

## Permanent Establishments under the Pillars: The Relevance of a Transfer Pricing Analysis

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This paper analyses the treatment of Permanent Establishments (PEs) under the OECD's Pillar One and Pillar Two frameworks. It delves into the complexities of the Global Anti Base Erosion Model Rules (GloBE) and the Qualified Domestic Minimum Top-Up Tax (QD-MTT) rules under Pillar Two, as well as the reallocation of taxing rights under Pillar One. The role of transfer pricing in dealing with PEs is scrutinised, particularly its influence on the calculation of Adjusted GloBE income and Elimination Profit. The practical implications of these rules on PEs are illustrated through case studies. The paper also highlights the potential for disputes and the need for upfront certainty on transfer pricing positions.

**Keywords:** transfer pricing, pillar one, pillar two, permanent establishment

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### Introduction

Pillar Two introduces the Global Anti Base Erosion Model Rules (GloBE) (OECD, 2021) and Qualified Domestic Minimum Top-up Tax (QDMTT) rules (OECD, 2023b; UK: Draft Legislation..., 2022). These rules deal with the global minimum taxation. According to these rules, an in-scope MNE (OECD, GloBE Rules, Article 1.1) needs to be subject to an Effective Tax Rate (ETR) of 15% in every country it operates. In case the MNE is subject to tax at a rate lower than 15%, then a top-up tax needs to be calculated and allocated. The top-up

tax could be allocated to the low-tax jurisdiction itself through the QDMTT or another jurisdiction pursuant to the GloBE rules, that is the income inclusion rule (IIR) or the Undertaxed Profit Rule (UTPR). It should be noted that the ETR per country is determined by dividing the Adjusted Covered Taxes (OECD, GloBE Rules, Article 4) by the Adjusted GloBE income (OECD, GloBE Rules, Article 3).

On the other hand, the Pillar One Amount A (OECD, 2022b; Chand, Turina, & Ballivet, 2020) project deals with re-allocation of taxing rights to market countries. According to these rules, an in-

scope MNE (OECD, 2022b, Article 1) needs to reallocate part of its residual profits calculated at the MNE Group level to market countries. If a market country taxes the re-allocated profits, then another country in which the MNE Group operates is required to provide relief from double taxation. The rules as currently drafted require MNEs to determine their Elimination Profit (OECD, 2022b, Schedule I). Elimination Profit determination is a prerequisite for applying the rules which deal with the Marketing and Distribution Profits Safe Harbour (MDSH) (OECD, 2022b, Article 6) as well as the rules which deal with the Elimination of Double Taxation (EODT) provisions (OECD, 2022b, Articles 7–11).

In light of the above background, the main purpose of this short article is to analyse the manner in which Permanent Establishments (PEs) are treated under the QDMTT/GloBE rules as well as under the proposed Amount A Rules. Moreover, the purpose is to understand the role of transfer pricing (OECD, 2022e), when dealing with such PEs. Our analysis will be limited to analysing the manner in which the Adjusted GloBE income of a PE as well as the Elimination Profit of a PE is required to be calculated.

A cautious note to the reader with respect to the Pillars: we would like to highlight that the GloBE/QDMTT Rules are complex. This is the case even though the OECD has released the commentary (OECD, 2022c), examples (OECD, 2022d) as well as the administrative guidance (OECD, 2023b) on these rules. At the same time, for Pillar One Amount A purposes, the OECD has only released the Pillar One Progress Report. No examples or commentary has been issued so far. As a result, interpreting the rules outlined in the Progress report are complex. This said, as the rules surrounding determination of Elimination Profit have been borrowed from chapter 3 of the GloBE rules, the commentary on the latter could be helpful to interpret certain parts of Amount A. Definitely, the rules may still evolve, and many changes could possibly be expected in the coming months. These changes could have an impact on the various issues highlighted and discussed in this article.

## Permanent establishments under the Pillars

### Different types of PEs

Under the GloBE rules, PEs are treated as separate constituent entities (OECD, GloBE Rules, Article 1.3.1 (b) read with Article 1.3.2.).<sup>1</sup> Therefore, if a MNE operates with a PE in another country, then the ETR of that PE will need to be determined to check whether further top-up taxes could be due with respect to the PE. For example, assume that an In-scope German bank, which is a tax resident of Germany, has a PE in Mauritius. In this case, in order to calculate the ETR of the PE, we would need to ascertain its adjusted covered taxes as well as the adjusted GloBE income.

