PE Watch: 2023 in review

February 2024

Contents

Introduction

Welcome to a new edition of PE Watch: in review, where the latest trends and developments of PE (PE) are reviewed. As a fundamental concept in determining the tax liability of multinational enterprises (MNEs) operating in foreign jurisdictions, understanding the complexities of the PE concept is crucial for businesses looking to navigate the global tax environment.

The PE 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 Pillar Two rules and their interaction with PEs, remote working, controversy, and the latest status of the Multilateral Instrument. Additionally, we review other relevant PE developments and their impact on businesses.

Staying abreast of PE developments is not just advisable but it is essential as non-compliance with PE rules can lead to severe tax consequences making it crucial for companies to remain informed and proactive. That's where PE Watch comes in. Our goal is to equip you with valuable insights and practical guidance, enabling you to turn these complexities into opportunities.

We believe that understanding PE in today's world requires a blend of expert analysis and forward-thinking strategy. This edition of the PE Watch is designed to spark new ideas and discussions, helping you navigate the intricate world of PE with confidence and clarity.

January

February

March

April

May

June

July

August

September

October

November

December

01 Pillar Two and Permanent Establishments

The global tax landscape has undergone a significant transformation with the introduction of the global minimum tax rules, commonly referred to as Pillar Two rules. These rules have introduced new complexities into international taxation, particularly in their interaction with the concept of permanent establishment (PE).

Under the Pillar Two rules, a PE is defined to mean:

a. A place of business (including a deemed place of business) that is treated as a PE under the terms of an in-force tax treaty and the income attributable to such PE is taxed similarly to Article 7 of the OECD Model Tax Convention;
b. In the absence of an in-force tax treaty, a place of business (including a deemed place of business) where the income attributable to it is taxed under a jurisdiction's domestic tax law on a net basis, in a manner similar to how it taxes its own tax residents;
c. A place of business (including a deemed place of business) situated in a jurisdiction that has no corporate tax income system, if it would be treated as a PE under the OECD Model Tax Convention and that jurisdiction would have had the right to tax the income attributable to it under Article 7 of that Model; or
d. If none of the above apply, a place of business (including a deemed place of business) through which operations are conducted outside the jurisdiction of the entity, provided that the jurisdiction exempts the income attributable to those operations. This type of PE is generally referred as 'stateless PE'.

This expanded definition of PE under Pillar Two rules may lead to scenarios where an entity could be considered a PE for corporate income tax purposes but not for Pillar Two purposes, and vice versa. For example, an airline may be regarded as having a PE for treaty purposes due to its branch operations but not regarded as having a PE for Pillar Two purposes because the branch may not be taxed under Article 7 due to the precedence of Article 8 of the OECD Model Tax Convention granting full treaty exemption on the airline profits. However, in a case where the PE is taxed on a gross income basis at a low fixed rate which is determined based on the statutory tax rate on a deemed profit (e.g., tax rate of 25% multiply by deemed profit of 20% to arrive at a flat tax rate of 5% on gross income), it may not always be clear whether a PE exists under above paragraphs (a) and (b).

In another example, when an Entity is exempt under a territorial tax regime on its income arising from foreign operations but those operations do not tantamount to a PE under the treaty or domestic tax law of another jurisdiction, a stateless PE arises for Pillar Two purposes. Stateless PE faces particular restrictions as no jurisdiction blending is allowed with other Constituent Entities or no payroll cost and tangible assets can be attributed to a stateless PE for the purpose of substance-based income exclusion. Given so, a top-up of 15% is likely to apply to income attributable to stateless PEs.

Furthermore, Pillar Two emphasizes the separate entity principle in PE taxation. A PE is treated as a separate Constituent Entity, and its income and taxes cannot be blended with the Main Entity or other PEs of the same Entity. This requires a clear delineation of separate business operations within a PE for accurate allocation.

The allocation of GloBE Income and Covered Taxes between the Main Entity and PE also presents challenges. While the Model Rules provide guidelines, practical implementation and financial accounting for PEs can be complex, as PEs are tax concepts rather than financial ones.

