Need for BEPS Inclusive Framework?

The need for the OECD's Inclusive Framework on BEPS stemmed from several key issues:

1. **Lost Tax Revenue:** Multinational corporations (MNEs) were exploiting loopholes and mismatches in international tax rules to shift profits to low-tax jurisdictions. This resulted in significant losses of tax revenue for governments, particularly developing countries that rely heavily on corporate income tax.
2. **Unfair Playing Field:** The ability of MNEs to minimize their tax burden through BEPS practices created an unfair advantage for them over domestic businesses that couldn't exploit the same loopholes. This hampered competition and stifled economic growth.
3. **Complexity and Uncertainty:** The inconsistencies and loopholes in international tax rules created a complex and uncertain environment for both governments and businesses. Companies faced difficulties complying with regulations, and governments struggled to effectively collect taxes.
4. **Erosion of Public Trust:** Public trust in tax systems eroded as citizens perceived that large corporations were not paying their fair share of taxes. This undermined government legitimacy and hampered efforts to raise public revenue for essential services.

The Inclusive Framework aimed to address these issues by establishing a more coherent and coordinated approach to international tax policy. By closing loopholes, promoting transparency, and setting minimum standards, the framework aimed to create a fairer and more efficient global tax system that benefits both governments and businesses.

What is the Inclusive Framework of BEPS?

Hence, the OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS) is a crucial initiative tackling tax avoidance by multinational enterprises (MNEs). Here's a breakdown of its key aspects:

Goal:

- To establish a level playing field for corporate taxation globally.
- The framework aims to prevent MNEs from exploiting loopholes and mismatches in tax rules between countries to minimize their tax burden (known as BEPS practices).

Structure:

- Launched in 2016, the Inclusive Framework is a collaborative effort involving over 140 countries and jurisdictions.
- This broad participation is what makes it "inclusive."

Key Actions:

- The framework delivers a comprehensive BEPS Package consisting of 15 Action Plans. These actions address various BEPS strategies and provide tools for governments to:

    - **Close loopholes:** The framework tackles gaps and inconsistencies in international tax rules that MNEs exploit.
    - **Improve transparency:** Increased transparency around MNEs' activities and profits in different countries helps ensure they pay taxes where they're due.
    - **Set minimum standards:** The framework establishes minimum standards for countries to follow regarding transfer pricing (pricing transactions between related companies) and other tax practices.
    - **Dispute resolution:** Mechanisms are included to help resolve tax disputes between countries.

Benefits:

- The Inclusive Framework aims to:
    - Increase government tax revenues lost due to BEPS.
    - Create a fairer and more stable tax environment for businesses.
    - Reduce the complexity of complying with international tax rules for MNEs.

Implementation:

- Countries within the Inclusive Framework commit to implementing the BEPS Package.
- The pace of implementation may vary depending on a country's development level.
- The framework also includes a peer review process to monitor countries' progress in implementing the BEPS Actions.

Recent Developments:

- A significant outcome of the Inclusive Framework was the agreement on a two-pillar solution to address the tax challenges arising from the digitalization of the economy. This solution includes:
    - Pillar One: Focuses on allocating taxing rights to market jurisdictions where MNEs engage with customers, even without a physical presence there.
    - Pillar Two: Introduces a global minimum corporate tax rate, along with the Subject-To-Tax Rule (STTR) we discussed earlier.

The OECD's Inclusive Framework is a significant step towards a more efficient and equitable global tax system. It continues to evolve and adapt to address new challenges in a constantly changing economic landscape.

<u>What is Pillar One ?</u>

Pillar One, part of the OECD's Inclusive Framework on BEPS, tackles how profits are taxed in the digital age. Here's a breakdown of its key aspects:

Goal:

- To ensure that a fair share of profits earned from digital activities is taxed in the market jurisdictions where the value is created, even if the company doesn't have a physical presence there.

Focus:

- Pillar One applies to large Multinational Enterprises (MNEs) that meet a certain threshold of profitability from in-scope activities.

Two Components:

Pillar One is comprised of two main parts:

1. **Amount A:** This re-allocates a portion of the taxable profits of these MNEs to market jurisdictions based on a formula that considers factors like sales and user participation in those markets. This ensures a share of the tax pie goes to countries where value is generated through digital interactions with users, even without a physical presence.
2. **Unified Approach:** This aims to establish a single set of rules for taxing the in-scope digital activities of MNEs. This reduces complexity and disputes by eliminating the patchwork of different national tax regulations for digital businesses.

