OECD/G20 Base Erosion and Profit Shifting Project

Tax Challenges Arising from the Digitalisation of the Economy – Subject to Tax Rule (Pillar Two)

INCLUSIVE FRAMEWORK ON BEPS

OECD

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BETTER POLICIES FOR BETTER LIVES

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Foreword

Digitalisation and globalisation have had a profound impact on economies and the lives of people around the world, and this impact has only accelerated in the 21st century. These changes have brought with them challenges to the rules for taxing international business income, which have prevailed for more than a hundred years and created opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

In 2013, the OECD ramped up efforts to address these challenges in response to growing public and political concerns about tax avoidance by large multinationals. The OECD and G20 countries joined forces and developed an Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions aimed at introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

After two years of work, measures in response to the 15 actions, including those published in an interim form in 2014, were consolidated into a comprehensive package and delivered to G20 Leaders in November 2015. The BEPS package represents the first substantial renovation of the international tax rules in almost a century. As the BEPS measures are implemented, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

OECD and G20 countries also agreed to continue to work together to ensure a consistent and coordinated implementation of the BEPS recommendations and to make the project more inclusive. As a result, they created the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework), bringing all interested and committed countries and jurisdictions on an equal footing in the Committee on Fiscal Affairs and its subsidiary bodies. With over 140 members, the Inclusive Framework monitors and peer reviews the implementation of the minimum standards and is completing the work on standard setting to address BEPS issues. In addition to its members, other international organisations and regional tax bodies are involved in the work of the Inclusive Framework, which also consults business and the civil society on its different work streams.

Although implementation of the BEPS package is dramatically changing the international tax landscape and improving the fairness of tax systems, one of the key outstanding BEPS issues – to address the tax challenges arising from the digitalisation of the economy – remained unresolved. In a major step forward on 8 October 2021, over 135 Inclusive Framework members, representing more than 95% of global GDP, joined a two-pillar solution to reform the international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate and generate profits in today's digitalised and globalised world economy.

This report was approved by the Inclusive Framework on 6 July 2023 and prepared for publication by the OECD Secretariat.

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Executive summary

The subject to tax rule (STTR) was developed by the members of the Inclusive Framework on BEPS (IF) as an integral part of the consensus solution on Pillar Two. Pillar Two consists of a set of rules that provide jurisdictions with a right to “tax back” where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of taxation. Pillar Two consists of the Global Anti-Base Erosion rules, which are designed to ensure large multinational enterprises pay a minimum level of tax on the income arising in each jurisdiction where they operate, and the STTR. The STTR is a treaty-based rule that applies to intragroup payments from source States that are subject to low nominal tax rates in the State of the payee.

The STTR was developed not to revisit the current allocation of taxing rights between source and residence States. Rather it is based on an understanding that where, under a tax treaty, a source State has ceded taxing rights on certain outbound intragroup payments, it should be able to recover some of those rights where the income in question is taxed (if at all) in the State of the payee (i.e. the residence State) at a rate below 9%. Contrived cross-border group structures devised to artificially shift profits out of source countries are a particular concern. By restoring taxing rights to the source State in these cases, the STTR is designed to help developing countries[1] – notably those with lower administrative capacities – to protect their tax base.

The STTR applies to interest, royalties, and a defined set of other payments made between connected companies. These are set out in the provision and explained in greater detail below. The rule operates by allowing the source State to apply additional tax, meaning that the tax rate applying in the residence State is recognised in the calculation of the source State’s extra taxing right (if any). Certain entities are excluded from the scope of the rule based, for example, on their characteristics or functions.

Members of the IF that apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and a defined set of other payments have committed to implement the STTR into their bilateral treaties with members of the Inclusive Framework that are developing countries when requested to do so. A multilateral instrument will facilitate the swift and consistent implementation of the STTR in relevant bilateral treaties.

Chapter I of this report contains the STTR provision and its commentary.[2] Chapter II contains provisions governing the application of elimination of double taxation provisions in respect of additional tax payable under the STTR.

[1] For this purpose, developing countries are defined as those with GNI per capita, calculated using the World Bank Atlas method (https://datahelpdesk.worldbank.org/knowledgebase/articles/378832-what-is-the-world-bank-atlas-method), of USD 12 535 or less in 2019 to be regularly updated.

[2] India wishes to record its reservation on the mark-up percentage which it considers too high and it finds the guardrails ineffective. However, India has no objection to the approval and subsequent publication of this document to enable jurisdictions to join the MLI on STTR/incorporating STTR in their tax treaties.

1 STTR and Commentary

Article [ ] - Subject to Tax Rule

Taxing right in source State where covered income taxed at below minimum rate

1. 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.

Source State taxing right limited to a specified rate

2. However, the tax charged in accordance with paragraph 1 in the Contracting State in which the item of covered income arises shall not exceed the specified rate multiplied by the gross amount of the covered income. For the purposes of this Article, and subject to the second sentence of paragraph 3, the specified rate is equal to the difference between 9% and the tax rate determined in accordance with paragraph 5, on that item of covered income in the Contracting State of which the person deriving that income is a resident.

Interaction with other Articles

3. The provisions of paragraphs 1 and 2 shall not apply where the gross amount of the item of covered income may be taxed, in accordance with any other provision of this Convention, in the Contracting State in which it arises at a rate equal to or greater than the specified rate, as determined in accordance with paragraph 2. Where, in accordance with any other provision of this Convention, the gross amount of the item of covered income may be taxed in the Contracting State in which it arises at a rate that is lower than the specified rate, as determined in accordance with paragraph 2, that other provision shall continue to apply and the specified rate shall be reduced by deducting such lower rate.

Covered income

4. For the purposes of this Article:

   a) the term "covered income" means:

      (i) interest, as defined in paragraph 3 of Article 11 (but omitting the words "as used in this Article");

      (ii) royalties, as defined in paragraph 2 of Article 12 (but omitting the words "as used in this Article");

      (iii) payments made in consideration for the use of, or the right to use, distribution rights in respect of a product or service;

      (iv) insurance and reinsurance premiums;

      (v) fees to provide a financial guarantee, or other financing fees;

(vi) rent or any other payment for the use of, or the right to use, industrial, commercial or scientific equipment; or

(vii) any income received in consideration for the provision of services.

b) Notwithstanding the provisions of subparagraph a), the term “covered income” does not include:

(i) rent or any other payment for the use of, or the right to use, a ship to be used for the transportation of passengers or cargo in international traffic on a bare boat charter basis; or

(ii) items of income derived by a person whose tax liability in respect of that income, under the laws of a Contracting State, is determined by reference to the tonnage of a ship.

c) Paragraph 5 of Article 11 shall apply to determine whether interest within subdivision (i) of subparagraph a) is deemed to arise in a Contracting State. In all other cases, an item of covered income falling within subdivisions (ii) to (vii) of subparagraph a) shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the item of covered income, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the liability to pay the item of covered income was incurred, and such item of covered income is borne by such permanent establishment, then such item of covered income shall be deemed to arise in the State in which the permanent establishment is situated.

Meaning of “tax rate”

5. For the purposes of this Article:

a) the tax rate on an item of covered income in the Contracting State of which the person deriving that income is a resident is the statutory rate of tax applicable in that State on such income; however, where that person benefits from a preferential adjustment in respect of such income in that State, the tax rate shall be determined after taking into account the effect of that preferential adjustment;

b) the taxes to be taken into account for the purposes of the tax rate determination are the taxes covered under Article 2 and any tax on net income (“relevant taxes”); and

c) the competent authorities of the Contracting States shall, so far as it is relevant for the application of this Article, notify each other in writing of:

(i) the statutory rate (or any changes to those rates) applicable to residents of that Contracting State with respect to items of covered income; and

(ii) the provisions of their taxation law (or any changes to those provisions) that apply to items of covered income of residents of that Contracting State and may result in a preferential adjustment.

Preferential adjustment

6. a) For the purposes of this Article, a preferential adjustment in respect of an item of covered income means a permanent reduction in the amount of the covered income subject to tax, or the tax payable on that income, in the Contracting State of which the person deriving the covered income is a resident, in the form of:

(i) a full or partial exemption or exclusion from income;

(ii) a deduction from the tax base that is computed on the basis of the amount of income and without regard to any corresponding payment or obligation to make a payment; or

(iii) a tax credit, excluding a credit for foreign taxes paid on the income, that is computed on the basis of the amount of income or tax on such income;

that is directly linked to the item of covered income or that arises under a regime that provides a tax preference for income from geographically mobile activities.

b) For the purposes of this paragraph:

(i) no account shall be taken of any obligation to provide a[n] [exemption or] credit under the provisions of Article [23 A] [23 B]; and

(ii) the term "permanent reduction" means a reduction that is not expected to reverse over time. However, a permanent reduction shall also be deemed to arise where the person deriving an item of covered income has control over the point at which that income is recognised for tax purposes in the Contracting State of which that person is a resident and that income is not recognised for tax purposes in that State within three years following the end of the fiscal year in which that income arises.

Covered income attributable to permanent establishment in third jurisdiction

7. Where:

a) for the purposes of paragraph 1 the tax rate applicable to an item of covered income arising in a Contracting State and derived by an enterprise of the other Contracting State is below 9%; and

b) that item of covered income is treated as attributable to a permanent establishment of the enterprise situated in a third jurisdiction by both the last-mentioned Contracting State and the third jurisdiction;

the tax rate referred to in paragraph 5 shall be determined by reference to the statutory rate, and the effect of any preferential adjustment, applicable in that third jurisdiction to the item of covered income attributable to that permanent establishment (as if the references in subparagraph a) of paragraph 5 and paragraph 6 to the person deriving the income and its State of residence were, respectively, to the permanent establishment and the jurisdiction in which it is situated), if that rate after any preferential adjustment is higher than the applicable tax rate in the last-mentioned Contracting State.

Exclusions

8. The preceding provisions of this Article shall not apply to an item of covered income arising in a Contracting State paid by an individual or derived by a resident of the other Contracting State that is:

a) an individual;

b) not connected to the payer;

c) a recognised pension fund;

d) a non-profit organisation that is established and maintained exclusively for religious, charitable, scientific, artistic, cultural, sporting, educational, or other similar purposes;

e)

(i) that other State itself, or a political subdivision or local authority thereof;

(ii) the central bank;

(iii) an agency, mandatary or instrumentality of, or an entity or arrangement established or created by, a Contracting State, political subdivision or local authority; and

(iv) any other person wholly or almost wholly owned directly or indirectly by a Contracting State, its political subdivisions or local authorities, agencies, mandataries or instrumentalities,

provided, in the case of subdivisions (iii) or (iv), that their principal purpose is to fulfil a government function, and that they do not carry on a trade or business;

f) an international organisation;

g) a professionally managed entity or arrangement designed to invest funds obtained from unconnected persons primarily to generate investment income or to provide protection against an event, for the benefit of those persons provided that the entity or arrangement, or its managers, are regulated. A company that is subject to regulation in that other Contracting State as an insurance company is deemed to satisfy this subparagraph, but only to the extent the covered income is derived from assets held for the purpose of meeting policyholder liabilities;

h) an entity or arrangement the taxation of which achieves a single level of taxation either in the hands of the entity or arrangement or its interest holders (with at most one year of deferral) provided that the entity or arrangement is widely held and either:

(i) holds predominantly immovable property; or

(ii) the entity or arrangement or its interest holders (excluding persons described in this paragraph) are subject to a tax rate of at least 9% in the Contracting State of which the entity or arrangement is a resident; or

i) an entity or arrangement that is wholly or almost wholly owned (directly or indirectly), or established or created, by one or more persons, entities, or arrangements referred to in subparagraphs c) to h):

(i) that is established and operated exclusively or almost exclusively to hold assets or manage or invest funds for the benefit of a person, entity, or arrangement referred to in subparagraphs c) to h) or that only carries out activities that are ancillary to those carried out by a person, entity, or arrangement referred to in subparagraphs c) to h); or

(ii) in the case of a person, entity or arrangement referred to in subparagraph e), is established and operated exclusively or almost exclusively to conduct the activities in subdivision (i) or to conduct related investment activities for a person, entity or arrangement referred to in that subparagraph.

Mark-up threshold

9. The provisions of paragraphs 1 and 2 shall not apply to covered income falling within subdivisions (iii) to (vii) of subparagraph a) of paragraph 4 if the gross amount of the item or items of covered income does not exceed an amount equal to the costs incurred by the person

deriving the income and that are directly or indirectly attributable to earning the income plus a mark-up of 8.5% on those costs. For the purposes of this paragraph:

a) all income derived by a person under the terms of a single contractual arrangement during a fiscal year with respect to the same category of covered income and all costs incurred during the same fiscal year and that are directly or indirectly attributable to earning that covered income shall be aggregated for the purpose of determining the mark-up on costs;

b) all income derived by a person during a fiscal year with respect to more than one contractual arrangement or category of covered income, and all costs incurred during the same fiscal year and that are directly or indirectly attributable to earning that covered income, shall be aggregated for the purpose of determining whether the mark-up on costs if, taken as a whole, the covered income is so interrelated that an aggregate analysis is more reliable;

c) where a person deriving income described in subdivision (vii) of subparagraph a) of paragraph 4 incurs costs that are directly or indirectly attributable to earning that income and such costs include costs from transactions with a person that is a resident of a third jurisdiction and connected to the person deriving the income, the costs incurred from those transactions shall be disregarded to the extent that they exceed 80% of total costs if the connected person that is a resident of a third jurisdiction is subject, in respect of the income received from those transactions, to a tax rate below 9% in that third jurisdiction and:

(i) the connected person provides the services directly to the person paying the consideration for the provision of services; or

(ii) the connected person enters into transactions with another person connected to the person deriving the income and that other person is subject, in respect of the income derived from those transactions, to a tax rate below 9% in the jurisdiction of which that other person is a resident and that other person provides the services directly to the person paying the consideration of the provision of services.

This paragraph does not apply where the item of covered income is an original or related payment, within the meaning of paragraph 11, in respect of which the conditions in subparagraphs a) to c) of paragraph 11 are met.

Connected persons

10. For the purposes of this Article, a person shall be considered to be connected to another person if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons. In any case, a person shall be considered to be connected to another person if:

a) one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company); or

b) another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person.

Connected persons – targeted anti-avoidance rule

11. Where:

   a) a payment of an item of covered income arising in a Contracting State ("the original payment") is made by a person other than an individual to a resident of either Contracting State (the "intermediary"); and

   b) the intermediary at any time during a 365 day period that includes the day of the original payment pays, directly or indirectly, an amount equal to all or substantially all of the original payment, in the form of payments ("related payments"):

      (i) to a person or persons (the "connected payee"), other than a person described in paragraph 8, that is connected to the person making the original payment;

      (ii) the connected payee is subject, in respect of the related payments, to a tax rate below 9% in the State of which it is a resident and a statutory rate of tax in the State of which the intermediary is a resident (taking into account of any reduction in that rate by virtue of a double taxation convention) ("intermediary tax rate") that is also below 9%; and

      (iii) if the intermediary includes the original payment in its taxable income in the Contracting State of which it is a resident, the related payments are deductible in computing its taxable income in that State; and

   c) it is reasonable to conclude that the intermediary would not have made the related payments in the absence of the original payment;

the original payment made to an intermediary or any related payment made to a connected payee that is a resident of the other Contracting State shall be treated, for the purposes of this Article, as if it had been covered income paid to a person connected to the payer that is a resident of that other State and the tax rate to which that item of covered income is subject shall be treated for the purposes of paragraphs 1, 2 and 5 as being:

   d) in the case where the original payment is made to an intermediary that is a resident of that other State, the higher of the tax rate to which the connected payee is subject, in respect of the related payments, in the State of which it is a resident and the intermediary tax rate; or

   e) in the case where the original payment is made to an intermediary that is a resident of the Contracting State in which that item of covered incomes arises, the tax rate to which the connected payee is subject, in respect of the related payments, in the State of which it is a resident.

Materiality threshold

12. The provisions of paragraphs 1 and 2 shall not apply to an item of covered income arising in a Contracting State and derived by a person that is a resident of the other Contracting State (the "tested payee") unless the sum of:

   a) the gross amount of covered income paid by one or more residents of the first-mentioned Contracting State that are connected to the tested payee and derived by the tested payee or one or more residents of the other State that are connected to the tested payee; and

   b) the gross amount of covered income borne by one or more permanent establishments situated in the first-mentioned State through which the tested payee, or persons that are connected to the tested payee, carry on business and derived by the tested payee or one or more residents of the other State that are connected to the tested payee;

is equal to or greater than [€Y[3]] in the fiscal year concerned.

For the purposes of this paragraph:

c) no account shall be taken of the tax rate that is applicable to the covered income in that other State; and

d) persons shall be deemed not to be connected if those persons are otherwise connected solely because of control exercised, or any beneficial interest (or, in the case of a company, the aggregate vote and value of the company's shares or beneficial equity interest) possessed directly or indirectly, by a person, entity or arrangement described in:

(i) subparagraph e) of paragraph 8; or

(ii) subparagraph i) of paragraph 8, replacing the references to "subparagraphs c) to h)" with "subparagraph e)".

Application to permanent establishment in source State

13. If the person deriving the item of covered income, being a resident of a Contracting State, carries on business in the other Contracting State in which that income arises through a permanent establishment situated therein, the provisions of paragraphs 1 and 2 shall not apply:

a) to interest and royalties if the debt claim, right or property in respect of which the interest or royalties are paid is effectively connected with that permanent establishment;

b) to other items of covered income to the extent that they are attributable to that permanent establishment in accordance with the provisions of Article 7.

In such case, the provisions of Article 7 shall apply.

Administration

14. The tax chargeable in accordance with the provisions of this Article in a Contracting State in respect of an item of covered income arising in that State and derived by a resident of the other Contracting State in a fiscal year shall be determined following the end of that fiscal year and shall not be levied by the first-mentioned State until it is so determined. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of the provisions contained in this Article.

Implications of this Article

15. It is understood that the provisions of this Article:

a) are included in this Convention as part of the implementation of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy;

b) do not otherwise reflect the tax treaty policies of either Contracting State; and

[3] €Y will be set according to the size of the smallest economy of the two Contracting States. For Contracting States with GDP equal to or greater than EUR 40 billion, the threshold will be EUR 1 million. For Contracting States with GDP of less than EUR 40 billion, the threshold will be EUR 250 000.

c) are without prejudice to subsequent modifications to this Convention or any other Convention concluded by either of the Contracting States.

Design of the STTR

1. The Subject to Tax Rule (STTR) takes the form of a conventional bilateral treaty article in order to make it easier to read and interpret, and to analyse its interaction with other treaty provisions. For the same reasons, it is presented in the form of a model provision that is included in a treaty consistent with the structure of and terminology used in the OECD Model; and as such certain defined terms, such as "interest" and "royalties", referred to in the model provision are aligned with those found in the OECD Model. Existing treaties may vary in this and other respects; using the existing treaty definitions for the purposes of the STTR when included in a particular treaty will avoid unnecessary complexity. However, States are free to agree to adopt the OECD/UN Model definitions for the purposes of the STTR through bilateral negotiation if they do not agree to use the definition in the treaty. The draft does not preclude the flexibility to make amendments in the context of a particular bilateral treaty.

2. The STTR is not implemented through individual changes to the Articles in Chapter III (taxation of income) of the OECD Model. That is because it can apply to different categories of income and because the existing allocation of taxing rights is not being changed. Instead, it is presented here as a separate standalone treaty Article. It is consistent with the structure of and terminology used in the OECD Model Tax Convention and could therefore be included in a bilateral tax treaty based on the OECD Model. It could also, with appropriate adaptations, be included in a bilateral tax treaty based on the UN Model Double Taxation Convention Between Developed and Developing Countries. The commentary that accompanies the STTR is likewise consistent with the Commentaries on other Articles of the OECD Model. However, the STTR and commentary should be read in the light of the observations some OECD member states have made, and positions that some non-member countries have set out, on those Commentaries – e.g. on the types of payments that constitute royalties. These observations and positions can be found in the published OECD Model Tax Convention.

3. By virtue of its design, the STTR model treaty provision operates only in respect of those items of covered income that are subject to adjusted nominal tax rates below the STTR minimum rate of 9% (and to which an existing source state taxing right at or above the minimum rate did not apply under the treaty).

4. The Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy released by the Inclusive Framework on BEPS (the Statement) on 8 October 2021 contains a commitment that members of the Inclusive Framework on BEPS (IF) that apply nominal corporate income tax rates below 9% to interest, royalties and a defined set of other payments would implement the STTR into their bilateral treaties with developing IF members when requested to do so. A footnote to the 2021 October Statement explains that IF jurisdictions considered as developing for this purpose are those with a Gross National Income (GNI) per capita, calculated using the World Bank Atlas method, of USD 12 535 or less in 2019. The footnote also says that the list of developing countries will be updated regularly. There is a process to support members of the Inclusive Framework on BEPS in the identification of relevant tax treaties for this purpose. However, it will not be appropriate to include the STTR in every tax treaty, because most jurisdictions apply nominal tax rates above 9% to the income in question in the hands of their residents.

5. The Statement also provided that a multilateral convention would facilitate the implementation of the STTR. The multilateral convention will provide one possible option for implementation of the STTR. States are also free to include the provision in their tax treaties on a bilateral basis. The form of the provision included in the multilateral convention will contain adaptations, such as the use of descriptive language in the place of the references to Article numbers used in the model provision, so that it is adapted to existing treaties that might conform to the UN Model Tax Convention. The multilateral convention will also be adapted to existing treaties by, for example, replacing the definitions of "interest" and "royalties" (which in the model provision follow the definitions found in subparagraph 3 of Article 11 and subparagraph 2 of Article 12 of the OECD Model) with the definitions used in the equivalent provisions of the existing treaty.