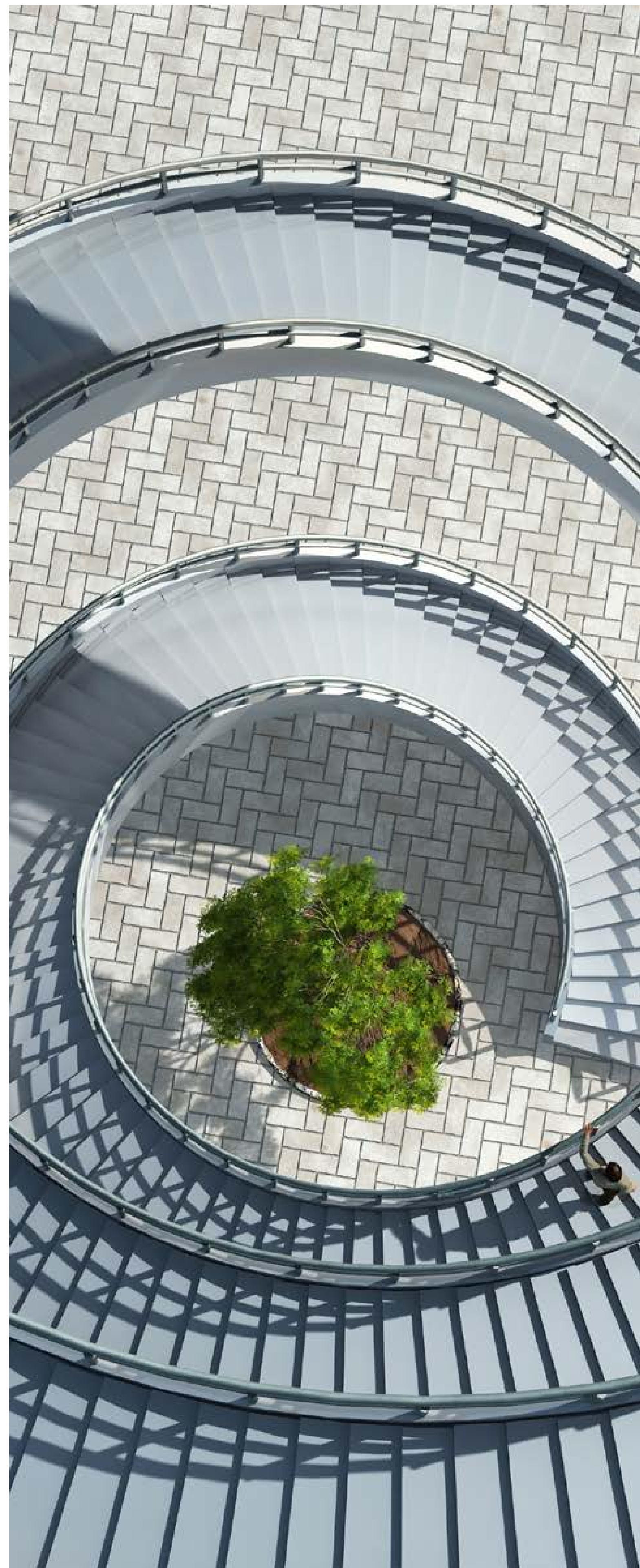
During 2023, the Inclusive Framework released different Administrative Guidance on Pillar Two addressing various issues related to PEs. The first Administrative Guidance, released in February 2023, stipulates that taxes paid at the Main Entity level cannot be allocated to the PE for the Qualified Domestic Minimum Top-up Tax (QDMTT) calculation. These QDMTT rules on allocation of taxes deviate from the Income Inclusion Rule (IIR) and the Undertaxed Profits Rule (UTPR) allocation rules since taxes paid at the level of the Main Entity can be pushed down to the relevant PE.

Additionally, the Administrative Guidance released in December 2023 clarifies aspects of the Transitional Country-by-Country Reporting (CbCR) safe harbor (TCSH, particularly when Qualified Financial Statements are unavailable for a PE. The Administrative Guidance also covers the Simplified Effective Tax Rate (ETR) Test under the TCSH, specifying that only the income tax expense incurred in the PE jurisdiction on the PE's income may be included in the Simplified ETR Test for that jurisdiction, and not for the Main Entity's jurisdiction. However, if different accounts have been prepared for the PE for different purposes (e.g., the accounts for tax filing differs from the accounts for internal management control purposes due to transfer pricing adjustments), it is still unclear whether the MNE Group can choose one type of accounts over another for TCSH.

As Pillar Two continues to evolve, several issues remain open. One of these issues is the switch over rule (SOR) proposed in the Pillar Two Blueprint released in 2020. The SOR becomes relevant when the head office intends to apply the IIR to the income of an exempt PE and is prevented from doing so where the head office has entered into a bilateral tax treaty that obliges the head office's jurisdiction to exempt the income of the PE. The absence of such rule may raise questions on whether the IIR is still applicable in those cases where the head office jurisdiction and the jurisdiction where the PE is located have a tax treaty that may prevent the head office jurisdiction from applying the IIR.

