



Lund University

School of Economics and Management  
Department of Business Law

## **Profit-allocation based on value creation in the digital economy**

**By**

**Tim Theunis**

**HARN60 Master Thesis**

Master's Programme in European and International Tax Law

2017/2018

Spring semester 2018

Date: 01-06-2018

Supervisor: Professor J. Monsenego

Examiner: Professor C. Brokelind

Author's contact information:

timtheunis@home.nl

+31 648 227 009

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## Executive summary

This thesis discussed the Directive in which the European Commission proposed to introduce the concept of a digital permanent establishment to address the issues raised by the digital economy. This is necessary since the current international tax principles have their origin more than a hundred years ago and are focussed too much on a business' physical presence. Information and communications technology however, especially the introduction of the internet, have changed the way businesses operate and enabled them to provide goods and services in jurisdictions in which they are not physically present. This results in a mismatch between the place where profits are made (the customer's jurisdiction) and the place where taxation takes place (the jurisdiction of the company's establishment).

In case a permanent establishment exists however, a company will become liable to pay tax on the profits that are accrued in that state, even though it is not established in that jurisdiction. The current definition of a permanent establishment as laid down in article 5 OECD Model Tax Convention however, requires some sort of physical presence to establish a nexus in a certain jurisdiction. This was perfectly illustrated by the Google Ireland vs. France case, which ran through this thesis as a common thread. With the recommendations from BEPS Action 7 now implemented in the OECD MTC 2017, the thresholds to deem a PE to exist are for several situations remarkable lower than before. To effectively capture digital activities without any physical presence however, a whole new definition is required.

The European Commission therefore proposed to introduce a new definition, which will exist next to the "traditional" permanent establishment definitions. The digital permanent establishment definition as proposed by the Commission can exist without any physical presence by taking into account a combination of economic factors that are indicative to have a significant digital presence to create a nexus in a certain jurisdiction. The commission proposed three different thresholds, each of which alone is enough for a DPE to exist:

- A revenue of at least € 7.000.000 from the supply of digital services to users located in a certain Member State;
- More than 100.000 users in a certain Member State make use of the digital services that a company provides;
- The number of business contracts for the supply of digital services in a certain Member State exceeds 3.000.

The proposed definition is well defined and the thresholds are set at levels that seem proportionate at the same time. However, while the definition will apply within the European Union and between Member States and third countries with which there is no double tax treaty in place, the definition will not apply in situations in which the digital company is established in a third country that has a double tax treaty with the given Member State. The latter is for example the case with the United States, a jurisdiction that particularly is the home base for many digital companies. For the DPE to be really effective, it has to be implemented in the various DTTs with the U.S., something that will at least take time, if it

will even happen at all. The U.S. is namely of the opinion that the European measures to tackle the digital economy are a direct attack on the U.S. taxable base and hence tax revenues.

While the definition of a DPE is clear and sufficient enough to effectively create a nexus for digital companies without any physical presence in a certain jurisdiction, the question arises how to tax it. In order to tax it, it has to be attributed profits that are deemed to be made in that jurisdiction. To minimise base erosion and profit shifting, profits have to be taxed in the jurisdiction in where value is created. The concept of value creation however is not defined in the law and quite often subject of different interpretation. This follows from the fact that “value” is subjective and therefore sensitive to manipulation.

Because of the distinct characteristics of digital companies, they are able to create value in different ways than traditional business models. Where BEPS Action 8-10 recommended to align transfer pricing outcomes with value creation by linking the significant people functions related to assets and risks to the attribution of profits, this would (because of the lack of people) not be effective for the DPE. Therefore, new functions have to be created, specifically to capture the value created by digital companies. On this point, the European Commission took into account the recommendations of the OECD’s interim-report, which suggested that “users” and “data” should be regarded as value creating factors for digital companies.

With regard to users, difference should be made between value created by active user participation and value derived from passive users. Active users for example create value by their contributions to a social media network (posting status updates, “liking” other user’s posts and commenting/sharing). These contributions make the network more attractive for other users to join the network and therefore have a positive impact on the user base. With more users joining the network, the possible viewers of advertisements displayed on the network increases accordingly, making the network more interesting for advertising companies and thereby increasing the revenues of the social media platform. By their contributions, the users also enhance the company’s intangibles, expand the brand’s recognition and improve the platform’s performance.

