International: October Pillar Two updates

Multilateral Convention to Facilitate the Implementation of Pillar Two's Subject to Tax Rule opens for signature and Minimum Tax Implementation Handbook is released

In brief

On 3 October 2023, the OECD published the Multilateral Convention (MLC) to Facilitate the Implementation of Pillar Two's Subject to Tax Rule (STTR). As a reminder, the STTR is an integral part of the Pillar Two package, which consists of domestic rules (the GloBE rules) and a treaty-based rule, the STTR. One of the key differences compared to the GloBE rules is that the STTR is not limited to MNE groups with a consolidated turnover exceeding the EUR 750 million threshold.

The STTR is defined as a treaty-based rule that applies to certain intra-group payments, such as interest, royalties and a specified list of other payments ("**Covered Income**"), including practically all intra-group service payments made from source states to the payee's state. The STTR kicks in when such a payment is subject to a nominal tax rate below 9% in the latter State. For a more detailed analysis of the STTR, we refer you to our 31 July 2023 client alert here.

On 11 October 2023, the OECD released the Minimum Tax Implementation Handbook. The aim of this handbook is to provide an overview of the key provisions of the Pillar Two rules and the considerations to be taken into account by tax policy and tax administration officials and other stakeholders in assessing the implementation of Pillar Two.

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More detail

It is important to note that the STTR does not itself impose a tax obligation, but that it allows source jurisdictions to impose a source tax obligation in cases where they are currently unable to do so under the provisions of an existing bilateral tax treaty. The implementation of the STTR aims to enable developing countries to levy source tax on intra-group payments when these are subject to tax in the hands of the recipient below a minimum tax rate. The STTR will not apply to Covered Income that is already subject to a nominal tax rate that is 9% or more.

Jurisdictions have two options for implementing the STTR.

1. They can renegotiate their current bilateral treaties to include the STTR.
2. They can sign the MLC to facilitate the implementation of the STTR.

It is important to note that, if a jurisdiction opts for option 2, the MLC will not amend the text, the sequencing of provisions or the application of a covered tax treaty. Rather, the MLC and its accompanying optional provisions will be added as an annex to the covered tax treaties.

Furthermore, the MLC will not amend the interpretation of terms or definitions in the covered tax treaty.

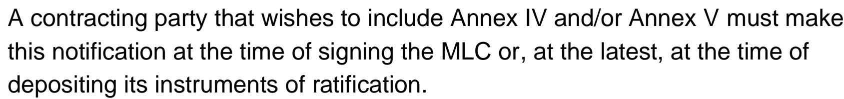
The MLC thus effectively acts as an amending protocol to an existing bilateral tax treaty.

The MLC consists of five annexes.

- The STTR is included in Annex I, and this Annex must be added to a covered tax treaty for the STTR to apply. Once Annex I is included in a bilateral tax treaty, no further action or "matching exercises" are required. Annexes II-V are optional. Annex II: Taxes computed on an alternative basis should be included when the contracting party does not compute tax on a net income basis but when, for example, a tax is imposed on gross income or in reference to equity (such as a wealth tax). Annex III: Taxes imposed at the point of distribution should be included when the contracting party does not tax the income when it is earned, but instead imposes a tax when the income is distributed.

A contracting party that either computes tax on an alternative basis or imposes tax only upon distribution must make the notification at the time of signing the MLC or, at the latest, at the time of depositing its instruments of ratification. Such notification will automatically trigger the inclusion of Annexes II and/or III respectively.

- Annex IV: Additions to the STTR: A uniform definition of a "recognised pension fund" can be included. This definition can be included if (1) the covered tax treaty does not already include the definition, or (2) one of the contracting parties would like to use the definition of a "recognised pension fund" that is provided in the Commentary of the 2017 Update on the OECD Model Convention. Under the OECD's definition, these funds "constitute a separate and distinct patrimony… They will be considered, for the purposes of a tax treaty, as a separate person".
- Annex V: Additions to the STTR: A circuit-breaker provision can be included to introduce a suspension mechanism for the application of the STTR in cases where a contracting party ceases to be a developing country for five consecutive years. Invoking this provision would not terminate the STTR; it would merely suspend its application, and the STTR could be reactivated when the contracting party again becomes a developing country. If a party chooses to include the circuit-breaker in a covered tax treaty, this will be included in all covered tax treaties.