At the same time, for Amount A purposes, PEs are considered to constitute a separate ‘taxable presence’ for the MNE Group (OECD, 2022b, Schedule I, Section 3, pp. 86–87). Therefore, if a MNE operates with a separate taxable presence, then the Elimination Profit of this taxable presence needs to be calculated. This calculation would aid to understand whether or not the MDSH rules or the EODT rules apply to this taxable presence. For example, assume that an online streaming business, which is a tax resident of Germany, has a PE in India. In this case, we would need to calculate the Elimination Profit of the PE to understand whether or not the MDSH rules apply (if they apply, then they would cap the Amount A to be allocated to India) and whether or not the EODT rules apply (whether India would be a surrender jurisdiction, in addition to Germany).

The GloBE rules (OECD, GloBE Rules, Article 10.1; OECD, GloBE Commentary on Article 10.1, para 96, p. 209 and para. 56, p. 203) as well as the Amount A (OECD, 2022b, Schedule I, Section 8 (point 18), p. 92) rules differentiate between four different types of PEs that a Main Entity (head office) could have in another country.

<sup>1</sup> The definition of the term ‘controlling interest’ also means that “A Main Entity is deemed to have the Controlling Interests of its Permanent Establishments”. See OECD, GloBE Rules, Article 10.1.

The first type of PEs that both sets of rules discuss are PEs (or taxable presence) that arise as a result of a tax treaty which is in force between the jurisdiction of the Main Entity and the PE (or taxable presence), and the latter State taxes the income attributable to the PE (OECD, GloBE Rules, Article 10.1; OECD, GloBE Commentary on Article 10.1, paras. 97–102, pp. 209–210; for rules on location of the PE, see Article 10.3.3 (a); OECD, 2022b, Schedule I, Section 8 (point 18a), p. 92).<sup>2</sup> The PE concept could either be based on the OECD Model (various versions) or the UN Model (various versions) and an actual tax treaty could include, for example, a fixed place PE, agency PE, service PE, insurance PE and so on. The provision includes PEs which are not only declared by the taxpayer on a self-assessment basis but also includes PEs that arise pursuant to a MAP or final decision of a high Court in a jurisdiction (OECD, GloBE Commentary on Article 10.1, para. 99, p. 209).

The second type of PEs that both sets of rules discuss are PEs (taxable presence) that arise when there is no tax treaty and the PE arises only due to domestic law and the jurisdiction of the PE taxes the income attributable to the PE on a net basis similar to the manner in which it taxes its own tax residents (OECD, GloBE Commentary on Article 10.1, paras. 103–107, p. 210).<sup>3</sup>

The third type of PEs that both sets of rules discuss are PEs that are located in a jurisdiction that does not have a corporate income tax system in place (OECD, GloBE Commentary on Article 10.1, paras. 108–110, pp. 210–211; OECD, 2022b, Schedule I, Section 8 (point 18c), p. 92). Currently, it is estimated that 10 countries in the world do not have a CIT system (Tax Foundation, 2021).

The fourth and final type of PEs (taxable presence) refers to Stateless PEs. A stateless PE could arise when the Country of residence of the Main Entity (Country R) deems that a PE exists in another Country (Country S) and exempts that profits attributable to the PE even though the other Country

(Country S) does not recognise the PE for national law or tax treaty purposes. For instance, this could be the case when a Company in Country R has dependent agents selling its goods in Country S and the latter State does not consider the dependent agents to trigger a PE pursuant to national law. However, from the perspective of Country R a PE arises, profits are then determined and attributed to the PE and then these profits are exempt from taxation in Country R (OECD, GloBE Rules, Article 10.1 and OECD, GloBE Commentary on Article 10.1, paras. 111–114, pp. 211–212).<sup>4</sup> We will not discuss this type of PE henceforth.

### Calculation of GloBE income of the PE or Elimination Profit of the PE

Once it is determined that a PE (or taxable presence) exists in a certain jurisdiction, then the Adjusted GloBE Income/Elimination Profit of the PE (taxable presence) needs to be determined.

