical issues with regard to the (then) Income Inclusion Rule.[18] Work on the STTR and other aspects of Pillar Two was postponed.[19] Two months later, at the end of January 2020, the Inclusive Framework issued a Statement,[20] which simply asserted that "work on key issues [on Pillar Two] is advancing at a

6. Some type of physical presence – a PE or fixed base – is required under the existing provisions of both the *OECD Model Tax Convention on Income and Capital* (21 Nov. 2017), Treaties & Models IBFD and *UN Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2021), Treaties & Models IBFD for a country to be entitled to impose tax on business profits derived from the country by a resident of another contracting state.
7. OECD, *Action 1 Final Report* (2015), *supra* n. 5.
8. By October 2023, over 35 countries had adopted or proposed to adopt DSTs.
9. OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, As approved by the Inclusive Framework on BEPS on 23 January 2019*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 23 Jan. 2019), available at www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf (accessed 8 Jan. 2024).
10. Presumably, this meant that the members of the Inclusive Framework were not making any commitment to proceed with Pillar Two, although there is no evidence that other alternatives, such as developing an international consensus on a DST, were explored seriously.
11. OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy, 13 February – 6 March 2019*, OECD/G20 Base Erosion and Profit Shifting Project, Public Consultation Document (OECD 2019), Primary Sources IBFD.
12. Id., at para. 106.
13. OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS (OECD 31 May 2019), available at www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf (accessed 8 Jan. 2024).
14. Id., p. 25, at para. 50.
15. Id., p. 31, at para. 75.
16. Id.
17. Id., p. 32, at para. 77.
18. OECD, *Global Anti-Base Erosion Proposal ("GloBE"), Pillar Two, 8 November 2019-2 December 2019)*, Consultation Document, Inclusive Framework on BEPS (OECD 2019) [hereinafter *Global Anti-Base Erosion Proposal ("GloBE"), Pillar Two*].
19. Id., at para. 11.
20. OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD Jan. 2020), available at www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf (accessed 8 Jan. 2024).

fast pace... but significant work still remains".[21] Nothing new was suggested about the work on the STTR other than a brief mention that the Working Parties were exploring options for "the design of a simple and targeted rule".[22]

In July 2020, the Inclusive Framework issued a brief Statement,[23] which provided new information about the STTR. First, it recognized for the first time that the STTR was a measure aimed primarily at addressing the concerns of developing countries and that members of the Inclusive Framework had agreed to include the STTR in their tax treaties with developing countries if requested to do so. Second, the tax imposed under the STTR would be a top-up tax that would be limited to the difference between a minimum rate of between 7.5% and 9% and the tax on the covered payment. The minimum rate was declared to be 9% in the Inclusive Framework's October 2021 Statement.[24]

Over the following two years, the STTR seemed to take a back seat to the work on the other aspects of Pillar Two. New developments with regard to the STTR were reported briefly in one paragraph of the Inclusive Framework's October 2021 Statement.[25] The STTR was acknowledged as "an integral part of achieving a consensus on Pillar Two for developing countries", a statement repeated in the SSTR Model Rule and the preamble to the STTR Multilateral Convention.[26] The Model Rules for the IIR and UTPR top-up taxes were published in December 2021, followed by Commentary and Agreed Administrative Guidance in March 2022 and July 2023, respectively.[27] However, it was not until July 2023 that the STTR Model Rule and Commentary were published, quickly followed by the STTR Multilateral Convention on 17 September 2023, which was opened for signature on 2 October 2023.

3. Tax Policy Aspects of the STTR

According to the OECD, "the STTR is designed to help developing countries – notably those with lower administrative capacities – to protect their tax base".[28] However, this rationale for the STTR does not withstand careful scrutiny. It is true that, to the extent that the STTR enables a developing country to impose tax on covered payments to connected persons resident in the other contracting state that are deductible against the developing country's tax base, the STTR can be said to protect the developing country's tax base. Any tax that a developing country can collect through the STTR will offset the erosion of its tax base as a result of the deduction of the outgoing payment.

However, as explained in more detail later in this section, the STTR applies only where the aggregate of the developing country's tax on the outgoing payment under a tax treaty and the nominal adjusted tax rate on the payment payable by the recipient to its country of residence is less than 9%. As a result, the maximum benefit to a developing country from the STTR occurs where a covered payment is exempt from tax by the developing country under the relevant tax treaty and the country of residence of the recipient of the payment also exempts the payment from tax. In this situation, the developing country would be entitled under the STTR to impose a 9% tax on the gross amount of the payment. However, in many cases, the deduction of the payment will likely erode the developing country's tax base by a much greater amount (the amount of the payment multiplied by the country's corporate tax rate). Although the STTR does not completely eliminate the erosion of the developing country's tax base, something is better than nothing and, under the current rules, without the STTR, nothing is exactly what the developing country would get.

To the extent that the recipient's country of residence imposes tax on a covered payment, that tax reduces the amount of tax collected as a result of the STTR, and where the tax imposed by the recipient's country of residence equals or exceeds 9% of the net income from the payment,[29] the developing country gets nothing to compensate for the erosion of its tax base. In effect, the tax imposed by the recipient's country of residence has priority over the STTR potentially applicable by the developing country where the payer is resident. As a result, according to the Inclusive Framework, the STTR provides assistance to developing countries to protect their tax base by proving an incentive to developed countries to impose tax on covered payments of at least 9%. If this is assistance, the author does not understand why developing countries would want it.

The preamble to the STTR Multilateral Convention repeats the assertion, first made in the Inclusive Framework's October 2021 Statement,[30] that the STTR is "an integral part of achieving a consensus for developing countries", but otherwise does not provide any rationale for the STTR. The preamble comes close to acknowledging that the STTR was the price of getting the developing country members of the Inclusive Framework to agree

21. Id., Annex 2, at para. 6.
22. Id., Annex 2, at para. 19.
23. OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD July 2020) [hereinafter the *July 2020 Statement on a Two-Pillar Solution*].
24. OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 8 Oct. 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 8 Jan. 2024).
25. Id.
26. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, at p. 5 and *STTR Multilateral Convention*, *supra* n. 3, at second paragraph of the preamble.
27. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS (OECD 14 Mar. 2022), Primary Sources IBFD and *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS (OECD 13 July 2023), Primary Sources IBFD.
28. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, at p. 5.
29. One bizarre aspect of the STTR is that it is a top-up tax (to a maximum of 9%) on the gross amount of certain payments to the extent that the recipient is subject to corporate tax on the net amount of the payment of less than 9%.
30. OECD, *July 2020 Statement on a Two-Pillar Solution*, *supra* n. 23.

to Pillar Two, although the meaning of "a consensus for developing countries" is obscure.

The Inclusive Framework's public documents reiterate frequently that the underlying rationale of the STTR is to restore some of the taxing rights that developing countries give up under the provisions of their tax treaties with regard to the covered payments where the other contracting state does not tax those payments at a reasonable rate.[31] At the same time, the Inclusive Framework has equally frequently emphasized that the STTR is not intended to alter the fundamental allocation of taxing rights between residence and source countries under tax treaties.[32]

This underlying rationale of restoring taxing rights to developing countries is not spelled out in the STTR Model Rule, although it is discussed explicitly in the Commentary. Importantly, the underlying rationale is limited to the STTR and does not apply to other aspects of a tax treaty. The preamble to the STTR Multilateral Convention states explicitly that the provisions of the Convention "do not otherwise reflect the tax treaty policies of members of the OECD/G20 Inclusive Framework". In addition, article 2(1) of Annex 1 of the STTR Multilateral Convention provides that:

> the provisions of this Annex [Annex 1 contains the STTR Model Rule] are without prejudice to subsequent modifications to this agreement [i.e. the tax treaty] or any other agreement concluded by either of the contracting jurisdictions.

Article 2(2) of Annex 1 of the STTR Multilateral Convention further provides that nothing in Annex 1 has any effect on the application of the tax treaty to deny benefits under a tax treaty where an item of income is not subject to a certain level of taxation. For instance, some tax treaties may include subject to tax provisions, which deny treaty benefits unless the recipient is subject to a certain level of tax by the country in which the recipient is resident. Article 2(2) of Annex 1 of the STTR Multilateral Convention ensures that, where such an existing subject to tax rule in a tax treaty and the STTR both apply, the existing subject to tax provision has priority, with the result that the income is subject to tax under the country's domestic law, as the tax treaty does not apply.[33] In effect, the provisions of the STTR have no relevance with regard to the application of other provisions of any tax treaty that includes the STTR. For instance, the 8.5% markup for purposes of the STTR is not intended to have any relevance for the application of the arm's length standard (ALS) under article 9 of the OECD Model. These provisions show how concerned developed countries are about negating any possible future implications of the STTR.

However, this concept of restoring taxing rights where the other state does not impose sufficient tax on the covered payments is not applied generally to all tax treaties or all income items. Moreover, it is inconsistent with what, until the STTR, was a fundamental principle of the interpretation and application of tax treaties, namely, it is within the discretion of each contracting state whether to exercise, and the extent to which to exercise, taxing rights allocated to it under a tax treaty. In other words, any limitations on the taxing rights of one state are not conditional on the other state imposing tax.

In addition, if the rationale of the STTR is restoring taxing rights given up by developing countries in concluding tax treaties, why are their taxing rights only partially restored? This may be explained by the origin of the STTR as part of the 15% global minimum tax. However, there is a significant difference between the policy of the global minimum tax (to establish a minimum tax floor under tax competition) and the restoration of the taxing rights developing countries. The 9% tax rate used for the STTR appears to represent the equivalent of the 15% rate for the global minimum tax, but is lower because it is imposed on the gross amount of the covered income items. However, the global minimum tax is explicitly asserted to not involve any change in the allocation of taxing rights between source and residence countries.

In summary, the STTR marks a clear departure from the allocation of taxing rights between residence and source countries under the OECD Model. This point is undeniable, and the Inclusive Framework implicitly recognizes it by emphasizing that the STTR is exceptional and does not have any broader implications for the interpretation and application of tax treaties. The question then becomes whether this special limited exception for the STTR can be justified. The justification advanced by the Inclusive Framework is that the purpose of the STTR is to restore taxing rights with regard to certain income items given up by developing countries in a tax treaty, on the assumption that the other state would tax those items at a rate of at least 9%. This justification is unconvincing. If the tax policy underlying the STTR is as described by the OECD, why does it not apply to all items of income with regard to which a developing country gives up taxing rights to the residence country under a tax treaty? Why is it limited to payments to connected persons? And why is this policy limited only to taxing rights given up by developing countries?

The unavoidable conclusion is that the STTR can be justified only as a political concession made by developed countries (that are members of the Inclusive Framework) to developing countries to get the developing countries (that are members of the Inclusive Framework) to agree to the rest of the Pillar Two package. As a result, the STTR cannot be properly assessed on a tax policy basis. Instead, it must be assessed as a negotiated bargain on the basis of the costs and benefits of the parties to the bargain.