On the other hand, research has shown that the majority of users are passive users, which are less likely to directly create a lot value for the company. Indirectly however, the data gathered from their memberships, subscriptions and online behaviour can be used to create value for the company. Raw data however, only becomes valuable by processing and analysing it specific for its targeted use. Therefore, a difference has to be made between the jurisdiction where the data is gathered, where it is analysed/processed and the jurisdiction in which it is used to create value respectively. This should, together with the active user’s contributions, be reflected in the functional analysis.

The attribution of profits to the DPE based on “active users” and “user data” as value drivers should be done by applying a combination of the PSM and FA. Where the PSM can be used to attribute the routine profits, FA is necessary to attribute the residual profits to the user jurisdictions.

## Preface

Dear reader,

You are currently looking at the Master's thesis that I wrote as part of the European and International Tax Law programme at Lund University. This thesis concludes that programme during which I have expanded my knowledge regarding European and international tax law, a field that is gaining in importance every day and which dynamics change constantly.

I want to thank Professor Monsenego for his helpful feedback during the writing of this thesis.

I also want to thank Professor Brokelind, not only for being the examiner of this thesis, but definitely for the inspiring lectures on direct taxation during the programme at Lund University.

I hope you will enjoy reading this thesis.

Sincerely,

Tim Theunis MSc.

## Abbreviations

<b>ALP</b>	Arm's Length Principle
<b>AOA</b>	Authorised OECD Approach
<b>ATAD</b>	Anti-Tax Avoidance Directive
<b>BEPS</b>	Base Erosion and Profit Shifting
<b>CCCTB</b>	Common Consolidated Corporate Tax Base
<b>CCTB</b>	Common Corporate Tax Base
<b>DPE</b>	Digital Permanent Establishment
<b>DPE Directive</b>	European Commission proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM(2018) 147 final, Brussels, 21 March 2018
<b>DPT</b>	Diverted Profits Tax
<b>DST</b>	Digital Sales Tax
<b>DTT</b>	Double Tax Treaty
<b>ECJ</b>	European Court of Justice
<b>ECOFIN Council</b>	Economic and Financial Affairs Council
<b>FA</b>	Formulary Apportionment
<b>Interim-report</b>	OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
<b>IP</b>	Intellectual Property
<b>IPR</b>	Intellectual Property Rights
<b>MLI</b>	Multilateral Instrument
<b>MNE</b>	Multinational Enterprise
<b>MTC</b>	Model Tax Convention (OECD) 2017
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>PE</b>	Permanent Establishment
<b>PSM</b>	Profit Split Method
<b>TFEU</b>	Treaty on the Functioning of the European Union
<b>TPG</b>	Transfer Pricing Guidelines (OECD) 2017
<b>U.S.</b>	United States (of America)

## Introduction

On 21<sup>st</sup> of March 2018, the European Commission proposed two Council Directives regarding taxation of the digital economy. One contained an interim solution in the form of a Digital Sales Tax (“DST”), levying 3% on the turnover of companies providing digital services. The second Directive proposed to introduce rules regarding taxation of companies with a significant digital presence through the concept of a digital permanent establishment (“DPE”). The proposals followed the conclusions made in October 2017 by the Economic and Financial affairs (“ECOFIN”) Council, aimed at updating international tax rules, with a special focus on companies operating in the digital economy. This would, according to the Minister of Finance of Estonia, “guarantee the equal taxation of all companies regardless of their location or place of activity. Countries are deprived of tax income and to compensate for that, they impose unilateral measures. This, however, harms our common market and the entire European Union,” the Estonian minister added.<sup>1</sup> To bring the tax rules up to date, the ECOFIN Council concluded to abandon the requirement that companies have to be physically present in a country or own assets there, and to replace this with the concept of a digital permanent establishment on the long term. For the short term, three options were proposed to tax companies in the digital economy more fair and efficient: (1) a tax on the turnover of digital economy businesses, a so-called ‘equalisation tax’, (2) a withholding tax on digital transactions, and (3) a levy on the revenue from certain digital services. The Commission thus chose for the first option with regard to the short-term solution, and followed the ECOFIN Council in their conclusion for the long term with the proposal for a digital permanent establishment definition.

