Chapter 3.5: PE and Flow-Through Allocations

Learning Objective

After completing this chapter, you will be able to allocate GloBE Income between main entities and permanent establishments, and apply the correct treatment for flow-through entities including tax transparent structures and reverse hybrids.

Why Special Allocation Rules Are Needed

The GloBE Rules rely on financial accounting information, but:

Structure	Challenge
Permanent Establishments	PEs are treated as separate CEs but may not have separate financial accounts
Flow-Through Entities	Income may be taxed at owner level, not entity level
Reverse Hybrids	Different jurisdictions may treat the same entity differently

Result: Articles 3.4 and 3.5 provide allocation rules to ensure income is attributed to the correct jurisdiction for ETR calculation.

Part A: Permanent Establishment Allocations

PE as a Separate Constituent Entity

For GloBE purposes, a PE is treated as a **separate Constituent Entity** located in the jurisdiction where it operates *(Article 10.1)*.

Key implication: Each PE has its own: - GloBE Income calculation - Covered Taxes calculation - ETR calculation - Potential Top-Up Tax

Three Types of PE *(Article 10.1)*

Type	Definition	Reference
(a) Treaty PE	PE under applicable tax treaty between main entity jurisdiction and PE jurisdiction	Art. 10.1(a)
(b) Domestic Law PE	PE under domestic law of PE jurisdiction (no treaty)	Art. 10.1(b)
(c) Deemed PE	Would be a PE under OECD Model if PE jurisdiction had a treaty with main entity jurisdiction	Art. 10.1(c)

Step 1: Determine PE's Financial Accounting Net Income *(Article 3.4.1)*

Priority order:

```
 1. Use PE's separate financial accounts (if they exist)
               |
               ▼
2. If no separate accounts:
   Prepare notional standalone accounts using UPE's accounting standard
```

Step 2: Adjust to Reflect Attributable Amounts *(Article 3.4.2)*

The PE's income must reflect only amounts **attributable to the PE** under:

PE Type	Attribution Basis
Treaty PE *(Art. 10.1(a))*	Applicable tax treaty or PE jurisdiction domestic law
Domestic Law PE *(Art. 10.1(b))*	PE jurisdiction domestic law
Deemed PE *(Art. 10.1(c))*	Article 7 of OECD Model Tax Convention (arm's length)

Important: The attribution is based on **what income is attributable**, not what income is actually taxed.

Worked Example: PE Income Attribution

Facts: - UK Co (main entity) has a PE in Country X - UK-Country X tax treaty applies - PE earns €1,000,000 in royalties - Country X exempts 50% of royalties from tax

PE Income for GloBE:

Item	Amount
Royalties attributable to PE under treaty	€1,000,000
Amount actually taxed in Country X	€500,000
GloBE Income of PE	**€1,000,000**

Key point: GloBE uses the €1,000,000 attributable under the treaty, regardless of the €500,000 actually taxed.

Step 3: Exclude PE Income from Main Entity *(Article 3.4.4)*

The Rule

PE income is **not included** in the main entity's GloBE Income.

The Exception: PE Loss Push-Down *(Article 3.4.5)*

If the PE has a **GloBE Loss**, special rules apply:

Condition: The PE loss is treated as an expense for domestic tax purposes in the main entity's jurisdiction.

Treatment:

Step	Action
1	PE Loss is treated as an **expense of the main entity** (not the PE)
2	PE's GloBE Loss for that year = €0
3	Main entity's GloBE Income is reduced by the loss
4	Future PE profits are treated as **main entity income** until loss is recaptured

Worked Example: PE Loss Push-Down

Year 1: - SG France SAS (main entity) has Belgium PE - Belgium PE has GloBE Loss of €(500,000) - France allows deduction for PE losses

Entity	GloBE Income
Belgium PE (before adjustment)	€(500,000)
Belgium PE (after Art. 3.4.5)	€0

Entity	GloBE Income
SG France SAS (before adjustment)	€2,000,000
SG France SAS (after Art. 3.4.5)	€1,500,000