31. *See*, for example, the OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, at p. 5.
32. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, at p. 5 states: "The STTR was developed not to revisit the current allocation of taxing rights between source and residence States." Similarly, the OECD, *STTR Multilateral Convention*, *supra* n. 3, Explanatory Statement, at para. 20, provides that the statement in the preamble "codifies the understanding of the negotiators that the STTR does not revisit the current allocation of taxing rights between Contracting Jurisdictions to a Covered Tax Agreement." This is reiterated in OECD, *STTR Multilateral Convention*, *supra* n. 3, Explanatory Statement, at para. 21.
33. *See* OECD, *STTR Multilateral Convention*, *supra* n. 3, Explanatory Statement, at paras. 144 and 145.

4. The Process for the Development of the STTR

The process followed by the Inclusive Framework reinforces the view put forward in section 3. that the STTR was a negotiated measure without any convincing tax policy justification. As the discussion of the background of the development of Pillar Two shows, originally, the STTR was seen as a complement to the proposed base-eroding payments rule (which ultimately became the UTPR top-up tax). Instead of denying the deduction of certain base-eroding payments, treaty benefits with regard to some payments (in the form of reduced source country tax) would be denied.[34] There was no suggestion in the early versions of the STTR that the base-eroding payments rule would be limited to developing countries. As the base-eroding payments rule was transformed into an undertaxed payment rule and then into the UTPR top-up tax, the STTR lost its *raison d'être* as a measure to complement a rule that denied the deduction of certain payments.

It was not until July 2020 that the STTR became a measure for the benefit of developing countries. Although the broad outlines of the STTR were settled in mid-2020, the detailed rules were not agreed until mid-2023, after the rest of Pillar Two had been settled by early 2022. The last-minute timing of the work on the STTR may indicate that the Inclusive Framework viewed the STTR as less important than the rest of Pillar Two, although there is no evidence that this was the case. However, it is notable that no public consultations were held with regard to the detailed rules of the STTR, as they were with regard to the other aspects of Pillar Two.[35]

5. Description and Analysis of the STTR

5.1. Introductory remarks

One of the most noticeable things about the STTR is how long and complicated it is. Unlike most provisions of the OECD Model and the UN Model, which are typically quite short, the proposed STTR is over 7 pages long, not including the consequential amendments to article 23, with 42 pages of Commentary. Although, as indicated in section 3.,[36] according to the OECD, the STTR is intended to assist developing countries with limited administrative capacity, it is far from simple and easy to administer.

The STTR has a very narrow scope. It applies only to a relatively short list of cross-border payments – interest, royalties, service fees and other specified payments – and only where those payments are made to connected persons resident in the other country. Moreover, the STTR is a top-up tax. It allows a country to tax only at a rate limited to the difference between 9% of the gross amount of the relevant payment and the sum of the tax that the country in which the payer is resident is entitled to impose on the payment under the tax treaty and the nominal corporate tax rate on the payment imposed by the other country in which the recipient of the payment is resident.[37] For instance, if a country is entitled to tax a payment of interest under a tax treaty at a 5% rate and the other country taxes the recipient of the interest at a rate of at least 4% (after allowing a credit for the source country's tax), the STTR will not apply. If, however, the other country does not tax the interest at all, the STTR would allow the first country to impose additional tax (a top-up tax) of (9% – 5%), i.e. 4% of the payment. Where the other country imposes corporate tax at a nominal rate of 9% or higher, the STTR will not apply and will not generate any additional tax revenue for the country from which the payment is made. Further, where a country's tax treaties allow it to impose tax on payments of interest, royalties or other payments at a rate of 9% or higher, the STTR will have no effect. Accordingly, the STTR will be beneficial for a country primarily with regard to payments, such as fees for services, that it is not entitled to tax at all under its existing tax treaties.

Another limitation of the STTR is that it applies only to developing countries, which for this purpose are defined to be countries with a per capita gross national income (GNI) of USD 12,535 or less in 2019 (the amount to be regularly updated according to the Atlas method of the World Bank Group (WBG)).[38] Further, the STTR applies only to the extent that developing countries request other member countries of the Inclusive Framework (with nominal corporate tax rates of less than 9%) with which they have tax treaties to modify those tax treaties to include the STTR. Although developed countries have made a commitment to modify their tax treaties with developing countries to include the STTR, if requested to do so, as far as the author is aware, they are not under any binding legal obligation to do so. The necessity for a developing country to make a request to a developed country to modify the tax treaty between the two countries to include the STTR may suggest that some developing countries may choose not to trigger the application of the STTR, even though they may be entitled to have it apply. This might be the case where developing countries are concerned regarding an adverse effect on investment from a particular treaty partner, or where the STTR could be used as an item to sacrifice to get other beneficial changes to the tax treaty with a particular

34. *See* OECD, *Global Anti-Base Erosion Proposal ("GloBE"), Pillar Two*, *supra* n. 18, p. 6, at par. 5, which described the proposed STTR as a rule "that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate".

35. Several public consultations were held with regard to Pillar Two. *See* OECD, *Global Anti-Base Erosion Proposal ("GloBE"), Pillar Two*, *supra* n. 18; *Public Consultation, Document 12 October 2020-14 December 2020* (OECD 2020) (only a few questions with regard to the STTR were posed in this consultation, and, at this time, the STTR was seen as a complement to the undertaxed payment rule); *Public Consultation Document, Implementation Framework, April 2022* (OECD 2022); *Public Consultation Document, Tax Certainty and Compliance, 20 December 2022* (OECD 2022); *Public Consultation Document, GloBE Return, February 2023* (OECD 2023); *Public Consultation Document – March 2023* (OECD 2023). *See also* generally OECD, *Planned stakeholder input in OECD tax matters* (OECD 2023), available at www.oecd.org/ctp/planned-stakeholder-input-in-oecd-tax-matters.htm (accessed 9 Jan. 2024) for a complete list of all the public consultations on Pillar One and Pillar Two.

36. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, at p. 5.

37. *See* the more detailed discussion of the determination of the rate of tax under the STTR in section 7.

38. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Executive Summary, p. 5, at fn. 1.

country or other countries, or where the administrative burden of applying the STTR outweighs the additional tax revenue that might be raised.

The Commentary on the STTR provides that "There is a process to support members of the Inclusive Framework on BEPS in the identification of relevant tax treaties for this purpose".[39] However, no further information is provided regarding this process. This is an important issue for developing countries because identifying the tax treaties that developing countries have with developed countries that could potentially be modified to add the STTR will be a difficult exercise. It is not as straightforward as simply identifying a country's treaty partners that have nominal corporate tax rates of less than 9% because, under the STTR,[40] the determination of a country's nominal corporate tax rate requires certain preferential adjustments under the country's domestic law to be taken into account. As discussed further in section 7., developed countries should have an obligation to notify their developing country treaty partners if they impose tax on items of covered income under the STTR at tax rates, as defined in the STTR, of less than 9%.

For the purposes of this article, it is assumed that the STTR will be included only in tax treaties between a developing country and a developed country, although there is no prohibition on the inclusion of the STTR in other tax treaties. Where there is a substantial discrepancy between the level of development of two developed countries or two developing countries,[41] it might be appropriate for the lesser developed country to negotiate for the inclusion of the STTR in the tax treaty.

5.2. Brief comments on the STTR Multilateral Convention

Although a detailed analysis of the STTR Multilateral Convention is beyond the scope of this article, a few comments on the substantive aspects of the Convention and the relationship between the STTR Model Rule and the Convention are appropriate.

Existing tax treaties can be amended to add the STTR either through bilateral negotiations or through the STTR Multilateral Convention, which was opened for signature on 2 October 2023. Where the STTR is added to a tax treaty through bilateral negotiations, presumably, the STTR Model Rule with appropriate modifications will be incorporated into the tax treaty. Where the STTR is added to a tax treaty through the operation of the STTR Multilateral Convention, the provisions of Annex 1 of the Convention, which contain the STTR Model Rule, must be included in the tax treaty.[42] The provisions of the STTR Model Rule and Annex 1 of the STTR Multilateral Convention are not identical. For instance, the references to articles 7, 11, 12 and 21 in the STTR Model Rule[43] cannot be used in the STTR Multilateral Convention, as the numbers of the equivalent provisions in actual tax treaties may be different. There are also other differences, which are noted where relevant in this article. Due to the differences between the STTR Model Rule and the provisions of Annex 1 of the STTR Multilateral Convention, most of the references in this article include references to both the relevant provision of the STTR Model Rule and the equivalent provision of Annex 1 of the STTR Multilateral Convention.

The STTR Multilateral Convention is accompanied by an Explanatory Statement, which was prepared by the OECD's Working Party 1 and adopted by the Inclusive Framework at the same time as text of the Convention.[44] The Explanatory Statement is not intended to affect the interpretation of the STTR itself,[45] which is the role of the Commentary on the STTR Model Rule. As a result, the Commentary on the STTR Model Rule is the relevant document for purposes of interpreting Annex 1 of the STTR Multilateral Convention.

The STTR will be added to a tax treaty only if both parties to the tax treaty notify the OECD, which is the Depository for the STTR Multilateral Convention, that they want the Convention to apply to their tax treaty.[46] This process does not reflect the commitment made by the developed country members of the Inclusive Framework to modify their tax treaties with developing countries to include the STTR if requested to do so; the STTR Multilateral Convention does not impose any such requirement on developed countries. Accordingly, developing countries must rely on the informal non-binding commitments made by developed countries that are members of the Inclusive Framework.

The provisions of the STTR Model Rule are included in Annex I of the STTR Multilateral Convention, and must be included in all tax treaties that become subject to the Convention through the notifications made by both parties to the tax treaty. Annexes II and III to the STTR Multilateral Convention are provided for special provisions to be added to the STTR where a country imposes tax on a basis other than net income,[47] and where income is distributed rather than when earned.[48] Annex IV to the STTR Multilateral Convention deals with the definition of a "recognised pension fund" for purposes of the exclusion of such funds from the STTR.[49]

39. Id., Commentary, at para. 4.
40. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, art. 5.
41. For instance, if one country is classified by the Atlas method of the World Bank Group (WBG) as a low-income economy (GNI per capita of USD 1,135 or less for 2022) and the other state is classified at the high end of the range for an upper-middle income economy (GNI per capita of more than USD 4,466 and less than USD 13,845 for 2022). High-income countries are those with a GNI per capita of USD 13,845 or more for 2022.
42. OECD, *STTR Multilateral Convention*, *supra* n. 3, at art. 3.
43. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1.
44. OECD, *STTR Multilateral Convention*, *supra* n. 3, Explanatory Statement, at para. 8.
45. Id., at para. 9.
46. Id., at art. 2(a)(ii).
47. Id., at Annex II.
48. Id., at Annex III.
49. Id., at Annex IV, which, in effect, uses the definition of a "recognized pension fund" in article 3(1)(i) of the *OECD Model* (2017), and extends that definition to include pension arrangements that would be within that definition if the arrangement were treated as a separate person.

Under Annex V of the STTR Multilateral Convention, the application of the STTR in a tax treaty is suspended for fiscal years beginning six months after a country that has not been classified as a high-income country at any time after 1 July 2020 is classified as a high-income country for five consecutive years after the STTR enters into effect. The suspension of the application of the STTR with regard to that tax treaty continues until the first day of a fiscal year beginning six months after the country ceases to be classified as a high-income country. In effect, if the STTR is added to a particular tax treaty, it is not a permanent addition to the tax treaty, but, rather, is conditional on the status of a country continuing to be a country other than a high-income country. However, even where a developing country becomes a high-income country, the STTR continues to apply until the country is classified as a high-income country for five consecutive years. The suspension of the STTR ceases to apply for fiscal years beginning six months after the country ceases to be a high-income country.