While the various measures from the OECD BEPS Action Plan, launched in October 2015, and the following Anti-Tax Avoidance Directive (“ATAD”), still aren’t completely implemented in the various national laws and double tax treaties of all Member States, the European Commission and ECOFIN Council thus seem in a rush to impose even further reaching measures, specific for the digital economy. This urge to target the digital economy and impose further-reaching rules can be explained by the fact that the public opinion is getting more and more frustrated by multinational enterprises not paying their “fair share” in taxes. Since the publication of the so-called “Panama papers”, “Paradise papers” and “LuxLeaks”, taxation of multinational enterprises has been at the top of the agenda of every opportunistic politician. This results in several Member States of the European Union to impose unilateral measures to combat the digital economy on their own, something that the European Union wants to prevent in order not to harm the European common market.

A few weeks before the meeting of the ECOFIN Council, on 12<sup>th</sup> of July, the administrative court of Paris ruled a case concerning the existence of a permanent establishment in favour of American tech-giant Google.<sup>2</sup> During the period 2005-2010, Google Ireland sold

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<sup>1</sup> Press release from the informal meeting of the ECOFIN Council on 16-09-2017 in Tallinn.

<sup>2</sup> Tribunal Administratif de Paris, Case 1505113/1-1, République Française vs. Société Google Ireland Limited, 12 juillet 2017.



advertisement services directly to customers in France. Google France provided administrative and marketing support to Google Ireland for which it charged a service fee. However, the French group company did not accept orders to display advertisements from French customers in France, which had to be approved by Google Ireland at its offices in the Irish Republic.<sup>3</sup> To be able to tax the profits made by Google Ireland in France however, the French tax authority argued that Google France was a PE of Google Ireland to which the profits of the advertisement sales could be attributed. The court in Paris didn't agree with that since the staff of Google France lacked the authority to bind Google Ireland.<sup>4</sup> Its authority was only to find customers for Google Ireland, which doesn't result in the existence of a permanent establishment.<sup>5</sup> Accordingly, France had no authority to tax the profits of the advertisement services sold to French customers and missed out on 1.1 billion euros of tax revenue.<sup>6</sup> It is exactly this kind of situation that the European Commission and ECOFIN Council, try to target with the introduction of a digital permanent establishment.

### Research question

With the definition of a digital permanent establishment being clear from article 4 of the proposed Directive, the first step has been made. However, to effectively tax this DPE, profits need to be attributed to this new phenomenon. Since the current profit-allocation principles are designed for a physical PE, there is doubt whether they are capable of dealing with the new digital permanent establishment. In this thesis, I will therefore research whether there is need for both a new profit attribution method and new functions that are deemed to create value to attribute profits to. The main research question of this thesis will accordingly be:

*“Do the current profit-allocation principles need to be adjusted to deal with the introduction of the digital permanent establishment?”*

### Purpose

The purpose of this thesis is to understand the impact of the new digital permanent establishment concept on the current profit-allocation principles and whether they need an update as well, to be aligned with this new concept. With profit-allocation principles is not only meant the attribution of profits rules and methods, but also the different functions (“value drivers”) which are deemed to create value for the business and are required in order to attribute profits to a permanent establishment. Introducing the digital permanent establishment concept without adjusting the current profit-allocation principles could possibly make the introduction of the digital permanent establishment useless.

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<sup>3</sup> Schwarz, J., *Permanent Establishment: La lutte continue*, Kluwer International Tax Blog, July 24, 2017.

<sup>4</sup> Monsenego, J., *Google France as a Dependent Agent PE of its Irish Sister Company?*, TPI, 1/2018, page 48.

<sup>5</sup> See note 3, Schwarz, J.

<sup>6</sup> Maidenberg, M., and Breeden, A., *Google Wins Tax Case in France, Avoiding \$1.3 Billion Bill*, New York Times, July 12 2017, <https://www.nytimes.com/2017/07/12/business/13google.html>.

## Method

In this thesis, the legal-dogmatic research method is used to research whether the current profit-allocation principles (as laid down in the (soft) law) need to be adjusted to deal with the introduction of the digital permanent establishment. The research is based on both on academic literature as well as on literature provided by practitioners (for example in tax law journals). The most recent versions of (proposed) legislations and guidance issued by the various (supranational) organisations (for example the OECD) and authorities will be taken into account. However, given the relative novelty of this topic, not much specific literature is expected to be available. Therefore also relevant literature outside the field of tax law is taken into account, for example economic literature dealing with the topic of value creation.