1. Taxing right in source State where covered income taxed at below minimum rate

6. Paragraph 1 allows the State in which the income arises (the "source State") to tax an item of "covered income" (defined in paragraph 4). The STTR operates as a derogation from the restrictions (in whole or in part) imposed on taxing rights of the source State under the allocation rules set out in the specified Articles of the Convention which would otherwise apply to that income. Where there is no restriction imposed on taxing rights of the source State, the STTR will not apply. The exercise of this taxing right is limited, however, to situations where the income is subject to a tax rate in the State of residence of the person deriving the income (the "residence State") that is below an agreed minimum rate of 9%. The meaning of the term "tax rate" is provided by paragraph 5, supplemented by paragraphs 6 and 7. The exercise of the source State's right to tax is further limited by paragraph 2.

2. Source State taxing right limited to specified rate

7. Paragraph 2 places a ceiling on the tax that may be imposed in the source State in accordance with paragraph 1. The tax is limited to the specified rate multiplied by the gross amount of the covered income. The specified rate is equal to the difference (with a floor of zero) between the agreed minimum rate of 9% and the tax rate applied to the covered income in the residence State. Because the specified rate is computed by reference to the tax rate applicable in the residence State, which may vary depending upon the character of the income or the person receiving it, it cannot be specified numerically. The rules for determining the tax rate for these purposes are set out in paragraphs 5, 6 and 7.

8. The effect of paragraph 2 can be illustrated by an example. The agreed minimum rate in paragraph 1 is 9%. Assume the tax rate determined in accordance with paragraph 5 is 5%, and the gross amount of the item of covered income is 100. The specified rate is therefore 9% - 5% = 4% and the source State's taxing right is limited by paragraph 2 to 4% of 100, producing tax of 4. Paragraph 2 sets a ceiling on the source State's taxing right, but does not require the source State to apply that taxing right in full or to tax the gross amount of the covered income. This will depend on the operation of the source State's domestic taxation laws. For example, the source State may apply a higher rate of tax to the net amount of the covered income determined in accordance with its taxation laws, as long as the tax so charged does not exceed the specified rate multiplied by the gross amount of the covered income. Extending the previous example, imagine that the net amount of the covered income determined under the source State's laws is 15, that those laws provide only for net basis taxation of the covered income, and that the rate applicable in the source State is 20%. The resulting tax is 20% x 15 = 3, which does not exceed the specified rate of 4% multiplied by the gross amount of the income (100) and the source State can exercise its domestic law taxing right in accordance with paragraph 2. If, however, all other facts were the same but the rate applicable to the net income in the source State was 30% (producing tax of 4.5), paragraph 2 would limit the source State to charging tax of 4.

9. Paragraphs 1 and 2 together govern the broad operation and effect of the STTR. The STTR:

a) applies only where the item of covered income is subject to an adjusted nominal rate of tax in the residence State that is below an agreed minimum rate; and then

b) allows the State in which the item of covered income arises to tax that income up to the gross amount of the income multiplied by the specified rate.

3. Interaction with other Articles

10. Paragraph 3 governs the interaction between the STTR and other provisions of the Convention that allow the source State to tax an item of covered income. The first sentence of paragraph 3 applies where another provision of the Convention allows the source State to tax the covered income at a rate that is equal to or greater than the specified rate computed in accordance with paragraph 2. The second sentence of paragraph 3 applies where another provision of the Convention allows the source State to tax the item of covered income at a rate that is below the specified rate computed in accordance with paragraph 2.

11. Where another provision of the Convention already allows the source State to tax the gross amount of the item of covered income at a rate that is equal to or above the specified rate, the first sentence of paragraph 3 stipulates that the provisions of paragraphs 1 and 2 will not apply. This ensures that those other provisions will apply in preference to the STTR and the source State will not be limited to taxing the income at the specified rate. It will be able to tax the income at the higher rates provided for under those other provisions. In those circumstances, the STTR has no purpose and paragraphs 1 and 2 are therefore disapplied, effectively switching off the STTR. The obligation to provide relief from double taxation consistent with Article 23 A or 23 B would continue to apply.

12. Where another provision of the Convention already allows the source State to tax the gross amount of an item of covered income at a rate that is below the specified rate, the second sentence of paragraph 3 governs the interaction between the STTR and that other provision. The effect of the second sentence of paragraph 3 is that the taxing right under the other provision is preserved and the STTR allows a supplementary taxing right to bring the combined rate under the two provisions up to the specified rate. This is achieved by deducting the rate provided for under the other provision from the specified rate computed in accordance with paragraph 2; the net rate is then the specified rate applicable in this scenario. This has no impact on the source State's taxing rights, which will always equate to the specified rate computed in accordance with paragraph 2, but is important in ensuring that the provisions of Articles 23 A and 23 B apply as intended. The interaction between the STTR and those Articles is discussed in Chapter II of this report. Where the second sentence of paragraph 3 applies, the source State's administration of the taxing right under the other provision is unaffected by the adoption of the ex-post annualised charge administrative practice in relation to the STTR.

13. The operation of the second sentence of paragraph 3 can be illustrated by the following example. SCo, a company resident of State S, makes a payment of 100 of covered income to RCo, a company resident in State R. SCo and RCo are connected persons. In State R, the income benefits from a preferential adjustment within the meaning of paragraph 6 which brings the tax rate applicable on the income in State R to 4%. Under another provision of the treaty between State S and State R, State S is permitted to tax this category of covered income at 2.5%. The treaty also includes an STTR in the format set out above. The agreed minimum rate in paragraph 1 is 9%. The STTR applies, because the tax rate applied to the covered income in State R is below the agreed minimum rate. The specified rate computed in accordance with paragraph 2 is the difference between the minimum rate of 9% and the applicable tax rate in State R of 4%, giving a specified rate of 5%. The second sentence of paragraph 3 applies, preserving the effect of the other provision allowing State S to tax the 100 at 2.5% and reducing the specified rate under the STTR to 2.5% (that is, 5% minus 2.5%). State S is therefore permitted to tax the full 100 of covered income at the full specified rate of 5%. The additional tax of 2.5% due under the STTR would be administered following the ex post annualised charge approach.

14. Paragraph 3 refers to taxation of the gross amount of the item of covered income in the State in which the income arises in accordance with any other provision of the Convention. Some bilateral treaties provide for the net taxation of covered income in the State in which the income arises. In such circumstances, the amount of taxation permitted in accordance with the provisions of the treaty requires a

calculation of the equivalent gross amount. This calculation must be performed once the net profit is determined.

15. This approach can be illustrated by the following example. SCo, a company resident of State S, makes a payment of 100 for the use of industrial, commercial or scientific equipment to RCo, a company resident in State R. RCo incurs costs (or, in the case of tax treaties that have specific rules for deeming costs to be incurred with respect to the payment, is deemed to have incurred costs) of 40 in earning that income. SCo and RCo are connected persons. In State R, the income is subject to a tax rate of 4%. Under another provision of the treaty between State S and State R, State S is permitted to tax this category of covered income at 10% of the net amount. The treaty also includes an STTR in the format set out above. The specified rate computed in accordance with paragraph 2 is the difference between the minimum rate of 9% and the applicable tax rate in State R of 4%, giving a specified rate of 5%. The tax permitted under the treaty is calculated as 100 – 40 = 60. This is multiplied by 10%, giving tax of 6 in State S. This represents taxation of 6% on the gross payment of 100. Taxation of 6% on the gross payment is above the specified rate of 5% and so the STTR will not apply.

4. Covered income

4.1. Subparagraph a) – categories of covered income

16. Subparagraph a) lists seven categories of income that constitute covered income for the purposes of the STTR.

4.1.1. Interest

17. Subdivision (i) of subparagraph a) applies to interest, where the term has the same meaning as it has for the purposes of Article 11. The definition is provided by paragraph 3 of Article 11. The words "as used in this Article" (meaning Article 11) in paragraph 3 of Article 11 are redundant and potentially confusing when applying the definition of "interest" for the purposes of paragraph 4 of the STTR. These words are therefore omitted when reading the definition for these purposes.

18. It is understood that in a bilateral treaty the Contracting States may agree a definition of "interest" that differs from the meaning provided by paragraph 3 of Article 11. Where this is the case, the Contracting States remain free to use that existing treaty definition for the purposes of the STTR in order to avoid unnecessary duplication and complexity. Where a bilateral treaty provides for preferential treatment for particular types of interest, Contracting States should consider whether that preference will have any practical impact on the operation of the STTR and whether the terms of that preference are consistent with the underlying policy objectives of the rule.

4.1.2. Royalties

19. Subdivision (ii) of subparagraph a) applies to royalties, where the term has the same meaning as it has for the purposes of Article 12. The definition is provided by paragraph 2 of Article 12. The words "as used in this Article" (meaning Article 12) in paragraph 2 of Article 12 are redundant and potentially confusing when applying the definition of "royalties" for the purposes of paragraph 4 of the STTR. These words are therefore omitted when reading the definition for these purposes.

20. As for interest, it is understood that in a bilateral treaty the Contracting States may agree a definition of "royalties" that differs from the meaning provided by paragraph 2 of Article 12. Where this is the case, the Contracting States remain free to use that existing treaty definition for the purposes of the STTR, taking into account the underlying policy objectives of the STTR, in order to avoid unnecessary duplication and complexity.

4.1.3. Payments made in consideration for the use of, or the right to use, distribution rights in respect of a product or service

21. Subdivision (iii) of subparagraph a) applies to payments for the use of, or the right to use, distribution rights. As outlined at paragraph 10.1 of the Commentary on Article 12, such payments are not royalties according to the definition in paragraph 2 of Article 12 and would therefore fall under Article 7. Such payments are made to increase sales receipts from the distribution of goods or of services. They may also be made to secure an exclusive distribution right, in which case the payer has the sole right to sell a given good or service in a particular geographic area, or a non-exclusive distribution right in which case the payer may be one of a number of persons with the right to distribute a good or service. The definition covers both types of payment, noting that an exclusive distribution right is likely to be of higher value. An example of such a payment is provided in paragraph 10.1 of the Commentary on Article 12 of the OECD Model Tax Convention.

22. Where a payment is in consideration for the transfer of the full ownership of distribution rights, the payment is not in consideration "for the use of, or the right to use" the distribution rights therefore does not fall within subdivision (iii). The essential character of the transaction cannot be altered by the form of the consideration, or whether payment of the consideration is made as a lump sum or in instalments.

4.1.4. Insurance and reinsurance premiums

23. Subdivision (iv) of subparagraph a) applies to insurance and reinsurance premiums and covers:

- Insurance premiums – that is, payments made under an insurance arrangement. For the purposes of subdivision (iv), an insurance arrangement is a contract where the insured party acquires risk protection in respect of uncertain future losses that may arise from the realisation of a specified event. In consideration of the premiums paid by the insured, the insurer will indemnify the insured or a beneficiary when the specified event occurs.
- Reinsurance premiums – that is, payments made under a reinsurance arrangement between an insurer and a reinsurer. For the purposes of subdivision (iv), a reinsurance arrangement is a contract where, for the payment of a premium, an insurer cedes insured risks to a reinsurer. In a reinsurance arrangement, the original insurer is still contractually responsible for payments to the policyholders.

24. While subdivision (iv) of subparagraph a) applies to insurance and reinsurance premiums of any description, like the other categories of covered income it is limited by the requirements of paragraph 8 which restricts the application of the STTR to payments between connected persons. This means, in effect, that the application of the STTR will generally be confined to "captive" insurance and reinsurance arrangements.

4.1.5. Fees to provide a financial guarantee, or other financing fees

25. Subdivision (v) of subparagraph a) applies to financial guarantee fees or other financing fees.

26. A guarantee is a legally binding commitment of the guarantor to assume an obligation of the guaranteed debtor if the debtor defaults on that obligation. Financial guarantees are paid under contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due. These fees are in scope of subdivision (v) of subparagraph a).

27. Within an MNE group a common example is the provision of a guarantee by one associated enterprise (the guarantor) of a loan taken by another associated enterprise (the borrower) from an unrelated lender. By providing an explicit guarantee to the lender, the guarantor is exposed to additional risk as it is legally committed to meet the borrower's obligations if the borrower defaults, while the

guarantee allows the borrower to borrow on terms preferential to those that would have been available based on its own, non-guaranteed, credit rating.

28. Financing fees cover incremental consideration paid by a debtor in connection with its borrowing funds or issuing debt securities. This category includes fees paid by the debtor to compensate the connected party lender for costs associated with advancing the funds. These fees include loan origination fees, commissions, accounting and auditing fees, legal fees and any other costs that are directly attributable to issuing a debt instrument that are not interest or fees related to financial guarantees. Debt issue costs are different from the interest paid as they may be paid under different terms, but increase the effective interest rate applicable to the debt instrument.

29. For example, Company T, a member of MNE Group Y, performs as the MNE group treasury entity and undertakes a range of different financial transactions both intra-group and externally. Company T's main purpose is to provide treasury services to other entities within the MNE group. Company T arranges intra-group loans to meet the funding needs of other group members as necessary. When lending to other entities within Group Y, Company T charges a loan origination fee to cover the cost of providing services required in the handling and processing of the loan. This fee is within the scope of subdivision (v) of subparagraph a). Loan interest paid is not within the scope of subdivision (v) of subparagraph a), but would fall within subdivision (i) of subparagraph a).

30. Alternatively, the role of Company T may be more limited. Instead, it may act as a finance broker, securing loan finance from third parties. In such circumstances, the interest paid, and any associated finance fees, would not be within scope of the STTR because the loan agreement would be with a third party. However, fees paid for the services provided by members of Group Y to Company T for its services as a broker would be within the scope of subdivision (vii) of subparagraph a) and therefore within scope of the STTR.

4.1.6. Rent or any other payment for the use of, or the right to use, industrial, commercial or scientific equipment

31. Subdivision (vi) of subparagraph a) applies to rent or any other payment for the use of, or the right to use, industrial, commercial or scientific equipment. This provision covers all payments received by the owner, or other person with rights over the disposition of, equipment, as consideration for letting another person use that equipment (commonly referred to as leasing).

32. The term "equipment" is not defined, but refers to tangible assets employed in a business. It does not include intellectual property or immovable property covered by Article 6. Industrial, commercial or scientific equipment is a subset of equipment and includes assets used outside of a consumer context such as ships, aircraft, cars, trucks and other vehicles, machinery, cranes, containers, and rigs. Satellites, pipelines and cables are also examples of industrial commercial and scientific equipment, though, as paragraph 9.1 of the Commentary on Article 12 explains, payments made to use the capacity of such equipment (e.g. to transmit communications or electrical power, or to transport gas or oil) that do not entail the physical possession or control of the equipment by the person using such capacity will generally fall outside this category of income, as payment would be in the nature of a payment for services provided by the person receiving the payment. And, where, in the case of pipelines and cables, they are properly regarded as immovable property under a State's domestic law, payment for their use is in any event excluded from this category. Subdivision (vi) of subparagraph a) applies only to payments for the use of, or the right to use, such equipment and does not include consideration for the sale of the equipment. A clear distinction must be made between payments for the use of equipment, which fall under subdivision (vi) of subparagraph a), and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, or 21. Some contracts combine the lease element and the sale element, so that it sometimes proves difficult to determine their true legal import. In the case of credit sale agreements and lease-purchase agreements, it seems clear that the sale element is paramount,

because the parties have from the outset agreed that the ownership of the property in question shall be transferred from one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/lessee do not, in principle, constitute income within subdivision (vi) of subparagraph a). In the case, however, of lend-lease, and of leasing in particular, the sole, or at least the principal, purpose of the contract is normally that of lease, even if the lessee has the right thereunder to opt during its term to purchase the equipment in question outright. Subdivision (vi) of subparagraph a) therefore applies in the normal case to the rentals paid by the lessee, including all rentals paid up to the date the right to purchase is exercised.

4.1.7. Any income received in consideration for the provision of services.

33. Subdivision (vii) of subparagraph a) applies to payments in consideration for the provision of services. The term "services" should be interpreted in accordance with its ordinary meaning and should generally be interpreted to mean an action performed for the benefit of another person. The method of delivery is not relevant to the determination of whether income is received in consideration for the provision of a service.

34. The term does not include income received in consideration for the provision or making available of goods, including hardware, and income received for the use of, or right to use, immovable property or intangible assets (however, see, for example, paragraphs 17.1 to 17.4 of the Commentary on Article 12 of the OECD Model Tax Convention explaining that payments for certain transactions that give the customer limited use or access to an intangible asset are not considered payments "for the use of, or the right to use," the intangible). Where income is dealt with separately in an earlier subdivision of subparagraph a), that subdivision applies in preference to subdivision (vii).

4.1.8. Mixed contracts

35. Covered income may be paid under so-called "mixed contracts", whereby a single payment includes a type of income that is included in paragraph 4, as well as a type of income that is not. A single payment under a mixed contract could also represent different categories of income within paragraph 4. In applying the STTR, the approach explained in paragraph 11.6 of the Commentary on Article 12 of the OECD Model should be taken in determining the treatment of payments made under these contracts:

> *"The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration."*

4.2. Subparagraph b) – rent or any other payment for the use of, or the right to use, a ship to be used for the transportation of passengers or cargo in international traffic on a bare boat charter basis and income derived by a person whose tax liability in respect of that income, under the laws of a Contracting State, is determined by reference to the tonnage of a ship

36. Subdivision (i) of subparagraph b) excludes from the definition of covered income, and therefore the STTR, any income from leasing a ship to be used for the transportation of passengers or cargo in international traffic on a bare boat charter basis. Leasing a ship on a bare boat charter basis means the lease of a ship on charter without crew or master.

37. Article 8 (International shipping and air transport) of the OECD Model Tax Convention is not one of the provisions listed in paragraph 1 of the STTR. This means that the STTR does not apply to items of covered income that form profits from international shipping and air transport. This includes profits that are directly connected with such operations of ships and aircraft as well as profits that are not directly connected with the operation of ships or aircraft in international traffic but that are ancillary to such operation, as described in paragraphs 4 to 10.1, 14 and 14.1 of the Commentary on Article 8.

38. Article 7 applies to profits from the leasing of a ship to be used for the transportation of passengers or cargo in international traffic on a bare boat charter that is more than an ancillary to the operation of an enterprise's ships in international traffic. As Article 7 is listed in paragraph 1 of the STTR, and leasing income is covered income under subdivision (vi) of subparagraph a) of paragraph 4 of the STTR, the STTR would apply to such profits absent a specific exclusion. Subparagraph b) provides such an exclusion.

39. Subdivision (ii) of subparagraph b) excludes from the definition of covered income any item of income that is taxed by reference to the tonnage of a ship. This provision applies to so-called "tonnage tax" regimes. The exclusion applies regardless of the way such a regime operates, provided that the tax liability of the person deriving that item of income is determined by reference to the tonnage of a ship.

4.3. Subparagraph c) – source rules

40. Subparagraph c) sets out the source rules that apply to determine whether an item of covered income arises in a Contracting State for the purposes of the STTR. In the case of interest within subdivision (i) of subparagraph a), subparagraph c) applies the source rule in paragraph 5 of Article 11. In all other cases, subparagraph c) sets out a source rule that adopts the same approach as the rule in paragraph 5 of Article 11, apart from substituting a reference to "in connection with which the *liability to pay the item of covered income* was incurred" for "in connection with which *the indebtedness on which the interest is paid was incurred*" in the second sentence.

41. Double taxation may arise in cases where both the person deriving the covered income and payer of interest are residents of the Contracting States, but the loan was taken out for the requirements of a permanent establishment owned by the payer in a third State and that interest is borne by that permanent establishment. The payment of interest may be subject to the STTR in both the State in which the payer is resident and the third State. Such instances of double taxation may be resolved through a multilateral convention. Alternatively, this might be resolved through the mutual agreement procedure (as envisaged in paragraph 3 of Article 25). Contracting States that include the alternative provision found at paragraph 30 of the Commentary to Article 11 in a convention may wish to consider the effect of that approach for the purpose of the applying the STTR. The same considerations would apply to other items of covered income that may be taxed in the source State according to the provisions of a bilateral tax treaty.

5. Meaning of "tax rate"

42. Paragraph 5 deals with the tax rate referred to in paragraphs 1 and 2 of the STTR. Subparagraph a) defines the "tax rate" for purposes of the STTR. Subparagraph b) refers to the taxes that are taken into account for purposes of determining the tax rate ("relevant taxes"). Subparagraph c), when relevant to the application of the STTR, requires the competent authorities to notify each other, in writing, of the statutory rates applicable to items of covered income and of preferential adjustments applicable to their residents (other than individuals).

43. The STTR applies before the GloBE rules. This means that application of the STTR does not take account of a qualified IIR, qualified UTPR or a Qualified Domestic Minimum Top-up Tax.

5.1. Subparagraph a) - Definition of tax rate

44. Subparagraph a) defines the tax rate for the purposes of the STTR. The starting point for determining the tax rate is the statutory rate of tax that applies to an item of covered income in the State of which the person deriving the income is a resident. That is, the tax rate that, as provided for in its taxation laws, the residence State will apply to the net income of the person deriving the income. Where the Contracting State of which the person deriving the covered income is a resident does not subject that person to tax on net income but on some alternative basis, the tax rate is not determined by reference to the statutory rate of tax. See paragraphs 62 to 64 for the determination of the tax rate for relevant taxes computed on an alternative basis.