Under article 7 of the STTR Multilateral Convention, Annex V applies only if a country chooses to include Annex V by notifying the OECD. However, the choice to include Annex V to the STTR Multilateral Convention applies to all of the country's tax treaties that are covered by the Convention. The inclusion of Annex V to the STTR Multilateral Convention in a tax treaty does not require notification by both parties to the tax treaty.[50]

It appears that any developed or developing country can sign the STTR Multilateral Convention and notify the OECD with regard to any of its tax treaties to which it wishes to add the STTR. Where two countries notify the OECD with regard to their tax treaty, the STTR will be included in that tax treaty. If neither party chooses to include Annex V, the STTR would be part of the tax treaty indefinitely. Where, however, Annex V to the STTR Multilateral Convention is included in the STTR (because one party to the tax treaty notified the OECD that it wanted Annex V to apply), the STTR will cease to apply, as described previously in this section, where a non-high-income economy becomes a high-income economy for five consecutive years. Any developed country that signs the STTR Multilateral Convention will undoubtedly choose to apply Annex V, so that the STTR will not apply indefinitely to any of its tax treaties covered by the Convention.

Assuming that developed countries adhere to their informal commitment to amend their tax treaties with developing countries, developing countries are identified using the classification of countries of the WBG as countries other than high-income economies on the basis of their per capita GNI using the Atlas method of the WBG.[51] For 2020, the STTR Model Rule refers to developing countries as countries with GNI per capita of USD 12,535 or less in 2019, as updated annually.[52]

Although it is not completely clear, it appears that any country that is not a high-income country according to the WBG classification system at the time that it signs the STTR Multilateral Convention may request any high-income country (that is a member of the Inclusive Framework) to add the STTR to the tax treaty between the two countries.[53] Although developed (high-income) countries that are members of the Inclusive Framework have informally committed to modify their tax treaties with developing countries to add the STTR, as emphasized in this article, there is no binding legal obligation for them to do so, nor is there even a statement to that effect in the preamble to the STTR Multilateral Convention.

Although the STTR is intended to benefit developed countries, under the STTR Multilateral Convention, it applies on a reciprocal basis to both parties to a tax treaty. Article 12(2) of the STTR Multilateral Convention provides that Annex I "shall have effect in each Contracting State with regard to a Covered Tax Agreement". As explained in section 3., the reciprocal application of the STTR is contrary to the fundamental rationale for the rule – to assist developing countries in protecting their tax base by restoring some of the taxing rights that they have given up in entering into tax treaties with developed countries. The STTR Multilateral Convention should include an explicit prohibition on the imposition of tax under the STTR by any developed country that signs the Convention, unless the STTR is suspended in accordance with Annex V because the developing country ceases to be a developing country.[54]

5.3. Basic rules for the application of the STTR

The STTR[55] applies where article 7, 11, 12 or 21[56] of the STTR Multilateral Convention limits the imposition of

50. Id., at art. 7(c). Under OECD, *STTR Multilateral Convention*, *supra* n. 3, article 7(c), it is necessary for only one party to notify the OECD that it wants Annex V to apply.
51. The WBG classifies countries annually into the following four categories: (i) low-income; (ii) lower-middle income; (iii) upper-middle income; and (iv) high-income.
52. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, p. 5, at fn. 1.
53. Presumably, the same rule would apply where the STTR is added to tax treaties through bilateral negotiations. Accordingly, any country that is not a high-income country may make a request to add the STTR to a tax treaty with a developed country as long as it is not a high-income country at the time it makes the request.
54. This suggestion is reasonable despite the fact that developed countries would be unlikely to be entitled to impose tax under the STTR.
55. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1.
56. The references to these articles must be modified with regard to the inclusion of the STTR in any tax treaties where the number of the particular article does not conform to the numbering in the *OECD Model* (2017). In the OECD, *STTR Multilateral Convention*, *supra* n. 3, the four provisions referred to in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 are identified by general descriptions of their content. The description of article 7 of the *OECD Model* (2017) in the OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1)(a) is any treaty provision that provides "that the profits of an enterprise of a contracting jurisdiction shall be taxable only in that jurisdiction unless the enterprise carries on business in the other contracting jurisdiction through a permanent establishment there". The description of articles 11 and 12 of the *OECD Model* (2017) in the OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1)(b) is any treaty provision that provides "that interest and royalties arising in a contracting jurisdiction shall be taxable only in the other contracting jurisdiction or limit the rate at which such interest or royalties, or at which any income in consideration for the provision of services, may be taxed in the first-mentioned jurisdiction". The description of article 21 (Other income) of the *OECD Model* (2017) in of the OECD, *STTR Multilateral Convention*,

tax by a contracting state on income arising in that state. The relevant part of the STTR[57] reads as follows:

> Where in accordance with the provisions of Articles 7, 11, 12 and 21 the tax that may be charged in a Contracting State on an item of covered income arising in that State is limited, that income may, notwithstanding those provisions, be taxed in that State if it is subject to a tax rate below 9% in the Contracting State of which the person deriving that income is a resident.

Although there are many additional limitations on the imposition of the STTR by a country, it[58] establishes that it applies only to payments that are within the scope of articles 7, 11, 12 and 21 of a tax treaty, and only where such payments are subject to tax by the country in which the recipient is resident at a rate[59] of less than 9%.

Taking article 7 of the STTR Multilateral Convention as an example, the STTR would apply to any covered payments that are included in a taxpayer's business profits under article 7 of a particular tax treaty that is similar to article 7 of the OECD Model, including article 7 of the UN Model, where article 7 limits the tax that may be imposed on those profits. Accordingly, the STTR[60] would apply to the country in which a business is carried on by a resident of the other state where the business is not carried on through a PE in the first country, as that country is precluded from taxing those profits. However, where the business is carried on through a PE, the STTR[61] would not apply because, although that country is limited to taxing the profits attributable to the PE, the tax rate that it is entitled to impose on those profits is not limited. Accordingly, the STTR[62] applies only where the rate of tax that a country is entitled to impose on an item of covered income is limited.[63] In addition, the STTR[64] would not apply to the country in which the taxpayer is resident, as article 7 of the OECD or UN Model does not impose any limitation on its right to tax the taxpayer's business profits from a business carried on in the other country, whether or not that business is carried on through a PE.[65]

This same basic point applies to the other articles mentioned in the STTR,[66] except for article 21 of the UN Model. Articles 11, 12 and 21 of the OECD Model limit the tax imposed by the source country on payments of interest, royalties or other income to residents of the other country. However, they do not impose any limit on the taxes imposed by the country in which the recipient of the payment is resident. In contrast, article 21 of the UN Model does not impose a limit on the tax rate imposed by a source country on items of other income that arise in the country, unlike article 21 (Other income) of the OECD Model, which prevents any source country taxation of items of other income, wherever arising. As a result, the STTR would not apply to items of other income that arise in a state under a tax treaty including article 21 of the UN Model, but would apply to items of other income that arise outside that state.

This result is intended and consistent with the underlying rationale of the STTR, under the version of article 21 in the UN Model, the developing country that is a party to such a tax treaty is entitled to tax items of other income arising in the country at the applicable rate under its domestic law (without any limit imposed by the tax treaty), which can exceed the 9% minimum rate under the STTR. The result is the same with regard to the country in which the recipient of an item of other income is resident under the version of article 21 of the UN Model, as the tax imposed by that country would not be limited either with regard to items of other income arising in or outside the source country. Although the residence country would have an obligation to provide relief for the source country's tax on any item of other income arising in the source country, this obligation does not mean that the residence country tax rate on the income is limited.[67] Consequently, the residence country would not meet the requirements of the STTR,[68] and would not be allowed to impose tax under the STTR on items of other income.

With regard to article 7 (Business profits), the STTR would not apply to any business profits that a developing country is entitled to tax under article 7 of a particular tax treaty, where that tax treaty defines a PE in accordance with article 5 of the UN Model, which includes article 5(3)(b) dealing with income from services and article 5(6) dealing with insurance. As, under such a tax treaty, the country in which a PE is located has the unlimited right to tax any business profits attributable to the PE under article 7 of that treaty, the STTR would not apply to fees for ser-

supra n. 3, Annex 1, at art. 1(1)(c) is any treaty provision that provides "that items of income of a resident of contracting jurisdiction that are not classified in this agreement as income having a specific character shall be taxable only in that jurisdiction or that limits the rate at which such items of income may be taxed in that other contracting jurisdiction".

57. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1.
58. Id.
59. The term "tax rate" in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1 is not used in its ordinary sense, but, instead, means the tax rate determined under OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5. *See also STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5. *See again* section 7.
60. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
61. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
62. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
63. This interpretation is implicit in paragraph 94 of the Explanatory Statement, which indicates that only provisions that provide exclusive taxing rights to the other country with regard to interest and royalties or limit the rate of tax that the source country may impose on such items are within the scope of OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
64. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
65. The fact that the residence country is obliged to provide an exception for the profits attributable to the PE or a credit for any tax imposed by the source country in which the business is carried on through a PE does not mean that the tax rate imposed by the residence country is limited. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 6(a)(iii) and 6(b)(i) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 6(a)(iii) and 6(b)(iii).
66. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1.
67. *See supra* n. 65.
68. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.

vices or payments for insurance by entities resident in the country to connected persons resident in the other state within article 5(3)(b) or 5(6).

The key point of the preceding analysis is that countries whose tax treaties follow articles 7, 12 or 21 of the UN Model will derive less benefit from the STTR than countries whose tax treaties conform to the OECD Model version of those provisions. This result can be seen clearly with regard to article 12 dealing with royalties. Under article 12 of the OECD Model, only the state in which the recipient of royalties is resident is entitled to tax royalties. The source state (the state in which the royalties arise) is not entitled to impose any tax on such royalties. Accordingly, if the STTR is included in a tax treaty with an article dealing with royalties that is the same as article 12 of the OECD Model, the source country has the potential to impose tax under the STTR of up to 9% on the gross amount of royalties paid by resident companies to connected persons resident in the other state. However, the maximum STTR tax would be payable only where the other state does not impose any tax on the recipient with regard to the royalties. In contrast, under article 12 of the UN Model, the source country is entitled to tax royalties arising in the country and paid to a resident of the other country at a rate agreed between the two countries. As a result, if the agreed rate exceeds 9%, the STTR will not apply to any royalty payments covered by article 12 of the UN Model.

Under the STTR,[69] the tax imposed by a source country on a covered payment to connected persons resident in the other country is limited to the "specified rate" of the gross amount of the payment.[70] For this purpose, the "specified rate" is 9% in excess of the tax rate imposed by the country in which the recipient of the payment is resident, which is its nominal corporate tax rate adjusted for any permanent tax preferences as determined under the STTR.[71] As a result, if the country in which the recipient is resident imposes tax on a payment at an adjusted rate of at least 9%, no tax can be imposed under the STTR.