## Outline

In Chapter 1 the traditional definition of the permanent establishment, based on article 5 of the OECD Model Tax Convention will be discussed, as well as the recommendations from the OECD following from BEPS Action 7 ('Preventing the Artificial Avoidance of Permanent Establishment Status') and the changes being implemented through the MLI.

Once the traditional definition of a permanent establishment is clear, Chapter 2 will focus on the proposed solution by the European Commission for the long term: the introduction of a digital permanent establishment. An overview is given of how the European Commission and OECD want to shape this phenomenon, reflecting to what extent the recommendations from BEPS Action 1 ('Addressing the Tax Challenges of the Digital Economy') are taken into account in the proposal.

In Chapter 3, the current profit-allocation principles are discussed and researched whether they can be applied to the DPE to effectively attribute profits to the user jurisdiction. The next step is to assess how value is created by digitalised business since under a global consensus it is determined that taxation should follow value creation. Once it is established what creates value, functions can be derived therefrom to which profits can be attributed. This very important part will be discussed in Chapter 4.

Under current attribution of profit principles, profits are attributed to a permanent establishment based on the 'significant people functions' it performs. But since a digital PE can exist without the presence of any people (or even assets), the current rules need to be adjusted to make sure any profit can be attributed to it. Also the new functions derived from the previous chapter will be taken into account to reveal the necessary changes to the attribution of profits rules in the context of a digital permanent establishment. This will be the topic of Chapter 5.

This thesis is end by answering the research question, after which some recommendations are made on how the profit allocation principles should be adjusted after the implementation of the digital permanent establishment.

## Chapter 1: The traditional permanent establishment

### 1.1 Introduction

One of the most controversial topics in international taxation that creates a lot of discussion is whether or not a permanent establishment exists in a given situation. The importance in determining the existence of a permanent establishment lies in the fact that a permanent establishment creates the right (so-called “nexus”) for a certain country to tax the profits attributable to a permanent establishment in that country, in line with the territoriality principle. If one exists, the source country has the right to tax the profits generated in that country and attributable to the permanent establishment. If one does not exist, then the profits are usually taxable by the country in which the legal entity is established (home country). Accordingly, the existence of a permanent establishment can result in large differences in the total tax burden of a multinational group, depending on the tax rates in the various jurisdictions. It therefore may not be of any surprise that the artificial creation of a permanent establishment or efforts not to deem a permanent establishment to exist are often part of a tax planning strategy to shift profits between countries. Until now, three different types of permanent establishments can possibly occur: a fixed place of business PE, one based on a dependent agent or one linked to certain services.

#### 1.1.1 Fixed place of business PE

The most common and existing kind of permanent establishment is the fixed place of business PE. According to article 5 of the OECD Model Tax Convention (“MTC”) 2017, a permanent establishment means “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. Paragraph 2 contains a list of situations in which a permanent establishment most likely exists: in case of a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. From established case law, it can be further derived that “permanent” requires that the place is available for at least the duration of the activities and that it is also specifically designed and equipped for those activities. Therefore, e.g. a hotel room used for sales meetings will not qualify as a permanent establishment<sup>7</sup> but a Formula One racing circuit used only once a year will.<sup>8</sup> With regard to the “fixed” aspect, this not necessarily means “fixed to the earth surface”. For example, following from (Dutch) case law also a circus tent<sup>9</sup> and a moveable drilling platform can qualify as a permanent establishment. Important is that the place of business must be established at a distinct place (a specific geographical point) with a certain degree of permanency (not of a purely temporary nature). The very minimum requirement to be able to recognise a permanent establishment is thus the existence of a physical construction. Accordingly, a website, software or a server location will, under the current OECD rules, not lead to the existence of a traditional (physical) permanent establishment.

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<sup>7</sup> Dutch Supreme Court, Case 1955/277, 12 369, 15 June 1955.

<sup>8</sup> Supreme Court India, Case 3849/2017 India vs. Formula One World Championship Ltd, April 2017.

<sup>9</sup> Dutch Supreme Court, Case 1954/336, 11 908, 13 October 1954.