45. The phrase "statutory rate" includes the rate established in regulations, rulings, and the applicable rate as interpreted by domestic courts. In many cases, this will be the main rate of the corporate income tax (CIT) applicable to companies resident in that State. But where the taxation laws of a State provide for a special statutory rate on certain categories of income, or for taxpayers with certain characteristics or meeting certain conditions, that special rate will be the rate applicable in accordance with paragraph 5. This means that, where covered income benefits from a reduced statutory rate of tax in the residence State, paragraph 5 identifies that rate as the applicable rate for the purposes of applying the test in paragraph 1 and calculating the specified rate under paragraph 2. For instance, a Contracting State may have a CIT rate of 25%, but a preferential tax regime that allows financial income to be taxed at a reduced rate of 5%. Under such circumstances, the reduced statutory rate of tax taken into account for applying the STTR is 5%. Equally, this means that where a preferential rate is available only to a certain type of entity, paragraph 5 identifies that rate as the applicable rate if the recipient falls under such a category. For instance, a State may provide a reduced rate of 5% for the income of corporations that are closely held by individuals. If an item of covered income is received by such a corporation, it is the reduced statutory rate of tax of 5% that is taken into account for applying the STTR.

46. For example, a State may have a CIT that is above the minimum rate but taxes a particular item of covered income at a rate that is lower than the general corporate rate. This reduced rate of tax may generally be available to all resident taxpayers, or be the consequence of the taxpayer qualifying for a preferential regime, or the reduced rate may only be available in respect of certain categories of income. In each case the lower rate of tax, rather than the general statutory tax rate, is the rate applicable in the residence State on that income for the purposes of paragraph 5.

47. In most cases, subparagraph a) requires that a determination of the tax rate applicable to an item of income in the hands of the person deriving the income. However, where an item of covered income of a person is included in the tax calculation of another person in the same State under that State's tax consolidation or tax grouping regime, the tax rate for that income is determined having regard to the tax rate applicable to that other person in respect of that income.

48. Some States provide for a graduated rate of tax on the net income of corporations. For example, a State with a generally applicable tax rate of 15% may impose tax of 5% on the first €X of income in each year. Where the graduated rate bands are narrow and most of the net income of the corporation is generally taxed at a rate that is significantly above the minimum rate, then the effect of these graduated rates is unlikely to have a material impact on the statutory rate applicable to an item of income.

49. In certain cases, however, significant differences in graduated tax rates could result in a materially lower tax rate on covered income. To address this concern, a simplified method could be applied to determine the statutory rate that applies to the company. For example, the applicable rate could be determined based on the average rate of tax imposed on the net income of the company. For instance, if a State has a generally applicable tax rate of 15% but imposes a tax of 5% on the first €1 million of income in each year, and if a company has net income of €4 million in a year, then its statutory rate for that year would be 12.5% calculated as follows:

$$Average\ rate\ of\ tax\ on\ income\ = \frac{(1\ million\ x\ 5\%) + (3\ million\ x\ 15\%)}{4\ million}$$

50. A general exemption or exclusion of a portion of the net income of a corporation should be treated in the same way as a graduated tax rate. For example, if, instead of providing a 5% rate on the first €1 million, a State exempted the first €1 million, the statutory rate on that taxpayer's income for that year would be 11.25%.

51. Averaging the rate of tax on income in line with the graduated rate structure in the residence State is necessarily a taxpayer-specific calculation that introduces some complexity into the determination of the applicable rate. An averaging approach may not produce a reliable result in all cases (for example, where the resident company is in a net loss position). It should only be applied where it will result in a more accurate determination of the statutory rate applicable to that taxpayer. For example, an averaging approach may be appropriate where the graduated rate structure in the residence State is expected to have a material impact on the statutory rate applying to the covered income.

52. Where the person deriving the item of covered income benefits from a "preferential adjustment" in respect of the income, paragraph 5 provides that the tax rate must be adjusted to take account of the effect of that adjustment. This is because when a preferential adjustment is provided in respect of the covered income the statutory rate of tax does not reflect the actual rate of tax that is applied to that specific item of income. Paragraph 6 defines what is meant by a "preferential adjustment" for these purposes and the commentary on that provision illustrates the combined operation of paragraphs 5 and 6.

5.2. Subparagraph b) - Relevant taxes

53. The taxes to be taken into account under the laws of the residence State are defined in subparagraph b). They include all taxes covered by the applicable tax treaty and any taxes on net income. The reference to net income in subparagraph b) is intended to align the definition of relevant taxes in subparagraph b) with the income taxes that are treated as covered taxes under the GloBE rules. A net income tax is levied on a flow of money or money's worth that accrues over a period of time and takes into account related expenses of producing the flow of money, or money's worth, to measure the taxpayer's net increase in wealth for the period. Where such net income taxes are first assessed on a group basis and subsequently allocated to the group entities, the tax allocated to a specific group entity would be taken into account in determining the adjusted nominal tax rate applicable on the covered income received by that entity. It includes taxes that allow for a simplified estimate of net profit and includes income taxes imposed by general government at the subnational, as well as at the national or federal, level.

5.3. Subparagraph c) - Notification of tax rates and preferential adjustments

54. Subparagraph c) provides that the competent authorities must notify one another in writing of the rates and other features of their taxation laws that are relevant for the purposes of subparagraph a) of paragraph 5 and paragraph 6. This provision facilitates tax certainty, by providing a mechanism through which the circumstances in which the STTR will apply can be understood by the Contracting States and made clear to their taxpayers. It complements the second sentence of paragraph 4 of Article 2 of the OECD Model Tax Convention, which obliges the competent authorities to notify each other of significant changes made in their taxation laws, but focuses more narrowly on the features of those laws governing the matters that are relevant specifically to the determination of the applicable statutory tax rates for the purposes of subparagraph a) and any regimes that may give rise to preferential adjustments within the scope of paragraph 6. Subparagraph c) therefore delineates more precisely the attributes of the Contracting States' taxation laws that must be notified for the purposes of the STTR. Contracting States notifying those matters under paragraph 4 of Article 2, as significant changes in their taxation laws, will have fulfilled the obligation under subparagraph c) provided the notification addresses all of the relevant features required under subparagraph c).

55. Subdivision (i) of subparagraph c) provides that the competent authorities shall notify each other of the statutory rates applicable to covered income in their State, so far as this is relevant to the application of the STTR. Thus, this provision only requires a competent authority to notify the other of the tax rates that are relevant for purposes of the STTR. For example, a competent authority would not be required to notify if there is a change of tax rate applicable to resident individuals because the STTR does not apply to individuals in accordance with paragraph 8.

56. It is expected that competent authorities notify each other of the relevant tax rates when STTR enters into force. After this first notification, subdivision (i) of subparagraph c) requires a competent authority only to notify when a relevant tax rate has changed and only where that change is relevant to the application of the STTR.

57. Subdivision (ii) of subparagraph c) provides that competent authorities should notify each other of the provisions of their taxation laws that apply to covered income and are relevant to the application of the STTR that may result in a preferential adjustment in accordance with paragraph 6. It is expected that such notification includes an explanation of how these provisions work or might impact paragraph 6. Therefore, the competent authority should not only provide a reference to a particular provision of its domestic law, but should explain how it may result in a preferential adjustment. As with subdivision (i) of subparagraph c), it is expected that competent authorities notify each other of the relevant provisions of their taxation law when the STTR enters into force and only make subsequent notifications if there are changes to those provisions that are relevant to the application of the STTR.

58. The expression “or any changes to” in subdivisions (i) and (ii) of subparagraph c) has to be interpreted broadly and includes the addition or deletion of tax rates or provisions.

59. Contracting States are expected to make comprehensive and timely notifications of relevant features of, and changes to, their rates and regimes, in accordance with subparagraph c) of paragraph 5, to all affected treaty partners; that is, those States with which a Contracting State has a treaty including the STTR. Although this will require an initial mutual exchange of notifications between States including the STTR in their bilateral treaty, and subsequent notifications of relevant changes in a Contracting State’s statutory tax rates and any regimes that may give rise to a preferential adjustment, the process is amenable to streamlining. Although a Contracting State may have multiple treaties including the STTR, the content of its notification to each affected treaty partner will be identical in all cases and the data will only need to be assembled once.

60. The content of a notification under subparagraph c), which serves to clarify the applicable statutory tax rates (and adjustments to those rates arising as a result of any preferential adjustment within the scope of paragraph 6) for the purposes of applying paragraphs 1 and 2 of the STTR, is also valuable in providing tax certainty to businesses (and their paying agents) whose income is within the scope of the rule. It is therefore desirable that the content of those notifications be published so that it is available to external users of treaties that contain the STTR.

61. Although the notification requirement under subparagraph c) is mandatory, the operation of subparagraph a) of paragraph 5 and paragraph 6 is not dependent upon such a notification having been made. The facilitation of comprehensive and timely notifications, and the publication of their content, under the processes briefly outlined above should nevertheless provide early certainty about the circumstances in which the STTR will apply between Contracting States including the provision in their treaties. This approach is designed to maximise tax certainty and remove doubts or difficulties about the operation of the STTR. Should any such doubts or difficulties arise in respect of the content of, or in the absence of, a notification, the first sentence of paragraph 3 of Article 25 of the OECD Model Tax Convention provides a mechanism through which the competent authorities may resolve these by mutual agreement. This mechanism allows the competent authorities to enter into a dialogue where, for example, there is an initial difference of view between them about the effect of a regime that has been notified as giving rise to a preferential adjustment or whether a regime that has not been notified may give rise to a preferential

adjustment within the scope of paragraph 6. Moreover, where a person considers that the way in which the STTR has been applied by a Contracting State will give rise to taxation not in accordance with the Convention, the provisions of paragraphs 1 and 2 of Article 25 provide a mechanism through which such a case can be resolved by mutual agreement, including by mandatory binding arbitration under paragraph 5 of Article 25.

5.4. Determination of tax rate for relevant taxes computed on an alternative basis

62. The tax rate under paragraph 1, together with the definition of the tax rate in subparagraph a), are both premised on the assumption that the person deriving the covered income will be subject to tax on net income in the State where it is resident. However, there may be situations where relevant taxes falling within subparagraph b) of paragraph 5 are imposed on a different basis. For example, where the bilateral treaty follows Article 2 of the OECD Model Tax Convention, any taxes on capital or income will be covered taxes under the treaty and should properly be taken into account for determining the tax rate on an item of covered income.

63. It will generally be necessary for the Contracting States to agree the tax rate or a methodology for determining the rate in respect of taxes that are calculated other than on a net income basis in order to prevent the STTR applying in circumstances that are outside the intended scope of the STTR. This is because the imposition of a tax imposed on such an alternative base may impose a greater incremental tax cost on the person deriving the income in respect of its covered income than a net income tax. All such taxes are relevant taxes for the purpose of determining the tax rate. For example, one of the taxes covered by the relevant bilateral treaty could be a tax on a company's assets or equity. This type of tax could be a separate tax on the net equity of a corporation that is imposed in addition to corporate income tax, or it could be one component of a tax that is based on multiple components including income and equity. A company resident in a State that imposes this type of tax may be subject to that tax (or an additional amount of such tax) as a result of lending money to a connected person. This tax will, however, be calculated not on the income from the intra-group loan, but by reference to the increase in the assets or equity of the resident company that results from this intra-group financing transaction. In this situation, such a tax (even one with a low statutory rate) could result in an increase in a tax liability for a resident company that is relatively high as a percentage of the covered income arising under the loan.

64. The paragraphs below address two situations:

a) the first is where the existing bilateral treaty includes, as a relevant tax, a tax calculated on an alternative basis;
b) the second is where one of the Contracting States introduces or modifies the operation of such a tax after the STTR has come into force.

5.5. Taxes in force at the time the STTR is introduced into the bilateral treaty

65. Where a relevant tax calculated on an alternative basis is already in force at the time the STTR is introduced, Contracting States should agree the tax rate or methodology for determining such rate prior to the STTR coming into force. This agreement should be reflected in an additional paragraph of the STTR or in a protocol to the treaty.

66. In reaching this agreement, the Contracting States should take account of the key design features of the relevant tax and the policy rationale of the STTR, including the need for a transparent rule that protects the tax base of the source State while avoiding undue complexity and the risk of over-taxation.

67. Where a Contracting State imposes a covered tax under Article 2 on gross income, or by reference to equity (e.g. a capital tax), or the tax base for which is calculated by reference to multiple components

(e.g. income and equity), applying the STTR by reference to the statutory rate on an item of covered income would not, given the broader base, accurately reflect the equivalent nominal rate applied to net income.

68. To address this, the Contracting States should include an additional provision in the treaty, or in a protocol, providing a methodology for establishing the tax rate to be applied in the case of that tax for the purposes of the STTR. The text for such a provision, which could be inserted in the STTR by renumbering subparagraph a) of paragraph 5 as paragraph 5 a)(i) and adding a new paragraph 5 a)(ii), is provided below.

> (ii) Notwithstanding subdivision (i) of subparagraph a), the tax rate with respect to an item of covered income subject to the [insert the name of the tax] in [insert the name of the residence State], shall be the rate that results from dividing the total amount of such tax paid by the resident of [insert the name of the residence State] in the year in which the covered income is reflected in its financial statements by the total amount of its net income of that same year reflected in those financial statements.

69. The tax rate computed in accordance with this additional provision would, for the identified tax, replace the statutory rate referred to in subparagraph a) of paragraph 5. This means that the statutory rate and any preferential adjustments that are taken into account in accordance with paragraph 6 are, in respect of the identified tax, ignored for the purposes of paragraph 5. This paragraph instead computes an equivalent rate on net income to adjust for the broader base of the tax on alternative or multiple components. It is this computed rate, and not the statutory rate, that is then used, in respect of the identified tax, for the purposes of applying the STTR. Where both an income tax and an alternative basis tax are applied to an item of covered income, the rates calculated under subparagraph a) of paragraph 5 (renumbered to 5 a)(i)) and 5 a)(ii)) are added together to produce the tax rate for the purposes of applying the STTR.

70. This additional paragraph does not alter the mechanics of the STTR. The STTR would continue to apply on a transactional basis to covered income referred to in paragraph 4 even though the computation of the tax rate is made on an entity basis. If the entity is subject to group taxation or a consolidation regime in the residence State, then the portion of the tax attributable to the resident of the other Contracting State would need to be separated from the rest of the group.

71. The tax rate computed in accordance with this paragraph results from dividing the total amount the tax paid in the year in which the covered income is reflected in the financial statements of the taxpayer by the total amount of its net income of that same year.

72. The following example illustrates the operation of this paragraph. State A has a corporate tax with a rate of 2.5% and whose tax base is the net income and net equity of the company. State A has a tax treaty with State B that follows the OECD Model Tax Convention, which includes the STTR with a minimum tax rate of 9% and paragraph 5 a)(ii) outlined at paragraph 68 above. A resident of State B makes a royalty payment of 100 to a resident of State A which is not subject to source taxation in accordance with the treaty. The resident of State A has 500 of net income (which includes the royalty payment of 100) and has net equity of 3000. The tax paid in State A is 87.5 (500 + 3000 x 2.5%). Instead of taking into account the statutory rate of 2.5%, this additional provision mandates that the tax rate for purposes of paragraph 5 shall be 17.5% (87.5/ 500). The STTR would not be triggered because 17.5% is above the minimum tax rate of 9% reflected in paragraph 1 of the STTR.

73. Similar considerations may arise where a State does not impose corporate income tax on items of covered income when that income is earned, but instead imposes tax at the point of profit distribution (both actual and deemed). In these circumstances, the tax rate determined in accordance with paragraph 5 may be lower than the tax rate specified in paragraph 1, but applying the STTR by reference to this rate would not accurately reflect the tax rate applied to net income over a period of time. This paragraph does not apply to deemed distributions made by a permanent establishment.

74. To address this, the Contracting States should include an additional provision in the treaty, or in a protocol, providing a methodology for establishing the tax rate to be applied in the case of that distribution tax for the purposes of the STTR. The text for such a provision, which could be inserted in the STTR by renumbering paragraph 5 a) as paragraph 5 a)(i) and adding an alternative new paragraph 5 a)(ii), is provided below.

> (ii) Notwithstanding subdivision (i) of subparagraph a), the tax rate with respect to an item of covered income subject to the [insert the name of the distribution tax] in [insert the name of the residence State], shall be the rate that results from dividing the total amount of such tax paid by the resident of [insert the name of the residence State] for the year in which the covered income is reflected in its financial statements and the two immediately preceding years by the total amount of its net income for that year and those two immediately preceding years reflected in those financial statements.

75. The following example illustrates the operation of this alternative paragraph. State B has a corporate income tax rate of 20% that applies to distributed profits. State B has a tax treaty with State C that follows the OECD Model Tax Convention, which includes the STTR with a minimum tax rate of 9% and the additional paragraph 5 a)(ii) outlined at paragraph 74 above. A resident of State C makes a royalty payment of 100 to a resident of State B which is not subject to source taxation in accordance with the treaty. The resident of State B has 500 of net income (which includes the royalty payment of 100) in year X, 450 of net income in year X-1, and 400 of net income in year X-2. It makes distributions of 400 in year X, 350 in year X-1, and 300 in year X-2, resulting distribution tax paid in those years of, respectively, 80, 70, and 60. The total distribution tax paid in State B across the three years is 210 and the total net income for those three years is 1,350. Therefore, for purposes of paragraph 5, the tax rate shall be 15.55% (210/ 1,350). The STTR would not be triggered in year X because 15.55% is above the minimum tax rate of 9% reflected in paragraph 1 of the STTR.

5.6. Taxes introduced or modified once the STTR has entered into force

76. Similar issues to those identified in the section above may arise where a relevant tax that is determined on an alternative basis is introduced or significantly modified after the STTR is in force. In this case, the Contracting States may wish to provide a mechanism through which the competent authorities shall agree on the applicable rate, or a method for determining that rate, in respect of the new or modified tax. The following alternative provision, which could be inserted as subparagraph d) of paragraph 5, may be used for this purpose:

> d) If a Contracting State imposes or makes significant changes to a relevant tax that is not a tax on net income then the competent authorities of the Contracting States shall agree the applicable tax rate in respect of that tax, or the methodology for determining that rate.

77. As noted above in respect of agreement between Contracting States, the competent authorities should take account of the relevant features of the relevant tax in light of the policy rationale of the STTR. The competent authority agreement could result in a deemed rate or an agreed proxy rate that applies to taxpayers that satisfy certain bright-line financial ratios, or a simplified methodology for determining the tax rate on income that takes into account the different tax base.

78. Where a Contracting State makes changes to a relevant tax that is not a tax on net income, then the approach originally used to determine the appropriate rate (or methodology for determining that rate) for that tax should be used to inform both the determination of whether there has been a significant change to the tax (such that subparagraph d) applies) and the new applicable rate or methodology itself.

79. Some Contracting States cannot delegate agreement of these matters to the competent authorities and, for these States, the matters described immediately above can only be addressed through the

negotiation of amendments to the STTR. Absent such amendments, the tax rate for a new or modified tax will be determined in accordance with the provisions of paragraphs 5 and 6.

6. Preferential adjustment

80. Paragraph 6 defines a “preferential adjustment” in respect of covered income for the purposes of adjusting the statutory rate of tax provided under paragraph 5. There are three broad components to the definition of a “preferential adjustment”.

81. The first component, contained in the opening words of the paragraph, is that for a preferential adjustment to arise there must be a permanent reduction in the amount of the covered income subject to tax, or the tax payable on that income, in the residence State. This basic requirement ties the concept of a preferential adjustment to a favourable treatment of covered income under the taxation laws of the residence State, which, through the mechanism of a reduction in income or tax, has the same effect as applying a lower statutory rate.

82. The reduction must be “permanent”, which means that it is not expected to reverse over time. Subdivision (ii) of subparagraph b) defines a permanent reduction for the purpose of paragraph 6. As well as a reduction that is not expected to reverse over time, the term is also deemed to include a reduction that arises where the person deriving the covered income has control over the point at which that income is recognised for tax purposes in the residence State. If the person is able to exercise such control, then the reduction is treated as permanent if the covered income is not brought into account within three years following the end of the fiscal year in which the covered income arises. This does not include a situation where a person has control over the contractual or commercial terms that result in a payment of covered income, including where those terms determine the point at which the income arises or at which it is recognised in the residence State.

83. For instance, there may be regimes according to which an item of income derived by a person is excluded from taxation until the person repatriates, or is deemed to have repatriated, that income. In such circumstances, the person deriving the covered income has control over the timing of repatriation or deemed repatriation and therefore recognition for tax purposes. Covered income derived by a person that is taxable only once the income is repatriated or deemed as repatriated shall be treated as subject to a preferential adjustment if that income is not repatriated or deemed as repatriated (and thereby brought within the charge to taxation) in the accounting period that the income arises or within three years following the end of that fiscal year.

84. A permanent reduction does not arise where there are timing differences in the recognition of income, such as the delayed taxation of income, if the person deriving the item of income does not have control over the point at which the income is recognised. This includes circumstances whereby the State of which the person deriving the income is resident requires the income to be recognised over a period of time (for example, to reflect the recognition of that income according to applicable accounting standards).

85. The second component is that the permanent reduction must take one of the three forms set out in subdivisions (i) to (iii) of subparagraph a) of paragraph 6. Subdivision (i) captures permanent reductions in the form of a full or partial exemption or exclusion from income. Subdivisions (ii) and (iii) to a certain extent serve as a backstop to subdivision (i) by capturing alternative mechanisms that have the same effect as exempting or excluding income from tax. Subdivision (ii) applies to deductions from the tax base that are computed on the basis of the amount of income and without regard to any corresponding payment or obligation to make a payment. A deduction that is allowed based on a corresponding payment or obligation to make a payment would be an economic cost to the taxpayer and therefore would not be treated as a preferential adjustment under paragraph 6. Subdivision (iii) applies where, instead of reducing the amount of income that is subject to tax, the amount of tax is reduced by a credit computed on the basis of the

amount of the income or the tax on that income. The operation of these conditions is further illustrated below (see sections 6.1 to 6.3).