Further, the STTR[72] provides that where the gross amount of a covered payment may be taxed by the source country under any other provision of a tax treaty (i.e. other than article 7, 11, 12 or 21 of the OECD Model or the UN Model) at a specified rate of 9% or more, the STTR[73] does not apply. In addition, where the source country taxes a covered payment at a specified rate of less than 9%, the tax under the STTR is limited to 9% less the tax rate imposed on the payment under the other treaty provision. As a result, the aggregate tax rate imposed on the payment by the source country would be limited to 9%.

69. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 2.
70. *See* the discussion in section 5.
71. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5.
72. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 3.
73. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at arts. 1 and 2.

5.4. Example of the basic operation of the STTR

The basic operation of the STTR with reference to the charging provisions in the STTR Model Rule[74] is illustrated by the following simplified Example 1.

Example 1

XCo, a company resident in Country X, a developing country, pays its parent company, PCo, resident in Country P, a developed country, 100,000 for services provided by PCo. Assume that the gross amount of the payment is subject to tax at a rate of 20% under Country X's domestic tax law. Under the Country P-Country X Tax Treaty, Country X's tax is limited to 5% of the gross amount of the payment (5,000). Assume that PCo does not have any PE in Country X and that PCo's costs incurred in providing the services are minimal so that the markup threshold in the STTR[75] does not apply.[76] Finally, assume that the Country X–Country P Tax Treaty has been modified to include the STTR.

Under the STTR,[77] Country X is entitled to tax the payments for services to PCo, notwithstanding that Country X is not entitled to tax the payment under article 7 of the Country X–Country P Tax Treaty, as PCo does not have a PE in Country X, as long as the payment received by PCo is subject to tax by Country P at a rate of less than 9%. The payment for services provided by PCo to XCo is an item of income within the meaning of the STTR.[78]

Under the STTR,[79] Country X's tax on the payment for services under the STTR[80] cannot exceed the "specified rate", which is 9% in excess of Country P's tax rate on the payment received by PCo as determined under the STTR.[81] The tax rate determined under the STTR[82] is Country P's nominal or statutory corporate tax rate on the payment for services, subject to any preferential adjustment to the tax rate. Assume that Country P's statutory corporate tax rate is 14%, and that the payment for services does not qualify for any tax preference. Alternatively, assume that the payment for services is subject to a special regime under which the gross amount of the payment is taxed at 3%.

According to the STTR,[83] assuming that Country P imposes corporate tax on the payment at a rate of 14%, no Country X tax under the STTR would be payable with regard to the payment, as the 5% Country X tax on the payment under the tax treaty is greater than the specified rate, which is 9% – 14% or zero. Accordingly, the STTR[84] does not apply to the payment for services.

However, assuming that Country P imposes tax on the payment at a rate of only 3%, the specified rate would be 9% – 3% = 6%

74. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1-3 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at arts.1-3.
75. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 9 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 9.
76. The operation of the markup threshold in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 9 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 9 with regard to this example is discussed in section 8.
77. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
78. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 6 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 6.
79. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 2.
80. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
81. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5.
82. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5.
83. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3, first sentence and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 3.
84. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at arts. 1 and 2.

and the STTR[85] would apply, with the result that the relevant provision of the tax treaty would continue to apply and Country X would be entitled to tax the payment at the treaty rate of 5%. The specified rate would be reduced by the lower of 5% and 6%. Accordingly, the specified rate for the purpose of applying the STTR[86] would be reduced to 9% – 5% = 4%. In summary, the result would be as follows:

– Country X would impose tax of 5% on the payment in accordance with the relevant provision of the tax treaty;
– Country P would impose corporate tax on the payment of 3%; and
– Country X would be entitled to impose top-up tax of 1% (the specified rate (4%) – Country P's rate (3%) = 1%) of the gross amount of the payment under the STTR.

The overall result makes sense in that the total amount of Country X and Country P tax on the payment is 9% of the payment, which is the minimum tax rate established by the STTR on covered payments.

5.5. Covered income (payments)

5.5.1. Opening comments

As noted in section 5.2., the STTR[87] applies where the tax imposed by a country under article 7, 11, 12 or 21 of a tax treaty "on an item of covered income arising in that state is limited". As a result, the STTR does not apply to all amounts taxable by a country under those articles of a tax treaty. Instead, it applies only to amounts of "covered income" that arise in a country and are within the scope of article 7, 11, 12 or 21 of the tax treaty. Items that are not within the definition of "covered income" are not subject to the STTR, even if they are within the scope of article 7, 11, 12 or 21 of the tax treaty. For instance, many types of business profits, such as profits from manufacturing and mining, are within the scope of article 7 of the OECD Model, but are not items of covered income. Similarly, types of income such as alimony and maintenance payments, are within the scope of article 21 of the OECD Model, but are not items of covered income.[88]

The term "covered income" is defined in the STTR[89] to mean:
– payments for the right to distribute goods or services;
– insurance and reinsurance premiums;
– guarantee and financing fees;
– payments of rent for the use of, or the right to use, industrial, commercial or scientific equipment; and
– payments for services.

Payments for the use or right to use a ship to transport passengers or cargo in international traffic on a bareboat charter basis and any items of income of a person whose tax liability is determined by reference to the tonnage of a ship are explicitly excluded from the definition of covered income.[90]

Only payments of the defined items of covered income are subject to the STTR and only if the payments are made to connected persons resident in the other country. As a result, for example, the payment of insurance premiums will be subject to the STTR only with regard to the payment of premiums to a captive insurance company.

As noted in this section, items of covered income are subject to the STTR[91] only if they arise in a country. This terminology is frequently used in bilateral tax treaties to limit the scope of certain articles to income that is derived from or has its source in a country. Some articles provide explicit rules for determining the source of income. For instance, article 11(5) of the OECD Model provides that interest arises in a contracting state if the payer is a resident of that state or the payer has a PE in that state, the indebtedness is incurred in connection with the PE and the interest is borne by the PE. Similar rules are provided in the UN Model with regard to interest, royalties and fees for technical services.[92]

Under article 21 of the OECD Model, no rules are necessary to determine when an item of covered income arises in a country because the residence country has exclusive taxing rights with regard to other income irrespective of where the income arises. In contrast, article 21 of the UN Model allows a source country to impose tax without any limit on the rate of tax where an item of other income arises in that country. However, unlike article 11, article 21 does not provide any rules for determining when income arises in a country. Presumably, domestic law would apply for this purpose, subject to the caveat that the context of the tax treaty may require a different meaning.[93] As discussed in this section, article 1(4)(d) of Annex 1 of the STTR Multilateral Convention provides a special rule to determine whether an item of other income is deemed to arise in a country for purposes of the STTR.

85. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3, second sentence and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 3.
86. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 2.
87. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
88. *See OECD Model Tax Convention on Income and on Capital: Commentary on Article 21*, para. 9 (21 Nov. 2017), Treaties & Models IBFD.
89. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 4.
90. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4(b) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 4(b). This exclusion is necessary because payments for the use of a ship on a bareboat charter basis are excluded from the scope of article 8 of the *OECD Model* (2017), unless they are merely ancillary to an enterprise's shipping activities (*see* paragraph 5 of the *OECD Model: Commentary on Article 8* (2017)). Such payments would be dealt with under article 7 or 12 of the *OECD Model* (2017) or the *UN Model* (2021), respectively, and would be potentially within the scope of the STTR.
91. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
92. *See* articles 12(5) and 12A(5) of the *UN Model* (2021). One curious feature of the source rule in the *OECD Model* (2017) and *UN Model* (2021) is that they "deem" interest, royalties and fees for technical services to arise in a country in certain circumstances, but they do not provide that those payments arise in a country only in those circumstances. In other words, deeming provisions usually apply to extend the meaning of the wording of provisions to situations that would not be within their ordinary meaning. Accordingly, there is an issue with regard to the provisions of the STTR and tax treaties providing rules for when income arises in a country whether or not that question is determined under a country's domestic law and that domestic law meaning is then extended by the deeming provisions in the STTR and the tax treaty in question.
93. Assuming that the tax treaty contains a provision similar to article 3(2) of the *OECD Model* (2017) and the *UN Model* (2021), and that provision applies to determine the source of items of other income.

Article 7 of both the OECD Model and the UN Model does not provide explicit rules for determining whether business profits arise in a country. Instead, article 7 of the OECD Model and the UN Model provides that a country in which a resident of the other country carries on business through a PE in the first country is entitled to tax only the profits attributable to the PE. In effect, the profits attributable to a PE[94] is an alternative method for determining the income that arises in a country, although the profits attributable to a PE can include profits arising outside the PE country.

The STTR Multilateral Convention[95] provides that the provisions of the tax treaty described in the Convention[96] (i.e. articles 7, 11, 12 and 21) that determine when income arises in a country also apply for purposes of the Convention.[97,98] As a result, the rules in the interest and royalties articles of a tax treaty with regard to the country in which interest and royalties arise are also applicable for purposes of the STTR. Accordingly, interest and royalties are considered to arise in a country where the payer is a resident of the country or has a PE in the country and the liability to make the payment was incurred in connection with the PE and payment is borne by the PE. However, as already explained in this section, whether other items of covered income arise in a country (i.e. those items otherwise covered by article 7 or 21 of the tax treaty) is not dealt with in most tax treaties. With regard to these items of covered income, the STTR Multilateral Convention[99] provides that, for purposes of the STTR, they are deemed to arise in the country of which the payer is a resident, or in which the payer has a PE, the liability to pay the amount was incurred in connection with the PE, and the amount is borne by the PE.[100] Accordingly, the same source rules apply for all items of covered income under the STTR. Where both rules apply (i.e. where an income item is paid by a resident of a country, but is borne by a PE which that resident has in another country), the item of income is deemed to arise in the country where the PE is located.

As the STTR applies to payments of covered income items by both residents of a developed country and non-residents of that country with a PE in that country with which the liability to make the payment is connected and that bears the payments, it will be necessary for developing countries to ensure that their domestic withholding regimes apply to payments of covered income by non-residents with PEs in their countries. In many cases, this extension of withholding taxes will require changes to domestic law and a significant commitment of resources to administer the withholding tax system effectively.

Under tax treaties that follow the OECD Model, these covered income amounts (other than interest) are taxable by a source country only if the taxpayer has a PE in the country. In contrast, under the UN Model, collecting insurance premiums and insuring risks in a country and furnishing services in a country for more than 183 days in a 12-month period are deemed to be a PE,[101] in which case the source country has an unlimited right to tax the payments for insurance or services and the STTR does not apply. In addition, rental payments for the use of, or the right to use, industrial, commercial or scientific equipment are treated as royalties under article 12 of the UN Model, which are taxable at an agreed rate even if the recipient does not have a PE in the other country to which the royalties are effectively connected. Accordingly, to the extent that the tax treaties of a developing country follow the UN Model, in general, they will derive less benefit from the STTR than those countries that have tax treaties that adhere to the OECD Model. However, many bilateral tax treaties between developed and developing countries follow the OECD Model, as the OECD Model is more favourable for developed countries.

Sections 5.5.2. to 5.5.8. provide brief comments about each of the items of covered income and the treatment of those items under tax treaties. With regard to all of these items of income, it must be emphasized that developing countries will be entitled to impose tax under the STTR only where the country in which the recipient of the item of income is resident does not impose tax on the income at a rate (the statutory corporate tax rate applying to the item of income adjusted for certain tax preferences, as discussed in section 7.), which, when added to the rate at which the developing country is entitled to tax the income under the tax treaty, is less than 9%.