Year 2: - Belgium PE earns GloBE Income of €300,000

Entity	GloBE Income	Recapture
Belgium PE	€0	€300,000 allocated to France
SG France SAS	+ €300,000	Recaptured profit
Remaining to recapture		€200,000

Year 3: - Belgium PE earns GloBE Income of €400,000

Entity	GloBE Income	Recapture
Belgium PE	€200,000	€200,000 completes recapture
SG France SAS	+ €200,000	Final recapture
Remaining		€0 (fully recaptured)

PE Income Allocation Methodology

Step-by-Step Process

```
┌─────────────────────────────────────────────────────────────────┐
│         PE INCOME ALLOCATION — STEP-BY-STEP                     │
├─────────────────────────────────────────────────────────────────┤
│                                                                 │
│  STEP 1: Identify all PEs of the Main Entity                    │
```

```
│           └── Treaty PEs, Domestic Law PEs, Deemed PEs      │
│                            │                                 │
│                            ▼                                 │
│  STEP 2: For each PE, determine Financial Accounting         │
│          Net Income                                          │
│          ├── Option A: Use separate PE accounts              │
│          └── Option B: Prepare notional standalone accounts  │
│                            │                                 │
│                            ▼                                 │
│  STEP 3: Adjust for attributable income/expense              │
│          ├── Treaty PE: Per applicable treaty/domestic law   │
│          ├── Domestic PE: Per PE jurisdiction law            │
│          └── Deemed PE: Per OECD Model Art. 7                │
│                            │                                 │
│                            ▼                                 │
│  STEP 4: Check for PE losses                                 │
│          ├── If PE has loss AND loss deductible for main     │
│          │   entity domestic tax: Apply Art. 3.4.5           │
│          └── Otherwise: PE retains loss                      │
│                            │                                 │
│                            ▼                                 │
│  STEP 5: Allocate Covered Taxes                              │
│          └── Taxes on PE income to PE jurisdiction           │
│                            │                                 │
│                            ▼                                 │
│  STEP 6: Calculate ETR for each jurisdiction separately      │
│                                                              │
└──────────────────────────────────────────────────────────────┘
```

Part B: Flow-Through Entity Treatment

Flow-Through Entity Definitions *(Article 10.2)*

Term	Definition
Flow-Through Entity	Entity that is fiscally transparent in its jurisdiction of creation (unless tax resident elsewhere)
Tax Transparent Entity	Flow-through entity that is also treated as transparent by its owners' jurisdiction
Reverse Hybrid Entity	Flow-through entity that is treated as opaque (non-transparent) by its owners' jurisdiction

Visual Summary

```
                 FLOW-THROUGH ENTITY
                (transparent in own jurisdiction)
                          |
          ┌───────────────┴───────────────┐
          |                               |
TAX TRANSPARENT ENTITY          REVERSE HYBRID ENTITY
(owner also treats as            (owner treats as
 transparent)                     opaque)
          |                               |
          ▼                               ▼
Income flows to owner           Income stays at entity
for GloBE purposes              for GloBE purposes
```

Tax Transparent Entity Treatment *(Article 3.5.1)*

The Rule

For a **Tax Transparent Entity**, the GloBE Income and Covered Taxes are allocated to the **Constituent Entity owners** in proportion to their ownership interests.

When This Applies

The entity must be: 1. Fiscally transparent in its jurisdiction of creation, AND 2. Fiscally transparent in the jurisdiction of its owners

Common Examples

Structure	Typical Treatment
US LLC owned by US corporation	Tax transparent (single-member or check-the-box)
UK LLP owned by UK companies	Tax transparent
German KG owned by German GmbH	Tax transparent
Luxembourg SCSp owned by Luxembourg entities	Tax transparent

Worked Example: Tax Transparent Entity

Structure:

```
SG Holdings Ltd (UK)
    │
    └── 100% ownership
            │
            ▼
```

```
    SG US LLC (Delaware)
    [Check-the-box disregarded entity]
```

SG US LLC financials: - GloBE Income: €3,000,000 - Covered Taxes: €0 (disregarded for US tax)

Allocation under Article 3.5.1:

Entity	GloBE Income	Covered Taxes
SG US LLC	€0	€0
SG Holdings Ltd (UK)	+ €3,000,000	+ €0

Effect: The US LLC income increases the UK jurisdiction's GloBE Income. The UK ETR calculation includes this €3M.