86. The third component is the requirement, set out in the words following subparagraph a), that the permanent reduction must either be directly linked to the item of covered income or arise under a preferential regime.

87. A permanent reduction is "directly linked" to an item of covered income if that reduction is the direct result of the way that item of covered income is categorised or characterised under local law. This language captures local tax preferences that attach to a specific category of income (or income of a particular character) rather than the taxpayer itself. For example, a preference (such as an income exclusion) that applies to all or particular categories of royalty income, or that applies only to income that is characterised as foreign income, will be a preference that is directly linked to an item of income. If that item of income also falls within the definition of covered income then the preference is one that is directly linked to an item of covered income. This language would not capture a permanent reduction that applies to all taxpayers in a defined category or preferences attached to a specific type of expenditure. In that case, the permanent reduction is not directly linked to the character of the income derived by the taxpayer, but rather to the status of the taxpayer or the character of investment.

88. The permanent reduction can apply to all or part of the covered income. For example, if the residence State provides an automatic exemption equal to 80 per cent of a certain category of income and all or part of the income falls within the definition of covered income then that exemption is directly linked to an item of covered income within the meaning of paragraph 6.

89. The determination of whether a particular item of income is eligible for a permanent reduction must be based on a proper determination of the application of the domestic laws in the Contracting State. For example, income arising under a hybrid financial instrument may be characterised as deductible interest in the source State, but as a dividend (and exempt from tax) in the residence State. In this case, the exemption is directly linked to the character of the payment and falls within the scope of paragraph 6. However, if the laws of the residence State include those in line with Recommendation 2 of the Final Report on Action 2 of the BEPS Project[4] (which recommends that jurisdictions exclude deductible dividends from the scope of their exemption regimes) then, on a proper determination of the domestic law of the residence State, the payment is not eligible for any exemption and the provisions of paragraph 6 will not apply.

90. Foreign branch profit exemption regimes (domestic laws that exempt from tax the profits of foreign branches) provide an example of a permanent reduction in the amount of covered income that is subject to tax. Under such regimes, however, the treatment of the covered income derived from the other Contracting State is not due to its characterisation (e.g. as foreign income). Instead, the exemption arises from the attribution of income to a permanent establishment in a third State. That attribution will be undertaken following a functional and factual analysis and will involve the attribution of income wherever it arises, including income that arises in the State of the enterprise. The requirement in paragraph 6 that the exemption be "directly linked to the item of covered income" is therefore not met, so such regimes are not "preferential adjustments" for the purposes of the STTR. Such regimes also do not provide a tax preference for income from geographically mobile activities (see below). The same conclusion arises where the profits of a foreign branch are exempted from tax in the State of the enterprise because the tax treaty between that State and the State in which the permanent establishment is located eliminates double taxation using the exemption method.

91. General tax benefits that apply to all taxpayers on their net income or to taxpayers that qualify for the benefits of a specific regime are not considered directly linked to an item of covered income. For

[4] OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

example, a State may provide taxpayers with a general exemption for the first €X of net income. In this case, the exemption is not directly linked to an item of covered income because it applies to the net income of the taxpayer regardless of its character. The correct way of taking into account exemptions of this nature is through the determination of the statutory rate, as illustrated in the commentary on paragraph 5 above.

92. A permanent reduction is still required to be taken into account under paragraph 6 if it arises under a regime that provides a tax preference for income from geographically mobile activities. The regimes that fall within the scope of paragraph 6 will be those identified as preferential regimes in line with the requirements of the Final Report on Action 5 of the BEPS Project[5] (BEPS Action 5) and the 1998 OECD Report on Harmful Tax Competition.[6] Such a regime must exhibit two key features:

a) First it must offer some form of tax preference in comparison with the general principles of taxation in the State of which the person deriving the income is a resident. A preference offered by a regime may take many forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. Even a small amount of preference is sufficient for the regime to be considered preferential. The key point is that the regime must be preferential in comparison with the general principles of taxation in the relevant State, and not in comparison with principles applied in other States.

b) Secondly the regime must apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Regimes designed to attract investment in plant, building and equipment will most likely be outside this concept because they usually do not apply to income from geographically mobile activities.

93. The term "regime that provides a tax preference for income from geographically mobile activities" takes its meaning from the 1998 Report and BEPS Action 5. This term describes any regime that specifically provides preferential tax treatment to banking, insurance, distribution and other service activities provided to members of the same group, or fund management activities and the provision of intangibles, among others. If the preference is only available in respect of non-mobile activities (such as manufacturing) it should not be treated as falling within the definition in paragraph 6.

94. For instance, a State may provide tax preferences to enterprises established in specific economic zones. These tax preferences may be linked to their non-geographically mobile activities (e.g. manufacturing), and apply irrespective of the types of income such enterprises may receive (domestic and foreign income, sales of goods and other types of income which do not include covered income). This type of tax regime would not be a preferential regime within the meaning of paragraph 6 because, although there is a tax preference relative to the rules generally applying in the State, the preference is not provided in respect of geographically mobile activities. The preference available to enterprises established within the economic zone could, however, apply to a broader range of industries or activities or to particular categories of mobile income earned by the taxpayer – e.g. interest income or income from the exploitation of intangible property. This type of regime could be considered as providing a tax preference for income from geographically mobile activities such that the effect of the preference may need to be taken into account in the determination of the tax rate under paragraphs 5 and 6.

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[5] OECD (2015), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[6] OECD (1998), Harmful Tax Competition: An Emerging Global Issue, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264162945-en.

6.1. Subdivision i) of subparagraph a) – Exemption or exclusion from income

95. Subdivision (i) of subparagraph a) applies where the income is fully or partially exempt or excluded from tax in State of which the person deriving the income is a resident. This subparagraph is intended to cover those cases where income is initially included in income for tax purposes but is then eligible for a full or partial exemption or exclusion. The exemption or exclusion must, however, either be directly linked to the character of the income (such as foreign source income) or arise because the taxpayer qualifies for the exemption or exclusion under a preferential regime. As noted above, subdivision (i) could apply, for example, to a payment of interest under a hybrid financial instrument that is permanently exempted or excluded from tax in the residence State. In this case, there is a full exemption within the scope of subparagraph a) under the laws of the residence State; and that exemption is directly linked to the character of the payment. Similarly, an exclusion or exemption that applies only to foreign income would be considered as one that is directly linked to the character of the payment and within the scope of subdivision (i). In contrast, subdivision (i) would not apply where a resident taxpayer qualifies for a general exclusion for a percentage of its net income, unless that exclusion arises under a preferential regime.

6.2. Subdivision (ii) of subparagraph a) – Deduction from tax base computed on basis of amount of income without regard to any corresponding payment or obligation to make a payment

96. Subdivision (ii) applies where the permanent reduction is given in the form of a deduction from the tax base, computed on the basis of the amount of the income and calculated without regard to any corresponding economic expenditure. Subdivision (ii) does not apply to deductions from the tax base that are not computed on the basis of the amount of income. Therefore, Subdivision (ii) does not apply to deductions computed on the basis of inflated actual expenses (e.g. deduction of more than 100% of the actual expense incurred by the taxpayer) or on the basis of accelerated recognition of expenses (e.g. accelerated depreciation). Furthermore, 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.

97. As with Subdivision (i), the reduction must either be directly linked to the character of the income or arise because the taxpayer qualifies for it under a preferential regime. Subdivision (ii) could apply where, for example, an item of covered income is eligible for inclusion in a “patent box” regime, under which a notional deduction is computed as a percentage of the net taxable income. Although this permanent reduction might not be directly linked to the character of the covered income (because it may be generally available in respect of all types of income, including income from the sale of products), it does arise under a preferential regime and is computed on the basis of the amount of the income and without regard to an economic cost to the taxpayer.

6.3. Subdivision (iii) of subparagraph a) – Tax credit

98. Subdivision (iii) applies to a tax credit or any reduction in the amount of tax that is directly linked to an item of covered income or available under a preferential regime, unless it is a direct foreign tax credit for the tax paid, or deemed as paid on the basis of a bilateral tax treaty or similar agreement, in the source State or a third State. A direct foreign tax credit is a credit for foreign taxes that are directly levied on the item of income, as opposed to indirect foreign tax credits which are intended to relieve economic rather than juridical double taxation by providing a credit for taxes paid on the underlying income. For example, if a tax credit is only provided in respect of a certain category of income, then such tax credit is directly linked to the income. This is included as a separate category because the amount of tax payable in respect of covered income produces a comparable effect to the permanent reductions in Subdivisions (i) or (ii), although in contrast to those mechanisms it does not affect the tax base.

99. Tax credits computed by reference to investment or expenditure are not directly linked to covered income if they are granted regardless of the taxpayer's income. For example, expenditure based tax credits such as R&D tax credits are granted in respect of expenses incurred by the taxpayer, irrespective of whether the taxpayer derives any kind of income. In these cases, the tax credit is directly linked to the investment and does not depend on and cannot be traced to the income itself.

6.4. Effect of paragraph 6

100. Paragraphs 5 and 6 together provide computational rules for determining the tax rate applicable to covered income where that income benefits from a preferential adjustment. In those circumstances, the applicable rate is determined after taking into account the effect of that preferential adjustment.

101. For instance, a State may provide for a reduced rate or a permanent reduction under a preferential regime for IP income. The scope of the IP income eligible for such preference will be defined under the taxation laws of that State and may include all kinds of receipts (e.g. sales of products, services income, royalties, etc.). In such a situation the permanent reduction is not directly linked to any item of covered income that is paid to the recipient, but part of the revenue that is used to compute the taxable base under the preferential regime. The tax rate on this item of covered income must therefore be adjusted as provided in paragraph 6 to reflect any permanent reduction provided under such preferential regime. This adjusted rate is then used for applying paragraphs 1 and 2 to this item of covered income.

102. For instance, RCo is a company resident in State R. The statutory tax rate in State R is 20%. RCo receives an item of covered income of 100 which is subject to a preferential regime. That preferential regime provides for an exemption of 80% of qualifying income. The adjusted nominal rate would be determined by multiplying the statutory rate by the portion of the income subject to tax. In this example, the tax rate would be 20% x (100% - 80%) = 4%. The same computation would be made if instead of an exemption of 80% of the income, taxpayers are allowed to claim a deduction for tax purposes equal to 80% of the income.

103. If instead the same preferential adjustment was not provided through an exemption or a deduction but through a tax credit of 80% of the tax due (16 in this example), then the tax rate would be adjusted and the outcome would be the same. In this case, the calculation can be done by first determining the amount of tax (by multiplying the statutory rate by the amount of income, then reducing it by the amount of the tax credit) and dividing the tax by the amount of income. In this example, the tax rate would be [(20% x 100)-16]/100 = 4%.

104. Where there are a mix of preferential adjustments, then all of these should be taken into account in calculating the tax rate.

105. For the purposes of paragraph 6, no account is taken of any obligation that the State of residence of the person deriving the covered income has under Article 23 A or 23 B of the OECD Model Tax Convention to provide exemption or credit. This ensures that the STTR does not result in a reallocation of taxing rights that goes beyond allowing the State in which the covered income arises to apply tax at the specified rate to the gross amount of that income. Such an unintended reallocation of taxing rights could otherwise arise where, for example, the only reason that the State in which the income arises may tax in accordance with the Convention is because the STTR applies and the State of residence (which would otherwise tax the income, albeit at a rate below the agreed minimum) is then obliged to exempt the income in full.

7. Covered income attributable to permanent establishment in third jurisdiction

106. Paragraph 7 deals with the situation where income arising in a Contracting State and derived by an enterprise of the other Contracting State is attributable to a permanent establishment located in a third

jurisdiction. For example, RCo (resident in State R) has a permanent establishment in State P, through which it provides a loan to SCo (resident in State S). The tax treaty between States R and S does not allow source taxation of interest and has an STTR with a minimum rate of 9%. The interest earned by RCo from the loan is exempt in State R but is taxed in State P at a statutory rate of 25% (not subject to preferential adjustments) because it is attributable to the permanent establishment located in State P. For purposes of applying paragraphs 1 and 2, this provision takes into account the applicable tax rate (as determined by paragraphs 5 and 6) in the third State where the permanent establishment is located to avoid overtaxing the covered income in case it is higher than the one applicable in the residence State.

107. To apply paragraph 7, two conditions need to be met. The first condition, referred to in subparagraph a), requires the tax rate applicable to the covered income in the residence State to be lower than the minimum rate. This avoids the unnecessary burden of determining the tax rate applicable to covered income of a permanent establishment in a third jurisdiction where the applicable tax rate in the residence State is already above the minimum rate.

108. The tax rate applicable to the covered income in the residence State referred to in subparagraph a) is the one determined in accordance with paragraphs 5 and 6 of the STTR. Any foreign tax credit given in the residence State for the tax borne by the permanent establishment located in the third jurisdiction does not impact the applicable tax rate in the residence State because subparagraph c) of paragraph 6 explicitly excludes the effect of any credit for foreign taxes paid on that income ("… excluding a credit for foreign taxes paid on the income that is computed on the basis of the amount of income or tax on such income").

109. The second condition, reflected in subparagraph b), is that the residence State and the third jurisdiction should both consider the covered income to be attributable to a permanent establishment located in the third jurisdiction. This requirement is satisfied as long as both the residence State and third jurisdiction treat the income as attributable to the permanent establishment in accordance with their domestic laws or their applicable tax treaty. Furthermore, it is not required that the residence jurisdiction has specific rules on how to attribute income to a permanent establishment in another jurisdiction as long there is an implicit recognition by the laws of such State of the existence of a permanent establishment in the third jurisdiction. For example, if the domestic law of the residence State provides a foreign tax credit for taxes borne by a permanent establishment situated in another jurisdiction, then there is recognition that income is attributable to such permanent establishment because the residence State provides a credit for the tax paid in relation to such income.

110. If both of the conditions in subparagraphs a) and b) are met, then the applicable tax rate referred to in paragraph 5 would be the one applicable in the third jurisdiction to the covered income attributable to that permanent establishment if that rate is higher than the applicable tax rate in the residence State. If both the applicable tax rates in the residence State and the third jurisdiction (as determined by paragraphs 5 and 6) are below the minimum rate, then the higher rate should apply. If the tax rate is the same in the residence State and the third jurisdiction, then the tax rate in the residence State still applies. For the purposes of determining the tax rate applicable in the third jurisdiction, subparagraph a) of paragraph 5 and paragraph 6 apply as if the references there to the person deriving the income and its State of residence were instead references to the permanent establishment and the jurisdiction in which it is situated. This ensures that those provisions then operate, for the purposes of applying paragraph 7, to find the tax rate applicable to the permanent establishment in the third jurisdiction, which is the required outcome.

111. While verifying the correct application of this paragraph, the tax authorities (in particular, the one from the source State) would need to know the applicable tax rate (including any preferential adjustments) in the jurisdiction where the permanent establishment is situated. In this case, the tax authorities could use existing exchange of information instruments in force which are ratified by the jurisdiction where the permanent establishment is situated (e.g. if it is part of the Convention on Mutual Administrative Assistance in Tax Matters or it has a bilateral tax treaty that includes Article 26 with the Contracting State of the tax

authority). In any event, the source State is entitled to require verification (e.g. a document that certifies the tax rate applicable to the permanent establishment, issued by the tax authority of the jurisdiction where it is situated) before applying paragraph 7.

112. Paragraph 8 of Article 29 deals with potential abuses that may result from the transfer of shares, debt-claims, rights or property to a permanent establishment situated in a third jurisdiction, income of which is exempt in the residence State (where the head office is located). If this provision is triggered, the source State can deny treaty benefits with respect to such income. The STTR only applies if the taxpayer enjoys treaty benefits. Therefore, if paragraph 8 of Article 29 applies such that no treaty benefits are available, the STTR would not apply and paragraph 7 of the STTR provision would be irrelevant.

8. Exclusions

113. Paragraph 8 provides that paragraphs 1 to 7 do not apply to covered income paid by an individual or derived by the persons listed in subparagraphs a) to i).

114. The reference to "paid by an individual", in combination with the exclusion in subparagraph a) of paragraph 8, ensures that the STTR does not apply to payments made to or by individuals. Subparagraph b) removes from the scope of the STTR covered income that is derived by a person that is not connected to the payer. Paragraph 10 provides the definition of a connected person for the purposes of subparagraph b). The exclusions for payments made to or by individuals, or to unconnected persons, could ultimately be integrated into paragraph 1.

115. Subparagraphs c) to h) of paragraph 8 specify the persons that are excluded from the application of the STTR. The excluded persons all have a particular purpose and status under the laws of the State in which they are created or established. This status is likely to result in the person not being exposed to domestic income tax in order to preserve a specific intended policy outcome under the laws of that State. The domestic tax outcome may, for example, be designed to ensure a single layer of taxation on vehicles used by investors (e.g. funds) or on retirement plans used by employees, or because the person is carrying out government or quasi-government functions. The tax policy objectives of the domestic tax exemption for these types of persons are not inconsistent with those of the STTR. Subjecting the income of such persons to the STTR would undermine the policy objectives that the State is seeking to achieve by granting the exemption, without furthering the policy objectives of the STTR.

116. Subparagraph c) covers recognised pension funds. These are defined in Article 3(1)(i) of the OECD Model Tax Convention, which reads as follows:

> *i) the term "recognised pension fund" of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:*
>
> > *(i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or*
> >
> > *(ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i).*

Paragraphs 10.5 to 10.8 of the Commentary on Article 3(1) discuss the application of this definition, and modifications that States may want to make to it or to other provisions of their tax treaties and domestic law, in relation to arrangements that might not constitute a separate person under the taxation laws of the State in which it is established. These apply equally in the context of the exclusion in subparagraph c) and, where such modifications have been made, they will be effective in adapting the definition of recognised pension funds for the purposes of the exclusion.

117. Subparagraph d) covers non-profit organisations and is based upon subparagraph (iv)(B) of the provision on special tax regimes in paragraph 86 of the Commentary on Article 1. This is, however, modified to include the references to a "non-profit organisation", "sporting" and "other similar" purposes. This list is illustrative, not exhaustive, and the closing words of subparagraph d) extend the exclusion to non-profit organisations established for other purposes which are consistent with the examples given in the provision. It would include purposes that overlap with one or several of the purposes listed in subparagraph d), but that may not clearly fit entirely into one or more of those categories. For example, this may include environmental, humanitarian, or animal well-being purposes. "Similar purposes" would generally include a purpose of providing a public benefit, that is, purposes that have regard to the needs, interests, and well-being of the general public.

118. An organisation must meet several criteria to qualify as a "non-profit organisation". It is intended to mean that the organisation is organised and operated exclusively for one or more purposes described in subparagraph d). An organisation is not operated exclusively for one or more such purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. This does not include the payment of reasonable compensation for services or payment of fair market value for purchases or leases. Further, an organisation is not organised exclusively for one or more exempt purposes unless its assets are dedicated to the purposes described in subparagraph d); for example, if, upon dissolution, its assets are distributed to other non-profit organisations for such purposes.

119. A non-profit organisation may undertake business activities that are unrelated to its purpose as long as the income received from those activities is not subject to tax at a rate below 9%.

120. Subdivisions (i) and (ii) of subparagraph e) cover the Contracting States, their political subdivisions or local authorities, and central bank. Subdivision (iii) extends the exclusion to an agency, mandatary or instrumentality of a Contracting State, political subdivision or local authority, or an entity or arrangement established or created by a Contracting State, political subdivision or local authority. Subdivision (iv) covers any other person wholly or almost wholly owned directly or indirectly by a Contracting State, political subdivision or local authority, or those agencies, instrumentalities or mandataries. Subdivisions (iii) and (iv) are subject to the requirement that these entities or organisations have a principal purpose of fulfilling a government function, and that they do not carry on a trade or business. The nature of the entities and organisations referred to in subdivisions (i) and (ii) means it is implicit that they will also fulfil a government function.

121. Subdivision (iii) of subparagraph e) covers an agency, mandatary or instrumentality of, or created or established by, a Contracting State, political subdivision or local authority. An agency, mandatary or instrumentality is "of", or "established or created by" a Contracting State, political subdivision or local authority if it is formed under public law.

122. Subdivision (iv) extends subparagraph e) to other persons who may have been created under private law, provided that they are wholly or mainly owned (directly or indirectly) by a Contracting State, political subdivision or local authority, or those agencies, instrumentalities or mandataries. The word "government" includes the central administration, and agencies whose operations are under effective control of central, state and local governments.

123. The term "government function", which is applicable to the persons referred to in subdivisions (iii) and (iv) of subparagraph e), is intended to have the same broad meaning as it may have under the applicable tax treaty. This would generally, but not universally, include activities such as providing public health care, public pensions and public education, as well as a mandatory public workplace insurance against employee injury or unemployment. It would also include building public infrastructure or ensuring defence capability and law enforcement within the State.

124. Furthermore, the persons referred to in subdivisions (iii) and (iv) cannot conduct a trade or business. This differentiates commercial enterprises owned by a Contracting State, political subdivision or

local authority, or agency, instrumentality or mandatary from entities whose activities are limited to the principal purpose of fulfilling a government function. For example, if a Contracting State wholly owns an entity that meets all the other requirements in the definition and that only provides products or services for use by that government to fulfil a government function, then the activities of the entity are assimilated to a government function rather than a trade or business. On the other hand, a commercial bank owned by the government would not have the principal purpose of performing a government function and would therefore be considered as engaged in a trade or business.

125. Subparagraph f) covers international organisations. It is expected that these organisations would fall out of the scope of the treaty and STTR because they are not liable to tax and would not be considered a resident of either Contracting State on first principles. However, subparagraph f) excludes them from the application of the STTR in case they are persons covered in accordance with Article 1 of the OECD Model Tax Convention to provide greater certainty. Contracting States that do not regard international organisations as residents for the purposes of the Convention may wish to exclude this category.