5.5.2. Interest

For purposes of the STTR, interest is defined in accordance with the definition in article 11(3) of the OECD Model (except that the words "as used in this article" must be ignored). As a result, assuming that the STTR is included in a bilateral tax treaty of a developing country, the developing country would be entitled to tax interest arising in the country where:
– the tax treaty limits the developing country's tax on such interest to less than 9%; or
– the tax treaty provides that interest is taxable exclusively by the residence country.

The first type of interest will seldom arise, as developing countries typically insist on imposing withholding taxes on interest at rates of at least 10%. The second type

94. For instance, where personnel of a PE work outside the country in which the PE is located and profits arise from their work, the profits arise outside the PE country, but are attributable to the PE.
95. OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 4(1)(c).
96. Id., Annex 1, at art. 1.
97. Id., Annex 1, at art. 4.
98. There is no counterpart to this provision in the OECD, *STTR Model Rule and Commentary*, *supra* n. 2. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4(c) is the same as OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(4)(d), although it provides that interest arises in a country applying the source rule in article 11(5) of the particular tax treaty in question. It is unclear why the provisions with regard to where covered income items arise are not the same in both the OECD, *STTR Model Rule and Commentary*, *supra* n. 2 and *STTR Multilateral Convention*, *supra* n. 3, but the differences do not appear to have any significance.
99. OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, art. 4(1)(d).
100. There is no counterpart to OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, art. 4(1)(d) in OECD, *STTR Model Rule and Commentary*, *supra* n. 2.

101. Art. 5(3)(b) and 5(6) *UN Model* (2021).

of interest will arise with regard to several tax treaties that exempt interest paid to or guaranteed by the government or central bank of a state, interest paid to certain government entities or financial institutions wholly owned by the government or central bank,[102] and interest with regard to the sale of industrial and scientific equipment.[103]

As explained in section 5.5.1., interest arises in a country for purposes of the STTR where the payer is a resident of the country or where the payer has a PE in the country, the indebtedness is connected with the PE and the interest is borne by the PE.

5.5.3. Royalties

For purposes of the STTR, the term "royalties" is defined in accordance with the definition in article 12(2) of the OECD Model (except that the words "as used in this article" must be ignored). As a result, in general, assuming that the STTR is included in a tax treaty of a developing country, royalties paid by its residents to connected persons resident in the other state or borne by a PE of the payer in the country will be subject to the STTR where the tax on such royalties under the tax treaty is limited to less than 9% or the taxing rights with regard to royalties are granted exclusively to the residence country. Typically, developing countries insist on retaining the right to tax royalties at a rate of at least 10%.

The definition of "royalties" in article 12(3) of the UN Model is broader than the definition in the OECD Model because it includes rent for the use of, or the right to use, industrial, commercial or scientific equipment.[104] Under the OECD Model, such rent is dealt with under article 7, and is taxable by the source country only if taxpayer has a PE in the source country and the rent for such equipment is attributable to the PE. This difference between the OECD Model and the UN Model with regard to the treatment of rent for such equipment is not significant because such rent is included as a separate item of covered income in the STTR,[105] as discussed in section 5.5.7. The STTR[106] potentially applies to rent for the use of or the right to use industrial, commercial or scientific equipment whether such rent is covered by article 7 of a particular tax treaty, as the source country is precluded from taxing the rent in the absence of a PE in that country, or by article 12, as the source country is either precluded from taxing such rent, or its right to tax is limited to the rate in that article.

As explained in section 5.5.1., royalties arise in a country for purposes of the STTR where the payer is a resident of the country or where the payer has a PE in the country, the equipment is connected with the PE and the rental payments are borne by the PE.

Although neither article 12(2) of the OECD Model nor article 12(3) of the UN Model provides any exceptions from the definition of "royalties", there is considerable variety in the definitions of royalties in the tax treaties of both developed and developing countries. As a result, the royalty article of each tax treaty must be examined to determine which amounts a developing country is prohibited from taxing or is limited to taxing at a rate of less than 9%. Further, the treatment of other amounts that are not included in a particular royalty article, but which would be included in the definition of royalties in article 12 of the OECD Model must be considered carefully under the particular tax treaty to see if the developing country's right to tax such amount is limited or prohibited entirely.

Unlike most other items of covered income, there appears to be no difference in the benefits derived from the application of the STTR by developing countries. This applies whether or not the developing countries in question have tax treaties with the version of the definition of "royalties" in the OECD Model or the UN Model.

5.5.4. Insurance and reinsurance premiums

Insurance and reinsurance premiums paid by companies resident in developing countries to insurance companies resident in another country are subject to the STTR only if they are paid to connected persons, which effectively limits the STTR to premiums paid to captive insurance or reinsurance companies resident in developed countries. Under the provisions of the OECD Model, insurance and reinsurance premiums payable to non-resident insurance companies are taxable by source countries only where an insurance company carries on its business in the source country through a PE in that country. Otherwise, source countries are not entitled to tax insurance or reinsurance premiums. As a result, for developing countries whose tax treaties follow the OECD Model and prohibit them from taxing insurance or reinsurance premiums paid to a connected person resident in the other country, the STTR will allow them to impose tax on such premiums to the extent that the recipient of the premiums is not subject to tax by its country of residence at a rate of at least 9%. This would be the case where the country in which the company providing the insurance protection is exempt from tax on its foreign insurance income.[107]

The situation is different with regard to developing countries with tax treaties that include a provision similar to article 5(6) of the UN Model, which deems an insurance enterprise of one state to have a PE in the other state if it collects premiums or insures risks in that state. Tax treaties that include article 5(6) would not limit a developing

102. This type of interest will usually be excluded from the STTR because the recipient is expressly excluded or the payer and recipient are not connected persons, as discussed in section 6.
103. *See* paragraphs 7.2-7.12 of the *OECD Model: Commentary on Article 11* (2017).
104. Article 12(3) of the *UN Model* (2021) also includes a specific reference to royalties for the use of copyright in films and tapes used for radio and television, although such royalties are included in the general phrase "any copyright of literary, artistic or scientific work".
105. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4(a)(vi) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 4(a)(vi).
106. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1.
107. However, this will not be the case where the insurance company is exempt only with regard to its foreign-source income earned through a PE in another country where the exemption is required under the tax treaty as the method for eliminating double taxation. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 90.

country's right to impose tax on insurance premiums paid to connected residents of the other state, and, as a result, the STTR would not apply to such payments.

However, article 5(6) of the UN Model does not apply to payments for reinsurance.[108] As a result, for tax treaties with a provision similar to article 5(6) of the UN Model, the STTR would apply only to payments by companies resident in a developing country to a connected insurance enterprise of the other state for reinsurance where that enterprise does not have a PE in the developing country, and only if the other state does not impose tax on those payments (less an 8.5% markup) at an adjusted rate of at least 9%.

The provisions of tax treaties based on either the OECD Model or the UN Model do not provide rules to determine where insurance premiums arise. As a result, as explained in section 5.5.1., under article 1(4)(d) of Annex 1 of the STTR Multilateral Convention, insurance and reinsurance premiums are considered to arise in the country where the payer is resident, or where the payer has a PE in the country, the liability to pay the premiums is connected with the PE, and the premiums are borne by the PE.

5.5.5. *Payments for distribution rights*

Payments for the use of or the right to use distribution rights with regard to goods or services are not included in the definition of royalties under either the OECD Model or the UN Model. As a result, they are taxable by the country in which they arise only if the recipient has a PE in that country, and these payments form part of the profits attributable to the PE. According to the Commentary on the STTR,[109] such amounts include payments for exclusive and non-exclusive distribution rights and payments to increase sales from the distribution of goods or services, but do not include consideration received for the transfer of full ownership of distribution rights. These payments are subject to the STTR only if they are made by a resident of a developing country to a connected person resident in the other country, or if they are incurred in connection with a PE that the taxpayer has in the developing country and the payments are borne by the PE. Payments made to an arm's length party for such rights are not subject to the STTR.

Where the recipient of such payments does not have a PE in a developing country, the tax treaty may prevent that country from taxing the payments. As a result, the payments are subject to the STTR only if the state in which the recipient is resident imposes corporate tax on the payments (less an 8.5% markup) at an adjusted rate of less than 9%. As explained in section 5.5.1., under article 1(4)(d) of Annex 1 of the STTR Multilateral Convention, payments for distribution rights are considered to arise in the country where the payer is resident or where the payer has a PE in the country, the liability to make payments is incurred in connection with the PE, and the payments are borne by the PE.

5.5.6. *Guarantee and financing fees*

Guarantee and financing fees paid by a resident of a developing country to a connected person resident in the other state are not included in the definition of interest under article 11(3) of the OECD Model as it applies for purposes of the STTR. As a result, such fees are subject to tax by a source country under an applicable tax treaty only where:
- the recipient of the fees carries on business in the source country through a PE located in the source country, the liability to pay the fees is incurred in connection with the PE, and the fees are borne by the PE; or
- the fees are within the Other income article of a tax treaty that is similar to article 21 of the UN Model, which allows the country in which other income arises to impose tax on the income.[110]

In both cases, the source country is entitled to tax the fees without any limitation on the rate of tax and as a result, the STTR does not apply.

Where a developing country is not entitled to tax guarantee fees or financing fees under an applicable tax treaty or the rate of its tax on such fees is limited,[111] the STTR is potentially applicable to such fees if they are paid to a connected person and arise in the developing country. For this purpose, the STTR provides that such fees arise in a country where they are paid by a resident of the country or by a non-resident payer with a PE in the country as long as the liability to pay the fees is incurred in connection with the PE and the fees are borne by the PE.[112]

Assuming that the relevant tax treaty does not allow a developing country to tax guarantee and financing fees paid by its residents to a connected person resident in the other state unless the connected person has a PE in the developing country, such fees are subject to the STTR only if the country in which the recipient of the fees is resident imposes corporate tax on the fees (less an 8.5% markup) at an adjusted rate of less than 9%.

5.5.7. *Rent or other payments for the use of, or the right to use, industrial, commercial or scientific equipment*

Under the OECD Model, rent and other similar payments for the use of industrial, commercial or scientific equipment are not included in the definition of royalties in article 12(2). Such payments are within the scope of article 7 of the OECD Model as business profits, and are taxable by the source country in which the payer is resi-

108. However, the UN Committee of Experts on Matters of International Taxation is currently considering amendments to the *UN Model* (2021) that would deal with income from insurance and reinsurance in a separate article.
109. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, Commentary, at paras. 21 and 22.
110. In contrast, under article 21 of the *OECD Model* (2017), the source country is not allowed to tax other income, wherever it arises.
111. This will be the case, for example, where a resident of a developing country pays such fees to a connected person resident in the other contracting state where that person does not carry on business in the developing country through a PE in that country.
112. OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(4)(a)(d).

dent only if the recipient of the payments carries on business through a PE in the source country. As a result, where the recipient of such rental payments carries on business through a PE in the source country, the STTR does not apply because the source country's right to tax the payments is unlimited. Where, however, the recipient does not carry on business through a PE in the source country, the STTR potentially applies where the payments are made to a connected person resident in the other country and arise in the source country. As explained in section 5.5.1., for this purpose, the payments are considered to arise in the country where the payer is resident, or where the payer has a PE, the liability to make the payments is incurred in connection with the PE and the payments are borne by the PE.[113]

In contrast, under article 12(3) of the UN Model, such payments are included in the definition of royalties and are taxable by the source country at the maximum rate agreed to by the parties unless the recipient of the payments carries on business through a PE in the source country, in which case the STTR would not apply.