Benefits:

- Pillar One aims to:
    - Increase tax revenues for governments, particularly those in developing countries with large digital economies.
    - Create a fairer tax system by ensuring MNEs pay taxes where they're due, regardless of physical presence.
    - Reduce tax disputes and create more certainty for businesses operating internationally.

Challenges and Current Status:

- Implementing Pillar One effectively requires international cooperation and agreement on the details of the formula for allocating profits and the unified approach. While there's been significant progress, negotiations are ongoing.
- Some complexities remain in defining exactly which businesses fall under Pillar One and how to determine the amount of profit to be reallocated.

Overall, Pillar One represents a significant step towards a more equitable and efficient system for taxing profits from the digitalized economy.

Current Status of Pillar One

Pillar One of the OECD's Inclusive Framework on BEPS **has not been fully implemented yet** as of March 25, 2024.

There has been significant progress on the framework, but some key steps are still needed:

- **Multilateral Convention:** A key component is the Multilateral Convention (MLC) for Amount A, which facilitates coordinated implementation across jurisdictions. The text of the MLC was released in October 2023, but it's not yet open for signatures by countries.
- **Agreement on Details:** While there's broad agreement on the concept, some details regarding the allocation formula and unified approach are still under negotiation.

Here's a timeline of some key developments:

- **July 2023:** OECD released a consultation document on Amount B of Pillar One.
- **October 2023:** The text of the MLC for Amount A was approved for publication.
- **December 2023:** An agreed Administrative Guidance for the Pillar Two GloBE Rules was reached.

Expected Implementation:

- The original intention was for the MLC to be open for signature by the end of 2023 and enter into force in 2025. However, due to ongoing negotiations on a few specific details, this timeline may be delayed.
- Some sources suggest a revised target of end of 2024 for a sufficient number of jurisdictions to sign the MLC, allowing for potential implementation in 2026 or later.

Overall, while Pillar One is not yet implemented, significant groundwork has been laid. The coming months will be crucial in finalizing the details and securing widespread adoption by countries.

<u>What is Pillar Two?</u>

Pillar Two, also known as the **Global Minimum Tax**, is the other key component of the OECD's Inclusive Framework on BEPS that works alongside Pillar One. Here's a breakdown of its main aspects:

Goal:

- To ensure that Multinational Enterprises (MNEs) pay a minimum level of corporate tax on their profits in each country or territory they operate in. This aims to prevent tax avoidance strategies like shifting profits to low-tax jurisdictions.

Mechanism:

- Pillar Two introduces a **global minimum tax rate**, currently set at **15%**.
- It uses two main mechanisms to achieve this:

    - **Income Inclusion Rule (IIR):** This rule allows a parent company's country of residence to "top-up" taxes if a subsidiary in another country pays a lower effective tax rate than the minimum.
    - **Undertaxed Profits Rule (UTPR):** This rule empowers the country where the MNE operates to impose a tax on any profits that fall below the minimum rate.

Impact:

- Pillar Two aims to:
    - Discourage MNEs from shifting profits to low-tax jurisdictions to minimize their tax burden.
    - Create a more level playing field for businesses by ensuring everyone pays at least a minimum tax rate.
    - Increase tax revenue for governments, particularly developing countries that may lose out due to profit shifting.

Implementation:

- Similar to Pillar One, Pillar Two is still under implementation.
- Many countries are working on incorporating the necessary rules into their domestic tax laws.
- The agreed timeline for implementation varies depending on the jurisdiction, with some aiming for 2024 and others for 2025.

Challenges:

- Challenges remain in ensuring consistent implementation across different countries.
- There are also complexities in defining exactly which MNEs are subject to the rules and how to handle specific situations.

Overall, Pillar Two represents a significant step towards a more balanced and fair global tax system by setting a minimum threshold for corporate taxation.

STTR vs Pillar Two

Here's a breakdown of the key differences between STTR and Pillar Two, although they both work together within the OECD's Inclusive Framework on BEPS:

Focus:

- **Pillar Two:** Sets a **global minimum tax rate** (currently 15%) for Multinational Enterprises (MNEs). It uses the **Income Inclusion Rule (IIR)** and **Undertaxed Profits Rule (UTPR)** to achieve this.