126. Subparagraph g) applies to investment funds. The definition is influenced by the hallmarks of a collective investment vehicle as described in the Commentary on Article 1 of the OECD Model Tax Convention, notably that the entity or arrangement, or its managers, are regulated, but also seeks to cater for the differing types of investment vehicles found in Contracting States. The approach is therefore broader than that described in the Commentary on Article 1 which only refers to investor-protection regulation.

127. Subparagraph g) starts by referring to a “professionally managed entity or arrangement”. This means that the fund has to be managed by fund management professionals on behalf of investors.

128. The phrase “entity or arrangement” is taken from paragraph 2 of Article 1 of the OECD Model Tax Convention and therefore applies regardless of how the investment fund is organised and whether or not it has legal personality. However, subparagraph g) applies only where the entity or arrangement is entitled to treaty benefits because it is considered a “person” that is a “resident” of one of the Contracting States or because it was agreed by the Contracting States that such vehicles are entitled to treaty benefits. The principles in paragraph 2 of Article 1 of the OECD Model applies for the purposes of the STTR and so if the investment fund is fiscally transparent and its investors are the ones entitled to the treaty benefits, subparagraph g) does not apply to it because the exclusion is only relevant where the investment fund is itself entitled to treaty benefits and, therefore, within the scope of the STTR. In this case, the STTR would not apply to the investment fund but to the investors that are entitled to treaty benefits and, therefore, within the scope of the rule. This would include, for example, determining whether the investors were connected to the payer.

129. Subparagraph g) states that the entity or arrangement has to be “designed to invest funds”. This condition requires the investments to be made in accordance with a defined investment policy because an entity or arrangement “designed to invest funds” would need a defined investment policy.

130. Subparagraph g) also requires that the entity or arrangement is designed to invest funds that are “obtained from unconnected persons”. Paragraph 10 of the provision provides a definition of “connected persons”. An entity or arrangement designed to invest funds obtained from unconnected investors will meet the description in subparagraph g) even if once opened to investors the entity or arrangement incidentally has connected investors. The entity or arrangement would meet the description in subparagraph g) provided that the entity or arrangement was not designed with the purpose of investing funds of “connected persons”. This would include the beginning and end of the life cycle of the entity or arrangement when there may be a single or small number of connected investors.

131. Whether the entity or arrangement is designed to invest funds obtained from unconnected persons may be demonstrated by documentation the entity or arrangement is required to prepare for regulatory or other purposes. For example, the defined investment policy or instruments of incorporation of the entity or arrangement, information prepared to meet regulatory requirements (including on the fair treatment of

investors), marketing materials, or other information made available to investors may evidence whether the entity or arrangement is designed to invest funds obtained from unconnected investors or is designed to invest funds for a broader scope of investors. The most recently available information should be used to determine whether there has been a change in the purpose of the entity or arrangement.

132. An ”arrangement” for this purpose would include any connected entities through which the relevant investment activity was organised; the particular legal form adopted would not affect the application of subparagraph (g). For example, one entity may raise funds from the public and then invest those funds through subsidiaries or sister companies, each of which holds a particular asset class.

133. Subparagraph g) states that the funds invested have to be “primarily to generate investment income or to provide protection against an event”. The phrase “to provide protection against an event” in subparagraph g) covers the case where an insurance company invests the premiums received from its policy holders to cover future claims. Subparagraph g) also states that the income generated or protection against an event has to be “for the benefit of its investors”. This requires the investor to have the rights of a return based on its contributions. In the case of an insurance company that invests the premiums received from its policy holders, the investor could be either the insurance company or the policy holder depending on how the investment is structured.

134. Subparagraph g) requires the investment fund or its managers to be regulated. This requires that the fund or the fund manager is subject to a regulatory regime in the State in which it is established or managed (such as appropriate anti-money laundering and investor protection legislation). This requirement is intended to encompass the different approaches to prudential regulation of investment funds. In respect of an investment fund that is established or created by a Contracting State, its political subdivisions or local authorities, agencies, mandataries or instrumentalities (but that does not meet the conditions of subparagraph e)), regulation may take any form endorsed by the person that established or created the investment fund, for example provisions for accountability and review contained in the legislation under which the investment fund is constituted.

135. An insurance company is deemed to satisfy the conditions of subparagraph g) as long as that insurance company meets certain conditions. The first of those conditions is that the insurance company is subject to regulation as such in the Contacting State of which it is a resident. The second condition is that the covered income received by that insurance company must be derived from assets used to back policyholder liabilities. Conversely, the provision does not exclude covered income received by an insurance company where that income does not back policyholder liabilities and is derived by that insurance company on its own account.

136. This provision may be relevant to life insurance companies that establish a fund for the purpose of providing retirement benefits to individuals, such as the employees of that entity or of other employers, or of investing funds for the benefit of other recognised pension funds (see paragraphs 10.5 to 10.10 of the Commentary on Article 3). In such a case, the life insurance company is analogous to a recognised pension scheme (see subparagraph c)), but does not meet that definition because that fund does not constitute a separate “person” and therefore cannot satisfy the requirement contained in the opening words of paragraph 8 that require that the covered income is “derived by a resident of the other Contracting State”. Moreover, even if the fund were a separate person, the liabilities of the fund may include other types of annuities beyond liabilities to pay benefits to pension funds.

137. The provision may also be relevant to an insurance company that would not meet the general conditions of subparagraph g) because it conducts activities other than investing funds obtained from unconnected persons primarily to generate investment income or to provide protection against an event, or because it conducts a combination of activities mentioned in subparagraph g). The deeming rule at the end of subparagraph g) ensures that covered income derived by eligible insurance companies from assets held for the purpose of meeting policyholder liabilities are excluded from the scope of the STTR.

138. Subparagraph h) is based upon subdivision (iv)D) of the “special tax regime” provision included in paragraph 86 of the Commentary on Article 1 of the OECD Model Tax Convention. One of the conditions in subparagraph h) is that the entity or arrangement achieves a single level of taxation. The intention of this language is to deal with tax neutral vehicles which are designed to ensure that a single level of taxation is achieved either in the hands of the vehicle or its interest holders. This could be the case of an entity whose income is exempted provided that it distributes its income within a time period. The distribution is then subject to tax in order to achieve a single level of taxation.

139. In some situations, however, the interest holders could also be tax neutral vehicles such as a recognised pension fund. In these cases, on a strict reading, a single level of taxation would not be achieved within a year as the distributions made to these investors could be exempted. However, subparagraph h) would still apply because the design of the tax regime was to achieve a single level of taxation.

140. Subdivisions (i) and (ii) contain two alternative conditions. Subdivision (i) requires that the entity or arrangement holds predominantly immovable property (following the approach in subdivision (iv)D) of the “special tax regime provision”. In some cases, such property would not be held directly but indirectly via holding a security whose value is linked to immovable property. An entity or arrangement that holds predominantly immovable property either directly or indirectly via such securities (or a combination of the two) will meet the condition in subdivision (i).

141. Subdivision (ii) requires that either the entity or arrangement or its investors are subject to a tax rate of at least 9% in the State of which the entity or arrangement is a resident. Where taxation is at the level of the investors, this is likely, but not necessarily, to be through a withholding tax applied to distributions from the entity or arrangement. The exception to this requirement is where an investor is not subject to a tax rate of at least 9% because that investor is an excluded investor described elsewhere in paragraph 8.

142. The applicable tax rate for the purpose of subdivision (ii) is determined by the domestic law of the State of which the entity or arrangement is a resident. The tax rate does not include any reduction resulting from a double taxation convention between the State of which the entity or arrangement is a resident and the State of which the investor is a resident.

143. Subparagraph i) deals with entities or arrangements used by the persons, entities or arrangements described in subparagraphs c) to h) to hold assets or manage or make investments, or that carry out activities that are ancillary to those carried out by a person, entity or arrangement referred to in subparagraphs c) to h). This subparagraph is intended to apply to entities or arrangements that do not carry out activities other than holding assets or investing funds. For example, it applies to a sovereign wealth fund (in case it does not already meet the definition in subparagraph e)).

144. Subdivision (ii) extends the exclusion to entities that perform certain activities on behalf of a Contracting State (and other entities and organisations referred to in subparagraph e)).

145. The first condition for the application of this subparagraph is that the entity is “wholly or almost wholly owned” by one or more persons in subparagraphs c) to h). This phrase has to be interpreted based on the facts and circumstances. However, it is expected that it covers situations where at least 95% of the entity or arrangement is owned by persons in subparagraphs c) to h). The purpose of the phrase “mainly owned” covers circumstances where a fund manager has a small percentage of an investment fund, or where domestic law requires at least two shareholders to incorporate a corporation.

146. Whether an entity or arrangement is “owned” by a person in subparagraphs c) to h) depends on domestic law. However, an entity is not owned by such a person if it distributes its profits to entities that are not referred to in subparagraphs c) to h), or if upon dissolution its net assets would be transferred for the benefit of an entity that is not a person referred to in subparagraphs c) to h).

147. In some situations, the entity of arrangement may not be "wholly or mainly owned" by one or more persons listed in subparagraphs c) to h), but established by one such person for the benefit of another such person. For example, an entity may not be owned by a Contracting State or pension fund, but may be established by a Contracting State for the benefit of a pension fund to exclusively or almost exclusively provide and administer retirement benefits. The words "or established" ensures that these cases are also within the scope of paragraph 8.

148. The phrase "by one or more persons referred to in subparagraphs c) to h)" only includes the persons that are the object of those provisions. It does not include other persons referred to in those subparagraphs. For example, the person referred to in subparagraph g) is the entity or arrangement designed to invest funds and does not include the unconnected persons from which the funds are obtained by that entity or arrangement.

149. Subdivision (i) of subparagraph i) also requires that the entity or arrangement "is established and operated exclusively or almost exclusively to hold assets or manage or invest funds". This includes "creation" and "operation" elements. The first element requires the entity or arrangement to be created exclusively or almost exclusively to hold assets or manage or invest funds, while the second element requires that it operates in the same manner. The words "exclusively or almost exclusively" mean that all or almost all of the activities must be related to holding assets or managing or investing funds. The test has to be interpreted based on facts and circumstances.

150. Subdivision (i) also requires that the assets are held and funds managed or invested "for the benefit of a person referred to in subparagraphs c) to h)". This condition has to be read in conjunction with the other conditions of subparagraph i). For example, this condition is still met even if the fund manager benefits from the investments made by such entity in proportion to its ownership percentage.

151. Subdivision (i) applies to a sovereign wealth fund (in case it does not already meet the definition in subparagraph e)). Governments typically use sovereign wealth funds (including those incorporated as companies) to hold and manage their investments. Sovereign wealth funds are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports[7]. The function of a sovereign wealth fund is to invest these amounts for the purpose of managing a country's future fiscal needs, stabilising a country's balance of payments and in order to strike an appropriate balance between domestic consumption and saving.

152. In addition, subdivision (i) includes an entity or arrangement that only carries out activities that are ancillary to those carried out by a person, entity, or arrangement referred to in subparagraphs c) to h). The exclusion in subparagraph i) is extended to such entities as it would have applied if the relevant activity had been performed by the person, entity or arrangement described in subparagraphs c) to h). This element of subdivision (i) would apply, for example, to an entity that provides HR services exclusively to a person, entity or arrangement referred in subparagraph c) to h).

153. Subdivision (ii) applies to an entity that is wholly or mainly owned, or established, by a person mentioned in subparagraph e) (which applies to a Contracting State, or a political subdivision or local authority thereof, or an agency, mandatary or instrumentality of, or established and created by, that State, political subdivision or local authority, agencies, mandataries or instrumentalities). That entity must be operated exclusively, or almost exclusively, to conduct the activities described in subdivision (i) or to conduct investment activities for the person referred to in subparagraph e). Subdivision (ii) would therefore apply to an entity that, for example, performs investment advisory activities for a sovereign wealth fund.

[7] See International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds — Generally Accepted Principles and Practices — "Santiago Principles" (IWG, 2008), October 2008, Annex 1; also replicated in 2017 Model Tax Convention (OECD, 2017), Commentary on Article 4, paragraph 8.5.

9. Mark-up threshold

154. Paragraph 9 excludes from the scope of paragraphs 1 and 2 some items of covered income that result in a mark-up on costs of 8.5% or less in the hands of the person deriving that income. The subparagraph applies to the items of covered income contained at subdivisions (iii) to (vii) of subparagraph a) of paragraph 4, and not to the items of covered income found in subdivisions (i) and (ii).

155. The mark-up threshold aims to exclude from the application of the STTR covered income from transactions that, due to the level of return, present a more limited BEPS risk. Instead of performing a transfer pricing analysis of the various functions, assets and risks borne by the parties to the transaction in order to assess eligibility, the mark-up threshold provides for a mechanical approach that focuses on numerical indicators.

156. The mark-up threshold, however, does not apply to the covered income items that fall within subparagraphs (i) (interest) or (ii) (royalties). Interest and royalties are usually considered as mobile categories of income. An MNE group could, for example, more easily contemplate transferring the money that is lent or the intangible assets that are licensed to benefit from a specific tax treatment. While this kind of restructuring would entail further consequences on the functions performed in relation to managing risks and developing these assets to comply with transfer pricing requirements, such a restructuring may be less burdensome than a transfer of another kind of activity.

157. In addition, a lender will often finance the loan that it grants with funds lent to it. In the context of a connected party lender, this may be funds received from third parties or excess funds lent to it by other connected parties. In such cases, the lender will often generate a low mark-up, recognising the functions it performs and risks it bears. For the reasons noted above, this does not mean that the lender does not present a reduced BEPS risk. These factors mean that interest and royalty payments may present a higher BEPS risk that makes application of the mark-up threshold inappropriate.

158. Paragraph 9 applies to single items of covered income; that is a payment consisting wholly of one of the categories contained at subdivisions (iii) to (vii) of subparagraph a) of paragraph 4 made in a single instalment. This general rule is subject to subparagraphs a) and b).

159. The return produced by an item of covered income is the difference between the gross amount of that income and the costs incurred by the person deriving the income that are directly or indirectly attributable to earning the income. The return produced by an item of covered income meets the mark-up threshold if it exceeds 8.5% of those costs.

160. The following example illustrates such a calculation. State A and State B have a tax treaty that includes the STTR and contains a rate of 8.5% in paragraph 9. A resident of State A makes a payment of 100 for intermediary services provided by a company resident of State B (BCo). BCo incurs total costs of 96 in generating that income. The return generated by the item of covered income is 4 and this return corresponds to a 4.17% mark-up on relevant costs. If instead total costs were 80, the return generated would be 20, which is a 25% mark-up on those costs. In the first scenario, the mark-up on costs is lower than 8.5% and therefore the covered income would be excluded from the application of the STTR. In the second scenario, the mark-up on costs is higher than 8.5% and therefore the mark-up threshold is met and paragraphs 1 and 2 of the STTR would apply.

161. The return produced by an item of covered income is determined by taking into account all the costs – both direct and indirect – incurred by the person deriving the covered income in earning it. This includes costs incurred in performing the activity that generates the item of covered income as well as, where relevant, the appropriate part of operating expenses (e.g. supervisory, general and administrative) and provisions, amortisation or depreciation expenses.

162. The costs should only include those that are incurred for the purpose of deriving the covered income. If costs are for the purposes of deriving non-covered income or are costs incurred for the benefit

of another person, only the portion of costs that are attributable to the person deriving the item of covered income in the course of earning that income are considered.

163. Where an intermediary that receives covered income incurs costs on behalf of the payor, these costs should be treated as pass-through costs. Pass-through costs incurred by an intermediary are not costs incurred by the owner of the item of covered income in earning it. Therefore, those costs are not taken into account in order to determine the mark-up on the covered income. For instance, a procurement agent that receives a commission would compare the commission it earned with its own (internal) costs, excluding the purchase price of the products. Costs that have been re-charged to the payor should not be included in the calculation of costs incurred earning the item of covered income.

164. Any reasonable approach may be used to establish the direct and indirect costs incurred in earning covered income. A cost should only be included in the cost base if that cost is identifiable and the covered income could only be derived by incurring that cost. As subparagraphs a) and b) apply by reference to a fiscal year, only costs incurred in the course of that fiscal year may be included when calculating the cost base for that period. This would generally mean costs recognised according to accounting standards.

165. A reasonable apportionment should be used to determine the proportion of indirect costs, such as overheads, that are attributable to an item of covered income. One possible approach is to multiply the total relevant cost by the amount of covered income divided by total income. For example, a person derives a procurement fee of 50 and has total income of 500. Total overhead expenses incurred are 100. According to this approach, the total overheads attributable to that item of covered income would be 10.

166. Covered income can generate a mark-up below the threshold for the person deriving the item of covered income irrespective of the transfer pricing method used to set or test the price of the transaction. However, a transfer pricing analysis may be of assistance when determining the costs relevant to the calculation under paragraph 9. The approach provided for in paragraph 9 is not binding upon the pricing of the transaction for transfer pricing purposes.

167. In order to establish the costs associated with an item of covered income, the person deriving the item of covered income may use any reliable business records. This might include its financial statements or internal accounting records (such as management accounts) that demonstrate the value and nature of costs related to the item of covered income.

168. If the calculation in paragraph 9 produces a negative result, then the covered income results a fortiori in a return below the mark-up threshold and paragraph 9 would apply.

169. Subparagraph a) of paragraph 9 provides that payments of the same item of covered income shall be aggregated to determine whether the income generates a mark-up below the threshold if the payments are made under the terms of a single contractual arrangement. The quantitative threshold applies to the mark-up over the appropriate cost base for this aggregate set of payments, rather than each payment individually.

170. For example, subparagraph a) applies to quarterly payments of a single annual fee. Each of the instalments paid in the fiscal year of the person deriving the covered income are aggregated to determine whether that income produces a mark-up below the threshold, as will the costs incurred in generating the income during that fiscal year. Payments of the same item of covered income that are made under different contracts are not aggregated for the purpose of applying the STTR and a separate calculation is required for payments made under those differing contracts.

171. For the purpose of subparagraph a), an item of covered income may be received from a single payer or from several payers, who in turn may be resident in different States. Such payments shall be aggregated if made under the terms of a single contract. The following example illustrates the application of this approach. A resident of State A (ACo) enters into a single contract to provide intermediary services to related parties in States B, C and D. These related parties are the counterparties to this contract and

they all make payments for these services directly to ACo. Subparagraph a) requires those payments of covered income, and the associated direct and indirect costs, to be aggregated in determining whether the income generates a mark-up below the threshold for the purposes of applying the STTR in the tax treaties between State A and States B, C and D.

172. The rule applies by reference to the income and related costs in a fiscal year. For this purpose, the fiscal year is that of the person deriving the income.

173. Subparagraph b) of paragraph 9 provides that payments made under different contractual arrangements, or payments of different items of income, are aggregated if they are so interrelated that the amount of each separate item of covered income, and the direct and indirect costs incurred in earning that item of income, cannot be reliably identified if taken in isolation. Unlike subparagraph a), subparagraph b) does not require the items of income to be paid under the same contractual arrangement and applies to payments of different categories of covered income.

174. If covered income is aggregated, the associated direct and indirect costs should also be aggregated. Subparagraph b) only applies where the direct and indirect costs incurred in earning that covered income are more reliably evaluated. If that is the case, then aggregation under this provision is required.

175. For the purpose of subparagraph b), a more reliable analysis would likely arise if one payment of covered income would not be made in the absence of other payments, or if the payments of covered income are complementary or closely linked. Taken individually it would be impractical or arbitrary to determine the costs associated with each individual item of covered income and may result in an outcome that is not well aligned with the economic reality of the payments. Therefore, the most reliable way of allocating costs to those items of income, and to better align the approach with the underlying commerciality of the arrangements, is to do so in aggregate because the covered income is so interrelated.

176. Portfolio approaches provide an example of such payments. A portfolio approach is a business strategy consisting of a person bundling certain transactions for the purpose of earning an appropriate return across the portfolio rather than necessarily on any single item within the portfolio. Some items may generate a low profit, or even a loss, because they create a demand for other items provided by the same person that are then sold or provided with high profits.

177. Subparagraph b) applies on the basis of a fiscal year. All payments derived, and the related costs incurred, in the course of that period must therefore be aggregated in the same way as payments of covered income according to subparagraph a).

178. Subparagraph c) determines the calculation of the direct and indirect costs used for the purpose of the mark-up threshold in certain circumstances. First, the covered income under consideration must be that described in subdivision (vii) of subparagraph a) of paragraph 4; income received in consideration for the provision of services.

179. Secondly, the person deriving the income from the provision of services must have incurred costs, directly or indirectly, from transactions with connected persons that are a resident of a third jurisdiction in earning that income from the provision of services.

180. Thirdly, the connected person resident of a third jurisdiction must be subject to a tax rate below 9% on the income they derive from those transactions. The tax rate applicable to that income is determined in accordance with paragraphs 5 and 6 of the STTR.

181. Finally, the services for which the consideration is received must be provided by the resident of the third jurisdiction to the person making the payment for the provision of services. For example, RCo, a resident of State R, derives income in consideration for the provision of services from SCo, a resident of State S that is connected to RCo. RCo incurs costs from a transaction with TCo, a resident of a third jurisdiction that is connected to RCo, in earning the consideration for provision of services derived from

SCo. This condition would be met if, under the arrangements, TCo provided some or all of the services directly to SCo.

182. This aspect of the provision (found at subdivision (ii)) also applies if the resident of the third jurisdiction enters into transactions with connected persons who are also subject to a tax rate below 9% and those persons provide services to the person paying the consideration for the provision of services. Following the example above, the conditions of subdivision (ii) would be met if TCo entered into transactions with XCo, a connected person resident of State X that is subject to a tax rate below 9% on the related income, and XCo provides some or all of the services to SCo.