Typically, tax treaties entered into by developing countries follow the UN Model with regard to royalties and include payments for the use of, or the right to use, industrial, commercial or scientific equipment in the definition of "royalties". Under these royalty articles, developing countries are usually entitled to tax such payments at a rate of 10% or more. As a result, the STTR would not apply to payments for the use of industrial, commercial or scientific equipment under these tax treaties.[114] Consequently, developing countries with tax treaties following the version of article 12 in the UN Model have less to gain from including the STTR in their tax treaties than developing countries that follow the version of article 12 in the OECD Model in their tax treaties.

5.5.8. Fees for services

The analysis of the implications of the STTR for many developing countries with regard to fees for services is complicated by the fact that their tax treaties often contain multiple provisions dealing with various types of services. The following discussion is limited to business services that are taxable under article 7 of the OECD Model, but may be dealt with by other provisions under the UN Model.

Fees for services may be covered by the reference to article 7 in the STTR[115] or by the general description in article 1(1)(a) of Annex 1 of the STTR Multilateral Convention, where fees for services constitute business profits under the business profits article of a particular tax treaty, as the source country's right to tax those fees is limited. Where, however, fees for services are taxable under other provisions of a tax treaty, the relevant provision of the STTR Multilateral Convention is Annex 1, article 1(1)(b), which, in addition to interest and royalties, refers to fees for services that a source country may tax only at a limited rate.

Where the STTR is included in a tax treaty that follows the OECD Model, fees for services are covered by article 7 of the relevant tax treaty, precluding a source country from taxing the fees unless a service provider resident in the other country has a PE in the source country and the fees are part of the profits attributable to the PE. In this case, the STTR[116] authorizes the source country to tax the fees, assuming they are paid to a connected person resident in the other country, arise in the source country,[117] and that country taxes the fees for services (in excess of an 8.5% markup) at an adjusted rate of less than 9%.

However, where the relevant tax treaty follows the UN Model with regard to fees for services, the tax treaty may include several provisions dealing with fees for services that would otherwise be included in article 7 of the OECD Model, and, therefore, would be within the scope of the STTR.[118] These provisions include:[119]
– article 5(3)(b) of the UN Model, deeming a taxpayer to have a PE in a country where the taxpayer performs services in the country for 183 or more days in any 12-month period;
– article 12A, allowing a source country to tax the gross amount of fees for consulting, technical and management services at an agreed rate;[120]
– article 12B, allowing a source country to tax the gross amount of payments for automated digital services; and
– article 14, allowing a source country to tax income from professional and other independent services derived by a resident of the other country where that

113. OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(4)(a)(d).
114. The STTR could apply where the maximum rate of tax agreed to by the parties in the royalty article of a particular tax treaty is less than 9%.
115. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1.
116. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1) and (2).
117. Fees for services are considered to arise in a country under article 1(4)(d) of the *OECD Model* (2017), where the payer is a resident of the country or the payer has a PE in the country, the liability to pay the fees is incurred in connection with the PE and the fees are borne by the PE.
118. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(a) and (b).
119. This list does not include premiums for insurance or reinsurance, guarantee fees and financing expenses and rental payments for the use of industrial, commercial, or scientific equipment, which are all explicitly included in the definition of "covered income" in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 4. By implication, these income items are not included in the meaning of the undefined term "services" in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 4(a)(vii) or *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(4)(a)(vii). Other fees for services, other than rent for the use or the right to use a ship on a bareboat charter basis which is explicitly excluded from the STTR, are effectively excluded from the STTR because they are not within the scope of OECD, *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1) (except possibly where they are within the scope of article 21 of the *UN Model* (2021) as an item of other income).
120. As, to the author's knowledge, article 12A (Fees for technical services) and article 12B (Income from automated digital services) of the *UN Model* (2021) have not been included in any tax treaties between developing and developed countries, they are relevant for purposes of the STTR only in a theoretical sense. If those articles were included in a tax treaty with a developed country, they would be relevant under OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 3, so that any tax imposed by a source country under those articles would reduce the specified rate.

resident has a fixed base in the source country that is regularly available for the resident's use or is present in the source country for 183 days or more in any 12-month period.

Where the tax treaties concluded by developing countries include a provision similar to article 5(3)(b) of the UN Model, the source country in which a PE is deemed to exist has an unlimited right to tax the non-resident service provider on the fees for services and as a result, the STTR would not apply.[121] However, in cases where article 5(3)(b) of the UN Model does not apply, the source country would have no right to impose tax on the fees for services under article 7 of the relevant tax treaty. As a result, the STTR[122] would apply to allow the source country to impose a top-up tax on the gross amount of the fees (less a markup of 8.5%), to the extent that the other state imposes corporate tax on the fees at a rate (adjusted for tax preferences) of less than 9%.

As the STTR does not apply to fees for services received by individuals, fees for professional and other independent services covered by article 14 of a bilateral tax treaty (rather than article 7) would not usually be covered by the STTR.[123] However, some countries take the position that article 14 of a tax treaty applies to professional and other independent services provided by legal entities.[124] Where this is the case, the STTR[125] would apply.[126] As a result, where the source country's right to tax under article 14 of a tax treaty is unlimited (as it would be if the taxpayer has a fixed base in the source country or is present in the source country for 183 days or more in any 12-month period), the STTR[127] provides that the STTR[128] does not apply, so that no tax will be imposed under the STTR. Where, however, a taxpayer does not have a fixed base in the source country and is not present there for at least 183 days, article 14 of a tax treaty does not apply to the taxpayer's income. As a result, article 7 of a tax treaty would apply to preclude any source country tax on the income from services, making the STTR potentially applicable. Again, the STTR applies only where the fees for services are paid to a connected person, the fees arise in the source country, and those fees are not taxable by the recipient's country of residence at a rate of 9% or more. Fees for services are considered to arise in a country for purposes of the STTR if the payer is a resident of the country or if the payer has a PE in the country, the liability to pay the fees is incurred in connection with the PE, and the fees are borne by the PE.

Under some tax treaties, a country may have the right to impose tax on the gross amount of fees for services paid by its residents to residents of the other country at a limited rate.[129] In this case, under the STTR, the source country would be allowed to impose an additional top-up withholding tax on payments for services (less a markup of 8.5%), to the extent that its withholding tax is limited to a rate of less than 9%, assuming that the payments are made to a connected person in the other country, and that the aggregate of the source country's withholding tax and the tax imposed by the recipient's country of residence do not equal or exceed 9%.

6. Exclusions

All payments of covered income made or received by individuals are excluded from the STTR.[130] This exclusion can be justified only on the basis that it simplifies the administration of and compliance with the STTR. Otherwise, it appears to be an arbitrary exclusion designed to limit the restoration of taxing rights to developing countries under the STTR. There is no principled reason for excluding payments made or received by individuals from the STTR, nor does the Commentary or any other supporting material provide any justification for this exclusion. Developing countries give up their taxing rights under their tax treaties with regard to payments of covered income items whether those payments are made by resident individuals or resident legal entities, and whether they are paid to individuals or legal entities resident in the other country. The risks of base erosion may be greater with regard to payments by or to legal entities, but even if this is the case, it does not mean that there are no risks of base erosion with regard to payments of income items by or to individuals. It may be more difficult for developing countries to enforce withholding taxes imposed on individual payers. However, this difficulty applies equally to payments of interest, royalties and other amounts that are

121. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3, first sentence and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 3, first sentence.
122. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 1 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1).
123. Although article 14 was eliminated from the *OECD Model Tax Convention on Income and on Capital* (29 Apr. 2000), Treaties & Models IBFD, it has been retained in the *UN Model* (2021) and is still found in many bilateral tax treaties.
124. *See UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 14* para. 11 (1 Jan. 2021), Treaties & Models IBFD.
125. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(3).
126. The provision in a particular treaty equivalent to article 7(4) of the *OECD Model* (2017) would make article 14 of the *UN Model* (2021) applicable in this situation. No difficulty appears to arise with regard to the use of the term "fixed base" in article 14 of a tax treaty, although the STTR uses the term "permanent establishment" exclusively. Where article 14 of a tax treaty does not apply (i.e. where a country's rate of tax on independent services is limited or it is precluded from taxing such fees), article 7 would apply under the priority rules in article 7(6) of the *UN Model* and article 7(4) of the *OECD Model* (2017), assuming that the fees for professional and other independent services are considered to be business profits. Apparently, some countries take the position that professional and other independent services are not business profits, which is the reason that article 3(1)(h) was added to the *OECD Model* (2000) when article 14 was deleted. If the fees are not considered to be business profits, presumably the Other income article of the relevant tax treaty would apply to the fees.
127. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 3, first sentence and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(3).
128. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 1(1) and (2).
129. *See*, for example, *Agreement between the Swiss Confederation and the Republic of Indonesia for the Avoidance of Double Taxation with Respect to Taxes on Income*, art. 13 (29 Aug. 1988) (as amended through 2007), Treaties & Models IBFD, which provides for a 5% withholding tax on any payments for services by residents of one country to residents of the other country.
130. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 8(a) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 8(a).

subject to withholding taxes under the provisions of the OECD Model and UN Model, and none of those provisions exclude payments by individuals (with the exception of article 12A (Fees for technical services) of the UN Model).

In addition, covered payments made by an entity resident in a developing country to an entity resident in the other state that is not connected with the payer are excluded from the STTR.[131] For this purpose, "connected persons" are defined in the STTR[132] as two entities where one controls the other or both are controlled by the same person or persons, directly or indirectly, through the ownership of more than 50% of the beneficial interests in those entities (50% or more of the aggregate votes and value of the shares in the case of a company), or controlled de facto by reference to all the facts and circumstances. This definition is similar to the definition of "closely related enterprises" in article 5(8) of the OECD Model and article 5(9) of the UN Model for purposes of the dependent agency rules in the definition of a "permanent establishment".[133]

The stated rationale for limiting the STTR to covered payments to connected persons is that such payments present greater risks of base erosion. The STTR will not apply to covered payments to persons not connected with the payer, even where developing countries gave up some or all of their taxing rights with regard to such payments in their tax treaties (on the assumption that the other country will tax the payments at a reasonable rate), and the other country fails to do so. The justification for limiting the STTR to payments to connected persons is arbitrary. All deductible payments by residents of a country erode its tax base. Where payments are made to an arm's length recipient resident in the other country, by definition, the amount of the payments will not exceed an arm's length amount base erosion. However, transfer pricing rules apply with regard to deductible payments to connected persons to ensure that the payments are not excessive. Once again, it appears that the limitation of the STTR to payments to connected persons is an arbitrary limitation that is designed to limit the extent of taxing rights provided to (restored to) developing countries under the STTR.

