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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.
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 Undetaxed Profits Rule (UTPR).
03 REMOTE WORKING

Overview

Denmark: CEO working from home creates a PE

On 21 November 2022, the Danish Tax Board (DTB) issued binding tax ruling SKM2022.557.SR analyzing partly whether two Norwegian companies had a place of effective management in Denmark and partly whether such companies also have a PE in Denmark. In this case, the Chief Executive Officer (CEO) of the companies works from home in Denmark three days a week and two days a week from the office in Norway. Further, the CEO holds 20% of the shares in the Norwegian companies.

The DTB concluded that both Norwegian companies have a PE in Denmark. This is because the Norwegian companies have an interest in being present in Denmark due to the relocation of the CEO to Denmark. Further, the CEO plays an important role in both companies and cannot be easily replaced. (See EY Global Tax Alert)

Denmark: Managing director working from home does not constitute a PE

On 29 August 2022, the DTB published binding tax ruling SKM2022.406.SR analyzing if a managing director working from home would create a PE in Denmark. In this case, the managing director of a foreign MNE group is a Danish citizen and wishes to work from Denmark due to personal reasons. The MNE group does not require the managing director to work from home or from another specific place in Denmark, but it accepts the condition of the managing director to stay in Denmark more frequently.

According to the DTB, the fact that the managing director partly works from home in Denmark should not mean that the nonresident entity has a PE in Denmark. Among other things, the DTB emphasized that the employee would not be involved in sales prospecting work or the like in Denmark, as this function was handled by the subsidiary, and that the work in Denmark could not be planned but arose randomly and sporadically. (See EY Global Tax Alert)

Denmark: CFO working from home does not constitute a PE in Denmark

On 1 April 2022, the DTB published binding tax ruling SKM2022.166.SR analyzing whether an employee who wants to move to Denmark due to personal reasons and work from home there would constitute a PE in Denmark. The employee has the role of Interim Chief Financial Officer and is also a member of the board of directors. He provides financial inputs that the Chief Executive Office and the board of directors can use to make strategic decisions. The employee plans to work in Switzerland three days a week and two days a week in Denmark. The work performed in Switzerland will not differ significantly when he is in Denmark and all tasks related to the board of directors would take place in Switzerland.

The DTB concluded that the employee would not constitute a PE for the Swiss employer. This is because the employee would not be involved in sales-related activities and his role was of an internal nature. Furthermore, the functions as a member of the board of directors would primarily be handled in Switzerland. (See EY Global Tax Alert)

Country developments

Spain: Remote worker does not create a PE

At the beginning of 2022, the Spanish General Directorate of Taxes (GDT) confirmed through a ruling that the presence of an employee working remotely from home due to the COVID-19 pandemic does not result in a PE in Spain. In the case at hand, an employee working for a company resident in the United Kingdom (UK) traveled to Spain and was unable to leave Spain due to a lockdown. The employee continued to work for the UK Company from Spain, without any change in his work while in Spain.

The GDT concluded that the employee's home office was not at the disposal of the UK company based on the following reasons: (i) working from Spain was a personal decision and was not imposed or required by the UK company; (ii) the UK company did not bear any costs; and (iii) the UK Company has an office in the UK which could have been used by the employee to develop his work without the need to be in Spain. (See EY Global Tax Alert)

Sweden: Home office PE guidance

On 13 May 2022, the Swedish Tax Agency updated its guidance on PEs for employees working from home. According to the updated guidance, working from home due to government restrictions or force majeure cases (e.g., the COVID-19 pandemic) will not give rise to the existence of a PE. Likewise, if an employee works from home for personal reasons (i.e., not required or imposed by the foreign employer) and there is no commercial interest for the foreign employer (i.e., there is no advantage for the foreign employer that the work is performed in the employee's home), then the employee's home would not be considered at the disposal of the foreign employer. (See EY Global Tax Alert)
**INTRODUCTION**

Remote working

MLI

Other PE developments

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**04 CONTROVERSY**

**Overview**

**Country developments**

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**European Union: Deduction of final losses by a PE**

On 22 September 2022, the Court of Justice of the European Union (CJEU) issued its decision in the case C-538/20. In this case, a German entity with a PE in the UK incurred PE losses which could not be deducted in Germany as the relevant tax treaty between these countries includes an exemption method for the elimination of double taxation.