183. If those conditions are met, the costs that result from transactions with the connected person that are included in the calculation of the mark-up on costs for the person deriving the income in consideration for the provision of services is limited to 80% of total costs. For this purpose, all costs incurred from transactions with connected persons that meet the conditions of subparagraph c) are aggregated. If the only costs incurred are from transactions with connected persons, then the 80% restriction applies solely by reference to those costs.

184. For example, RCo, a resident of State R, derives income in consideration for the provision of services of 160 from SCo, a resident of State S. In earning that income, RCo incurs total costs of 150. Of those costs, 60 arise from transactions with TCo1 and 70 arise from transactions with TCo2. TCo1 and TCo2 are residents of a third jurisdiction and are connected to RCo. The remaining 20 of costs arise from transactions with a third party. Before the application of subparagraph c), SCo has a mark-up on total costs of 6.67%. TCo1 and TCo2 are subject to a tax rate below 9% on the income they derive from the transactions with RCo. TCo1 and TCo2 provide the services directly to SCo. As a result, RCo's connected party costs are capped at 80% of total costs, meaning that they are restricted to 120. As the costs incurred from the transactions with TCo1 and TCo2 are more than that amount (they are 130), the mark-up for the purpose of paragraph 9 must be calculated using 140 (120 connected party costs + 20 third party) of costs. The mark-up is therefore 14%, which exceeds the mark-up threshold in paragraph 9.

185. The connected party costs that are subject to limitation in accordance with subparagraph c) are only those paid to a connected person that is subject to a tax rate below 9%. For example, RCo, a resident of State R, derives income in consideration for the provision of services of 160 from SCo, a resident of State S. In earning that income, RCo incurs total costs of 150. Of those costs, 60 arise from transactions with TCo1 and 70 arise from transactions with TCo2. TCo1 and TCo2 are residents of a third jurisdiction and are connected to RCo. The remaining 20 of costs arise from transactions with a third party. Before the application of subparagraph c), SCo has a mark-up on total costs of 6.67%. TCo1 is subject to a tax rate below 9% on the income it derives from the transactions with RCo. TCo2 is subject to a tax rate above 9% on the income it derives from the transactions with RCo. TCo1 and TCo2 provide the services directly to SCo. Costs incurred from RCo's transactions with TCo1 are capped at 80% of total costs, meaning that they are restricted to 120. As the costs incurred from the transactions with TCo1 are less than that amount (they are 60), the mark-up for the purpose of paragraph 9 will not be affected by subparagraph c) and will remain 6.67%.

186. In circumstances where subparagraph b) applies and a person derives more than one category of covered income, including services, any costs that meet the conditions of subparagraph c) will need to be identified and subparagraph c) applied to those costs accordingly. Any reasonable approach may be used for this purpose.

187. Paragraph 9 does not apply where the item of covered income is an original or related payment that meets the conditions provided in paragraph 11 of the STTR provision (targeted anti-avoidance rule). This approach is justified by practical considerations.

188. First, subparagraph b) of paragraph 11 provides that the recipient of the original payment pays, directly or indirectly, an amount equal to all, or substantially all, of the original payment, in the form of

payments (“related payments”) to another person. It follows that the original payment is likely to produce a mark-up on costs below the threshold of 8.5% in the hands of the person deriving the income. Second, if the mark-up threshold applied to a related payment it could be difficult for the source States to assess the return made in the hands of the connected payee. In each circumstance, it would be inappropriate for the mark-up threshold to prevent application of the targeted anti-avoidance rule.

189. In addition to the anti-avoidance rule in paragraph 11, other provisions may be relevant to paragraph 9 and ensure its appropriate application. This may be particularly relevant in circumstances whereby costs used in the return on an item of covered income are incurred in transactions with associated enterprises.

190. For example, those costs will be determined in accordance with transfer pricing principles. Arrangements that seek to inappropriately seek to take advantage of paragraph 9 may result in the benefits available under a tax treaty being restricted in accordance with a provision such as Article 29(1) of the OECD Model. Further, the principal purposes test (found at Article 29(9) of the OECD Model) may also apply where obtaining the benefit of paragraph 9 was one of the principal purposes of such an arrangement or transaction and granting of that benefit was not in accordance with the object and purpose of the tax treaty.

10. Connected persons

191. Paragraph 10 defines what is meant by a connected person for the purposes of the STTR. This provision is based on Article 5(8) of the OECD Model Tax Convention. Connection is established by virtue of a control relationship. The first part of the provision sets out the primary rule, which is a de facto control test based on all the relevant facts and circumstances. This is supplemented by a deeming rule, providing that a connection exists where there is a direct or indirect participation of more than 50 per cent. Paragraphs 119 to 121 of the Commentary on Article 5 are relevant to the interpretation of this provision.

192. Paragraph 10 uses the term “connected”, rather than the term “closely related” as found in Article 5(8). The term “connected persons” is also defined in Article 29(6)/(7)(d) for the purposes of the simplified and detailed versions of the limitation on benefits (LOB) provision, but for those purposes the participation threshold is “at least 50 per cent”. To avoid confusion, Contracting States concluding a convention that includes an LOB provision based on Article 29 of the Convention are free to substitute, or apply for the purposes of the STTR, the definition in Article 29(6)/(7)(d).

11. Connected persons – targeted anti-avoidance rule

193. Both the de facto control test in paragraph 10 and purpose based anti-treaty abuse rules such as the principal purposes test in Article 29(9) offer effective remedies against arrangements designed to circumvent the STTR. Mechanical rules, such as the limitation on benefits provisions found at paragraphs 1 to 7 of Article 29, when combined with appropriate anti-conduit rules, also provide effective protection against such arrangements. Paragraph 11 sets out a further mechanical anti-avoidance rule that targets particular abuses, such as the use of back-to-back payment arrangements, designed to sever a connection between the payer and connected payee, or interpose a connected person that is subject to a tax rate above 9%, in order to escape the application of the STTR. Member States of the European Union may want to co-ordinate the scope of paragraph 11 with legal obligations applicable to that membership.

194. Paragraph 11 targets two broad types of abuse. The first is the interposition of an unconnected person between two connected persons, in order to present a flow of covered income as a series of payments each of which is made between unconnected persons and obtain the benefit of the exclusion in subparagraph b) of paragraph 8. The second is routing a payment of covered income through a high-tax

connected person and on to a low-tax connected person, in order to avoid triggering the rate test in paragraph 1. In each of these cases the covered income is paid through an intermediary, which in accordance with subparagraph a) of paragraph 11 must be a resident of either Contracting State. Where the intermediary is a resident of the other Contracting State, paragraph 11 is only relevant if the income is derived by the intermediary itself (for example, in the case of royalties, that it is the beneficial owner of those royalties). This is because the STTR operates to restrict benefits under the Convention that are only available to the person that derives the income (see paragraph 1 of the STTR and the associated commentary). If the income does not belong to the intermediary, no benefits are available under the Convention to which the STTR (including paragraph 11) could apply. Where the intermediary is in the same Contracting State as the person making the payment of covered income, the intermediary is not claiming benefits under the Convention and the requirement that the income is derived by a person will apply to the low-tax connected person to which the intermediary makes cross-border payments in respect of which benefits are sought under the Convention. Paragraphs 9 to 10.4 of the Commentary on Article 11 and paragraphs 3 to 4.6 of the Commentary on Article 12 discuss the meaning of beneficial owner in this context.

195. A series of cumulative conditions must be met before paragraph 11 will apply, each of which applies a factual test. These are discussed in turn below. Where paragraph 11 applies, the cross-border payment is deemed to be a payment to a connected person resident in the other Contracting State. Where the intermediary is a resident of the same State in which the item of covered income arises, the tax rate for the purposes of paragraphs 1, 2 and 5 is the tax rate to which the ultimate connected payee is subject in its State of residence. Where the intermediary is in the other Contracting State, tax rate for the purposes of paragraphs 1, 2 and 5 is the higher of the statutory rate of tax to which the connected payee is subject in the intermediary State and the tax rate in the State of which the connected payee is a resident.

196. Where the intermediary is in the other Contracting State, the cross-border payment will be the original payment of covered income; and where the intermediary is in the same Contracting State as the person making the original payment, the cross-border payment will be the related payments. Examples 1 to 6 in Annex A illustrate the operation and effect of paragraph 11. The commentary below also addresses the interaction between paragraph 11 and the principal purposes test in Article 29(9).

11.1. Conditions under which paragraph 11 applies

197. Paragraph 11 applies only where all of the conditions in subparagraphs a), b) and c) are met. These conditions apply a series of factual tests to identify arrangements, including back-to-back arrangements, designed to circumvent the application of the STTR by routing payments of covered income through an intermediary that is either an unconnected person or a connected person subject to a tax rate of 9% or higher to an ultimate recipient that is a connected person subject to a tax rate below 9%.

198. Subparagraph a) contains the condition that covered income arising in a Contracting State is paid by a person other than an individual to an intermediary that is a resident of either of the Contracting States. This payment of covered income is termed the “original payment”. The reference to “other than an individual” is required because, by virtue of the opening words of paragraph 8 of the provision, the STTR does not apply to payments of covered income made by individuals; but paragraph 8 applies for the purposes of the preceding provisions of the STTR (i.e. paragraphs 1 to 7). The combined effect of limiting the application of paragraph 8 to paragraphs 1 to 7 and including the limitation “other than by an individual” in paragraph 11 is that paragraph 11 will not apply where the original payment is made by an individual, but can apply where the intermediary is an individual (or any other category of excluded person). This produces the correct outcome.

199. This is because paragraph 11 is not restricted by paragraph 8 and a “person” acting as an intermediary as part of an arrangement within the scope of paragraph 11 could include an individual, or any of the categories of excluded persons referred to in paragraph 8. However, paragraph 11 does not

broaden the scope of application of the STTR beyond its intended application to payments of covered income between connected companies. Thus, if a payment of covered income is made via one or a series of transactions involving intermediate unconnected persons to, for example, a recognised pension fund within subparagraph c) of paragraph 8, the STTR will not apply, because such a payment made directly to a recognised pension fund is outside the scope of paragraphs 1 and 2 by virtue of paragraph 8.

200. Under subparagraph a), the intermediary must be a resident of either Contracting State. The intermediary could therefore be a resident of the same State as the person making the original payment (State S), or a resident of the other Contracting State (State R). If the intermediary is a resident of a third State (State T), paragraph 11 of an STTR included in the S-R treaty will not apply. Recourse would instead need to be made to an equivalent provision in the S-T treaty (the interaction with the principal purposes test in Article 29(9) is discussed separately in section 10.3 below). This condition therefore governs the operation of paragraph 11 in triangular cases and makes clear which treaty applies. States including paragraph 11 in their treaties may wish to do so consistently to ensure that paragraph 11 offers an effective remedy against the arrangements it is designed to address.

201. Subparagraph b) applies a series of factual tests to the intermediary to which the original payment is made. Under subparagraph b), the intermediary must, during a period of 365 days that includes the day the original payment was made, directly or indirectly make payments equal to all or substantially all of the amount of the original payment that meet all of the additional requirements in subdivisions (i), (ii) and (iii). These payments are termed “related payments”. The related payments will be made directly if they are made by the intermediary without the interposition of other intermediaries, and indirectly if other intermediaries (wherever resident) are interposed resulting in a cascading chain of payments. The requirement that the related payments must be made during a 365 day period that includes the day of the original payment means that some or all of the related payments could be made before the original payment is received, but subparagraph c) imposes an additional requirement in respect of the relationship between the original payment and related payments which is discussed below. These tests do not prejudice the question of whether a recipient of income is the beneficial owner of that income according to the principles set out in paragraphs 9 to 10.4 of the Commentary on Article 11 and paragraphs 3 to 4.6 of the Commentary on Article 12 (the condition under those Articles being that relief is due only to the beneficial owner).

202. The related payments must equate by value to “all or substantially all” of the original payment. As an administrative rule of thumb, “all or substantially all” generally means 90 per cent. But the application of this test is not formulaic; all of the facts and circumstances must be examined to determine if the “all or substantially all” test has been met. There may be situations where the “all or substantially all” test can be met even though the related payments are less than 90 per cent of the original payment. But the further away from 90 per cent the related payments are, the less likely the “all or substantially all” test will be met.

203. The related payments must meet all of the three additional requirements in subdivisions (i) to (iii) of subparagraph b). Subdivision (i) requires that the intermediary makes the related payments to a person or persons, other than an excluded person within paragraph 8, that is connected to the person making the original payment within the meaning of paragraph 11. The connected person or persons receiving the related payments is termed the “connected payee”. This requirement identifies arrangements, such as back-to-back arrangements, under which covered income is routed from one connected person to another connected person or persons that is not an excluded person (and therefore to which the STTR would *prima facie* apply, but for the interposition of the intermediary). The reference to “or persons” is designed to counteract so-called fragmentation arrangements under which the related payments are split between more than one connected payee. Where the related payments are fragmented in this way, the aggregate payments to the two or more connected payees must meet both the “all or substantially all” requirement and the “causal link” condition in subparagraph c). Subdivision (i) does not stipulate that the connected payee must be a resident of one of the Contracting States, and it may be a resident of a third State.

204. Subdivision (ii) applies a tax rate test. It requires a calculation of the tax rate that the connected payee is subject to in its State of residence and the statutory rate of tax which it is subject to in the intermediary State. This requirement focuses the application of paragraph 11 on arrangements that result in a rate of tax below 9% in the hands of the ultimate connected payee and mirrors the triggering rule in paragraph 1 of the STTR provision. The terms “tax rate” and “statutory tax rate” take their meaning from paragraphs 5 and 6. The statutory tax rate in the intermediary State is that which applies to the related payments in the hands of the connected payee; it does not consider the tax rate to which the intermediary is subjected. The tax rate is adjusted to reflect any reduction in that rate by virtue of a double taxation agreement. For example, if the statutory tax rate applicable to the related payments in the intermediary State is 20%, but a double taxation agreement between the intermediary State and the State of which the connected payee is a resident limits that rate to 5%, the statutory rate to which the connected payee is subject in the intermediary State for the purposes of subdivision (ii) would be 5%. Subdivision (ii) applies if both the rates to which the connected payee is subject (in the intermediary State and that of which it is a resident) are below 9%.

205. Subdivision (iii) applies a base-erosion test to the intermediary. This test is only relevant where the original payment is taxed in the Contracting State where the intermediary is resident. Thus, this test does not need to be met in cases where the original payment is not considered as taxable income in that State; it is not then necessary to test whether the intermediary is entitled to a deduction for the related payment. An intermediary that is generally exempt from income tax in its State of residence, such as a recognised pension fund, would therefore meet the base-erosion test. The requirement in subdivision (iii) is met where the intermediary includes the original payment in its taxable income and is entitled to a deduction for tax purposes for the related payments. This requirement identifies arrangements under which all or substantially all of the original payment is excluded from the tax base in the intermediary’s State of residence. Subdivision (iii), however, ensures that paragraph 11 will not apply where the original payment is included in the tax base in the intermediary’s State of residence. Such an outcome is an indicator that the intermediary is not being used as a vehicle for avoiding the application of the STTR.

206. Subparagraph c) applies a nexus test to the original payment and related payments and requires a causal link between the two. The condition is met where it is reasonable to conclude that the related payments would not have been made in the absence of the original payment. This does not impose a requirement that the related payments must be made after and out of the original payment, but applies a factual test to the conditions under which the related payments are made. Where, for example, an unconnected intermediary (“UI”) in State R enters into an agreement with a company in State S, under which UI will rent an asset and make leasing payments to another company in State R that is connected to the company in State S, on condition that the company in State S will, during the same term, rent and make leasing payments to UI in respect of the same asset, and the leasing payments that UI is obliged to make to the company in State R amount to all or substantially all of the leasing payments it will receive from the company in State S, it is reasonable to conclude that the requisite causal link is present. It does not matter whether UI makes the leasing payments to the company in State R before or after it is entitled to receive the leasing payments from the company in State S, provided the obligation to make the payments to the company in State R arises within a 365 day period that includes the day of the original payment. Where, however, an unconnected company (“UC”) in State R contracts to lease an asset that it owns to a company in State S and, under a separate contract that is not dependent upon the conclusion of the first, UC rents from another company in State R that is connected to the company in State S a different asset that is owned by the company in State R and that UC uses in its business, it would not be reasonable to conclude that the requisite causal link is present. Another example of where the condition in subparagraph c) would not apply is where an UI acts as a cash pooling centre for the benefit of various clients, including companies that may belong to the same group. As part of the cash pooling activity UI may both pay and receive interest from connected entities depending on their debit or credit cash positions. However, in the absence of other facts and circumstances showing otherwise, it would not be reasonable to conclude that the payment of interest from UI to a creditor is caused by the payment made by an entity

that is a debtor to UI. This is because UI in this example acts as an independent entrepreneur and the debit and credit positions of related entities are likely to change regularly, as the members of the cash pooling arrangement could be debtors or creditors over time.

207. Subparagraph c) applies an objective test, requiring an assessment of the facts to determine whether they lead to a reasonable conclusion that the necessary causal link exists between the original and related payments. It is a neutral provision, containing no directives imposing a burden of proof on a tax administration or taxpayer; the test must simply be applied.

11.2. Operation and effect of paragraph 11

208. Where all of the cumulative requirements in subparagraphs a), b) and c) of paragraph 11 are met, the effect of paragraph 11 is to apply two parallel provisions. The first is to treat the cross-border original or related payments made by a resident of the State in which the covered income arises to a resident of the other Contracting State as payments of covered income made to a connected person resident in that other Contracting State. This treatment is for the purposes of the application of the STTR only and does not extend to or affect the operation of other provisions of the Convention.

209. The second, found in subparagraphs d) and e), is to determine the tax rate for the purposes of paragraphs 1, 2 and 5 of the STTR provision. Subparagraph d) provides that where the original payment is made to an intermediary that is a resident of the other Contracting State, the tax rate for the purposes of paragraphs 1, 2 and 5 is the higher of the tax rate in the Contracting State of which the connected payee is a resident and the statutory rate of tax to which the connected payee is subjected in the intermediary State. Subparagraph e) applies where the original payment is made to an intermediary that is a resident of the Contracting State in which the item of covered income arises and provides that in such circumstances the tax rate for the purposes of paragraphs 1, 2 and 5 of the STTR is the tax rate to which the connected payee is subject in respect of the related payments in its State of residence.

210. Together, these parallel provisions ensure that the other provisions of the STTR can then apply to the avoidance arrangement in line with its true character and effect. A payment to an unconnected person that meets the conditions in subparagraphs a) to c) and is passed on to a low-tax connected person is treated as if it were a payment to a connected person resident in the other Contracting State, and a payment to a high-tax connected person that meets the conditions in subparagraphs a) to c) and is passed on to a low-tax connected person is treated as a payment to a low-tax connected person resident in the other Contracting State. The treatment does not, however, change the identity of the recipient of the original payment (or, where the intermediary is also a resident of the source State, the related payments); it simply treats that recipient as a connected person resident in the other Contracting State. For example, where SCo (resident in State S) makes an original payment to UI, an unconnected intermediary resident in State R, and UI makes related payments to TCo (resident in State T and connected to SCo), and the conditions in subparagraphs a) to c) are met, paragraph 11 treats the original payment from SCo to UI as a payment to a connected person resident in State R for the purposes of applying the STTR in the S-R treaty. The same result would be produced if TCo were a resident of State R. The payment to which the STTR applies remains the original payment from SCo to UI, which is the payment subject to the S-R treaty because it is sourced in State S and paid to a resident of State R.

211. In all cases, the tax rate, as defined in paragraph 5, that is applied for the purposes of paragraphs 1 and 2 will produce the right result under paragraphs 1 and 2, because it takes into consideration the tax which the connected payee is subjected to on the covered income originating in State S, whether that be the intermediary State or the State of which the connected payee is a resident. The STTR will apply if the covered income is subject to a tax rate below 9% in both the connected payee’s State of residence and the intermediary State.

212. The first provision applies either to the original payment or to the related payments, depending upon the State of residence of the intermediary. This is because the intermediary can be a resident of either the Contracting State in which the person making the original payment is resident, or of the other Contracting State. In the first scenario, in which the person making the original payment and the intermediary are residents of the same State (the source State), the original payment will be made between two domestic entities. The effect of a provision treating the original payment as made to a connected person resident in the other Contracting State in this scenario is questionable, because that State (the source State) would be taxing a resident. It is not clear that such a treatment would be imported into the domestic law of that State at all, or that the domestic law of that State would facilitate the taxation of a purely domestic payment as if it were a cross-border payment. In this scenario, the effect of paragraph 11 is to treat the cross-border related payments made by the intermediary (and not the original payment) as payments of covered income made to a connected person in the other Contracting State. This is also consistent with the fact that any difference between the value of the original payment and the related payments would be included in the intermediary's income in its State of residence and liable to tax therein. It is therefore appropriate that the STTR applies only to the value of the cross-border related payments in this scenario. Where, however, the intermediary is a resident of the other Contracting State, the original payment will be a cross-border payment and it is appropriate that the STTR applies to that payment.

213. The application of paragraph 11 is illustrated by the examples in Annex A.

11.3. Interaction with the principal purposes test

214. Paragraph 9 of Article 29 contains a broad spectrum anti-abuse rule, commonly known as the principal purposes test, which denies a treaty benefit arising from a transaction or arrangement one of whose principal purposes was the obtaining of that benefit. It applies throughout the Convention to all possible types of transaction or arrangement. Virtually all States that were members of the Inclusive Framework on BEPS at the time of writing of this commentary have undertaken to include the principal purposes test in their treaties as part of their commitment to implementing the minimum standard on treaty shopping set out in the final report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.