In addition, covered payments received by the following persons are also excluded from the STTR: individuals, non-profit organizations, recognized pension funds, national and subnational governments, international organizations, and certain investment funds and holding entities owned by the specified excluded entities.[134] The exclusion of these organizations and entities appears to be justified based on their nature. Similar exclusions are provided for these organizations and entities for purposes of the Pillar Two global minimum tax.[135]

Given that the scope of the STTR is limited to payments to connected persons, it could be avoided quite easily through the use of back-to-back arrangements. As a result, the use of non-connected entities or connected entities resident in a country with a corporate tax rate of at least 9% as intermediaries to avoid the STTR is subject to a back-to-back anti-avoidance rule that applies where "it is reasonable to conclude" that an intermediary would not have made "related payments" to the connected person in the absence of the original payment to the intermediary.[136] Related payments are amounts equal to all or substantially all of the original payment made within a 365-day period, including the day on which the original payment is made.[137] The Commentary to the STTR provides a series of examples to illustrate the application of the back-to-back anti-avoidance rule, including the potential overlap with the general treaty anti-abuse rule in article 29(8) of the OECD and UN Models. According to the Commentary to the STTR, the specific anti-avoidance rule in the STTR, which is not based on a purpose test, can apply in situations where the general treaty anti-abuse rule would not apply, and the general rule can apply in situations where the specific rule would not apply.

Although a detailed analysis of the back-to-back anti-avoidance rule for purposes of the STTR is beyond the scope of this article, a few brief comments are appropriate. First, the back-to-back anti-avoidance rule will be very difficult for the tax authorities of developing countries to apply in an effective manner because it requires access to all of the relevant information, which may include multiple intermediaries and payments of different character and different amounts. Second, it would appear to be relatively easy to avoid the back-to-back rule by, for example, limiting the amount of the related payments through the intermediary to less than, say, 80% of the amount of the original payment. The back-to-back rule applies only where the related payments are equal to "all or substantially all" of the original payment. Although the meaning of the phrase "all or substantially all" is not clear, it seems doubtful that payments of less than 80% of the original payment would be caught by the rule.[138] Similarly, the back-to-back rule can be avoided by making related payments outside the 365-day period, which may be feasible because the STTR applies only to payments

131. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 8(b) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 8(b).
132. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 10 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 10.
133. The term "connected person" is also used in article 29 (Limitation on benefits) of the *UN Model* (2021) (*see* the definition in article 29(7)(d)).
134. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 8(c)-(i) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 8(c)-(i).
135. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS, art. 1.5 (OECD 20 December 2021), Primary Sources IBFD [hereinafter *Global Anti-Base Erosion Model Rules (Pillar Two)*].
136. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 11 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 11.
137. In effect, this 365-day period means that any payments made either 364 days before or 364 days after the day on which the original payment is made are considered to be related payments.
138. The requirement that a related payment must be equal to all or substantially all of the original payment means that the rule can be avoided, subject to the possible application of the general treaty anti-abuse rule, by a payment of an amount that is substantially less than the original payment. For instance, it seems clear that a payment that is only 50% of the original payment would not be caught.

between connected persons. Third, in any situation where the back-to-back rule is avoided, there is a possibility that the general anti-abuse rule in the tax treaty could apply, and this possibility may have a prophylactic effect on strategies to avoid the rule. However, the capacity of developing countries to administer the STTR and the treaty general anti-abuse rule is unlikely to deter taxpayers from attempting tax avoidance strategies.

7. The Determination of the Tax Rate in the Recipient's Country of Residence

A key element of the STTR is that it applies only where, and to the extent that, the aggregate of the source country's tax on an item of covered income (as limited by the tax treaty) and the tax on the income item on the recipient by its country of residence is less than 9%. Where this is the case, and the other conditions for the application of the STTR are satisfied, the source country is entitled to tax the item of income at the specified rate, which is 9% in excess of the tax rate on the item of income imposed by the country in which the recipient is resident. However, where the recipient of an item of covered income is subject to tax on that income at a rate of at least 9%, the STTR cannot apply.

The tax rate imposed by the country in which the recipient of an item of covered income is resident is determined under the STTR.[139] For this purpose, the relevant tax rate is the country's statutory corporate tax rate on the income. The relevant taxes are those covered by article 2 of the applicable tax treaty (national and subnational income taxes) and any other tax on net income.[140] As a result, any IIR or UTPR top-up taxes under Pillar Two will not be taken into account for purposes of the STTR, as those top-up taxes are not imposed on income.[141] Similarly, any Qualified Domestic Minimum Top-Up Tax (QDMTT) imposed by a country would not be taken into account for purposes of the STTR because a QDMTT is imposed on a taxpayer's excess profit less its substance based income exclusion, and not on the taxpayer's net income.[142]

According to the Commentary on the STTR Model Rule,[143] the reference to taxes on net income is intended to align the treatment of taxes under the STTR with the treatment of covered taxes under the Pillar Two global minimum tax rules. As a result, covered taxes allocated to a group entity under the global minimum tax will be taken into account in determining that entity's adjusted nominal tax rate for purposes of the STTR. For instance, where covered payments received by a CFC are taxable to the CFC's parent company under the CFC rules of the country in which the parent company is resident, those taxes will be allocated to the CFC for purposes of the STTR.[144] It is not clear how this approach to the allocation of taxes will work with regard to taxes on covered payments attributable to a PE.[145]

Where a state applies different tax rates to various types of entities or income, the relevant rate is the one that applies to the particular recipient and the particular item of covered income. In addition, where a state applies a graduated corporate tax, the applicable rate for purposes of the STTR is determined based on the average rate if the graduated rate structure is likely to have a material effect on the nominal corporate tax rate applicable to the particular item of income.[146]

A country's nominal corporate tax rate must be reduced where it is subject to a "preferential adjustment", which is defined to be a permanent reduction in the amount of the covered income subject to tax or the tax payable on that covered income as a result of an exemption, exclusion, deduction or credit (other than a foreign tax credit) with regard to the income, where the reduction is "directly linked" to the relevant payment or arises under a preferential regime under BEPS Action 5 with regard to geographically mobile activities.[147]

The Commentary indicates that the words "directly linked" mean that the "reduction is the direct result of the way that item of covered income is categorised or characterised under local law".[148] For instance, if a reduction of tax is based on the character of the income (for example, foreign-source income or royalties), it is treated as a preferential adjustment. However, if the reduction is based on the status of the taxpayer or on a type of expenditure, it will not be a preferential adjustment.

Only permanent reductions of tax are treated as preferential adjustments. Provisions that provide for the deferral of income or tax, such as accounting reserves, are not considered to be permanent reductions, unless the taxpayer has control over the timing of the recognition of the income (for example, a remittance-based regime for foreign-source income). Where the taxpayer does have control over the timing of the income, the deferral is limited to three years.[149]

Deductions that are allowed in computing income without any obligation to make any payment are treated as permanent reductions of income.[150] However, notional deductions and deductions that are based on expenditures, even

139. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5.
140. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5(b) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5(b).
141. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, *Commentary*, at para. 43.
142. Id.
143. Id., at para. 53.
144. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 133, at art. 4.3.2(c).
145. Id., at art. 4.3.2(a).
146. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, *Commentary*, at paras. 48-52.
147. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 6(a) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 6(a).
148. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, *Commentary*, at paras. 86-87.
149. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 6(b)(ii) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 6(b)(ii).
150. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 6(a)(ii) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 6(a)(ii).

where an amount in excess of the actual expenditure is deductible, are not taken into account.[151]

Under the STTR,[152] the competent authorities of the contracting states have an obligation to notify one another in writing of their statutory tax rates and other aspects of their tax systems that are relevant for purposes of determining the applicable tax rate on the relevant income items under the STTR.[153] This obligation is similar to, but more specific than, the general obligation on the competent authorities to notify each other about any significant changes in their tax laws under article 2(4) of the OECD Model and the UN Model. However, it is questionable whether this obligation on the competent authority of a developed country to notify the competent authority of a developing country is sufficient to enable the developing country to determine the developed country's tax rate for purposes of applying the STTR.

8. The 8.5% Markup Threshold

The covered income items (other than interest and royalties) are subject to the STTR only if the amount of the payment exceeds the costs incurred, directly and indirectly, in earning the income by more than 8.5%. Where the return earned by the recipient is not more than 8.5%, the rationale for excluding the item from the STTR is that the erosion of the source country's tax base is immaterial. The calculation of the markup must be done on a payment-by-payment basis except where payments of the same type are made under a single contract or where covered income items are so closely interrelated that it is impossible to deal with them separately. Where payments are aggregated, the related costs must also be aggregated. The costs taken into account in computing the markup are determined by applying transfer pricing rules to transactions between non-arm's length persons.

Interest and royalties are not subject to the markup because they present greater risks of base erosion than other types of payments. For instance, MNEs could easily take inappropriate advantage of the markup threshold by funding an interest-bearing loan made to a connected company with funds borrowed from another connected company where the markup is low.

The operation of the markup threshold can be shown based on the facts of Example 1 in section 5.4. as set out in Example 2.

Example 2

Assume that PCo incurs direct and indirect costs of 90,000 in earning fees of 100,000 for its services to XCo. According to the markup threshold in the STTR,[154] the STTR[155] does not apply where the gross amount of fees for services does not exceed the costs incurred in earning the payment plus a markup of 8.5%. Where the costs incurred by PCo are 90,000, the gross amount of the payment (100,000) would exceed those costs plus 8.5% (97,650) and the STTR would apply as calculated in Example 1 in section 5.4. In other words, the markup is a threshold for the application of the STTR, not a *de minimis* exemption; once the threshold is exceeded the markup does not reduce the amount of the STTR. Where, however, the costs incurred by PCo are 95,000, the costs plus the markup (95,000 plus 8,075 = 103,075) would exceed the gross amount of the payment for services and the STTR would not apply.

Companies will be tempted to manipulate both the prices in intragroup transactions giving rise to covered payments and the allocation of direct and indirect costs to such payments to avoid the application of the STTR. Developing countries appear to be expected to administer these aspects of the STTR through their transfer pricing rules to ensure it is not avoided.

Special rules apply in computing the markup threshold with regard to income from services where the service provider incurs costs in transactions with a connected person resident in a third country and that connected person is subject to tax on the income derived at a rate of less than 9% and provides services to the original payer for the services.

Example 3 may help to explain this special rule.

Example 3

Assume Company A, resident in Country A, provides services to a connected person, Company B, resident in Country B; Company A pays an amount to another connected person, Company C, resident in Country C in consideration for Company C providing all or part of the services that Company A is obliged to provide to Company B. Company C is subject to a tax rate of less than 9% on its income derived from Company A. In this situation, for purposes of computing the markup threshold, the costs incurred by Company A from the transactions with Company C are limited to 80% of those costs.