The CJEU held that Germany’s rules on deductibility of losses from a PE do not restrict the freedom of establishment. According to the CJEU, the situation of the foreign PE in the UK is not objectively comparable with the situation of a domestic PE with a head office in Germany. This is because the losses incurred by the PE in UK are excluded from the tax base in Germany under the relevant tax treaty, whereas, in a domestic scenario this would not be the case. (See EY Global Tax Alert)

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**Germany: Allocation of assets to PE without personnel**

On 3 March 2022, the German Federal Tax Court (FTC) published a temporary injunction 1B 44/21 on whether the significant people functions are to be regarded as the decisive allocation parameter for assets held by a PE. In the case at hand, a PE operates a wind farm on leased property. The PE does not employ its own personnel and its technical and business management services are handled by other German companies. The German tax authorities concluded that in the case of a PE without personnel, no assets and business transactions could be allocated to the PE, as it did not perform any significant people functions. Instead, the assets should be allocated to the head office since it performs the PE’s significant people functions. As a result, all PE’s assets were deemed to be transferred for tax purposes and thus subject to German exit taxation.

The FTC expressed serious doubts about the tax authorities’ position. According to the FTC, German exit tax rules (existing outside the Authorized OECD Approach (ADA) rules) do not recognize an allocation in accordance with the significant people functions and consequently do not apply in this case. (See EY Global Tax Alert)

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**India: Purchase of extended warranty does not constitute a PE**

On 26 September 2022, the Delhi Bench of the Income Tax Appellate Tribunal (ITAT) ruled on case ITA No. 9198/Del/2019 whereby it analyzed whether a contract for extended warranty could constitute a PE. In this case, an Indian company is the exclusive dealer of a manufacturer of luxury cars. The Indian company purchased an extended warranty from a unit of the manufacturer’s administrative services, which it further sold to customers in India.

The ITAT noted that that the extended warranty was an additional feature provided to customers in India which was not mandatory and the price of the extended warranty sold to customers in India was different from the price paid by the Indian company. Thus, the relation between the parties was only between the Indian company and the customers in India. Consequently, the ITAT concluded that the Indian company cannot be construed as a Dependent Agent PE of the nonresident. (See EY Global Tax Alert)

**India: Decision on threshold period for Construction PE**

On 15 November 2022, the Delhi High Court decided case 2022/DNC/004893 whereby it analyzed when to start counting the threshold period for purposes of the Construction PE clause under the India-Cyprus Double Tax Agreement (DTA) which provides a 12-month threshold for construction/installation activities to create a PE. In this case, a company from Cyprus was awarded a contract to work in relation to the development of a gas field in India. The actual installation work commenced in January 2008 and was completed in September 2008. The Assessment Officer held that the Cypriot company had a PE in India because one employee of this company visited India in September 2007. According to the Cypriot company, such visit was only to collect data and information to bid for the contract to develop the gas field.

The Delhi High Court noted that a building site or an assembly project can only be construed as a fixed place of business when the enterprise commences its activities at the project site. Any activity which may be related or incidental but was not carried out at the project site should not be construed as a PE. (See EY Global Tax Alert)

**Kazakhstan: Allocation of dividends to a PE**

On 9 September 2022, a Court of Appeal in Kazakhstan ruled in case no.7199-22-00-4a/81.2 whereby it analyzed whether a dividend distribution should be allocated to a PE. In this case, a French company registered a PE in Kazakhstan, and it was also a shareholder in a Joint Venture (JV) entity in Kazakhstan. The personnel of the PE were considered as executing strategic and managerial functions with respect to the JV entity paying dividends.

The tax authorities believed the dividends distributed and paid to the French company should have been allocated to the PE in Kazakhstan and consequently taxed at 20%. The tax authorities reached this conclusion since the JV entity’s directors were also performing management positions in the PE in Kazakhstan. The Court disagreed with the tax authorities and noted that the functions of the employees of the PE were only of an organizational nature and could not influence the shareholder’s decisions nor contribute to the dividends. Thus, the Court confirmed that the dividends should not be allocated to the PE. (See EY Global Tax Alert)

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2. Post 2016 cases
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
- 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:

<table>
<thead>
<tr>
<th>Signatories:</th>
<th>Number of ratifications:</th>
<th>Number of tax treaties covered:</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>79</td>
<td>Approximately 1850</td>
</tr>
</tbody>
</table>

Country PE positions

As of 31 December 2022:

<table>
<thead>
<tr>
<th>Incorporates all PE articles:</th>
<th>Incorporates some of the PE articles:</th>
<th>Does not incorporate any of the PE articles:</th>
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<tr>
<td>34</td>
<td>32</td>
<td>34</td>
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Specific PE positions:

<table>
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<th>Article 12 (agency PE)</th>
<th>Article 13 (specific activity exemptions)</th>
<th>Article 14 (splitting-up of contracts)</th>
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<td>64</td>
<td>38</td>
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<tr>
<td>48</td>
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<td>62</td>
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**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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