A contracting party that wishes to include Annex IV and/or Annex V must make this notification at the time of signing the MLC or, at the latest, at the time of depositing its instruments of ratification.

No reservations can be made to any of the provisions of the MLC.

Entry into force

The MLC was opened for signature on 2 October 2023 and will enter into force for a covered tax treaty on the first day of the month following the expiration of a period of three calendar months after the second instrument of ratification is deposited. For example, if a second instrument of ratification is deposited on 3 April 2024, the MLC will enter into force on 1 August 2024.

The provisions of Annex I, the STTR, will come into effect on or after the first day of a fiscal year beginning on or after the expiration of a period of six calendar months from the date the MLC entered into force for the covered tax treaty. For example, if the MLC entered into force on 1 August 2024, the STTR will come into effect on 1 January 2026.

Materiality threshold

It is important to note that the MLC introduces a materiality threshold for the STTR to come into effect. In accordance with the materiality threshold as laid out in paragraph 12, the STTR will not apply to income arising in a contracting jurisdiction and derived by a person resident in the other contracting jurisdiction, unless the gross income amount is at least EUR 1 million in the fiscal year concerned or at least EUR 250,000 in the fiscal year concerned, when one of the contracting parties has a GDP of less than EUR 40 billion p.a. Payments that do not meet the materiality threshold are thus not subject to the STTR.

Related party

Furthermore, the STTR will only apply to payments of Covered Income paid to related parties. A related party is defined by the MLC as "one who has control of the other, or both (parties) are under the control of the same person or persons". Entities will be deemed to be related if one (in)directly holds an interest of at least 50% in the other, or if another entity (in)directly holds an interest of at least 50% in each entity.

Intermediary

The MLC contains an anti-abuse provision to discourage the use of intermediaries to avoid the application of the STTR. When an intermediary is used, in exchange for payment of the same or similar value made within a 365-day period, to make a payment to a related party of the original payer, either the original payment to the intermediary or the payment made by the intermediary will be treated, for purposes of the STTR, as if it had been paid directly to the related party.

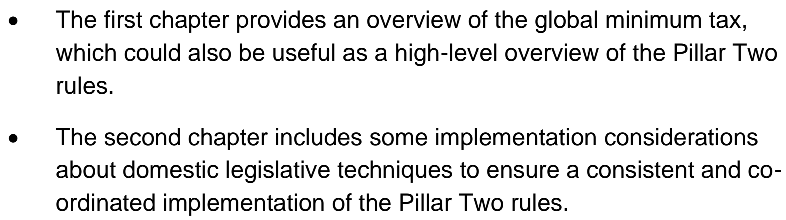
Next steps

The MLC aims to implement the treaty-based rule that allows source jurisdictions to impose a minimum tax on certain low-tax payments between related parties. When imposed, the STTR will be creditable as a covered tax under the GloBE rules.

Minimum Tax Implementation Handbook (Pillar Two)

On 11 October 2023, the OECD released the Minimum Tax Implementation Handbook.

The main purpose of this implementation handbook is to help facilitate the local implementation of the GloBE rules. In this regard, it does not include additional detailed guidance material but rather seeks to explain the core elements of the rules in a way that provides a high-level understanding of the Pillar Two rules. This implementation handbook is divided into two chapters.



- The first chapter provides an overview of the global minimum tax, which could also be useful as a high-level overview of the Pillar Two rules.
- The second chapter includes some implementation considerations about domestic legislative techniques to ensure a consistent and co-ordinated implementation of the Pillar Two rules.

If you have any questions, please reach out to your local Baker McKenzie contact.