9. *De Minimis* Threshold

The STTR does not apply to an item of covered income, unless the aggregate of the gross amount of covered payments arising in a country and paid by its residents to a particular connected person (referred to as the "tested payee") resident in the other contracting state (and any persons resident in that state that are connected to the particular connected person) in a fiscal period equals or exceeds EUR 1 million (EUR 250,000 for developing countries with gross domestic product (GDP) of less than

151. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, *Commentary*, at paras. 95-96. The rationale for the different treatment of: (i) notional deductions; (ii) deductions where there is no obligation to make a payment; and (iii) deductions for amounts in excess of the actual amount of an expenditure is unclear, all three represent different ways of reducing tax payable. The statement in OECD, *STTR Model Rule and Commentary*, *supra* n. 2, *Commentary on Article 6(a)(ii)*, at para. 96 only confuses matters: "Subparagraph (b) does not apply to deductions of notional expenses such as notional interest deductions because such deductions are not computed on the basis of the amount of taxable income".
152. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 5(c) and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 5(c).
153. Why is it necessary for the competent authority of a developing country to notify the competent authority of the developed country? This suggests that developed countries may be entitled to impose tax under the STTR on items of covered income paid by their residents to connected persons in a developing country.
154. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 9 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 9.
155. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at arts. 1 and 2.

EUR 40 billion).[156] This *de minimis* threshold also takes into account covered payments borne by PEs of the particular connected person (and other persons resident in the same country that are connected with the particular connected person) located in the developing country.

This threshold is referred to in the STTR as a "materiality threshold" on the basis, presumably, that payments of covered income received by a taxpayer and other connected persons that are under the threshold are immaterial from the perspective of the developing country whose tax base is being eroded by those payments. The threshold is not an exemption. Where the threshold is not exceeded, the consequence is that the STTR does not apply to the payments to the particular recipient or connected persons resident in the same country. Where, however, the *de minimis* threshold is exceeded, all of the payments of covered income (and not just the payments in excess of EUR 1 million) are subject to the STTR.

The *de minimis* threshold applies to each recipient of payments of covered income (and any connected persons resident in the same country) and not to each payer of items of covered income. As a result, its purpose is to alleviate the compliance burden for corporate groups deriving relatively small amounts of covered income from a particular developing country.

It is difficult to understand how developing countries will be able to apply the *de minimis* threshold effectively. First, they would need to collect information from legal entities and PEs in their countries with regard to all payments of covered income to the residents of all the countries with which they have tax treaties that include the STTR. Second, they would need to aggregate all the payments made by their residents and any resident connected persons, including payments borne by PEs, to each recipient resident in the other country. Third and finally, they would need to aggregate those payments with any payments of covered income to persons resident in the other country that are connected with each recipient. Needless to say, the collection and management of the necessary information required to monitor the *de minimis* threshold properly would be beyond the administrative capacity of many developing countries, and probably would not justify the allocation of the necessary additional administrative resources. It is notable that no other provisions of the OECD Model or the UN Model impose *de minimis* thresholds on source country taxation.

10. Payment of the STTR

The STTR is not payable on each covered payment, but, instead, only after the end of each year, on the aggregate amount of covered payments by a particular payer.[157] This will alleviate some of the compliance burden on taxpayers, although the STTR is calculated with regard to each payment, and taxpayers will be required to file an annual tax return with the necessary information to support the calculation of the STTR and to pay any tax owing or claim a refund for any excess tax paid. Developing countries will have the serious administrative burden of auditing STTR returns and setting up the systems to collect any tax owing or refund any excess tax paid.

11. Double Taxation Relief

Where a particular tax treaty is modified to include the STTR, the provisions of that tax treaty dealing with relief of double taxation must also be modified.[158] With regard to any amounts that are subject to source country tax under the STTR, the other contracting state (the residence state) is required to provide relief from double taxation by exempting the amounts from residence country tax (where article 23A(1) of the OECD Model or the UN Model applies), or by allowing a credit for the source country tax imposed in accordance with the STTR against the residence country tax on those amounts (where article 23A(2) or article 23B applies).

Tax paid in accordance with the STTR is treated as covered tax (as a tax in lieu of an income tax) for purposes of the IIR and the UTPR top-up taxes under Pillar Two, and will be taken into account in determining a country's effective tax rate (ETR). However, as discussed in section 7., any IIR or UTPR top-up taxes are not taken into account for purposes of the STTR because they are not taxes on net income.

12. Implications of the STTR for Developing Countries

The major implications of the STTR for any particular developing country are uncertain at this stage and require a detailed analysis of all of the relevant provisions of its tax treaties, as well as the corporate tax rates (adjusted for tax preferences) imposed by its treaty partners on the categories of covered income. However, some preliminary comments can be made at this stage.

Developed countries that are members of the Inclusive Framework are not legally obligated to modify any tax treaty with a developing country to include the STTR. Instead, they have made an informal commitment to do so. Further, developed countries have agreed to modify their tax treaties with developing countries only where the conditions for the application of the STTR are satisfied. Many developed countries, with the exception of investment hubs, have most likely concluded that they will not be required to modify their tax treaties because they tax their residents on all the items of covered income at a rate of at least 9%. Accordingly, the potential application of the STTR will arise only where the statutory corporate tax rate of developed countries is subject to a preferential adjustment directly related to an item of covered income.

156. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 12 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 12.
157. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 14 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 14.
158. OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at para. 15 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at art. 15. These rules with regard to the payment of the STTR will not eliminate the need for developing countries to put in place legal requirements under their domestic law for resident and non-resident payers to withhold tax on payments of covered income.

In order to avoid this result, it is not necessary for developed countries to raise their general corporate tax rates, which might adversely affect many taxpayers. All that is necessary is for developed countries to ensure that their residents are subject to tax on items of covered income at a rate of at least 9%. With regard to investment hubs with corporate tax rates of less than 9%, the response to the STTR is obvious, i.e. raise the corporate tax rate to 9%, as has recently been done by Barbados and the United Arab Emirates. As a result, in the author's opinion, it is unlikely that developing countries will derive any significant additional tax revenue from the inclusion of the STTR in their tax treaties. In this regard, it should also be noted that even where a tax treaty with a developed country is modified to include the STTR, the developed country can avoid the imposition of any tax by its developing country treaty partner simply by increasing its tax rate on items of covered income to 9%, which it can do at any time.[159]

Moreover, even assuming that some of a developing country's tax treaties qualify for the addition of the STTR, the modification of its tax treaties to include the STTR will impose significant administrative costs on the country. As not all tax treaties with developed countries qualify for modification by the addition of the STTR, the first step for developing countries is to identify the relevant tax treaties with developed countries. In itself, this is a substantial undertaking for any developing country, requiring a detailed analysis of those tax treaties as well as tax systems of its treaty partners, and any tax preferences it offers with regard to covered income items. The second step is a detailed cost and/or benefit analysis of the addition of the STTR to one or more tax treaties should be performed for each tax treaty as well as for all of a country's relevant tax treaties. For instance, where a developing country determines that the STTR can be added to only a few of its tax treaties, it might decide that adding the STTR to those tax treaties is not justified because of the costs involved in setting up the systems necessary to administer the STTR.

The OECD has offered to provide assistance to developing countries in identifying their tax treaties with developed countries that impose adjusted tax rates on covered income at less than 9%. However, even if the OECD performs this function for developing countries, in the author's view, developing countries should be very cautious about adding the STTR to any of their tax treaties because they will incur ongoing administrative costs, but generate little additional tax revenue.

The proposed STTR is surprisingly narrow, and the benefits (the increased tax revenue) are at best uncertain, and at worst non-existent. In this regard, it is worthwhile reviewing a simple list of all the limitations on the imposition of the STTR by developing countries. Significantly, the STTR will result in additional tax revenues for a developing country only if:

– the country is not a high-income country according to the classifications of the WBG's Atlas method;
– the treaty partner is a developed (high-income) country according to the classifications of the WBG's Atlas method;
– the STTR is added to its tax treaties with developed countries, which requires the developing country to request that the tax treaty be modified to include the STTR and the agreement of those countries to modify their tax treaties;
– payments of covered income within the scope of the STTR are made;
– the payments arise in the developing country (i.e. the payer is a resident of the developing country or the payer has a PE in the developing country that bears the payment);
– the payer is not an individual, and the recipient of the payment is connected with the payer, and is not an individual or other excluded entity;
– the payments exceed the minimum threshold of either EUR 250,000 or EUR 1 million;
– the developing country taxes the payment under its domestic law;
– the developing country's treaty partner does not impose corporate tax, adjusted for certain permanent tax preferences, on the payments of 9% or more, and does not subsequently increase its corporate tax on the relevant payments to 9% or more;
– the provisions of the developing country's tax treaty with the other country provides for the taxation of the payment at a rate of less than 9% or exempts the payment from tax by the developing country;
– the combined tax rate of the developing country (as limited by the tax treaty) and the other country on the payments is less than 9%;
– the gross amount of the payment (except with regard to payments of interest and royalties) exceeds the direct, and indirect costs incurred by the recipient that are attributable to the payment plus a markup equal to 8.5% of those costs;
– even where all of these requirements are satisfied, the developing country is entitled to impose tax on the covered payments only to the extent that 9% of the gross amount of the payment exceeds the aggregate of the developed country's tax on the recipient with regard to the payment and the developing country's tax on the payment is in accordance with the tax treaty; and
– furthermore, in order to collect any STTR, a developing country must establish an administrative regime dealing with the filing of STTR tax returns, the payment of STTR tax after the end of each year, interim withholding on account of STTR tax on covered payments to non-residents and the refund of excess tax withheld or the payment of additional tax where the interim withholding is insufficient.

159. Any tax imposed by the country in which the recipient of an item of covered income is resident reduces the STTR. *See* OECD, *STTR Model Rule and Commentary*, *supra* n. 2, at paras. 1 and 2 and *STTR Multilateral Convention*, *supra* n. 3, Annex 1, at arts. 1 and 2, in particular, the definition of "specified rate".

13. Conclusions

In the author's opinion, the list of all the requirements for the imposition of tax under the STTR in section 12. indicates clearly that the STTR is unlikely to result in any significant tax revenues for developing countries and is likely to require developing countries to incur significant costs if they attempt to impose tax under the STTR.[160] Moreover, it seems equally clear that the STTR has been deliberately designed to produce these results. It has been misleadingly portrayed by the Inclusive Framework as an important concession to developing countries. The STTR is a package of complex rules that appears at first glance to be a new self-contained tax regime that allows developing countries to impose gross-based withholding taxes on certain payments to connected persons in the other contracting state. However, when the STTR is analysed, unpacked and deciphered, the STTR can be seen for what it really is – nothing more than a sophisticated illusion of increased taxing rights for developing countries. Accordingly, developing countries should be very, very cautious about buying in to the STTR.

160. The STTR stands in stark contrast to the subject to tax rule adopted by the UN Committee of Experts on International Cooperation in Tax Matters at its 26th session in March 2023. This rule will be added to the *UN Model* in the next update scheduled for 2024. *See* UN Committee of Experts on International Cooperation in Tax Matters: Report on the twenty-sixth session (New York, 27-30 March 2023) (E/2023/45/Add.1-E/C.18/2023/2), (E/2023/45/Add.1/E/C.18/2023), available at https://financing.desa.un.org/sites/default/files/2023-06/English.pdf (accessed 11 Jan. 2024). The UN subject to tax rule is much broader than the Inclusive Framework's STTR. For instance, it is not limited to a short list of covered income items, but, instead, applies to any income under the distributive articles of the *UN Model* (2021) arising in a contracting state that is "not fully included in the taxable income" of the resident of the other state or is subject to "a low level of taxation" in the other state. A low level of taxation is to be established through the negotiations of the contracting states, as is customary in the *UN Model* (2021).