- **STTR (Subject-To-Tax Rule):** Focuses on specific situations where an MNE makes a payment to a subsidiary in a **low-tax jurisdiction**. It allows the source country (where the profits are earned) to impose an additional tax if the tax rate in the payee country falls below the minimum rate.

Mechanism:

- **Pillar Two:** Primarily relies on **domestic tax law changes** within each country. The IIR allows the residence country of the MNE to "top-up" taxes on low-taxed subsidiaries, while the UTPR empowers the source country to tax profits below the minimum rate.
- **STTR:** Is a **treaty-based rule**. It requires amendments to existing tax treaties between countries to incorporate the STTR provision.

Implementation:

- **Pillar Two:** Countries are working on incorporating the necessary rules into their domestic tax laws. The timeline for implementation varies by jurisdiction.
- **STTR:** Requires individual countries to negotiate and adopt the STTR provision in their tax treaties with other countries. This can be a slower process compared to domestic law changes.

Benefits:

- **Pillar Two:** Creates a more **level playing field** for businesses by ensuring everyone pays at least a minimum tax rate. It also increases overall tax revenue for governments.
- **STTR:** Particularly benefits **developing countries** that may not have the resources for the IIR. It allows them to directly recoup tax revenue lost due to profit shifting to low-tax havens.

Here's an analogy:

Think of a company (MNE) operating in two countries (A and B).

- **Pillar Two** is like a universal law requiring all companies to pay at least a minimum wage (tax rate) to their employees (profits) regardless of location.
- **STTR** is like a special agreement between countries A and B. If the company pays its employees in country B a wage below the minimum, country A can directly withhold some additional funds (tax) to make up the difference.

Overall, both STTR and Pillar Two are crucial for a fairer global tax system. Pillar Two establishes the minimum tax rate, while STTR provides a specific tool for source countries to address profit shifting to low-tax jurisdictions.

The Subject-To-Tax Rule (STTR) is **an integral part of Pillar Two** of the OECD's Inclusive Framework on BEPS. Here's how they connect:

- **Shared Goal:** Both STTR and Pillar Two aim to address the issue of profit shifting by multinational corporations (MNEs) to avoid paying taxes in countries where they operate.

- **Complementary Mechanisms:** While Pillar Two uses the **Income Inclusion Rule (IIR)** and **Undertaxed Profits Rule (UTPR)** to achieve a minimum tax rate, STTR focuses on a **treaty-based approach**.
- **STTR in Action:**
  - STTR applies in situations where an MNE makes a payment to a subsidiary in a low-tax jurisdiction (payee country).
  - If the tax rate in the payee country falls below the minimum rate (currently 15%), the source country where the profits are earned can impose an additional tax under STTR.
- **Benefits of STTR:**
  - STTR is particularly relevant for **developing countries** that may not have the resources or legal framework to implement the IIR effectively.
  - It allows them to directly recoup tax revenue lost due to profit shifting to low-tax havens.

Here's an analogy to understand the connection:

Imagine a bakery (MNE) selling bread in two countries (source and payee country). Pillar Two, with the IIR and UTPR, is like a national law that ensures all bakeries pay at least a minimum price for flour (profits) regardless of location. STTR is like a special agreement between the two countries allowing the source country to directly charge an extra fee if the bakery buys flour from a low-cost supplier in the payee country.

Overall, STTR and Pillar Two work together to create a more comprehensive system that discourages profit shifting and ensures MNEs pay a fairer share of taxes in the countries they operate in.

<u>Example-1</u>

The Case of Retail Giant: Understanding Profit Shifting and Pillar Two

Let's use a fictional company, Retail Giant, to illustrate the current problem of profit shifting and how Pillar Two with its IIR, UTPR, and STTR aims to address it.

Retail Giant is a multinational corporation headquartered in Country A (developed nation with a 25% corporate tax rate). They sell clothing and operate in many countries, including Country B (developing nation with a 10% corporate tax rate).