### 1.1.2 Dependent agent PE

One of two exceptions in which a permanent establishment can currently exist without a fixed place of business follows from paragraph 5 of article 5 OECD MTC. A permanent establishment is deemed to exist “in case a person habitually concludes contracts on behalf of the company of which he is dependent (e.g. as an employee) and these contracts are either concluded in the name of the enterprise or for the transfer of the ownership of property owned by that enterprise.”<sup>10</sup> Of importance is that he habitually makes use of his authorization to conclude contracts on behalf of the company. In case he only makes rarely/incidental use of his authorization or his activities are considered to be of preparatory or auxiliary nature (see par. 1.2.1), no permanent establishment will be deemed to exist and the profits derived from his activities are taxable in the home state. The term ‘agent’ might create the idea that only one person at a time can be deemed to be a dependent agent PE, but this is wrong. A whole company can also be deemed to qualify as a dependent agent if the employees and directors of that company considered together act on behalf of the enterprise in the other state.<sup>11</sup>

New in the 2017 update of the OECD MTC is the addition to the definition of a dependent agent that also a person who “habitually plays the *principal role* leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise” leads to the existence of a dependent agent PE.<sup>12</sup> Its aim is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, for example where that person acts as the sales force of the enterprise.<sup>13</sup> This addition to the OECD MTC will most likely solve issues as did occur in the Google Ireland vs. France case (see introduction). The French court decided that no dependent agent PE in France could exist because Google France did not have the authority to conclude contracts (that was done by Google Ireland). However, on the basis of the new addition, that is not necessary anymore and it can now be argued that the employees of Google France played a principal role in the conclusion of the contracts (namely finding the customers in France) by Google Ireland and hence a dependent agent PE in France exists.<sup>14</sup> It is however yet to be seen in practise how a “principal role” should be defined and what kind of activities will be sufficient enough to establish a permanent establishment. From paragraph 88 of the commentary on article 5 however, it can be derived that the person who convinced the third party to enter into a contract with the enterprise played a principal role. On the other hand, the promotion and marketing in a way that does not directly result in the conclusion of contracts will not qualify as a principal role and therefore not lead to the existence of a dependent agent PE.

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<sup>10</sup> OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing, Commentary on Article 5, paragraph 83.

<sup>11</sup> See note 10, OECD MTC 2017, paragraph 84.

<sup>12</sup> OECD (2017), *Update to the OECD Model Tax Convention*, OECD Publishing, 21 November 2017, page 17 changes to article 5(5).

<sup>13</sup> See note 10, OECD MTC 2017, paragraph 88.

<sup>14</sup> In paragraph 90 of the commentary on article 5 OECD MTC, an example is given of a situation in which a permanent establishment will exist and which looks fairly similar to the business model used by Google.

### 1.1.3 Services PE

The second exception, in which a permanent establishment can currently exist without a fixed place of business, is in case of a services PE. One who only looks in the text of the Model Tax Convention itself might not even be aware of the existence of this version. Paragraph 144 of the Commentary on Article 5 however, includes, since the update in 2008, a provision for countries that are willing, in their tax treaties, to broaden the definition of a PE to companies providing services in their territory.<sup>15</sup> “These States are concerned that some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein and consider that these additional rights are therefore appropriate and the State where the services are performed should have a right to tax even when these services are not attributable to a permanent establishment as defined in Article 5.”<sup>16</sup> A permanent establishment linked to certain services can exist in the two situations listed in subparagraphs a) and b) of paragraph 144. Firstly, a services PE will exist in case more than 50% of the gross revenues attributable to active business activities of the enterprise are derived from the services performed by an individual who is present in that State for a period or periods exceeding in the aggregate 183 days in any twelve month period. Secondly, a services PE will also exist in case the services performed through one or more individuals exceed the 183 days threshold. Because of the OECD’s preference for residence taxation, the services PE is not part of the MTC itself and not implemented in most DTTs.<sup>17</sup>

## 1.2 OECD Model Tax Convention 2017

### 1.2.1 Preparatory or auxiliary exceptions

In article 5(4) OECD MTC an exception for preparatory and auxiliary activities is included to prevent a PE to exist for activities that are not part of a company’s core business activity. A few (non-exhaustive) examples are listed from which can be concluded that for example a mere storage facility/warehouse will not lead to the existence of a permanent establishment. Although “it is recognised that such a place of business may well contribute to the productivity of the enterprise, the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.”<sup>18</sup> The situation is different if, seen from the overall business activity of the enterprise, the activities performed in the warehouse constitute an essential part of the enterprise’s sale/distribution business, for example a warehouse of an online retailer at a strategic location with a significant number of employees.<sup>19</sup>

Going back to the Google vs. France case from the introduction, it is *inter alia* this exception in the Ireland-France treaty that prevented Google from having a permanent establishment in

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<sup>15</sup> Pijl, H., The OECD Services Permanent Establishment Alternative, 472-476 (European Taxation, September 2008).