Reverse Hybrid Entity Treatment *(Article 3.5.2)*

The Rule

For a **Reverse Hybrid Entity**, the GloBE Income and Covered Taxes **remain at the entity level**.

When This Applies

The entity is: 1. Fiscally transparent in its jurisdiction of creation, BUT 2. Treated as opaque (non-transparent) by the owners' jurisdiction

Common Examples

Structure	Why It's a Reverse Hybrid
US LLC owned by German GmbH	US: transparent; Germany: treats LLC as corporation

Structure	Why It's a Reverse Hybrid
Luxembourg SCSp owned by French SA	Luxembourg: transparent; France: may treat as opaque
UK LP owned by Japanese KK	UK: transparent; Japan: treats LP as corporation

Worked Example: Reverse Hybrid Entity

Structure:

```
SG Japan KK (Japan)
    │
    └── 100% ownership
            │
            ▼
   SG US LLC (Delaware)
   [Japan treats as opaque corporation]
```

SG US LLC financials: - GloBE Income: €2,500,000 - US Covered Taxes: €0 (not taxed at entity level)

Treatment under Article 3.5.2:

Entity	GloBE Income	Covered Taxes	Jurisdiction
SG US LLC	€2,500,000	€0	**USA**
SG Japan KK	€0 (from LLC)	€0 (from LLC)	Japan

Effect: The LLC's income stays in the US jurisdiction for ETR purposes. US ETR = €0 ÷ €2,500,000 = **0%**. Top-Up Tax will arise.

The Reverse Hybrid Problem

Reverse hybrids can create **stateless income** for GloBE purposes:

Jurisdiction	Tax Treatment	GloBE Treatment
Entity location (e.g., US)	Not taxed (transparent)	Income attributed here
Owner location (e.g., Japan)	Not taxed (waits for distribution)	No income attributed

Result: Income sits in a jurisdiction with 0% ETR, triggering Top-Up Tax.

UPE as a Flow-Through Entity *(Article 3.5.3)*

Special Rules

When the **UPE itself** is a flow-through entity (e.g., a US LLC or UK LLP):

Scenario	Treatment
UPE is tax transparent to owners	GloBE Income may flow up to natural persons or non-MNE owners
UPE is reverse hybrid	GloBE Income stays at UPE level

Reduction for Non-CE Owners

If the UPE is tax transparent and some owners are **not Constituent Entities** (e.g., individuals, excluded entities), the GloBE Income is reduced by their share *(Article 3.5.3)*.

Worked Example: UPE as Flow-Through

Structure:

```
 Individual A (50%)  ←┐
                      │
PE Fund LP (UK)  ─────┼──── SG Operating Ltd (UK)
[UK LLP - transparent]│
                      │
Individual B (50%)  ←─┘
```

PE Fund LP financials: - GloBE Income from SG Operating: €10,000,000

Allocation:

Owner	Share	CE?	GloBE Income Allocated
Individual A	50%	No	€0 (excluded)
Individual B	50%	No	€0 (excluded)
PE Fund LP	—	Yes (UPE)	€0

Effect: The 100% owned by individuals reduces the GloBE Income to €0. No Top-Up Tax arises because income flows to non-CE owners.

Allocation in Ownership Chains

Multiple Flow-Through Entities

When flow-through entities are stacked, determine transparency at each level:

```
SG Holdings Ltd (UK)
    │
    └── SG Luxembourg SCSp
            │ (Tax transparent to SG Holdings)
            │
```

```
            └── SG US LLC
                    (Tax transparent to SCSp)
```

Analysis: 1. SG US LLC: Transparent in US, transparent to Luxembourg SCSp owner 2. SG Luxembourg SCSp: Transparent in Luxembourg, transparent to UK owner 3. **Result:** Income flows up to SG Holdings Ltd (UK)

Chain Resolution Rule

The **June 2024 Administrative Guidance** clarifies:

> *When a flow-through entity is owned by another flow-through entity, classification is determined by reference to the next owner up the chain who is NOT a flow-through entity.*

Stratos Worked Example: PE and Flow-Through

Structure

```
Stratos Group plc (UK)
    │
    ├── SG France SAS (France)
    │       └── Belgium PE
    │
    ├── SG Holdings Ltd (UK)
    │       └── SG US LLC (Delaware) [disregarded]
    │
    └── SG Japan KK (Japan)
            └── SG Singapore LP [reverse hybrid]
```

Analysis: Belgium PE

SG France SAS — Belgium PE Allocation

Item	France	Belgium PE
Total entity income	€8,500,000	—
Less: PE attributable income	—	€1,200,000
Remaining main entity	€7,300,000	—
PE GloBE Income	—	€1,200,000

Analysis: SG US LLC (Tax Transparent)

SG US LLC — Flow-Through to UK

Item	USA	UK (SG Holdings)
LLC GloBE Income	€2,800,000	—
Less: Allocated to UK owner	(€2,800,000)	+ €2,800,000
Remaining at LLC	€0	—
Added to UK GloBE Income	—	€2,800,000

UK Covered Taxes on LLC income: - UK taxes SG Holdings on worldwide income including LLC - UK corporate tax at 25% on €2,800,000 = €700,000 - This €700,000 goes into UK Covered Taxes

Analysis: SG Singapore LP (Reverse Hybrid)

SG Singapore LP — Stays in Singapore

Item	Singapore	Japan (SG Japan KK)
LP GloBE Income	€1,500,000	—
Singapore taxes (17% assumed)	€255,000	—

Item	Singapore	Japan (SG Japan KK)
Allocated to Japan?	No	—
Singapore ETR	17%	—

Note: Singapore LP remains a Singapore CE. Japan doesn't recognise the income until distribution.

Summary Table

Entity/PE	Jurisdiction	GloBE Income	Covered Taxes	ETR
Stratos Group plc	UK	€45,600,000	€10,944,000	24.0%
SG Holdings Ltd	UK	+€2,800,000*	+€700,000*	(combined)
SG France SAS	France	€7,300,000	€1,825,000	25.0%
Belgium PE	Belgium	€1,200,000	€300,000	25.0%
SG US LLC	USA	€0	€0	N/A
SG Japan KK	Japan	€22,300,000	€6,690,000	30.0%
SG Singapore LP	Singapore	€1,500,000	€255,000	17.0%

*LLC income flows to UK; taxes paid by UK on that income.

Documentation Requirements

For PE Allocations

Document	Purpose
PE separate accounts (if available)	Primary source for PE income
Transfer pricing documentation	Supports arm's length attribution
Tax treaty analysis	Confirms PE existence and attribution rules
Domestic law analysis	For domestic law PEs
Loss tracking schedule	For Article 3.4.5 recapture

For Flow-Through Entities

Document	Purpose
Entity classification analysis	Transparent vs reverse hybrid
Ownership structure chart	Identifies CE vs non-CE owners
Tax treatment in each jurisdiction	Confirms classification
Allocation calculations	Shows income flow-through

8. Common Pitfalls

Pitfall 1: Double-Counting PE Income

Error: Including PE income in both PE and main entity GloBE Income.

Correct: Exclude PE income from main entity under Article 3.4.4.

Pitfall 2: Ignoring PE Loss Recapture

Error: Pushing PE loss to main entity without tracking future recapture.

Correct: Maintain schedule to recapture future PE profits to main entity.

Pitfall 3: Misclassifying Flow-Through Entities

Error: Assuming all LLCs/LPs are tax transparent.

Correct: Check treatment in **both** entity jurisdiction AND owner jurisdiction.

Pitfall 4: Forgetting Reverse Hybrid Consequences

Error: Assuming income flows to owners as for tax transparent entities.

Correct: Reverse hybrid income stays at entity level—often creates low ETR jurisdiction.

Pitfall 5: Missing Non-CE Owner Reduction

Error: Including full GloBE Income when UPE is flow-through with non-CE owners.

Correct: Reduce GloBE Income by share attributable to non-CE owners.