In this regard, the GloBE Rules as well as the Amount A Rules provide that the net income/loss reflected in the separate financial accounts of the PE, if they exist, should be used as a starting point to determine the PEs (taxable presence) GloBE Income/Loss (OECD GloBE Rules, Article 3.4.1 (1st sentence); OECD, GloBE Commentary on Article 3.4.1, para. 189, p. 77; OECD, 2022b, Schedule I, Section 3, para. 1 (1st sentence), p. 86).

On this matter, it should be noted that the commercial law of many countries require PEs, which are taxable, to prepare separate financial accounts as per local accounting standards (for example, in Switzerland (Martin, Chand, & Burkhalter, 2022) and the UK (UK: HMRC, INTM267050). Even if they are not made in accordance with local accounting standards (for example, they are made for management reporting purposes) they will need to be adjusted to local standards. This said, there is no uniform practice among countries. Also, in many cases the PE has to submit to the local tax admin-

<sup>2</sup> For rules on location of the PE, see Article 10.3.3 (a); OECD, 2022b, Schedule I, Section 8 (point 18a), p. 92.

<sup>3</sup> For rules on location of the PE, see Article 10.3.3 (b); OECD, 2022b, Schedule I, Section 8 (point 18b), p. 92.

<sup>4</sup> For rules on location of the PE, see Article 10.3.3 (d); OECD, 2022b, Schedule I, Section 8 (point 18d), p. 92.

istration not only its own separate financial accounts but also the financial accounts of the entire Entity to which it belongs.

If the PE does not have separate financial accounts (for example, it is common in the airlines sector that PEs of Main Entities do not prepare financial statements), then the starting point for the GloBE Income/Loss or Elimination Profit/Loss is the amount that would have been reflected in its separate financial accounts if prepared on a standalone basis and in accordance with the accounting standard used in the preparation of the Consolidated Financial Accounts of the Ultimate Parent Entity (OECD, GloBE Model Rules, Article 3.4.1 (2nd sentence); OECD, GloBE Commentary on Article 3.4.1, para. 190, p. 77; OECD, 2022b, Schedule I, Section 3, Para 1 (2nd sentence) p. 86). For example, if a Japanese Ultimate Parent (which uses Japanese GAAP for consolidated purposes) has a subsidiary in India and the Indian subsidiary has a PE in Uganda, then the PEs financial accounts need to be made using the Japanese GAAP. Thus, one may consider that additional compliance requirements and related costs are enforced on MNE Groups with respect to PEs, as in many cases financial accounts of the PE are most likely to be prepared under the accounting standard of the Main Entity (in the example above, Indian accounting standards) rather than under the standard used to prepare the Group's consolidated financial statements.

Thereafter, depending on the type of PE (or taxable presence) that arises, certain adjustments need to be carried out based on Article 3.4 of the GloBE rules or Schedule I Section 3(2) of the Amount A rules. Special rules also apply for loss making PEs, which are not explored in this contribution.

### **Adjustments to PEs (or taxable presence) financial statements**

With respect to the first type of PEs, the GloBE Rules and Amount A rules provide that the separate financial accounts need to be further adjusted to reflect the amounts and items of income/ex-

penses that are attributable to the PE in accordance with the tax treaty (as tax treaties prevail over national law). The GloBE rules contain the additional clarification towards the end of the sentence “regardless of the amount of income subject to tax and the amount of deductible expenses in that jurisdiction” (OECD, GloBE Rules, Article 3.4.2(a); OECD GloBE Commentary on Article 3.4.2, paras. 191–192, p. 78)., which is not present in the Amount A rules.

In general, when a tax treaty applies, in order to determine the income/expenses that are ‘*attributable*’ to a PE, the current version of the OECD Model Tax Convention (2017), that is Article 7(2), provides that items are to be attributed to a PE by treating the PE as a separate entity and by taking into account its functions performed, assets used and risks assumed. The OECD has done substantial work in this area and in addition to the OECD Commentary on Article 7, the 2010 OECD Report on the Attribution of Profits to a PE (OECD, 2010) need to be taken into account to interpret this provision. Moreover, as a result of BEPS Action 7 which made certain updates to the PE definition in the OECD Model and actual bilateral tax treaties, the OECD had released additional guidance (2018) on attribution of profits to a PE (OECD, 2018). Thus, in general, these two reports have to be taken into account to determine the profits attributable to a PE (along with the guidance issued by tax administrations of countries who follow the AOA approach).