<sup>16</sup> See note 10, OECD MTC 2017, paragraph 136 and 137.

<sup>17</sup> See note 15, Pijl.

<sup>18</sup> See note 10, OECD MTC 2017, paragraph 58.

<sup>19</sup> See note 10, OECD MTC 2017, paragraphs 59 and 62.

France. Because Google France only provided administrative and marketing support to Google Ireland, the court decided that its activities were preparatory or auxiliary within the meaning of article 5(4) and hence no permanent establishment could exist.<sup>20</sup> Under the lower threshold in the 2017 version of the OECD MTC however, it has to be determined that these activities actually are of a preparatory or auxiliary nature in order for this exception to apply. This follows from the fact that what for one business is qualified as a auxiliary activity, can be the core business for another business. The marketing support provided by Google France could be considered of such importance for Google's business model that it can not be deemed to be of preparatory or auxiliary nature. Under the 2017 MTC, Google would thus not have been "saved" by this exception.

BEPS Action 1 already recognised that certain activities that were previously considered preparatory or auxiliary (and hence benefit from the exceptions to the definition of PE) may be increasingly significant components of businesses in the digital economy (i.e. form the core activity of those businesses).<sup>21</sup> For example, if the need for quick delivery to customers is a key component of the business model of an online retailer of physical products, its local warehouse is most likely part of the core activity of that retailer. Before the 2017 OECD MTC however, the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise was explicitly listed as excluded from the permanent establishment definition. After the 2017 version, the exemption only applies provided that such activity is actually of a preparatory or auxiliary character for the specific business in question.

### 1.3 BEPS Action 7

As stated in the introduction of this chapter, the artificial creation or avoidance of a permanent establishment is often part of a tax planning strategy to shift taxes to a country with the most favourable tax system. In its Base Erosion and Profit Shifting (BEPS) Action Plan, the OECD made recommendations on how to prevent such base erosion and profit shifting by putting more emphasis on taxation where value is actually created. This resulted in 15 so-called "Action Plans" from which report number 7 deals with the artificial avoidance of the permanent establishment status. Such avoidance was for example achieved by "arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by commissionaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country."<sup>22</sup> With the addition to the 2017 version of the OECD MTC that now also a person who "habitually plays the *principal role* leading to the conclusion of contracts" (see paragraph 1.1.2) leads to the existence of a PE, this loophole now seems to be fixed. Further, with the introduction of the anti-fragmentation rule it is not possible anymore to avoid PE status by

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<sup>20</sup> See note 3, Schwarz, J.

<sup>21</sup> OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, paragraph 260.

<sup>22</sup> OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status*, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, Executive Summary, page 9.



fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of article 5(4) OECD MTC.<sup>23</sup> The recommended changes to the definition of the (traditional) PE from BEPS Action 7 are included in the Multilateral Instrument.

#### 1.4 Conclusion

Being clear from the Google Ireland vs. France case, the international tax law framework as it exists today is not sufficient to deal with effective taxation of companies engaged in digital activities yet. The 2017 updates to the OECD MTC, following from BEPS Action 7 and to be implemented through the MLI, however, are a good step in the right direction and significantly lower the thresholds for the various traditional permanent establishments to exist. Under the new 2017 OECD MTC definitions, the outcome of the Google Ireland vs. France case would probably have been different. However, these changes to the traditional PEs do not go far enough to solve the problem regarding digital activities. Even after the implementations from BEPS 7, physical presence remains the main criterion for the creation of a nexus. Instead of changes and additions to the traditional permanent establishment definition, a whole new definition of a permanent establishment is required with the right qualifications (without a requirement related to physical presence) to effectively and efficiently tax companies in the digital economy.

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<sup>23</sup> See note 22, BEPS Action 7, Executive Summary.