215. There is therefore a large overlap between the principal purposes test and the rule in paragraph 11 given that paragraph 11 is chiefly aimed at arrangements that are designed to sidestep the STTR. Paragraph 11, however, does not contain a motive test; its operation is more mechanical, given that several objective criteria have to be fulfilled before it can apply, and the connecting factor between the payments asks whether it is reasonable to conclude that the intermediary would not have made the related payments in the absence of the original payment.

216. This means that there could be transactions that will not fall within paragraph 11 that would nevertheless meet the criteria of the principal purposes test. In these circumstances, the fact that paragraph 11 does not operate does not prejudice the application of the principal purposes test – i.e. the principal purposes test applies even though paragraph 11 does not. The same is also true of the provisions at paragraphs 1 to 7 of Article 29 (commonly referred to as the "limitation on benefits" provision); those provisions may apply to restrict treaty benefits even if paragraph 11 of the STTR does not apply.

217. One example of the interaction between paragraph 11 and the principal purposes test would be where transactions were put in place that did not trigger paragraph 11 because the related payment did not amount to substantially all of the original payment. It could still be the case, however, that one of the principal purposes of the transactions was to obtain the benefit of the Convention (in this case, for example, the protection of the connected persons exemption), and the principal purposes test would therefore apply to remove the protection of the connected persons exemption and thus restore the application of the STTR.

218. There will be other cases where paragraph 11 did apply to protect the STTR, but the arrangement that triggered it might also have had as one of its principal purposes the obtaining of a wider treaty benefit. For example, a conduit arrangement could be in place that took advantage of the fact that the treaty between the State of residence of the person making the original payment and the State of residence of the intermediary permitted no source State taxation of the payment other than pursuant to the STTR. In this case, the principal purposes test could apply such that that payment would be subject to source taxation at the full domestic rate. In other cases, the effects of applying paragraph 11 and the principal purposes test might be identical. In this case, the anti-conduit rule would have applied all the remedy that was required – i.e. the STTR would apply as intended, and there would be no need to invoke the principal purposes test.

219. Conversely, cases also exist where paragraph 11 would apply to arrangements that would not fall within the principal purposes test. This is because paragraph 11 operates in a largely mechanical fashion, without a motive test, and is consistent with the fact that the STTR can apply to transactions that are not an abuse of the Convention. Paragraph 11 should therefore not be applied with the principal purposes test in mind: it stands on its own.

220. In summary, there will be cases to which both rules apply and cases to which only one of them will apply. But each is applied on its own merits without regard to the other.

221. The paragraphs above have examined the interaction between the principal purposes test and paragraph 11. However, there is also an interaction between the principal purposes test and the STTR itself. The STTR can be viewed as an anti-abuse rule in its own right, so even where a Convention omits the rule in paragraph 11 there will be cases where the principal purposes test and the STTR can apply together. For example, a conduit arrangement where all the entities were related could trigger the STTR. But it could have had as one of its principal purposes the elimination of any source State tax on the transaction. In this case, the STTR would restore some source State taxation, but a subsequent application of the principal purposes test could in principle restore all of it – especially if the bilateral provision lacked the extension to the principal purposes test set out in paragraph 184 of the Commentary on Article 29.

222. States that consider that any cases of concern can be adequately dealt with through the application of the principal purposes test alone are free to omit the rule in paragraph 11 in their bilateral treaties. States that do not include the principal purposes test in their treaties but instead include detailed limitation on benefits provisions in combination with bespoke anti-conduit rules may also contemplate omitting paragraph 11. States will be cognisant that paragraphs 1 to 7 of Article 29 are designed to deal with certain cases of treaty shopping that contain certain features and therefore may not address the specific circumstances prevented by paragraph 11.

12. Materiality threshold

223. Paragraph 12 sets out a threshold test, below which the STTR will not apply.

224. The threshold considers the total amount of covered income that is:

a) paid by one or more residents of the Contracting State in which the income arises and that are connected to the person that is a resident of the other Contracting State and deriving the covered income (the "tested payee") and that is derived by the tested payee or one or more persons connected to the tested payee that are also residents of the other Contracting State; and

b) covered income that is borne by one or more permanent establishments situated in the Contracting State in which the income arises through which the tested payee, or persons that are connected to the tested payee, carry on business and that is derived by the tested payee or one or more persons connected to the tested payee that are also residents of the other Contracting State.

225. The place of residence of the enterprise with the permanent establishment is not relevant for this purpose, including if that person resides in a third State.

226. The total amount of such covered income in the fiscal year is considered for the purpose of paragraph 12. The STTR will only apply to an item of covered income if the total amount of covered income identified exceeds the materiality threshold.

227. Where the total value of amounts arising in that fiscal year do not exceed the materiality threshold, paragraphs 1 and 2 do not apply and the State in which the item of covered income arises will not be able to apply the STTR to that item of covered income. Where the total value exceeds the threshold, paragraphs 1 and 2 will apply and the State in which the item of covered income arises will be able to apply the STTR to an item of covered income that meets the tax rate condition in paragraph 1. Items of covered income meeting the tax rate condition in paragraph 1 include payments in respect of which the deeming rule in paragraph 11 substitutes the tax rate enjoyed by a connected payee subject to a tax rate below 9%.

228. For the purpose of determining whether the threshold in paragraph 12 is met, subparagraph c) provides that it does not matter whether the covered income is subject to a tax rate below the minimum rate in that other State; the threshold operates by reference to the total value of all payments of covered income arising in the fiscal year concerned.

229. Subparagraph d) provides that, for the purpose of aggregating the payments (and amounts borne) for the purpose of the materiality threshold, payments between persons that would otherwise be connected are not included if the sole reason those persons are connected is because of control by, or any beneficial interest (or, in the case of a company, the aggregate vote and value of the company's shares or beneficial equity interest) directly or indirectly possessed by, a person, entity or arrangement described in subparagraphs e) or i) of paragraph 8. For this purpose, the references in subparagraph i) are modified to limit to entities or arrangements that are wholly or almost wholly (directly or indirectly), or established or created, by one or more persons, entities, or arrangements described in subparagraph e).

230. Subparagraph d) would apply, for example, in circumstances whereby a sovereign wealth fund controls (according to the definition in paragraph 10) two sub-groups. Absent the fact that each sub-group is controlled by that sovereign wealth fund, those two sub-groups would not be connected. A sovereign wealth fund is akin to an investment company or an asset management company, wholly-owned by the government, that consolidates the government's investment activities. It is unlike the headquarters company of a conglomerate business. The result is that those functionally independent businesses do not have access to information to determine whether the materiality threshold is met. Following subparagraph d), payments between entities in those two sub-groups would not be included in the calculation of the materiality threshold.

231. In applying the test, all categories of covered income paid (or borne) by that taxpayer, or taxpayers, to connected persons in the other Contracting State are aggregated to arrive at the total value of such payments made during the period. Where paragraph 11 applies, the total value of payments of covered income made to connected persons in the other Contracting State will include payments made to unconnected persons but treated by paragraph 11 to have been made to a connected person in the other Contracting State.

232. The following example illustrates the application of paragraph 12. SCo1, a resident of State S, makes payments of covered income of 50,000 to RCo1 and 30,000 to RCo2. SCo2, also a resident of State S makes payments of covered income of 130,000 to RCo3. TCo, a resident of a third State, has a permanent establishment in State S that bears costs for covered income derived by RCo1 totalling 45,000. RCo1, RCo2 and RCo3 are all resident of State R. RCo3, the tested payee, is connected to SCo1, SCo2, RCo1, RCo2 and TCo. The statutory tax rate in State R is above the agreed minimum rate, but RCo3

benefits from a preferential adjustment that reduces the rate below the agreed minimum rate. The treaty between State S and State R includes the STTR with a materiality threshold following paragraph 12. The agreed threshold value is 250,000. The total value of covered income arising in State S and derived by persons connected to RCo3 is 255,000, meaning that the threshold is crossed and the STTR applies. State S can impose a tax at the specified rate to the payments of 130,000 made from SCo2 to RCo3 because these are the only amounts that are within the scope of paragraphs 1 and 2. If the only covered income arising in State S in that fiscal year that is derived by connected persons in State R were those made by SCo2 the materiality threshold would not have been crossed and the STTR would not apply to any of the items of covered income arising in State S.

233. For Contracting States with Gross Domestic Product equal to or greater than EUR 40 billion, the threshold for payments of covered income in a year should be set at EUR 1 million. For Contracting States with Gross Domestic Product of less than EUR 40 billion, the threshold should be EUR 250 000.

13. Application to permanent establishment in source State

234. Paragraph 13 mirrors the provisions in Articles 10(4), 11(4) and 12(3) of the OECD Model Tax Convention and relieves the State in which the covered income arises from the limitations under paragraphs 1 and 2 where the covered income forms part of the profits attributable to a permanent establishment that the person deriving the income has in that State. In those circumstances, the State in which the permanent establishment is situated is permitted to tax those profits in accordance with Article 7. The formulation of the rule for interest and royalties differs from that for other items of covered income because, while those other items may be attributable to a permanent establishment in accordance with Article 7(2), they may not be paid in respect of a right or property effectively connected with that permanent establishment.

235. An example of the second type of payment could be an insurance premium. This could be effectively connected with a permanent establishment which is a fixed place of business for the foreign insurer. In addition, some conventions contain a provision, based on paragraph 6 of Article 5 of the UN Model, which deems a non-resident insurance enterprise (but not a re-insurer) to have a permanent establishment in a State if, through the activities of a person present in that State, it collects premiums in that State or insures risks situated there. In doing that, the paragraph extends source State taxing rights to cases where the person's activities are not carried out through a fixed place of business. Paragraph 5 of Article 5 operates in a similar way (and not just for insurance premiums) and, where either paragraph applies, the STTR will likely not apply to all, or possibly any, of the income.

236. The point is that not all income received by or through that person is likely to be attributable to the PE (and hence be excluded from paragraphs 1 and 2 of the STTR by paragraph 13 of the STTR). Paragraph 13 only applies to income that is attributable to the permanent establishment in accordance with Article 7.

14. Administration

237. Paragraph 14 provides that the tax chargeable in accordance with the provisions of this Article in a Contracting State in respect of an item of covered income arising in that State and derived by a resident of the other Contracting State in a fiscal year shall be determined following the end of that fiscal year and shall not be levied by the first-mentioned State until it is so determined. It also provides that the competent authorities of the Contracting States may by mutual agreement settle the mode of application of the provisions contained in the STTR.

238. This paragraph ensures that the STTR is administered following an ex post annualised charge. The approach to the submission of a tax return containing relevant information and the collection of tax due under the STTR is important because applying some core components of the STTR requires information that commonly will not be available at the point a payment of covered income is made. These include: whether the mark-up threshold in paragraph 9 is met; whether covered income qualifies for a preferential adjustment for the purposes of the tax rate test; whether the value of payments of covered income exceeds for a relevant fiscal year the threshold in paragraph 12; and whether the STTR applies to a payment of covered income where the alternative provisions catering for taxes imposed on an alternative basis or at the point of a profit distribution apply.

239. The ex post annualised charge seeks to ensure that all information needed to determine whether the STTR applies to a payment is known before any tax is determined under the STTR. This approach seeks to prevent over-taxation and to limit the delays and challenges that can arise in securing refunds of tax collected in excess of the amount properly due under the STTR.

240. As provided in paragraph 14, the tax chargeable under the STTR for a fiscal year can only be determined following the end of that fiscal year and cannot be levied by the Contracting State in which an item of covered income arises prior to that determination. Therefore, the resident deriving that item of covered income shall not be subject to any taxation including tax collection on the basis of the STTR provision before the determination. This does not, however, affect the application of other provisions of the Convention that may apply to an item of covered income derived by a resident of a Contracting State entitled to benefits under the Convention. Those other provisions include provisions on business profits, interest, royalties or other income.

241. As explained in paragraph 109 of the OECD Model Commentary on Article 1, with respect to other provisions of the Convention, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law. A State can therefore automatically limit the tax that it levies in accordance with relevant provisions of the Convention or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule and as highlighted in the Commentary paragraph just cited, in order to ensure expeditious implementation of taxpayers' benefits under a treaty, the first approach is the highly preferable method and where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer.

242. With respect to tax chargeable under the STTR, a State that automatically limits the tax that it levies in accordance with other relevant provisions of the Convention (such as those applying to business profits, interest, royalties, and other income) would apply those limitations at the time a payment of covered income is made. That State would then only determine and levy any tax chargeable under the STTR for a fiscal year following the end of that fiscal year. A State that instead imposes tax under the provisions of its domestic law at the time a payment of covered income is made and subsequently refunds the part of that tax that exceeds the amount that it can levy under other relevant provisions of the Convention (such as those applying to business profits, interest, royalties, and other income) would, when benefits are claimed in accordance with the Convention before any tax chargeable under the STTR is determined, provide a refund on the basis of those other provisions and not at that point take into consideration the application of the STTR. That State would also then only determine and levy any tax chargeable under the STTR for a fiscal year following the end of that fiscal year.

243. Under both approaches, the ex post annualised charge ensures that the tax chargeable under the STTR for a fiscal year is only determined, and can only be levied, following the end of that fiscal year.

244. The ex post annualised charge operates by way of self-assessment and also seeks to limit compliance burdens by ensuring that a self-assessment of liability under the STTR is not required whenever there is a cross-border payment of covered income to a connected person. Instead, under the

ex post annualised charge approach, a resident of a Contracting State will only be required to submit a tax return in the other Contracting State where following the end of a fiscal year, it has a liability to tax under the STTR.

245. The competent authorities of the Contracting States may wish to supplement the ex post annualised charge approach with a certification system, under which a non-resident could in certain circumstances obtain a certificate confirming that it is not liable to tax under the STTR and does not need to submit a tax return. Such a certification system could ensure that the Contracting State of which a connected payer is a resident can access relevant information relating to a non-resident payee's potential liability under the STTR. For instance, the competent authorities of the Contracting States could agree that a resident of a Contracting State that derives covered income from a connected person resident in the other Contracting State could obtain a certificate in the first mentioned Contracting State to confirm that it is an excluded person under paragraph 8.

246. Similarly, the competent authorities of the Contracting States may want to agree that an STTR tax return is required in instances where the materiality threshold in paragraph 12 has been met for a fiscal year (regardless of whether tax would be due for that fiscal year under the STTR).

247. The competent authorities of the Contracting States that wish to supplement the ex post annualised charge with a certification system would discuss such a system as part of their agreement on the mode of application of the STTR (noting that in some Contracting States competent authorities are not permitted to enter into such agreements).

248. In that agreement, the competent authorities of the Contracting States could also refer to deadlines for filing the STTR tax return or for paying tax chargeable under the STTR. In some jurisdictions, such deadlines are to be provided for in their domestic law. In all cases, a taxpayer should only be required to file an STTR tax return following the end of its fiscal year. In addition, it is also expected that the tax chargeable under the STTR is to be paid in the Contracting State where the covered income arises following the end of the fiscal year, without undue delays.

15. Implications of this Article

249. The STTR was developed by the members of the IF as an integral part of the consensus solution on Pillar Two. Pillar Two consists of a set of rules that provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of taxation. Pillar Two consists of the Global Base Erosion rules, which are designed to ensure large multinational enterprises pay a minimum level of tax on the income arising in each jurisdiction where they operate, and the STTR. The STTR applies to intragroup payments that are subject to low nominal tax rates in the State of the payee.

250. The STTR was not developed to revisit the current allocation of taxing rights between source and residence States. Rather it is based on an understanding that where, under a tax treaty, a source State has ceded taxing rights on certain outbound payments, it should be able to recover some of those rights where the income in question is taxed (if at all) in the State of the payee (i.e. the residence State) at a rate below 9%.

251. Paragraph 15 sets out the context in which the STTR was developed and codifies the understanding that the STTR does not revisit the current allocation of taxing rights between Contracting States.

252. Subparagraph a) sets out this context by providing that the STTR is included in the Convention as part of the implementation of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.

253. Subparagraph b) confirms that the STTR does not otherwise reflect the tax treaty policies of either Contracting State. This confirms that the inclusion of the STTR in a treaty does not indicate that the Contracting States believe there should be any change to the principles reflected in that treaty, including to the allocation of taxing rights. It also means that, for example, no inference should be drawn from the mark-up threshold in paragraph 9 and that a return on cost of below 8.5% should not be considered as a benchmark for any other purpose, including the application of Article 9.

254. Subparagraph c) provides that the STTR is without prejudice to subsequent modifications to the Convention (or any other Convention concluded by either of the Contracting States). This confirms that the inclusion of the STTR in a tax treaty does not prejudice the position of a Contracting State in the negotiation of future tax treaties. This includes the allocation of taxing rights in those tax treaties.

255. This means that the inclusion of the STTR in an existing treaty shall not be interpreted as an indication that the relevant Contracting State has changed its approach to the allocation of taxing rights in its tax treaties, nor that it has accepted that principles within the STTR have an application beyond the specific circumstances in which the STTR is intended to apply.

256. This also confirms that the approach taken in the STTR also carries no implications for the allocation of taxing rights or any principles contained in the OECD Model Tax Convention on Income and on Capital. For example, the STTR does not affect the taxation of services. The OECD Model Tax Convention provides that services are taxed in accordance with Article 7 and the approach to the taxation of services is described at paragraphs 132-169 of the Commentary to Article 5.

257. Where both Contracting States agree, paragraph 15 may be omitted.

11 Elimination of Double Taxation

Article 23 A

5. The provisions of paragraph 1 shall not apply to income derived by a resident of a Contracting State which may be taxed in the other Contracting State only in accordance with the provisions of Article [STTR].

6. The provisions of paragraph 2 shall not apply to tax paid by a resident of a Contracting State in the other Contracting State in accordance with the provisions of Article [STTR].

Article 23 B

3. The provisions of paragraph 1 shall not apply to tax paid by a resident of a Contracting State in the other Contracting State in accordance with the provisions of Article [STTR].

1. Introduction

1. The STTR restores to the source State a limited taxing right, or in some cases supplements an existing limited taxing right retained by the source State, and operates as a derogation from the other provisions of the Convention that would otherwise restrict the source State's right to tax. This creates an interaction between the STTR and the elimination of double taxation provisions contained in tax treaties.

2. For example, under paragraph 1 of Article 23 A of the OECD Model, the residence State is obliged to exempt an item of income where the source State is permitted to tax that item of income in accordance with the treaty. Where the conditions are met for the STTR to apply, the source State will be permitted, in accordance with the treaty, to apply additional tax and the residence State will then be obliged under the provisions of the elimination article to exempt that income from tax. Even where that obligation is not taken into account for the purposes of determining the adjusted nominal rate, and therefore does not increase the additional tax that can be applied in the source State, the residence State will nevertheless be deprived of its taxing right. The result of this will be that only the source State will tax the affected payment; and only at the specified rate.

3. Similar considerations arise where the residence State is obliged to provide a credit under paragraph 1 of Article 23 B or paragraph 2 of Article 23 A of the OECD Model. Even though that credit is not taken into account in computing the adjusted nominal rate for the purposes of the STTR (according to subdivision (i) of subparagraph b) of paragraph 6), the residence State's taxing right is reduced by the credit it is obliged to give for the additional tax applied in the source State.

4. These considerations are relevant where the application of the STTR would result in a new or greater obligation being imposed on the residence State under provisions based on Article 23 A or 23 B.

5. As a general rule, the approach taken in this report preserves the position that would have applied before the STTR comes into play and makes adjustments to the operation of the treaty elimination provisions in respect of an additional obligation that would otherwise be imposed on the residence State as a result of the source State taxing covered income at the specified rate. This avoids an unintended reallocation of taxing rights away from the residence State.

6. This approach sets limits on the obligations imposed on the residence State under the elimination of double taxation provisions of treaties based on the Convention, but it does not govern or disturb other mechanisms that may apply outside the treaty to mitigate or eliminate double taxation. For example, a residence State may, under its domestic law, provide unilateral credit relief for the additional tax imposed as a result of the source State taxing covered income at the specified rate under the STTR, or it may provide relief for the tax paid to the source State by way of a deduction.

7. Neither does the approach taken in this report regulate or alter the treatment, for the purposes of applying the IIR and UTPR, of tax paid as a result of the operation of the STTR. Tax paid as a result of the operation of the STTR is, as a tax in lieu of generally applicable income tax, a covered tax for the purposes of the IIR and UTPR; and is allocated and accounted for in the ETR computation required under the GloBE rules.

8. Therefore, the only adjustments made to Articles 23 A and 23 B are to add a sentence that would disapply the exemption method in cases where it would not have applied in the absence of the STTR, and a sentence that would disallow a foreign tax credit for the tax paid under the STTR. These outcomes permit the source State to apply tax at the specified rate in accordance with the STTR, without this resulting in a reallocation of taxing rights away from the residence State that would arise solely as a result of the operation of the STTR. Given that the STTR only applies where covered income is subject to a rate of tax below 9% in the residence State, applied to a measure of net income, and that the STTR results in the source State being permitted to tax the gross amount of the covered income up to the specified rate, the residence State's capacity to provide additional relief may in many cases already be limited or exhausted.

2. Exemption method

9. The STTR only applies in situations where the tax rate in the State of residence is below the agreed minimum rate of 9% and, under the other provisions of the Convention, the covered income either cannot be taxed in the State of source, or that State's taxing right is limited to a rate below the specified rate (see paragraph 3 of the STTR). The modifications to Article 23 A are intended to preserve the position that would have applied before the operation of the STTR in both of these scenarios.

