

PE Watch: 2022 in review

February 2023

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01 INTRODUCTION

Welcome to a new edition of PE Watch: in review, where the complex and constantly evolving world of Permanent Establishment (PE) is reviewed. As a fundamental concept in determining the tax liability of multinational enterprises (MNEs) operating in foreign jurisdictions, understanding the intricacies of PE is crucial for businesses looking to navigate the global tax environment.

As globalization continues to shape the business landscape, the importance of understanding the nuances of PE cannot be overstated. The concept, which has evolved over the years, determines whether a company has a taxable presence in a particular jurisdiction and also is central to the allocation of taxing rights between countries.

This issue explores the new rules of Pillar Two and their impact on PEs, the implications of new ways of working remotely, controversy, and the latest status of the Multilateral Instrument. Additionally, we will review recent PE cases and developments and their impact on businesses.

Regarding the future of the PE concept, it is likely that it will continue to evolve in response to changes in the way businesses operate and the increasing globalization of the economy. For example, the rise of digital technologies and the increasing use of the internet for conducting business may lead to the development of new rules or interpretations of existing rules related to PEs.

Overall, it is important for companies to stay up to date on PE developments, as failure to comply with the rules related to PEs can result in significant tax consequences. The objective of PE Watch is to provide you with valuable insights and practical guidance on PEs. We hope you find this annual edition informative and useful in your professional practice.

02 PILLAR TWO

The concept of PE and the Pillar Two rules (global minimum tax) are closely interrelated. Under the Pillar Two rules, a PE is not only subject to a minimum level of taxation of 15% but its definition is also broader than the PE definition typically found in tax treaties or domestic law. This means that tax authorities will likely place greater emphasis on identifying PEs in order to ensure that MNEs are paying a minimum level of tax. The expansion of the concept of PE under Pillar Two may also result in a greater number of activities being considered as creating a PE.

PE definition under Pillar Two

The Pillar Two design introduces four categories of PEs, and generally ensures that no actual or deemed business presence in a jurisdiction goes unidentified. First, a PE will exist in a jurisdiction with an applicable tax treaty if the PE definition in said tax treaty is satisfied, and income is allocated to this PE under a method that is similar to Article 7 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. Second, a PE will exist in a jurisdiction with no applicable income tax treaty if the local jurisdiction recognizes the business presence and taxes income attributable thereto on a net basis in a manner similar to how it taxes its own residents. Third, a PE will exist in a jurisdiction with no corporate income tax if, hypothetically, the business presence would have satisfied the PE definition under the OECD Model Tax Convention, and the local jurisdiction would have had the right to tax it. Finally, and as a catch all provision known as the “stateless PE,” a PE will exist for any business presence that does not satisfy any of the three aforementioned categories.

It is noteworthy that it is possible to have a PE for Pillar Two purposes in circumstances where there would be no PE under an applicable tax treaty. On the other hand, it is also possible not to have a PE for Pillar Two purposes even though a PE exists for the purpose of a tax treaty.

Attribution of profits

The allocation of income to a PE varies depending on the type of PE. Generally, the net income as reflected in the separate financial accounts of the PE should be followed. Where separate accounts do not exist, then the net income will be the amount that would have been reflected if the PE had prepared standalone financials in accordance with the Ultimate Parent Entity’s accounting standard. The financial

accounts will be adjusted, if necessary, depending on the type of PE to only reflect the income or loss attributable to the PE based on the applicable tax treaty, domestic law or OECD Model Tax Convention.

For stateless PEs, the allocated income is the profit that is exempt from tax in the jurisdiction of residence of the head office. This income is not blended with the income of other Constituent Entities or other PEs within the group, and it is likely that no covered tax will be attributed to it, resulting in the requirement for Top-up Tax to be paid under the Pillar Two rules for that income.

If the PE incurs a Global Anti-Base Erosion (GloBE) Loss, such loss will be considered as an expense of the head office (and not the PE) when calculating its GloBE Income or Loss. This is provided that the loss of the PE is treated as an expense in the computation of the domestic taxable income of the head office, and it is not offset against an item of income that is subject to tax by both the jurisdiction of the head office and the jurisdiction of the PE.

