OECD releases Pillar Two STTR, administrative guidance and GloBE information return under BEPS 2.0

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In brief

On 17 July 2023, the OECD/G20 Inclusive Framework on BEPS (IF) released the following documents relating to Pillar Two under Base Erosion and Profit Shifting (BEPS) 2.0:

(1) the model treaty text of the Subject to Tax Rule (STTR) together with an accompanying commentary;
(2) the second set of administrative guidance (Guidance) on the Global Anti-Base Erosion Rules (GloBE rules); and
(3) a document on the GloBE information return (GIR)[1].

This news flash provides an overview of the above documents and our observations thereon. For a detailed discussion, please refer to the *PwC Global Tax Policy Alerts*[2].

In detail

STTR

While the STTR is not part of the GloBE rules, it is an integral part of the consensus achieved on Pillar Two and is especially important for developing IF members[3]. The STTR is a treaty-based rule that allows source jurisdictions to impose an additional tax liability on certain intragroup payments if the recipient is subject to a nominal corporate tax rate below 9% in the residence jurisdiction (adjusted for tax base reductions, such as tax exemptions and tax credits). The STTR takes priority over the GloBE rules and is treated as a covered tax when computing the effective tax rate for GloBE purposes. The multilateral instrument implementing the STTR is expected to be released and opened for signature from 2 October 2023.

Connected persons and exclusions

The STTR only applies to payments between connected persons. Entities are considered connected based on a control relationship. Additionally, a deeming rule provides that persons will be connected in the case of a direct or indirect participation of more than 50% or based on facts and circumstances.

That being said, the STTR does not apply when the recipient falls into the following categories: individuals, non-profit organisations, states and government entities fulfilling a government function, international organisations, investment funds meeting specific conditions (including pension funds), or holding vehicles that are wholly (or almost wholly) owned by an excluded recipient.

Covered income and thresholds

The STTR applies to seven categories of covered income:

(1) interest;
(2) royalties;
(3) payments for distribution rights for a product or service;
(4) insurance or reinsurance premiums;
(5) payments of guarantee or financing fees;
(6) rental payments for industrial, commercial or scientific equipment; and
(7) payments for services.

The following types of income are specifically excluded from the covered income: (1) rental payments for a ship to transport passengers or cargo in international traffic on a bareboat charter basis (i.e. without a crew or master); and (2) income derived by a person whose tax liability in respect of that income is determined by reference to the tonnage of a ship.

Our observations: *Notably, covered income does not include dividends. Instead, it focuses on a broad spectrum of payments that reduce the tax base in the source jurisdictions by their tax deductibility. This implies that the STTR targets both passive (e.g. interest and royalties) and active (e.g. service fees) income as long as it can be broadly qualified as base eroding. Nonetheless, the STTR does not apply to items of covered income that form profits from international shipping and air transport as Article 8 (International shipping and air transport) of the OECD Model Tax Convention is not one of the provisions within the scope of the STTR.*

Mark-up threshold

Except for interest and royalties, the STTR only applies if the gross amount of the covered income exceeds the relevant costs plus a mark-up of 8.5%. Both direct and indirect costs are included and a multinational enterprise (MNE) group may use any reasonable approach to establish these costs. Payments to connected parties under certain circumstances may not be taken into account when calculating the relevant costs.

Materiality threshold

The STTR only applies if the total covered income paid/borne by one or more residents/permanent establishments in the source jurisdiction and paid to one or more connected persons in the residence jurisdiction exceeds the following materiality threshold in the fiscal year concerned:

Gross domestic product (i.e. GDP) of the smaller economy of the two contracting jurisdictions	Threshold (per year)
Less than EUR 40 billion	EUR 250,000
Equal to or greater than EUR 40 billion	EUR 1 million

STTR mechanism – computation of the additional tax charged under the STTR

The tax charged under the STTR shall not exceed the specified rate multiplied by the gross amount of covered income. The specified rate equals the difference between 9% and the nominal tax rate in the residence jurisdiction of the recipient (generally the statutory tax rate applicable to the covered income, subject to certain preferential adjustments), further reduced by any tax imposed by the source jurisdiction as permitted under the existing provisions of the applicable tax treaty.