The 2010 report provides a two-step approach, also known as the Authorised OECD Approach (AOA), towards PE profit (income/expenses) attribution (OECD, 2017, Article 7, paras. 20–22). The first step involves carrying out a functional and factual analysis to hypothesise the PE, that is, to understand the activities carried out by the PE (considering but not limited to its significant people functions, assets, and risks) and its dealings with associated enterprises, including the head office. The second step involves pricing the dealing with the associated enterprise(s) by reference to the transfer pricing principles. The steps are similar to the steps required to undertake a transfer pricing analysis under Article 9 (OECD, 2022e,

paras. 1.33–1.40). and it is well accepted that the 2010 AOA incorporates the full ALP approach in a majority of cases.

However, it should be noted that many actual tax treaties are based on the 2008 OECD Model Version. This version, similar to the current version, provided for the separate entity concept. However, the 2008 version also included provisions that were considered not to be consistent with the arm's length principle.

For instance, it is argued that Article 7(3): (1) in some situations, restricts the head office from charging a profit mark-up to the PE for internal dealings (also see OECD, 2017, Article 7, paras. 38–40). relating to goods, intangibles (and corresponding royalty payments), and services (especially management services) and (2) denies the recognition of internal loans and corresponding internal interest payments (except for banks). This stated, in a number of other situations, a profit mark-up was considered appropriate. This is the case when there was a supply of goods (from the head office to a PE or vice versa) or a supply of services (when the PE is usually in the business of providing services or when the head office is in that business itself. These statements were indeed confusing (Martin, Chand, & Burkhalter, 2022).

Moreover, Article 7(4) allowed States to allocate profits to a PE using an apportionment method based upon various formulae up to the extent it was customary in that State (OECD, 2017, Article 7, para. 41).

Finally, Article 7(5) provided that profits cannot be attributed to a fixed place which carried out purchasing activities. It is generally accepted that the 2008 OECD Model partially adopts the ALP (OECD, 2017, Article 7, para. 43).

Provisions similar to Art. 7 of the 2008 OECD Model are also contained in the UN Model (various versions). At the same time, the Committee of experts on international taxation has rejected the application of the AOA approach to interpret the business profits provision of the UN Model. Thus, it could well be possible that developing countries have a different approach towards applying the separate entity concept.

For the second type of PEs, the GloBE rules and Amount A rules provide that the separate financial accounts need to be further adjusted to reflect the amounts and items of income/expenses that are attributable to the PE in accordance with domestic law. Once again, the GloBE rules contain the additional part towards the end of the sentence “regardless of the amount of income subject to tax and the amount of deductible expenses in that jurisdiction” (OECD, GloBE Rules, Article 3.4.2(a); OECD GloBE Commentary on Article 3.4.2, paras. 191–192, p. 78), which is not present in the Amount A rules.

In this regard, we would like to highlight that many countries have adopted the separate entity approach or the AOA in their national law towards profits allocation to a PE. For example, the Netherlands (NL: Decree on..., 2022)<sup>5</sup> seem to have adopted the full AOA. On the other hand, countries like the UK (UK: HMRC, INTM267100) seem to have adopted the partial AOA approach (that is restrictions exist on internal dealings). Thus, the separate entity concept and the ALP will be used to determine items of income/expenses (profits) allocable to PEs in these countries.

However, at the same time, the practice adopted in many other countries by tax administrations/courts (e.g. in India) (IN: India Ministry of Finance..., pp. 10–11) indicates that there is an inclination to formulary approaches linked to either entities' overall turnover, assets, or employees.

Finally, in relation to the third type of PE, it should be noted that it could well be possible that many MNEs carry out commercial businesses in no tax jurisdictions through branches or dependent agents. Thus, the GloBE rules and Amount A rules state that a place of business in these countries (including a deemed place of business) would be treated as the PE in accordance with the OECD Model Tax Convention (2017) provided that such a jurisdiction would have the right to tax the income attributable to it in accordance with Article 7 the OECD Model Tax Convention (OECD, GloBE Rules,

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<sup>5</sup> This said, some exceptions apply for certain internal dealings.