## Chapter 2: Digital permanent establishment

### 2.1 Introduction

Today's technology and new business models have made it possible for businesses to sell products to customers in markets in which they have no physical presence. As seen in the previous chapter, for the existence of the traditional permanent establishment at least some sort of physical presence is needed. While technology and business models have developed immensely over the past few decades, tax laws have obviously not, or at least not to the same extent. To align international tax laws with the modern way of doing business again, some radical changes are required, especially with regard to the permanent establishment definition. The European Commission therefore introduced a definition of the digital permanent establishment in article 4 of the proposed Directive, a topic on which the OECD's BEPS Action 1 report from 2015 provided recommendations.

### 2.2 Definition

#### 2.2.1 Commission's proposal

Article 4 of the proposed Directive deals with the definition of the digital permanent establishment.<sup>24</sup> The definition builds on the existence of a "significant digital presence" to create a nexus for imposing corporate income tax. This nexus is deemed to exist when a business in a Member State, in a tax period, taken together with that entity's associated enterprises:

- Supplies digital services to users in that Member State resulting in revenues exceeding € 7.000.000; or
- Supplies digital services to more than 100.000 users in that Member State, determined by the location (IP address) of the device used to access the digital interface through which the digital services are supplied; or
- Concludes more than 3.000 business contracts for the supply of digital services in that Member State, in the course of carrying on a business.<sup>25</sup>

Being clear from the abovementioned criteria, a DPE can thus exist without the "traditional" criteria required for a physical permanent establishment. The proposed criteria deem a DPE to exist without the need for physical/tangible connections, irrelevant of any fixed place or human resources (personnel) available. Instead, it relies on more economical factors and thresholds above which a significant digital presence is deemed to exist. This seems in line with one of the objectives of the OECD's BEPS Action Plan to ensure that profits are taxed where economic activities take place and value is created.<sup>26</sup> The Commission also seems to follow the recommendation set forth in BEPS Action 1 to use a combination of a revenue-

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<sup>24</sup> Proposal for a Council Directive, laying down rules relating to the corporate taxation of a significant digital presence, COM(2018) 147 final, 2018/0072 CNS, Brussels, 21 March 2018.

<sup>25</sup> See note 24, DPE Directive, article 4.

<sup>26</sup> OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, Introduction, paragraph 1.



based factor together with a second indicator based either on the digital presence of the company (through a local domain name or digital platform) or the volume of active users or data collected.<sup>27</sup> At the same time, the thresholds can be considered to be set at a sufficient level to keep smaller companies or companies not mainly involved in providing digital services out of the scope. This improves the proportionality of the proposed Directive, something that is a highly important criterion in European law and for the European Court of Justice (ECJ) to adjudicate. Also the user factor and the conclusion of contracts factor were considered by the OECD in BEPS Action 1 as options for user-based factors.<sup>28</sup>

The OECD considers revenue earned from customers in a country a factor for establishing a nexus in the country concerned since “a strong user network (and the attached user data) is likely to result in enterprises either selling more or enterprises charging more for their core products/services, or both, because user data serves to enhance the value of the services an enterprise offers.”<sup>29</sup> Revenue alone however, is not a sufficient factor to create a nexus, which is why, as reflected in the Commission’s proposal, it should be complemented with other factors. Moreover, the use of revenue as factor could relatively limit the compliance costs for taxpayers (since smaller taxpayers will not reach the threshold) and provide a high degree of tax certainty for cross-border activities (since the threshold is a fixed number which is easily foreseeable).<sup>30</sup>

One of the main critics to the announcements of new legislative proposals to target the digital economy was that it’s hard to define which companies belong to that digital economy. In other words, it’s hard to “ring-fence” part of the economy and put a label on those companies that they are deemed to be digital for tax purposes. The difficulty of this problem became only more visible after the ECJ ruled that Uber, the smartphone app that connects individuals to non-professional drivers, is a transport service, not a digital company.<sup>31</sup> Although it was not a case concerning taxes, it is just a foretaste of what is to be expected when a difference should be made between digital companies subject to the new digital taxation rules, and non-digital companies.

To avoid that obstacle, the proposed Directive therefore does not refer to digital companies but merely to digital services, provided by any kind of company. Article 3(5) defines “digital services” as: “services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology.”<sup>32</sup> This includes, *inter alia*:

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<sup>27</sup> Escribano, E., *Is the OECD/G20 BEPS Initiative Heading in the Right Direction? Some Forgotten (and Uncomfortable) Questions*, Bulletin for International Taxation, 2017 (Volume 71), No. 5 and BEPS Action 1, par. 282.