The interplay between Pillar Two and the concept of PE introduces potential areas of controversy. This situation prompts the question of whether the implementation of Pillar Two will lead to an increase in PE challenges. Tax authorities may seek additional tax revenue not only through corporate income taxes but also via top-up taxes under Pillar Two. This could occur primarily under a QDMTT but also under the UTPR, in which a PE qualifying as a Constituent Entity may allocate taxing rights to the jurisdiction where the PE is located. It is essential to monitor this development closely, particularly as jurisdictions that have traditionally refrained from challenging the PE status might now find new incentives to do so.

As the Pillar Two framework continues to be implemented and refined, the interplay between Pillar Two and PEs will require ongoing attention. The expanded scope of PE under Pillar Two may require businesses to reconsider their structures and strategies in response to the evolving tax landscape.



02

Remote Working

03 Controversy

04 Multilateral Instrument

05 Other PE developments

The year 2023 has seen significant activity globally related to the PE concept. As countries continue to take actions to protect their tax bases and increase tax certainty, some overarching trends are emerging.

Delving into the specific PE definition changes in 2023 reveals consistent efforts by tax authorities to expand the scope of PE exposure. For example, Egypt and Saudi Arabia moved to reduce the period threshold for a Service PE to 90 and 30 days respectively within a 12 month period. Pakistan also enacted substantive changes, no longer requiring a "fixed" place of business to constitute a PE. Consequently, even a temporary place of business could now create a PE.

Other countries updating the PE definition include Cambodia, Egypt, Qatar, and Slovenia which introduced the Agency PE provision of the 2017 OECD Model Tax Convention. Accordingly, if a person who is acting on behalf of a nonresident habitually concludes contracts or plays a principal role in their conclusion without material modification, the nonresident will be deemed to have a PE.

Zooming in on PE profit attribution, noteworthy changes were introduced in Qatar's amended domestic tax law. The revised provisions exempt a Qatar resident entity from domestic taxation on any income attributable to its foreign PEs. However, for the exemption to apply, the foreign jurisdiction where the PE is located should subject the PE income to taxation. Additionally, Qatar introduced force-of-attraction rules.

Similarly, Saudi Arabia released a public consultation that proposes amendments to the Income Tax Law. Among other items, the amendments update the force-of-attraction rules. As part of these rules, if a nonresident, with a PE in Saudi Arabia, earns income from Saudi Arabia but fails to substantiate the reasons for not conducting those activities through a PE in Saudi Arabia, the income attributable to the nonresident should be treated as taxable income in Saudi Arabia.

As the digital economy continues to grow, we are seeing more countries take unilateral action to introduce the concept of digital PE. Pakistan updated its domestic law to include a "virtual business presence". This includes any business conducting transactions through the internet or any other electronic medium, regardless of whether a physical presence exists. Similarly, Colombia published regulations on its "Significant Economic Presence" regime that aims to tax foreign providers of digital services. (For more details see EY Global Tax Alert).

On the policy front, the OECD released in November 2023 a public consultation on proposed changes to the Commentary on Article 5 of the OECD Model Tax Convention and its application to extractible natural resources. The consultation document comprises an alternate provision for both onshore and offshore activities related to the exploration and exploitation of extractible natural resources such as oil, gas, and minerals, together with related commentary. As per the proposed provision, relevant activities in the source state in the aggregate 30 days in any 12-month period will be deemed to be carried on through a PE.

The proposed Directive of the European Commission for a Head Office Tax regime for micro, small and medium sized enterprises (SMEs) is also noteworthy. The proposed rules would create a one-stop-shop regime whereby the tax filing, tax assessments and collections for PE(s) would be dealt centrally by the tax authority of the Member State in which the head office is located. If adopted, the Directive would ease corporate income tax compliance for in-scope SMEs operating cross-border in the EU through PEs in other Member States. (For more details, See EY Global Tax Alert).

As changes span across profit attribution along with widening the PE definition, businesses should monitor developments closely and assess impact on their operating models. Keeping abreast of the amendments to domestic law, evolving guidelines and maintaining robust documentation will be key to stay compliant.

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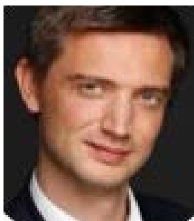

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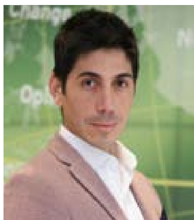

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EYG no. 000435-24Gbl

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