Article 10.1; OECD, GloBE Commentary on Article 10.1, paras. 108–110, pp. 210–211).<sup>6</sup>

Essentially, this provision requires a hypothetical analysis of whether or not a PE would exist. The GloBE Commentary states “The analysis proceeds as if the residence and source country had a treaty that replicates the last version of the OECD Model Tax Convention. This means that it takes into account the version of the OECD Model Tax Convention of the year in which this analysis is made” (OECD, GloBE Commentary on Article 10.1, para. 110, p. 211).

Once it is determined that a PE exists, separate financial accounts would need to be drawn up. These financial accounts would further need to be adjusted to “reflect only the amounts and items of income and expense that would have been attributed to it in accordance with Article 7 of the OECD Model Tax Convention” (OECD, GloBE Rules, Article 3.4.2(b); OECD GloBE Commentary on Article 3.4.2, para. 196, p. 78)

The reference to the OECD Model Tax Convention (2017 version) in the definitions indicates that the full AOA will need to be used to determine the items of income and expenses attributable to a PE.

To summarise, a uniform standard towards determining the profits attributable to PEs does not exist. A facts and circumstances analysis will indeed be required. In some cases, the full or partial ALP approaches will be used (which are transfer pricing approaches) and in other cases formulas could be used.

Against this backdrop we will now analyse two case studies. We will assume that the MNE is within the scope of the GloBE rules as well as Amount A. The objective of the case studies is to ascertain the exact numbers that will flow into the GloBE Income calculations as well as Elimination Profit calculations.

### Case Study 1: Fixed place PE

In this case study we assume that R Co. is the UPE of the MNE Group which is engaged in the pro-

<sup>6</sup> For rules on location of the PE, see Article 10.3.3 (c).

duction and sale of consumer electronics. R Co. has set up a contract research centre in Country S. The research centre has been set up under a branch structure. All key DEMPE (OECD, 2022e, paras. 6.32–6.85).<sup>7</sup> functions associated with the intangible are performed at the head office level and the branch carries out research activities for R Co. under the direction and supervision of the head office.<sup>8</sup>

R Co.’s tax team after analysing the relevant national law and tax treaty provisions has determined that there is a fixed place PE as in Country S (due to the branch).

The PE draws up separate financial statements according to the accounting rules in Country S (see column 1 in Table 1). One can see that in the profit/loss account, the main item on the expense side are the various personnel related expenses (salaries of researchers), depreciation expenses, and other operating costs. The main component on the income side is the service fee from the head office for the R&D services. We assume that in the financial accounts the income item is recorded at cost due to local PE accounting rules (which do not recognise internal dealings).

The question now is how do we calculate the GloBE Income of the PE for Pillar Two purposes or the Elimination Profit of the taxable nexus for Amount A purposes?

If the applicable tax treaty between Country R and Country S follows the 2010 OECD Model, it could well be possible that the service fee recorded in the financial statements needs to be adjusted to take into account the AOA approach.

Applying Step 1 of the AOA would most likely result in the outcome that the PE is characterised as a limited risk service provider which provides contract research and development services to its head office (OECD, 2010, para. 201, p. 53). If we assume independent enterprises similar to the PE report a cost-plus operating margin of 10% (based on a transfer pricing study) then, pursuant

<sup>7</sup> For a detailed analysis of the DEMPE concept, see Chand & Lembo, 2020.

<sup>8</sup> For a similar example, see OECD, 2022e, Annex I to Chapter VI, Example 14, paras 46–48.

Table 1. Case study 1: Fixed place PE

	Column 1 Financial accounts	Column 2 AOA Accounts GloBE Profit and Elimination Profit
Income from services (A)	1,000	1,100 (based on a TP study)
Salary expense (B)	700	700
Depreciation (C)	250	250
Other operating expenses (D)	50	50
Operating profit before interest (E) = (A) – (B) – (C) – (D)	0	100 (10% mark up on 1000)
Internal charge (F)*	0*	20* (based on AOA)
Profit after internal charge (G) = (F) – (E)	0	80

Source: own elaboration.

to step 2 of the AOA, the internal research and development service fee needs to be adjusted to reflect this margin.<sup>9</sup>

In general, the numbers that are used for AOA purposes will most likely be used to determine the GloBE income of the PE as well as the Elimination Profit of the PE (see column 2 in Table 1).