The Current Problem: Profit Shifting

Retail Giant uses a transfer pricing strategy to minimize its tax bill. Here's how:

- Retail Giant sets up a subsidiary in Country B to handle its online sales globally.
- Retail Giant charges its subsidiaries in other countries (like Country A) inflated prices for the clothes they sell. This inflates the "cost of goods sold" for these subsidiaries, reducing their taxable profits in Country A.

- The subsidiary in Country B simply records the sales revenue and a much lower cost of goods sold (due to the inflated prices paid), resulting in a high profit margin.
- Since Country B has a lower corporate tax rate (10%) compared to Country A (25%), Retail Giant pays less tax overall.

The Issues:

- This strategy reduces tax revenue for Country A, which loses out on funds for public services and infrastructure.
- It creates an unfair advantage for Retail Giant compared to smaller businesses that can't exploit such loopholes.
- It undermines public trust in the fairness of the tax system.

How Pillar Two Addresses Profit Shifting:

Pillar Two, with its IIR, UTPR, and STTR, aims to fix this problem:

- **Income Inclusion Rule (IIR):** Even if Retail Giant's subsidiary in Country B shows high profits due to transfer pricing, Country A can use the IIR.
    - Country A can essentially tax Retail Giant on the difference between the minimum tax rate (let's say 15%) and the amount paid in Country B (10% in this case).
    - This ensures Retail Giant effectively pays at least a minimum tax rate on its global profits, regardless of the transfer pricing strategy.
- **Undertaxed Profits Rule (UTPR):** Imagine Retail Giant goes a step further and not only inflates prices but also directly shifts some profits from Country A to the subsidiary in Country B.
    - Country A can use the UTPR to directly tax the portion of the subsidiary's profit that falls below the minimum rate.
    - This prevents Retail Giant from artificially lowering its taxable profits in Country A.
- **Subject-To-Tax Rule (STTR):** Let's say Country A and Country B don't have a tax treaty with the STTR provision yet. The mechanisms above would still apply domestically.
    - However, if a tax treaty existed with STTR, Country A could directly tax Retail Giant on the difference between the minimum tax rate and the amount paid in Country B, regardless of where the profits are "booked" in the subsidiary.
    - This can be a simpler and more efficient way for Country A to recoup tax revenue lost due to transfer pricing and profit shifting.

Impact:

By implementing Pillar Two, countries like Country A can expect:

- Increased tax revenue from multinational corporations like Retail Giant.

- A fairer tax system that discourages profit shifting and creates a more level playing field for all businesses.
- More resources for governments to invest in essential services and infrastructure.

Conclusion:

Pillar Two's IIR, UTPR, and STTR represent a significant step towards a more equitable and efficient global tax system. By setting a minimum tax rate and closing loopholes exploited by profit shifting, countries can ensure multinational corporations pay their fair share of taxes.

Example-2: Retail Giant's Transfer Pricing Strategy: A Numerical Example

Let's delve deeper into Retail Giant's transfer pricing strategy using a specific example with numbers:

Scenario:

- Retail Giant sells a shirt for $100 in various countries.
- The actual cost to produce the shirt (including materials and labor) is $40.
- Retail Giant has a subsidiary in Country B (low tax rate of 10%) that handles online sales globally.

Without Transfer Pricing:

- In a normal scenario, Retail Giant would sell the shirt to its subsidiaries in other countries (like Country A with a 25% tax rate) for a reasonable profit margin, say $20 per shirt.
- This means the cost of goods sold for the subsidiaries in Country A would be $60 (actual cost $40 + markup $20).
- Country A would then tax Retail Giant on the $40 profit (selling price $100 - cost of goods sold $60) at a 25% rate, resulting in a tax bill of $10 per shirt.

With Transfer Pricing:

- Retail Giant inflates the price it charges its subsidiaries for the shirt.
- Instead of $60, they charge $80 (actual cost $40 + inflated markup $40) for each shirt.
- This significantly increases the cost of goods sold for the subsidiaries in Country A, leaving only a $20 profit (selling price $100 - cost of goods sold $80).

Benefits for Retail Giant:

- Country A can only tax Retail Giant on the reported profit within its borders.
- In this case, the tax bill in Country A is reduced to $5 (profit $20 x tax rate 25%).
- Overall, Retail Giant pays less tax by shifting a portion of the profit to the subsidiary in Country B, which has a lower tax rate (10% of the inflated $80 profit = $8).