2.1. No original source taxation in accordance with the treaty

10. In the scenario where income cannot be taxed in the State of source in the absence of the STTR, there is no obligation on the residence State to provide exemption under Article 23 A. But where the STTR applies, the source State would be permitted to tax in accordance with the Convention, which would then give rise to an obligation on the residence State to exempt the whole of the income. This obligation arises solely because the STTR applies. A new provision is therefore needed to deactivate the application of the exemption method in this scenario, preserving the position before the application of the STTR. Obliging the residence State to provide an exemption in this scenario would result in that State losing any taxing right it would be exercising before the application of the STTR. This goes beyond the intended effect of the STTR, which is not to reallocate taxing rights but to permit the source State to apply tax capped at the specified rate to income subject to low nominal rates of tax in the residence State.

11. For example, a resident of a Contracting State derives income from the rental of movable property used in the other Contracting State, which is not attributable to a permanent establishment in that other

State. In this case, absent the STTR, the other Contracting State cannot tax such income in accordance with Article 7. The residence State (the first-mentioned State) would not therefore provide an exemption in accordance with Article 23 A, because the income cannot be taxed in the source State (the other State). Assume the treaty has an STTR and this income is covered income; if the STTR is triggered, the source State will have a taxing right in accordance with the Convention and, therefore, the residence State would be required to provide an exemption under Article 23 A. However, given that approach taken is to preserve the original outcome, then a special provision is needed to deactivate the exemption under paragraph 1 of Article 23 A.

12. Therefore, paragraph 5 of Article 23 A regulates the interaction between the STTR and the exemption method. Paragraph 5 deactivates the application of the exemption method under paragraph 1 where the source State can tax in accordance with the Convention only because the STTR applies. This ensures that, in the scenario outlined above, the original outcome (no exemption in the residence State) is preserved regardless of the application of the STTR.

2.2. Original limited source taxation in accordance with the treaty

13. Under the OECD Model Tax Convention the only items of income over which the source State has limited taxing rights are dividends and interest under Articles 10 and 11. The elimination of double taxation in respect of these items of income is not governed by paragraph 1 of Article 23 A, because that paragraph is subject to the provisions of paragraph 2. Under paragraph 2, the exemption method is disapplied and the credit method is substituted. The requirement under paragraph 2 of Article 23 A for the application of the credit method ("…which may be taxed in the other Contracting State in accordance with the provisions of Articles 10 and 11…") is therefore still met. It follows that no adjustments are needed to deal with this interaction and the credit method continues to apply with respect to these items of income. Paragraph 5 has no effect on this treatment, but paragraph 6 is brought into play, the effect of which is discussed under the credit method below.

14. However, the provisions of bilateral treaties may allow limited source taxation of other categories of income and may not include those categories in provisions based on paragraph 2 of Article 23 A. In that scenario, the residence State will have an obligation to provide exemption under paragraph 1 of Article 23 A, regardless of whether the STTR applies. In order to preserve this existing treatment, it is important that paragraph 5 does not disapply paragraph 1. This is achieved by the limitation in paragraph 5, which restricts its application to cases where the "only" reason the source State is permitted to tax in accordance with the Convention is that the STTR applies. Where there is a pre-existing source State taxing right under another provision of the Convention, this condition is not met and paragraph 5 has no effect. This preserves the position that would have applied before the STTR comes into play.

15. The principles outlined under both subheadings above can be illustrated by the following examples.

2.2.1. Example 1 – no original source State taxing right

16. SCo, a resident of State S, pays 100 of covered income to RCo, a company resident in State R. In State R, RCo benefits from a preferential adjustment in respect of the item of covered income that reduces the State R tax rate on the income to 4%. States S and R have a treaty which does not allow State S to tax the 100 of covered income, but includes the STTR with the agreed minimum rate of 9%. The 100 of covered income is within the scope of the STTR and the specified rate computed in accordance with paragraph 2 of the STTR is 5% (9% - 4%). The total tax that State S can apply in accordance with the S-R treaty is therefore 5 (5% on 100). The only reason that State S can tax in accordance with the treaty is that the STTR applies. Paragraph 5 of Article 23 A disapplies paragraph 1 and State R is not obliged to exempt the income.

2.2.2. Example 2 – limited original source State taxing right

17. The facts are the same as example 1, except that under the terms of the S-R treaty the article governing this item of covered income generally permits the source State to tax it at 2.5%. State R has adopted the exemption method in the S-R treaty and this category of covered income is not included in a provision based on paragraph 2 of Article 23 A. The 100 of covered income is within the scope of the STTR and the specified rate computed in accordance with paragraph 2 of the STTR is 5% (9% - 4%). Another article of the S-R treaty permits the 100 of covered income to be taxed at 2.5%. This is preserved by the second sentence of paragraph 3 of the STTR. State S is also permitted to apply tax at the specified rate, which the second sentence of paragraph 3 of the STTR reduces to 2.5% (5% - 2.5%). The total tax that State S can apply in accordance with the S-R treaty is 5 (2.5% + 2.5% on 100). If the STTR had not applied, State R would have exempted the whole 100 in accordance with paragraph 1 of Article 23 A. Although the STTR applies, it is not the “only” reason that State S can tax the covered income in accordance with the treaty. Paragraph 5 of Article 23 A does not therefore apply and State R will continue to exempt the income in accordance with paragraph 1 of Article 23 A.

3. Credit method

18. Paragraphs 6 of Article 23 A and 3 of Article 23 B deal with the interaction between the STTR and the credit method. The principle reflected in this paragraph is that no credit should be given in the residence State for the tax paid in the source State in accordance with the STTR. As with the exemption method, the approach taken preserves the position that would have applied before the STTR comes into play. Therefore, the residence State will continue to provide a deduction from tax as if the STTR was not applied.

19. The STTR supplements other provisions of the Convention that allow limited source taxation. Thus, these other provisions continue to apply as well as the provisions in Articles 23 A and 23 B, that require the residence State to provide a credit for the tax paid in the source State. This ensures that the outcome is not modified by the inclusion of a STTR.

20. Paragraph 6 of Article 23 A and paragraph 3 of Article 23 B disallow a credit for any additional tax paid in the source State in accordance with the STTR. This will preserve the position that would have been applied with respect to the credit method in the absence of an STTR.

21. For example, a resident of State S makes a payment of covered income of 100 to a company that is a resident of State R. The R-S treaty includes an article generally permitting the source State to tax this category of income at a rate of 2.5% and includes an STTR with the agreed minimum rate of 9%. State R has a tax rate of 4% in accordance with paragraphs 5 and 6 of the STTR. In the absence of an STTR, the tax paid in State S would have been 2.5. State R would have been required to give a credit of up to 2.5 against its own tax on the covered income.

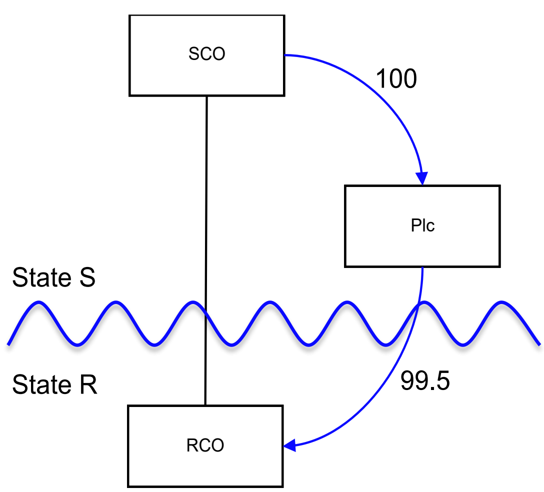
22. The specified rate in accordance with the STTR is 5% (9% - 4%). However, the tax paid under the STTR cannot exceed 2.5% (5% specified rate - 2.5% existing rate) in accordance with the second sentence of paragraph 3 of the STTR. In this case, State S would tax the interest payment at 5% (2.5% original source right + 2.5% under the STTR). State R would continue to provide a credit for the tax paid in State S with respect to the original 2.5%, but would not be required under the treaty to give a credit for the tax paid in State S with respect to the additional 2.5%, which is the outcome that would have obtained before the application of the STTR.

23. States providing unilateral relief by way of credit under their domestic taxation laws may wish to consider aligning the domestic law and treaty outcomes where the STTR applies.

Annex A. Operation of the targeted anti-avoidance rule

Example 1

1. States S and R have concluded a treaty that includes the STTR with the rule in paragraph 11. SCo (a resident of State S) enters into an arrangement with Plc (a bank, also resident in State S) under which SCo will make a payment of covered income of 100 to Plc and Plc is contractually obliged to make a payment of 99.5, on the first day of the calendar month following the day on which SCo makes the payment of 100, to RCo (a company that is connected to SCo within the meaning of paragraph 11 and a resident of State R, which applies a statutory tax rate below the agreed minimum rate to the covered income). Plc is not connected to either SCo or RCo. Plc includes the 100 in its income and is entitled to a deduction for the 99.5 in computing its taxable income in State S.

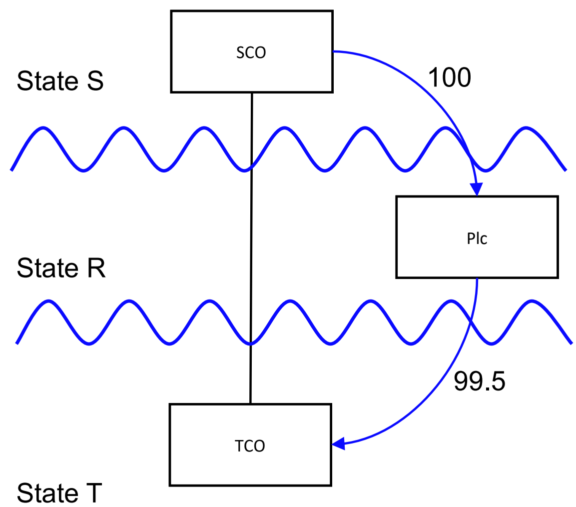


2. The condition in subparagraph a) is met because a payment of covered income arising in State S is made by a person other than an individual (SCo) to a resident of either Contracting State (Plc, a resident of State S). The payment of 100 is the "original payment" and Plc is the "intermediary". The condition in subparagraph b) is also met because, during a 365 day period including the day the original payment is made, Plc pays an amount (99.5, the "related payments") equal to all or substantially all of the original payment directly to (i) RCo, a person that is not an excluded person and is connected to SCo (RCo is the "connected payee"); and (ii) RCo is subject to a tax rate below 9% in respect of the related payments in State R; and (iii) Plc recognises the 100 as income but is entitled to deduct the 99.5 in computing its taxable income in State S, meeting the base-erosion test. The condition in subparagraph c) is also met because it is reasonable to conclude that under the terms of the arrangement between SCo and Plc there is the requisite causal link between the original and related payments.

3. The effect of paragraph 11 is to treat the related payments of 99.5 made by Plc to RCo, with which it is unconnected, as payments of covered income made to a connected person in State R. The tax rate for the purposes of applying the STTR is deemed to be the rate, computed in accordance with paragraph 5, to which RCo is subject in State R in respect of the related payments. The STTR now applies because the 99.5 is deemed to be a payment of covered income arising in State S and derived by a resident of State R that is subject to a tax rate below 9%. The requirements of paragraph 1 are met. The exclusion in paragraph 8 b) does not apply, because RCo is deemed to be connected to Plc for the purposes of applying the STTR.

Example 2

1. The facts are the same as in example 1, except that Plc is a resident of State R and the connected payee is TCo (a company that is connected to SCo and resident in State T, a third state). Under the arrangement, Plc will make a payment of 99.5 (the “related payments”) to TCo and SCo is contractually obliged, on the first day of the third calendar month following the date of that payment, to make a payment of covered income of 100 (the “original payment”) to Plc. TCo is subject to a tax rate, computed in accordance with paragraph 5, below 9% in State T in respect of the income of 99.5 it receives from Plc. In State R, Plc is exempt from tax in respect of the income of 100. TCo is not subject to tax in State R on the payment of 99.5 paid from Plc.

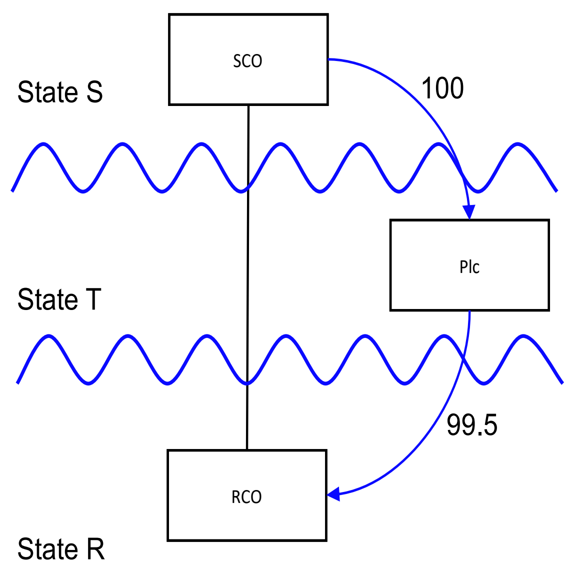


2. The condition in subparagraph a) is met for the same reasons as in example 1 (as a resident of State R, Plc is a resident of either Contracting State under the S-R treaty). The opening requirement in subparagraph b) is also met for the same reasons as in example 1 (it does not matter that the related payments precede the original payment, provided they are made in a 365 day period that includes the day of the original payment). The condition in subdivision (i) of subparagraph b) is met for the same reasons as in example 1 (that condition does not stipulate where the connected payee, TCo, is resident and applies where the connected payee is resident in a third state). The condition in subdivision (ii) of subparagraph b) is met for the same reasons as in example 1. The condition in subdivision (iii) of subparagraph b) does not need to be met because it only applies if the original payment is taxable in the State of the intermediary and, in this case, the payment received by Plc is not taxable in State R. The condition in subparagraph c) is met for the same reasons as in example 1.

3. The effect of paragraph 11 is to treat the original payment of 100 made by SCo to Plc with which it is unconnected, as a payment of covered income made to a connected person in State R. The tax rate for the purposes of applying the STTR is the rate, computed in accordance with paragraph 5, to which TCo is subject in State T in respect of the related payments of 99.5. The STTR now applies because the 100 is treated as a payment of covered income arising in State S and derived by a resident of State R that is subject to a tax rate below 9%. The requirements of paragraph 1 are met. The exclusion in subparagraph b) of paragraph 8 does not apply, because SCo is treated as connected to Plc for the purposes of applying the STTR.

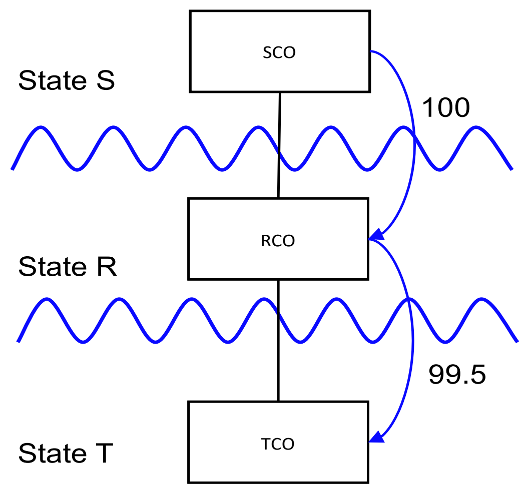
Example 3

1. The facts are the same as example 2, except that Plc is a resident of State T and the connected payee is RCo (a resident of State R and connected to SCo). Under an arrangement having the same features of the arrangement in example 2, SCo makes an original payment of 100 to Plc, which makes related payments of 99.5 to RCo. RCo is subject to a tax rate below 9% in State R in respect of the related payments. Paragraph 11 of the STTR in the S-R treaty does not apply, because the condition in subparagraph a) is not met. Plc is not a resident of either State S or State R. Paragraph 11 of an STTR included in the S-T treaty would, however, apply for the same reasons as in example 2.



Example 4.

1. The facts are the same as example 2, except that Plc is replaced by RCo (a resident of State R that is connected with both SCo and TCo). Under the arrangement, RCo will make a payment of 99.5 (the "related payments") to TCo, and SCo is contractually obliged, on the first day of the third calendar month following the date of that payment, to make a payment of covered income of 100 (the "original payment") to RCo. TCo is subject to a tax rate, computed in accordance with paragraph 5, below 9% in State T in respect of the income of 99.5 it receives from RCo. In State R, RCo is subject to a tax rate above 9% on its net income of 100. RCo includes the original payment of 100 in its taxable income and is entitled to a deduction for the related payments of 99.5.

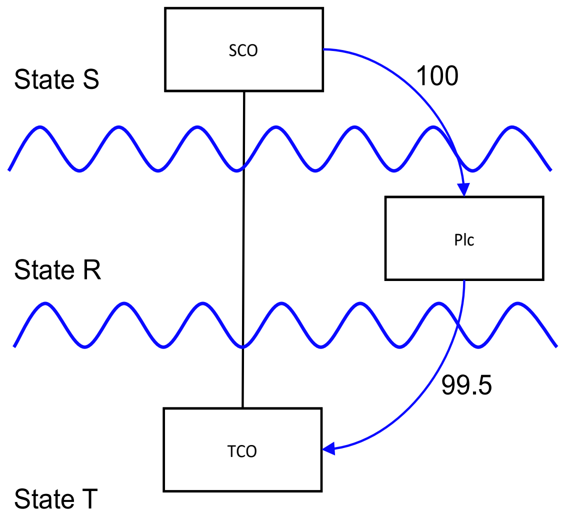


2. Although the original payment of 100 is made by SCo to RCo, a connected person resident in the other Contracting State, the condition in paragraph 1 is not met because RCo is not subject to a tax rate below 9%. Paragraph 11, however, addresses arrangements, such as back-to-back arrangements, designed to get around the rate test in paragraph 1 as well as arrangements designed to take advantage of the exclusion for unconnected persons. The conditions in subparagraphs a) and b) apply equally to intermediaries that are connected persons or unconnected persons and are met for the same reasons as in example 2. In particular, RCo, although resident in a high-tax State, pays away substantially all of the original payment in the form of deductible payments that meet the base-erosion test in subdivision (iii) of subparagraph b). The conditions in subdivisions (i) and (ii) of subparagraph b) are met because the connected payee, TCo, is connected to SCo (which makes the original payment) and is subject to a tax rate below 9% in State T in respect of the related payments. The condition in subparagraph c) is met for the same reasons as in example 2.

3. The effect of paragraph 11 is to treat the original payment of 100 made by SCo to RCo as a payment of covered income made to a connected person in State R and substitute the tax rate to which TCo is subject in State T in respect of the related payments of 99.5 for the purposes of the STTR. The STTR now applies because the 100 is treated as a payment of covered income arising in State S and derived by a resident of State R that is subject to a tax rate below 9%. The requirements of paragraph 1 are met.

Example 5

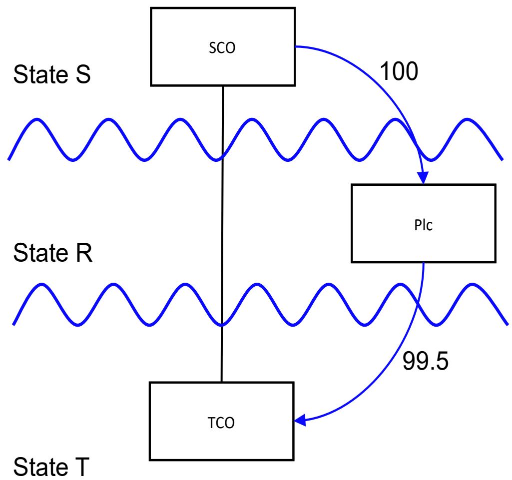
1. The facts are the same as in example 2. However, TCo is subject to a statutory rate of tax of 10% in State R on the payment of 99.5. TCo is also subject to a tax rate, computed in accordance with paragraph 5, of 5% in State T in respect of the income of 99.5 it receives from Plc.



The condition in subparagraph a) is met for the same reasons as in example 1 (as a resident of State R, Plc is a resident of either Contracting State under the S-R treaty). The opening requirement in subparagraph b) is also met for the same reasons as in example 1 (it does not matter that the related payments precede the original payment, provided they are made in a 365 day period that includes the day of the original payment). The condition in subdivision (i) of subparagraph b) is met for the same reasons as in example 1 (that condition does not stipulate where the connected payee, TCo, is resident and applies where the connected payee is resident in a third state). The condition in subdivision (ii) of subparagraph b) is not met. That is because the connected payee is subject to a statutory rate of tax in State R of 10% (which is higher than the tax rate in State T and therefore used for the purpose of subdivision (ii)). As a result, TCo is not subject to tax rate below 9% and paragraph 11 in the S-R treaty would not apply.

Example 6

1. The facts are the same as in example 5. However, TCo is subject to a statutory rate of tax of 2% in State R on the payment of 99.5. TCo is also subject to a tax rate, computed in accordance with paragraph 5, of 5% in State T in respect of the income of 99.5 it receives from Plc.



2. The condition in subparagraph a) is met for the same reasons as in example 1 (as a resident of State R, Plc is a resident of either Contracting State under the S-R treaty). The opening requirement in subparagraph b) is also met for the same reasons as in example 1 (it does not matter that the related payments precede the original payment, provided they are made in a 365 day period that includes the day of the original payment). The condition in subdivision (i) of subparagraph b) is met for the same reasons as in example 1 (that condition does not stipulate where the connected payee, TCo, is resident and applies where the connected payee is resident in a third state). The condition in subdivision (ii) of subparagraph b) is also met because the tax rate in State T is 2% and TCo is subject to tax on the related payment in State R at 5%, both of which are below 9%. As a result, paragraph 11 in the S-R treaty would apply and the tax rate for the purposes of paragraphs 1, 2 and 5 would be 5%, being the higher of the statutory rate of tax to which the connected payee is subject in State R, and the tax rate in State T.

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