Our observations: *Although the maximum STTR liability is calculated by reference to the gross amount of covered income, the source jurisdiction is not required to exercise that taxing right in full or to levy taxation on a gross basis.*

Elimination of double taxation

To preserve the position that would have applied before the application of the STTR, the residence jurisdiction of the recipient is not required to (1) exempt the covered income from tax or (2) provide a tax credit in respect of the tax payable under the STTR.

Our observations: *The document notes that this approach only limits the obligations imposed on the residence jurisdiction of the recipient under the applicable tax treaties. It does not affect the relief mechanisms that may be available under the domestic law (such as unilateral tax credit and tax deduction), nor does it disturb the treatment of the tax payable under the STTR as a covered tax for GloBE purposes.*

Targeted anti-avoidance rule (TAAR)

The STTR includes a TAAR intended to prevent the use of intermediaries to avoid the STTR, such as interposing an unconnected person between two connected persons or routing a payment through a high-tax connected person. However, if contracting states have the principal purpose test and the limitation on benefits articles in force under their tax treaties and consider them sufficient to address situations covered by the TAAR, they are free to omit the TAAR.

Administration

The IF leaves the compliance matters such as the mode of application and deadlines to be determined by mutual agreement between the competent authorities of the contracting states. Nonetheless, the IF proposes a self-assessment through the filing of an STTR tax return in the source jurisdiction if the recipient of a payment has an STTR liability. The STTR tax return would need to be filed after the end of a fiscal year when all information relevant for ascertaining a potential STTR liability is known.

However, the actual timeline for the STTR to come into force remains uncertain.

Our observations: *The STTR can be implemented through the signing of a multilateral instrument which amends all tax treaties it covers, or via bilateral negotiations in respect of the relevant tax treaties individually. The Advisory Panel on BEPS 2.0 established by the Financial Secretary recommended that Hong Kong should accept requests for inclusion of the STTR in its existing or future tax treaties with developing jurisdictions if requested, as this is a requirement of Pillar Two, implying that the latter approach is preferred, perhaps with a view to minimising the impact on Hong Kong resident taxpayers. Currently, about one-third of Hong Kong's bilateral treaties are with developing jurisdictions. When the STTR is adopted, certain inbound payments received by Hong Kong taxpayers from these jurisdictions could be in scope, for instance if they are not subject to Hong Kong profits tax due to their offshore source, or subject to Hong Kong profits tax at a preferential tax rate. Furthermore, unlike the GloBE rules, the STTR is not limited to MNE groups with consolidated revenues of at least EUR 750 million and applies to all cross-jurisdictional payments that meet the criteria of the STTR. Hopefully, the Hong Kong SAR Government will soon provide further details in this regard so that taxpayers potentially affected by the STTR can assess the impacts of the STTR on their cross-jurisdictional transactions. Furthermore, taxpayers should monitor the jurisdictions that will sign the multilateral instrument which will be opened for signature from 2 October 2023.*

The Guidance

The Guidance follows the publication of the first set of administrative guidance in February 2023 and covers a range of issues where stakeholders sought additional clarity[4]. The Guidance, including more detailed examples, will be incorporated into a revised version of the GloBE commentary that will be released later this year. The salient points of the Guidance are set out below.

A new transitional Undertaxed Payment/Profits Rule (UTPR) safe harbour

The new transitional UTPR safe harbour is designed to provide transitional relief from the UTPR in the ultimate parent entity (UPE) jurisdiction during the first two years in which the GloBE rules come into effect. Under this safe harbour, the UTPR top-up tax for the UPE jurisdiction is deemed to be zero for each fiscal year during the transition period if the UPE jurisdiction has a corporate income tax rate of at least 20% (based on the nominal statutory rate and accounting for subnational taxes).