Impact:

- Country A loses tax revenue due to the inflated transfer price.
- Retail Giant gains an unfair advantage by minimizing its tax burden.

Pillar Two's Response:

Pillar Two, with its mechanisms, aims to counteract this strategy:

- **IIR:** Country A can use the IIR to "top-up" the taxes owed by Retail Giant.
    - They can essentially tax Retail Giant on the difference between the minimum tax rate (let's say 15%) and the amount paid in Country B (10% in this case) on the **actual** profit earned globally (before transfer pricing manipulation).
    - This ensures Retail Giant effectively pays at least the minimum tax rate on the true profit, regardless of the inflated transfer price.
- **UTPR:** Imagine Retail Giant further shifts some profit from Country A to the subsidiary in Country B. The UTPR allows Country A to directly tax the portion of the subsidiary's profit that falls below the minimum rate.
- **STTR:** With a tax treaty incorporating STTR, Country A could directly tax Retail Giant on the difference between the minimum tax rate and the amount paid in Country B, disregarding the inflated transfer price.

Conclusion:

By implementing Pillar Two, countries can address transfer pricing strategies and ensure multinational corporations pay a fairer share of taxes based on their global profits, not just where they choose to "book" them through artificial pricing manipulation.

<u>Example-3:</u>

Here's an alternate example explaining IIR, UTPR, and STTR of Pillar Two, using a lemonade stand business structure:

Imagine you run a lemonade stand empire (MNE) with two locations:

- **Sunnyville (High-Tax Country):** Your main stand with high foot traffic and a 20% lemonade tax.
- **Shadyville (Low-Tax Country):** A smaller stand with a secret family recipe and a 5% lemonade tax.

Scenario 1: Income Inclusion Rule (IIR) - The "Top-Up"

- **Shadyville Stand:** Sells $100 worth of lemonade and pays $5 in tax (5% x $100).
- **Minimum Tax Rate:** Let's say the agreed minimum tax rate for lemonade is 15%.
- **Tax Shortfall:** Shadyville's stand falls short by 10% (15% - 5%).

Here's where the IIR comes in:

- You, as the MNE owner (headquartered in Sunnyville), would be responsible for "topping-up" the tax for the Shadyville stand.
- This means paying an additional $10 in Sunnyville (10% x $100) to ensure your overall lemonade empire reaches the minimum tax threshold.

Scenario 2: Under-Taxed Profits Rule (UTPR) - Questioning the Recipe

- **Shadyville Stand:** Reports high sales and low expenses due to your "secret recipe."
- **UTPR Scrutiny:** The tax authorities in Sunnyville might suspect the Shadyville stand is under-reporting profits to avoid taxes.

Under the UTPR, they can:

- Analyze factors like ingredients purchased, employee hours, and sugar consumption in both stands.
- Based on this analysis, they might determine the Shadyville stand should have earned a higher profit (say, $150).
- Any tax shortfall on this "deemed profit" (based on the 15% minimum rate) would be subject to a top-up tax in Sunnyville.

Scenario 3: Subject to Tax Rule (STTR) - Taxing the Sweet Profits

Imagine you decide to:

- Close the Sunnyville stand (maybe the rent is too high).
- Move all operations to Shadyville and:
  - Pay yourself a salary from the Shadyville stand (considered a related-party transaction).
  - Claim a tax treaty with Shadyville exempts this salary from withholding tax.

Here's where the STTR comes in:

- Shadyville might have a treaty clause allowing them to impose a withholding tax if your salary falls below a certain tax threshold (e.g., 7.5%).
- This STTR ensures Shadyville collects some minimum tax on the profits you're taking out, even though the formal business operates under their lower tax rate.

Key Takeaways:

- IIR ensures the overall MNE (lemonade empire) pays the minimum tax, even if subsidiaries in low-tax countries fall short.
- UTPR prevents profit shifting within the MNE by scrutinizing profit allocation based on broader business activity.
- STTR is a treaty-based tool for low-tax countries to ensure they collect some minimum tax on certain related-party transactions.

This example simplifies the concepts but hopefully makes them easier to understand. Remember, the actual calculations and implementation can be more complex.