Additionally, it could be possible that due to the application of the AOA, free capital and an internal expense (such an interest based on the head office’s capital structure) is allocated to the PE (OECD, 2010, paras. 150–171, pp. 42–46, para. 205, p. 54; OECD, 2017, Article 7, para. 28), which would further reduce the GloBE Income or Elimination Profit (see column 2 in Table 1).

As already discussed, the GloBE rules contain the additional expression that “regardless of the amount of income subject to tax and the amount of deductible expenses in that jurisdiction”.

It could well be possible that once the adjusted financial profit is determined, a country may, under its general tax rules, make further adjustments for taxable income purposes. For example, putting aside our case study, a State may apply a general interest limitation rule (such as the one proposed by BEPS Action 4) which would restrict

interest deductions (also see OECD, 2017, Article 7, paras. 30–32). A country may also permit additional expenses to be claimed for tax law purposes, for example, accelerated depreciation (OECD GloBE Commentary on Article 3.4.2, para. 195, p. 78).

In this case, the numbers reported under the AOA approach and financial accounting (e.g. depreciation expense booked for financial accounting purposes) could, in principle, prevail for GloBE purposes.

### Case Study 2: Agency PE

We now turn to another situation and analyse the case of an agency PE. We assume that R Co. in Country R is the UPE of the MNE Group. R Co. employs Mr X, a national and resident of Country S, to sell its products in Country S. Mr X works with his team (who are also employed by R Co. to work in State S) to ensure that the sales targets are met.

We also assume that there is a tax treaty between Country R and S based on the 2008 OECD Model and Country S’s national tax law just indicates that the ALP is relevant for allocating profits to a PE (without any further details).

R Co.’s tax team after analysing the relevant tax treaty, admitted that the OECD Commentary (OECD, 2017, Article 5, paras. 88–89). acknowl-

<sup>9</sup> For other examples, see Gramm, 2020; Ruberti, 2022.

edged that there is an agency PE as Mr X plays a key role in contract conclusion in Country S.<sup>10</sup> The tax team declared an agency PE to the local tax administration.

Moreover, a functional analysis performed in Country S reveals that Mr X and his team perform sales, distribution, inventory management, and marketing activities under the guidance and supervision of R Co. In terms of risks, based on Mr X's activities, the analysis also indicates that the PE bears limited risks, that is limited sales and market risks, inventory risks, and credit risks.<sup>11</sup> Essentially, the PE is characterised as a limited risk distributor under Step 1 of the AOA approach (also see OECD, 2010, paras. 64–65, p. 26).<sup>12</sup> Further, based on the analysis, it is concluded that the internal dealing at stake here is the purchase of the goods from the head office, which are then sold to third parties (also see OECD, 2017, Article 7, para. 24).

R Co.'s accounting team makes separate financial statements according to the accounting rules in Country S (see column 1 in Table 2). One can see that in the profit/loss account, the main component on the income side are the sales to third parties (Euro 1,000), whereas on the expense side the costs of the agency PE include purchase of goods from the head office (internal dealing), which we assume that in the financial accounts is recorded at cost due to local accounting rules (Euro 600). Moreover, the PE has other costs such as salary of Mr X, warehousing expenses, payments made towards local marketing activities (Euro 150 – shown as third party expenses). Its profit before tax for financial statements is Euro 250.

The question now is how do we calculate the GloBE Income of the PE for Pillar Two purposes as well as Elimination Profit of the taxable presence for Amount A purposes? If the applicable tax

treaty follows the 2008 OECD Model, it could well be possible that the purchase price (internal dealing) recorded in the financial statements needs to be adjusted to take into account the AOA approach (under Step 2) (OECD, 2017, Article 7, para. 47).<sup>13</sup> If we assume independent enterprises similar to the PE report an operating margin of 3% (based on a transfer pricing study), then the internal purchase price needs to be adjusted to reflect this margin (also see OECD, 2017, Article 7, para. 47).<sup>14</sup> This would increase the purchase price to Euro 820 and decrease the profit to Euro 30 (so that 3% on sales is reported as operating profits). We will assume that for the purpose of this case, an internal interest dealing is not allowed as deduction as the relevant treaty followed the 2008 OECD Model (see column 2 in Table 2).

