# Unpacking Pillar Two: permanent establishments

**Pillar Two of the of the OECD Inclusive Framework contains the rules to implement the global minimum tax. It does so by identifying jurisdictions in which the operations of a multinational group are taxed at an effective tax rate (ETR) that is below the agreed minimum (15%) and then charging a top-up tax on those profits.**

The OECD published a set of model rules for the implementation of the main aspects of Pillar 2 (the Model Rules) in December 2021 and a commentary on those rules in March 2022.

The general approach of the Model Rules is to identify such low-tax jurisdictions by allocating profit (referred to as Globe income) and tax on those profits (referred to as covered tax) to companies within a multinational group and then aggregating the Globe income and covered tax of companies located in the same jurisdiction before determining an ETR for the jurisdiction as a whole. The Model Rules also include some specific rules which apply where companies operate in jurisdictions outside the state in which they are otherwise treated as located for the purpose of the Model Rules – usually the state in which the company is tax resident. This note provides a summary of those issues.

## What is a "permanent establishment" for the purpose of the Model Rules?

Like the OECD Model Convention, the Model Rules adopt the concept of a "permanent establishment" (PE) to define the level of presence that a company must have in a jurisdiction outside its state of residence before profits are allocated to that jurisdiction. However, the definition of PE in the Model Rules (Model Rules, Article 10.1) differs from the familiar definition found in Article 5 of the OECD Model.

The definition in the Model Rules has four limbs. In summary, a company that has a place of business (or deemed place of business) in a jurisdiction (the source state) other than place in which it is resident (or otherwise treated as located) will have a PE in the source state for the purpose of the Model Rules in the following circumstances:

- where there is an applicable double tax treaty in force between the state of residence and the source state, and the place of business is treated as a PE for the purpose of that treaty provided that the source state taxes the income attributable to the PE in accordance with a provision similar to Article 7 of the OECD Model (a treaty-PE);
- where there is no applicable treaty in force, and the source state taxes the profits attributable to the place of business under its domestic law on a net basis similar to its own residents (a domestic law PE);
- where the source state has no system of corporate income tax, and the place of business would have been treated as a PE under the terms of a treaty based on the OECD Model (i.e. Article 5) provided that the source state would have had the right to tax the income attributable to it in accordance with Article 7 of the OECD Model (a deemed-PE); or
- where none of (a), (b) or (c) applies, and the state of residence exempts the income attributable to the business that is carried on through that place of business (a stateless PE).

As can be seen from this description, it is possible to have a PE for the purpose of the Model Rules in circumstances where there would be no PE under an applicable double tax treaty, but it is also possible not to have a PE for the purpose of the Model Rules even though a PE exists for the purpose of a double tax treaty. The most obvious example of the latter is for the operation of ships and aircraft in international traffic. In treaties based on the OECD Model, the profits of these businesses are taxed only in the place of effective management (OECD Model, Article 8). Even if the company has a PE in another jurisdiction within Article 5 of the OECD Model, profits attributable to that PE are not taxed in the source state under Article 7.

Special rules apply to shipping businesses under the Model Rules. But for airlines, this means that the company will not have treaty-PE under the Model Rules and, where none of the other limbs of the definition apply, the effect will usually be that Globe income (and covered tax) are allocated to the location of the main entity for the purpose of calculating jurisdictional ETRs (Model Rules commentary, Chapter 10, paragraph 101). This will be a welcome result, in many cases, as it will align the allocation of profit under the Model Rules with the allocation of taxing rights under most double tax treaties.

## Where is the PE located for the purpose of the Model Rules?

The Model Rules include specific rules to determine the "location" of a company (or an entity) for the purpose of the Model Rules – usually its jurisdiction of tax residence – and also the location of a PE. These rules are important as they determine the jurisdiction to which Globe income and covered tax, which are allocated to the company or the PE, are attributed for the purpose of determining a group's ETR in a relevant jurisdiction.

The rules relating to PEs are found Article 10.3.3 of the Model Rules.

- A treaty-PE is treated as located in the jurisdiction in which it is treated as a PE under the applicable treaty.
- A domestic law PE is treated as located in the jurisdiction where it is taxed on a net basis.
- A deemed-PE is treated as located in the jurisdiction where it is situated.
- A stateless PE is treated as precisely that i.e. "stateless".

## Scope and definition

Before we turn to the important issue of the allocation of Globe income and covered tax, we should address one or two questions of scope and definition.

First, as a general rule, the Pillar Two rules will apply to multinational groups that operate in more than one jurisdiction and that have an annual turnover in excess of €750m. However, the scope is extended to include a standalone company that conducts business in more than one jurisdiction through PEs except where its only PE is a stateless PE as described above (Model Rules, Article 1.2.3).