IIR vs UTPR:

Let's imagine two scenarios involving a fictional company, MegaCorp, to illustrate the difference between UTPR and IIR:

Scenario 1: IIR in Action (Parent Company Pays Top-Up Tax)

- MegaCorp is a US-based multinational company with a global income of $100 million.
- MegaCorp has a subsidiary in Country X with a profit of $20 million but a corporate tax rate of only 10% (below the minimum 15%).
- Under normal circumstances, MegaCorp would only pay $2 million in taxes in Country X.

Here's how the IIR applies:

- Since MegaCorp is a US company, the IIR would apply in the US.
- The US would calculate the "top-up tax" which is the difference between the minimum tax (15%) and the tax paid in Country X (10%). In this case, it's an additional 5% on the $20 million profit, which translates to $1 million.
- MegaCorp would then be required to pay this extra $1 million in top-up tax to the US government, ensuring their global profits are taxed at least at the minimum rate.

Scenario 2: UTPR in Action (Subsidiary's Country Applies Top-Up Tax)

- Let's change the scenario slightly. Imagine MegaCorp is still a US-based company, but the US doesn't have the IIR implemented yet (or it has a specific exception that applies).

Here's how the UTPR applies:

- Since the IIR isn't an option, the UTPR comes into play.
- Country X, where MegaCorp's subsidiary is located, has implemented the UTPR. They identify the $20 million profit taxed at only 10%, which falls short of the minimum 15%.
- Country X would then calculate the top-up tax similar to the US in scenario 1, which is $1 million (5% of $20 million).
- MegaCorp's subsidiary in Country X would be required to pay this additional $1 million in top-up tax directly to Country X, ensuring the minimum tax rate is met within that jurisdiction.

Key Differences:

- **Who Pays:** In the IIR scenario, the parent company (MegaCorp in the US) pays the top-up tax. In the UTPR scenario, the subsidiary in the low-tax country (Country X) pays the top-up tax.

- **Trigger:** The IIR is triggered by the parent company's location, while the UTPR is triggered by the location of the subsidiary with low-taxed profits.

In essence, the IIR ensures the minimum tax is collected in the parent company's jurisdiction, while the UTPR acts as a back-up to make sure the minimum tax is paid somewhere, even if the parent company's country doesn't have the IIR in place.

Deep Dive into the Subject to Tax Rule (STTR)

The Subject to Tax Rule (STTR) is a specific provision within Pillar Two of the OECD's BEPS framework that targets a particular strategy used by multinational enterprises (MNEs) to minimize their overall tax burden. Here's a breakdown to understand it better:

The MNE Strategy:

Imagine a large company (MNE) operates in two countries:

- **Country A (High-Tax Country):** This is where the company headquarters resides, and the corporate tax rate is high (e.g., 20%).
- **Country B (Low-Tax Country):** The MNE has a subsidiary here, and the corporate tax rate is significantly lower (e.g., 5%).

The MNE might shift profits to the low-tax subsidiary through various means, such as:

- Charging inflated prices for goods or services sold to the subsidiary from the high-tax country.
- Paying the MNE owner (resident of the high-tax country) a management fee from the low-tax subsidiary.

These strategies reduce the taxable profits in the high-tax country and minimize the overall tax bill for the MNE.

The STTR Intervention:

The STTR comes into play when the MNE attempts to further minimize taxes by:

- **Exploiting Tax Treaties:** Many countries have tax treaties that exempt certain cross-border payments from withholding tax.
- **Shifting Profits Through Related-Party Transactions:** The MNE might pay low-taxed profits from the subsidiary to the owner in the high-tax country as:
    - Dividends (often exempt from withholding tax under treaties).
    - Management fees or royalties for intangible assets (like intellectual property) held by the subsidiary.

How STTR Works:

The STTR empowers the low-tax country (Country B) to:

- **Override Treaty Benefits:** Under specific conditions, Country B can disregard the treaty exemption and impose a limited withholding tax on the payment from the subsidiary to the owner in the high-tax country.
- **Minimum Tax Threshold:** This withholding tax typically applies only if the effective tax rate on the profits used to fund the payment falls below a certain threshold (e.g., 7.5% or 9%). Essentially, it ensures some minimum tax is collected in Country B.

Benefits of STTR:

- **Prevents Treaty Abuse:** It discourages MNEs from exploiting tax treaties to completely avoid taxes in low-tax countries.
- **Protects Tax Base:** Low-tax countries can ensure they collect some minimum tax on profits generated within their borders.
- **Levels the Playing Field:** It discourages profit shifting strategies and promotes fairer competition among companies.