The transition period refers to the fiscal years which run no longer than 12 months that begin on or before 31 December 2025 and end before 31 December 2026. On the understanding that currently no jurisdiction is expected to implement UTPR before 2025, for constituent entities (CEs) whose fiscal year follows the calendar year, the transition period will effectively be one year (i.e. from 1 January 2025 to 31 December 2025).

Our observations: *The Guidance states that an MNE group that qualifies for more than one transitional safe harbour may choose which safe harbour to apply for the jurisdiction concerned. Given that the transitional CbCR safe harbour may apply to fiscal years beginning on or before 31 December 2026 but not including a fiscal year that ends after 30 June 2028 (i.e. a longer period than the transitional UTPR safe harbour) and in view of the 'once out, always out' approach of the transitional CbCR safe harbour, an MNE group that qualifies for both transitional safe harbours may wish to apply the transitional CbCR safe harbour instead of the transitional UTPR safe harbour[5].*

A new qualified domestic minimum top-up tax (QDMTT) safe harbour

The QDMTT safe harbour deems the top-up tax under the GloBE rules to be zero for a jurisdiction when an MNE group qualifies for the safe harbour in that jurisdiction, thereby eliminating the need for an MNE group to undertake a second calculation under the GloBE rules after completing the QDMTT calculation.

To qualify for the QDMTT safe harbour, a jurisdiction's QDMTT must meet the following three standards in addition to the existing QDMTT rules and guidance:

(1) The QDMTT accounting standard, which requires a jurisdiction to base its QDMTT upon either (i) the financial accounting standard of the UPE or (ii) a local financial accounting standard (the latter of which is subject to certain limitations);

(2) The consistency standard, which requires the QDMTT computations to be the same as those required under the GloBE rules, except where the QDMTT guidance requires mandatory variations or allows for optional variations; and

(3) The administration standard, which requires the QDMTT jurisdiction to meet the requirements of a continuous monitoring process with respect to the QDMTT.

While the applicability of the QDMTT safe harbour is considered on a jurisdictional basis, it is acknowledged that a jurisdiction may not be able to apply the QDMTT to certain enterprises or CEs in certain instances. To cater for this, the consistency standard prescribes specific circumstances in which the non-application of a QDMTT is allowed. In such cases, a switch-off rule applies such that the MNE group benefitting from the non-application of the QDMTT cannot benefit from the QDMTT safe harbour and needs to switch to the credit method for relieving double taxation under the GloBE rules in respect of a QDMTT.

The Guidance contains several examples to demonstrate the application of the switch-off rule. In particular, based on an example concerning 'Joint Ventures' as specifically defined (JVs)[6], while a QDMTT jurisdiction in general has the option not to apply the QDMTT to MNE groups that have a member of a JV Group (as defined) located in the jurisdiction, it will only be able to meet the consistency standard if the QDMTT jurisdiction decides to apply QDMTT to such MNE groups. The consistency standard will remain unaffected regardless of whether the QDMTT liability is imposed on the members of the JV Group directly or on the CEs of the main group. However, in the latter case, the MNE Group will be subject to the switch-off rule with respect to the members of the JV Group.

Our observations: *The QDMTT safe harbour applies a more stringent standard to a QDMTT than the general QDMTT guidance published in February 2023, in that it requires the QDMTT to use the same computations as required under the GloBE rules (except as specifically authorised by the administrative guidance or the IF).*

However, the QDMTT safe harbour allows a jurisdiction to legislate for a QDMTT that uses a local financial accounting standard, which may yield different top-up tax results than those computed under the GloBE rules and may potentially lead to greater complexity for jurisdictions.

The need for a peer review process to determine whether a jurisdiction's QDMTT qualifies for the safe harbour introduces uncertainty as to how extensive the relief will be.