We would just like to highlight that the discussion on the single taxpayer vs dual taxpayer approach is not relevant here as Mr X and his team do not come within the scope of Article 9 (also see OECD, 2010, paras. 230–245, pp. 59–62).

In general, the numbers that we build for AOA purposes will most likely be used to determine the GloBE Income of the PE as well as the Elimination Profit of the PE (see column 2 in Table 2).

As discussed before, a State may allow certain deemed expenses to be deductible for tax law purposes (e.g. a certain percentage of inventory as a provision for bad debts) (also see OECD, 2017, Article 7, paras. 30–32). In these circumstances, the adjusted financial profit needs to be used as opposed to the profit reported for taxable income purposes (GloBE Commentary on Article 3.4.2, paras. 193–195, p. 78).

## Conclusion

Under the current international tax system, the approach adopted to allocate profits to a PE varies among countries. Based on the relevant domestic

<sup>10</sup> For a detailed analysis on such an issue, see K. Dziurdź, 2014, pp. 135–167.

<sup>11</sup> The OECD also recognizes that in some cases, PEs can be attributed such risks. See OECD, 2010, paras. 23–24, p. 17.

<sup>12</sup> For another example when R Co. operates through a related company in another country, see Drobnik, 2018.

<sup>13</sup> For a discussion on comparability analysis for distributor PEs, see OECD, 2010, paras. 185–186, p. 50.

<sup>14</sup> For examples on distribution models, see OECD, 2022e, Annex I to Chapter VI, Examples 7–13.

Table 2. Case study 2: Agency PE

	<b>Column 1 Financial accounts</b>	<b>Column 2 AOA Accounts  GloBE and Elimination Profit</b>
Income from sales (A)	1,000	1,000
Purchase from Head office (B)*	600*	820* (based on a TP study)
All third party expenses (C)	150	150
Operating profit before interest (D) = (A) - (B) - (C)	250	30 (based on a TP study)
Internal interest charge (E)*	0*	0*
Profit after internal charge (F) = (D) - (E)	250	30

Source: own elaboration.

law and tax treaty, some countries adopt the full AOA approach (full transfer pricing approach), some adopt the partial AOA approach, and others use formulary approaches. Thus, determining profits attributable to PEs requires a case-by-case/facts and circumstances analysis.

The new system is tightly interlinked with the current system. In other words, the approach adopted towards determining the GloBE Income/Loss or Elimination Profit/Loss of a PE is based on the existing system. This also implies that calculating the GloBE income of a PE as well as its Elimination Profits requires a case-by-case/facts and circumstances analysis.

As shown in the case studies, transfer pricing rules become relevant, in many cases, to make such determinations. This would also imply that a sophisticated analysis would be required, in particular, when we are dealing with PEs of financial services businesses (such as banks, global financial trading, and insurance companies). Such analysis could also become complex as in many cases they require subjective determinations (e.g.

allocation of free capital and interest-bearing debt to the PE).

Thus, it is essential that MNEs get upfront certainty on their transfer pricing positions as these positions could lay down the basis for making GloBE or Elimination Profit calculations (in many instances). Consequently, we could anticipate that, in the near future, bilateral Advance Pricing Arrangements (APA) (OECD, 2022e, para. 4.142; OECD, 2017, Article 25, para. 52; OECD, 2022a) or multilateral APAs<sup>15</sup> may play a prominent role as this area is ripe for disputes (OECD, 2017, Article 7, paras. 55–70; OECD, 2017, Article 25, para. 9).

In this paper, with the assistance of the case studies, the authors have briefly analysed the manner in which PEs are treated under the Pillars and the relevance of transfer pricing rules in these cases. Definitely, further research is required in this area, especially when we are dealing with triangular cases and hybrid/transparent entities. These matters will be discussed in another publication.

<sup>15</sup> For an example of a multilateral issue, see OECD, 2017, Article 25, para. 38.2; OECD, 2023a, pp. 43–45.

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