Limitations of STTR:

- **Treaty Negotiations:** Implementing the STTR requires revising existing tax treaties between countries. This can be a complex and time-consuming process.
- **Administrative Burden:** Both tax authorities and MNEs face additional administrative burdens in complying with the STTR rules.
- **Threshold Issues:** The effectiveness of the STTR depends on setting an appropriate minimum tax threshold.

Conclusion:

The STTR is a key tool within Pillar Two for developing countries to safeguard their tax base and prevent MNEs from exploiting loopholes in tax treaties. While it has limitations, it promotes a fairer global tax environment and discourages profit shifting strategies.

<u>Example to understand STTR:</u>

The Subject to Tax Rule (STTR) is a tax provision that applies to certain types of income earned by multinational corporations operating in the United States. It is designed to prevent income from being shifted to low-tax or no-tax jurisdictions through related-party transactions. The STTR essentially requires that certain deductible payments made by a U.S. corporation to a related foreign entity be subject to taxation in the United States.

Let's illustrate the STTR using a numeric example:

Suppose XYZ Corp is a U.S.-based multinational corporation, and it has a subsidiary called XYZ International located in a country with a lower corporate tax rate than the U.S. XYZ Corp pays royalties to XYZ International for the use of intellectual property (IP) rights owned by XYZ International.

Without the STTR:

- XYZ Corp pays $1,000,000 in royalties to XYZ International.
- XYZ International's country has a tax rate of 10%, so it pays $100,000 in taxes on this income.
- XYZ Corp deducts the $1,000,000 royalty payment as an expense, reducing its taxable income in the U.S. by that amount.
- As a result, XYZ Corp pays less tax in the U.S. because of the deduction.

With the STTR:

- The STTR requires that the $1,000,000 royalty payment be subject to taxation in the U.S. even though it was paid to a foreign entity.
- XYZ Corp still pays $1,000,000 in royalties to XYZ International.
- XYZ International pays $100,000 in taxes to its local government.
- However, the $1,000,000 royalty payment is also included in XYZ Corp's taxable income in the U.S., subject to the U.S. corporate tax rate.

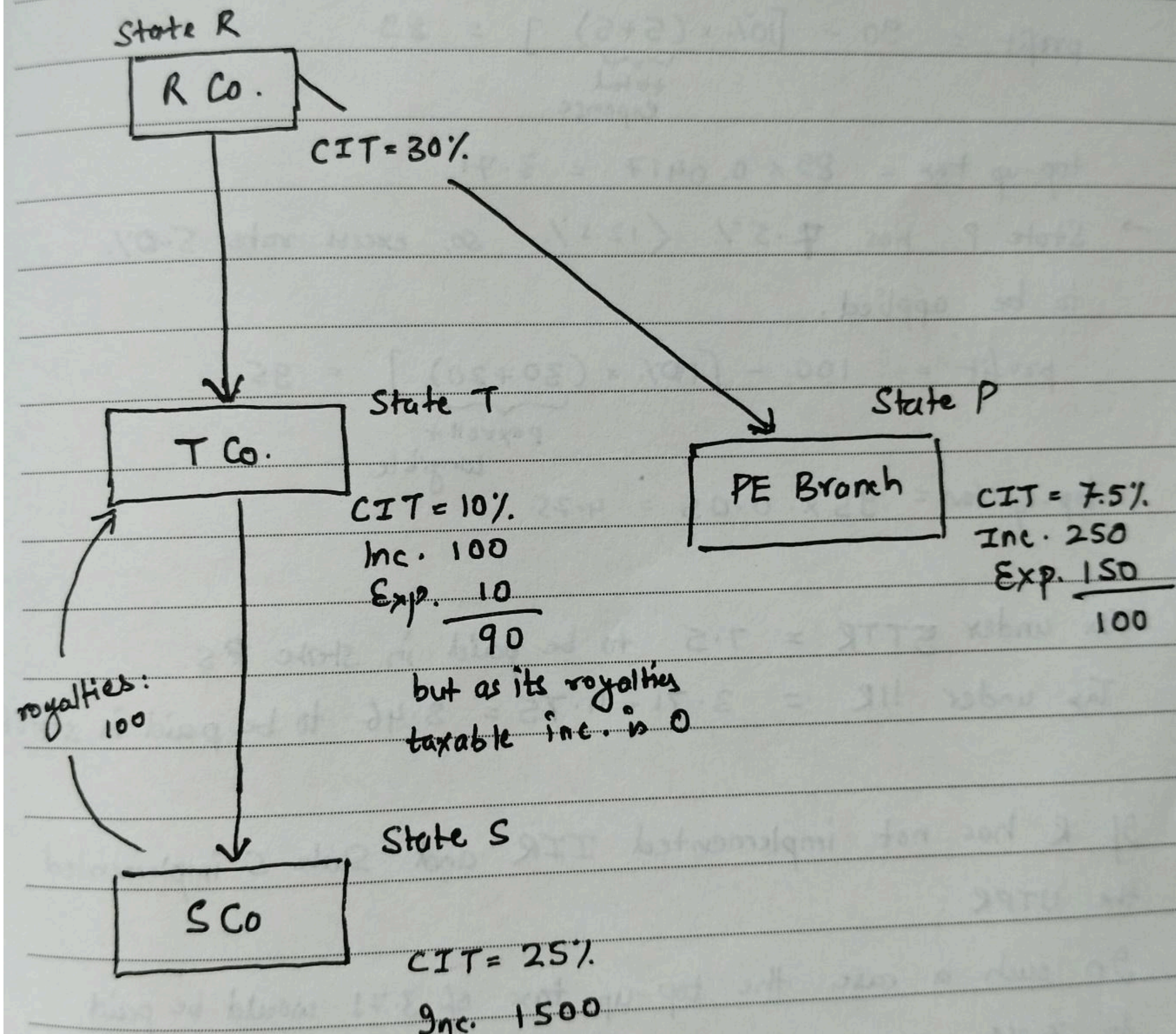
Let's assume the U.S. corporate tax rate is 21%:

- XYZ Corp's taxable income increases by $1,000,000 due to the royalty payment.
- At a 21% tax rate, XYZ Corp would owe an additional $210,000 in taxes to the U.S. government on this income.
- So, even though XYZ International paid taxes in its country, the royalty payment is still subject to U.S. taxation under the STTR.

In summary, the STTR prevents multinational corporations from reducing their U.S. tax liability by making deductible payments to related foreign entities in low-tax jurisdictions. It ensures that certain types of income are taxed in the U.S. regardless of where they are earned or paid out.

Further Explanation:

→ R Corp - Ultimate Parent Entity in state R
Its income threshold has been exceeded for all rules to apply
→ Corportate Income Tax (CIT) in R is 30%



① STTR (7.5%) comes first. Therefore, b/w S & T the royalty of 100 × 0.075 = 7.5 STTR is collected TDS by T

② IRR:

→ State S has CIT > 12.5%. hence no additional here

→ State T has actually collected 7.5/90 ~ 8.33% < 12.5%.

So, additional ~~4.17%~~ 4.17% top-up tax has to be paid.

$$\text{profit} = 90 - [10\% \times \underbrace{(5+5)}_{\text{total expense}}] = 89$$

$$\text{top-up tax} = 89 \times 0.0417 = 3.71$$

→ State P has 7.5% < 12.5%. so, excess rate 5.0% to be applied.

$$\text{profit} = 100 - [10\% \times \underbrace{(30+20)}_{\text{payroll + tangible}}] = 95$$

$$\text{top-up tax} = 95 \times 0.05 = 4.75$$

Tax under STTR = 7.5 to be paid in state S

Tax under IIR = 3.71 + 4.75 = 8.46 to be paid in state R

③ If R has not implemented IIR and State S implemented the UTPR.

In such a case the top-up tax of 3.71 would be paid to 3.71

However, since S Co. has no direct connection with PE Branch, it wont come unde UTPR.

So, here, tax under STTR = 7.5 to pe paid to state S

tax under IIR = 3.71 to be paid to state S

Other reference: [The Pillar Two Mechanism in Light of the Blueprint – A Case Study - Kluwer International Tax Blog (kluwertaxblog.com)]

- Inspired from article published on 25-03-24 in the Financial Express by Jayati Ghosh.