Substance-based income exclusion (SBIE)

We set out below some of the specific issues concerning the application of the SBIE that are addressed in the Guidance:

(1) Interjurisdictional assets and employees

The Guidance provides simplification provisions for calculating the carve-outs under the SBIE for assets and payroll used in more than one jurisdiction:

An eligible tangible asset/employee is located in the jurisdiction of their CE owner/employer for:	**Carve-out allowed**
More than 50% of the time	Full carve-out
50% or less of the time	Proportionate share of the carve-out

Our observations: *For MNE groups with employees spending much of their working time abroad, a system will need to be in place for tracking the employees' working locations for calculating the payroll carve-out.*

(2) Simplification

An MNE group can choose to claim only the carve-out in respect of the eligible payroll costs and eligible tangible assets for which it is willing to undertake the relevant compliance work. For example, if the cost of substantiating the eligible payroll costs with respect to independent contractors is disproportionate to the relevant benefit under the SBIE, the MNE group may choose not to include these amounts in its eligible payroll costs.

(3) Stock-based compensation

When computing the GloBE income or loss of a CE, an MNE group may elect to substitute the amount allowed as a deduction in the computation of the CE's taxable income for the amount expensed in the CE's financial accounts. The Guidance confirms that irrespective of whether the aforesaid election is made, the stock-based compensation expensed in a CE's financial accounts will be used to calculate the eligible payroll costs under the SBIE.

(4) Lease

A lessor will be allowed to include a portion of the carrying value of operating leases of eligible tangible assets for the SBIE calculation if those assets are located in the same jurisdiction as the lessor. The Guidance includes several examples to demonstrate how the qualifying portion should be computed.

(5) Impairment loss

The Guidance clarifies that impairment losses and any subsequent reversals should be taken into account when calculating the carrying value of eligible tangible assets. The timing of recognition should be in line with the accounting treatment.

QDMTT

The Guidance supplements the first set of administrative guidance in respect of QDMTTs by providing clarifications and addressing specific issues identified therein. Some of the issues discussed are set out below:

- The Guidance covers the application of the QDMTT mechanism for entities such as JVs, JV subsidiaries, minority-owned CEs, flow-through entities and flow-through UPEs.
- The Guidance provides an update on the filing obligations under the QDMTT mechanism, whereby a QDMTT jurisdiction may use a return in a format other than the GIR to collect QDMTT information. Alternatively, a QDMTT jurisdiction may use the GIR or rely on the information included on the GIR.
- The Guidance indicates that any amount of QDMTT that an MNE group directly or indirectly challenges based on constitutional grounds or a specific agreement with the government will not be treated as QDMTT payable, i.e. the challenged amount will not reduce the GloBE top-up tax.
- The Guidance introduces a supplementary rule that refreshes the transition year for the purposes of QDMTT when the GloBE rules come into effect after the QDMTT and re-sets certain tax attributes that arose under the QDMTT (e.g. deferred tax liabilities, GloBE loss deferred tax asset, excess negative tax expense carry-forward).

Tax credits including transferable credits

Under the GloBE rules, tax credits could either be classified as qualified refundable tax credits (QRTCs) or non-qualified refundable tax credits (non-QRTCs). A QTRC is treated as an addition to the GloBE income (denominator) but the amount of covered taxes reflected in the financial statements remains unchanged, whereas a non-QRTC decreases the amount of covered taxes (numerator) for the credit in the computation of the jurisdictional effective tax rate under the GloBE rules.

The Guidance introduces additional categories of tax credits under the GloBE rules, namely marketable transferable tax credits (MTTCs), non-marketable transferable tax credits (Non-MTTCs) and other tax credits (OTCs). Same as QTRCs, the newly introduced MTTCs will be taken into account as part of the GloBE income while Non-MTTCs and OTCs will be taken into account as a reduction to the covered taxes.