In terms of allocating Covered Taxes, the Model Rules provide that any Covered Taxes incurred by the head office or another Constituent Entity that relate to the income of a PE will not be considered as part of the Adjusted Covered Taxes of the Constituent Entity that incurred them. Instead, these taxes will be included in the Adjusted Covered Taxes of the PE.

Other discussion points

The new construct of PE under Pillar Two challenges the traditional understanding of PE, and the interaction of this new regime with local legislation continues to raise questions. For example, is the concept of Effectively Connected Income (ECI) in the United States deemed to be similar enough to Article 7 of the OECD Model Tax Convention?

As the concept of PE continues to evolve, increased scrutiny is anticipated in the coming years due to its interaction with Pillar Two. Under the Pillar Two rules, a PE is also subject to a minimum level of taxation of 15%. As a result, it is likely that tax authorities will place greater emphasis on the activities of nonresidents within their jurisdiction to determine the existence of a PE. This would not only allow for the taxation of the profits of the head office of the PE, but also the profits of other members of the MNE group via the Undertaxed Profits Rule (UTPR).

03 REMOTE WORKING

Overview

Country developments

04 CONTROVERSY

Overview

Country developments

05 MLI

Overview

The Multilateral Instrument (MLI) was created to put into practice the various treaty-related measures outlined in the BEPS plan. It allows jurisdictions to choose which parts of the MLI to incorporate into their existing bilateral tax treaties based on their specific needs. The MLI includes four provisions related to PEs that were developed through the work on BEPS Action 7. These provisions aim to prevent the use of techniques that inappropriately avoid the creation of a PE:

- ▶ Article 12 - Agency PE: Broadens the scope of the dependent agent PE rule and narrows the scope of the independent agent exception
- ▶ Article 13 - Specific activity exemptions: Jurisdictions may opt for one of the following options with respect to preparatory and auxiliary activities:
 - ▶ Option A: the list of activities, or the combination thereof, is restricted to activities of a preparatory or auxiliary character
 - ▶ Option B: the list of activities is considered intrinsically preparatory or auxiliary

This article also contains an anti-fragmentation clause preventing enterprises, and related enterprises, from fragmenting their activities in order to qualify for a PE exemption. It applies to the extent the activities constitute complementary functions that are part of a cohesive business operation.

- ▶ Article 14 - Splitting-up of contracts: Prevents related enterprises from splitting-up contracts to not meet the time threshold required under the construction PE provision
- ▶ Article 15 - Closely related enterprise: Contains the definition of "closely related enterprise" for purposes of applying Articles 12 to 14 of the MLI

The implementation of the MLI has seen a marked rise in the number of ratifications and Covered Tax Agreements entering into effect by the end of 2022, when compared to the initial year of its implementation. As a result, the MLI's PE provisions may now apply to a larger number of tax treaties.

General MLI data

As of 31 December 2022:

Signatories: 100	Number of ratifications: 79	Number of tax treaties covered: Approximately 1850
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Country PE positions

As of 31 December 2022:

Incorporates all PE articles: 34	Incorporates some of the PE articles: 32	Does not incorporate any of the PE articles: 34
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Specific PE positions:

	Yes	No
Article 12 (agency PE)	52	48
Article 13 (specific activity exemptions)	64	36
Article 14 (splitting-up of contracts)	38	62

06 OTHER PE DEVELOPMENTS

Overview

Country developments

CONTACTS



Jose A. Bustos

EY International Tax Policy Desk Leader

JoseAntonio.Bustos@ey.com



Ronald van den Brekel

EY Global Transfer Pricing Market and Innovation Leader

ronald.van.den.brekel@nl.ey.com



Chester Wee

EY International Tax & Transaction Services Partner- Singapore

chester.wee@sg.ey.com



Roberto Aviles

EY BEPS Desk

Roberto.Aviles.Gutierrez1@ey.com

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