Second, although a PE is not itself an "entity" for the purpose of the Model Rules, a PE of an entity that is a member of a group is treated as a "constituent entity" and as a separate "constituent entity" from its parent company (referred to as its main entity) and from any other PEs of that main entity or any other group entity (Model Rules, Articles 1.3.1, 1.3.2).

This means that Globe income and covered tax can be allocated separately to PEs for the purpose of calculating jurisdictional ETRs under the Model Rules.

## Allocation of Global income and covered tax to a PE

### Global income

Where a PE has been identified, the Model Rules then apply to allocate Globe income to the PE (and not to the main entity of which it is part). The Globe income allocated a PE is then aggregated with the Globe income allocated to other constituent entities located in the same jurisdiction as the PE in determining that jurisdiction's ETR.

The income allocated to the PE depends on the nature of the PE.

- For treaty-PEs, domestic law PEs and deemed PEs, the starting point is the profits of the PE in the financial accounts of the PE (drawn up in accordance with acceptable accounting standards) or, where no separate accounts are drawn up, the profits that would have been reflected in such accounts (Model Rules, Article 3.4.1).
- This accounting profit is then adjusted:
- in the case of treaty-PEs and domestic law PEs to reflect items of income and expense taken into account in determining profit attributable to the PE under the applicable treaty or under domestic law (Model Rules, Article 3.4.2 (a)); and
- in the case of a deemed-PE, to reflect items of income and expense that would have been attributed to it under Article 7 of the OECD Model (Model Rules, Article 3.4.2 (b)).

The effect of these rules is that the attribution of profit to a PE for the purpose of the Model Rules will reflect OECD guidance in the case of treaty-PEs and deemed PEs, but not domestic law PEs, where the locally taxed profit will be the measure used.

The amount of Globe income allocated to a stateless PE is, in essence, the profit that is exempted from tax in the jurisdiction of residence of the main entity of which the PE is part (Model Rules, Article 3.4.3). The Globe income attributed to a stateless-PE is not aggregated with Globe income of other entities or other PEs within the group, and, given the manner in which the rules operate, it is likely that no covered tax will be attributed to that income so that top-up tax will become payable under the Pillar 2 rules in respect of that income.

### Covered tax

The amount of covered tax in the financial accounts of the main entity that is attributable to Globe income that is allocated to a PE is also allocated to the PE (and not to the main entity). This amount will include corporate income tax paid on the profit allocated to the PE in both the jurisdiction in which the PE is located and the jurisdiction in which the main entity of which it forms part is located. This amount is then aggregated with the covered tax allocated to other constituent entities located in the same jurisdiction as the PE as part of the calculation of that jurisdiction's ETR.

## The effect on credit and exemption systems

In jurisdictions where relief from double taxation on profits of PEs is given by exemption from tax (such as in the UK when a branch profit election has been made), the allocation of Globe income and covered tax under the Model Rules will broadly align with the allocation of taxing rights under applicable double tax treaties that follow the OECD Model.

The position is more complex in jurisdictions that tax companies on all of their profits wherever arising (including profits of PEs) and provide relief from double taxation by giving credit for tax paid in the jurisdiction in which PEs are located. In such cases, the Commentary to the Model Rules (Commentary, Chapter 4, paragraphs 46 to 54) sets out a process by which the covered tax that is allocated to the PE should be ascertained - in short, by identifying the corporate income tax paid in both the state in which the PE is located and in the state in which the main entity is located after giving effect for credit the tax paid on the profits of the PE in state in which it is located. The calculation is relatively straightforward where credit is given only against tax in the state in which the main entity located on the profits of the same PE, but, as the Commentary acknowledges, it is far more complex where credit is given against other profits of the main entity or profits of other PEs of the main entity.

## Use of losses

Similar issues can arise where, as a matter of domestic law in location of the main entity, the loss of a PE is allowed to reduce its taxable profits of a main entity. Although, for the most part, the Globe income and covered tax allocated to a PE under the Model Rules is not taken into account in determining the income or covered tax of the main entity of which it is a part, an exception is made for such cases so that the Globe Income of the main entity is also reduced. The price is that an equivalent amount of profit in the PE in subsequent years (and, subject to certain limitations, the tax attributable to it) is treated as Globe Income (and covered tax) of the main entity and not the PE (Model Rules, Articles 3.4.4, 3.4.5 and 4.3.4). The effect, of course, is to provide a cash flow benefit in terms of an increased ETR (and so potentially reduced top-up tax) in the jurisdiction of residence of the main entity in early years at the cost of a reduced ETR (and so potentially increased top-up tax) in later years.

Keep up to date with the latest developments and other useful information on our OECD BEPS 2.0 hubpage.