Our observations: *Considering that a QRTC will benefit from a more favourable treatment under the GloBE rules as compared to other types of tax incentives, there are calls for the Government to modify the existing enhanced tax deduction regime for qualifying research and development expenditures such that it would qualify as a QRTC and remain attractive to entities impacted by Pillar Two going forward.*

In a recent tax conference, the Deputy Commissioner (Technical) of Inland Revenue responded that as QRTC is defined in the GloBE rules as a tax credit that must be paid to the recipient as cash or cash equivalents within four years of the time that the recipient satisfies the conditions for receiving it, the Government needs to carefully assess the potential fiscal costs and sustainability before making any adjustments to the existing regime.

Currency conversion

The Guidance also addresses specific issues in relation to currency conversion when performing the GloBE calculations, including issues such as the currency in which the GloBE calculations and the GIR disclosures should be made, and the translation of amounts relevant to the GloBE calculations into the presentation currency.

GIR

Further to the public consultation document released in December 2022, the IF released a new document on the GIR. The document provides for a transitional simplified jurisdictional reporting framework (Simplified Framework) as a temporary measure that allows for simplified reporting for all fiscal years beginning on or before 31 December 2028 and ending on or before 30 June 2030. Under the Simplified Framework, an MNE Group is generally not required to report adjustments to financial accounting net income and loss, current tax expense or deferred tax expense on a CE-by-CE basis, and all adjustments can be reported on a net basis. The Simplified Framework is only allowed for jurisdictions where either:

(1) no top-up tax liability arises; or
(2) top-up tax liability arises but it does not need to be allocated on a CE-by-CE basis.

As regards the sharing of GloBE information, the following ‘targeted’ approach will be applied for each MNE group:

- The UPE jurisdiction is provided with the entire GIR;
- Jurisdictions with taxing rights under the GloBE rules are provided with the relevant sections of the GIR; and
- All CE implementing jurisdictions are provided with the general information and the corporate structure (to verify whether they have any taxing rights over any other jurisdiction under the GloBE rules).

MNE groups may also opt for the whole GIR to be exchanged with all implementing jurisdictions where it has CEs.

Our observations: *The Simplified Framework will be a welcome change, but questions remain whether more permanent simplifications may be made in the future. Furthermore, as the Simplified Framework will not limit any rights of tax authorities to request additional information for verification of compliance with the GloBE rules, in-scope MNE groups should perform a data and system gap analysis to identify areas in need of improvement to facilitate information collection and possible reporting on a CE-by-CE basis for GloBE purposes.*

The takeaway

The IF will continue working on other issues in the upcoming months, such as the dispute prevention and resolution mechanisms, the peer review process, the outstanding items of the Guidance, as well as exploring the possibility of developing other administrative mechanisms to facilitate further coordination and consistent application of the GloBE rules across jurisdictions. We will keep close track of these developments and provide respective updates.

Endnotes

1. The documents can be accessed via these links:
https://www.oecd.org/tax/tax-challenges-arising-from-the-digitalisation-of-the-economy-subject-to-tax-rule-pillar-two-9afd6856-en.htm
https://www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two-july-2023.pdf
https://www.oecd.org/tax/beps/globe-information-return-pillar-two.pdf

2. The *PwC Global Tax Policy Alerts* can be accessed via these links:
https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-releases-pillar-two-sttr.pdf
https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-releases-p2-globe-rules-guidance-and-information-return.pdf

3. Defined as jurisdictions with Gross National Income per capital of USD12,535 or less in 2019. The list of developing jurisdictions will be updated regularly.

4. For an overview of the first set of administrative guidance, please refer to our previous news flash which can be accessed via this link:
https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-mar2023-3.pdf

5. Under the 'once out, always out' approach, if an MNE group has not applied the transitional CbCR safe harbour with respect to a jurisdiction in a fiscal year in which it is subject to the GloBE rules, the MNE group cannot qualify for that safe harbour for that jurisdiction in a subsequent year, unless the MNE group did not have any CE in that jurisdiction in the previous year.

6. Defined in the GloBE model rules to mean an entity whose financial results are reported under the equity method in the consolidated financial statements of the UPE provided that the UPE holds directly or indirectly at least 50% of its ownership interests.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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