<sup>28</sup> See note 21, BEPS Action 1, paragraph 280.

<sup>29</sup> See note 21, BEPS Action 1, paragraph 278.

<sup>30</sup> See note 21, BEPS Action 1, paragraph 278.

<sup>31</sup> C-434/15, *Asociación Profesional Élite Taxi vs. Uber Systems Spain SL*.

<sup>32</sup> See note 24, DPE Directive.

- The supply of digitised products (e.g. software, including changes and updates to software);
- Services providing or supporting a business or personal presence on an electronic network (e.g. different social media platforms);
- Services automatically generated from a computer via the internet or an electronic network;
- The transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market (e.g. eBay).<sup>33</sup>

Besides the abovementioned examples of digital services, Annex II of the Directive proposal lists 26 other examples of services as referred to in article 3(5). For a good understanding about which kind of services are taken into account for the establishment of a DPE, that list is attached to this thesis in Annex I.

With regard to the Directive's scope, the Explanatory Memorandum states that the Directive will apply to cross-border digital activities of companies established within the European Union, even without the double tax treaty including a provision dealing with the DPE. The Directive will also apply with regard to businesses established outside the European Union that are deemed to have a DPE in one of the Member States, in case there is no double tax treaty in place. However, the proposal does not affect enterprises that are incorporated or established in a non-Union jurisdiction with which there is a double taxation treaty in force with the Member State of the significant digital presence without a provision dealing with the DPE, in order to avoid causing any breaches of those double taxation treaties.<sup>34</sup>

This last situation is the case for example with the United States, note well, the country in which most of the large tech/digital companies towards whom this DPE Directive is basically aimed, are established.<sup>35</sup> In first instance, they will thus not be affected because the DTT does not contain a provision dealing with the DPE. Unless a new MLI will be created to implement the DPE in the various DTTs of EU Member States with third countries, all those DTTs – including those with the U.S. – will have to be renegotiated one-by-one, a process that can take multiple years. Even when this will eventually happen, it is a big question whether the U.S. will be willing to implement the DPE in its DTTs. As *Sapirie* points out, the United States has an obvious interest in avoiding international rules that give other countries justification for taxing U.S. domestic companies. But the alternative – a jumble of different unilateral measures that make operating abroad more difficult – will also turn out to be problematic.<sup>36</sup>

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<sup>33</sup> See note 24, DPE Directive.

<sup>34</sup> See note 24, DPE Directive, Explanatory Memorandum.

<sup>35</sup> The so-called “Big Five” tech companies (Apple, Alphabet, Microsoft, Facebook and Amazon) are all US-based.

<sup>36</sup> Sapirie, M., *Permanent Establishment and the Digital Economy*, Bulletin for International Taxation, 2018 (Volume 72), No. 4a/Special Issue.

### 2.2.2 OECD's interim-report<sup>37</sup>

Only a few days before the European Commission published its proposals regarding taxation of the digital economy, the OECD launched its interim-report “Tax Challenges Arising from Digitalization”. The report is basically a follow-up on BEPS Action 1, which, in a lot of criticizer’s opinions only raised more questions without actually providing answers and concrete recommendations. While no consensus was reached on a way to go forward, the goal to reach consensus in the future remained present. This resulted in some countries implementing one or more suggestions from BEPS Action 1 in their legislations on their own, without having reached any consensus on international level. This is a thorn in the eye of the European Commission, which believes that unilateral measures only cause more harm than good.

The March 2018 interim-report also failed to reach consensus but sets a goal to get there by 2020. The report recognises that “there is no consensus on the merits of, or need for, interim measures, and that a number of countries consider that an interim measure will only give rise to risks and adverse consequences irrespective of any limits on the design of such a measure.”<sup>38</sup> Given this statement, it is highly unlikely that the proposed Directive for a Digital Sales Tax will be agreed upon, which is why I won’t go into further detail with regard to this proposal in the remaining of this thesis. This also means that the one proposal left, regarding the digital permanent establishment, will most likely get agreed upon sometime and will eventually be implemented into the national legislations and DTTs of the various Member States.

### 2.3 Alternative solutions

Besides the significant economic presence solution that the Commission adopted for the long term, BEPS Action 1 also included options relating to the introduction of a withholding tax on digital transactions and an equalisation levy. “To avoid some of the difficulties arising from creating new profit attribution rules for purposes of a nexus based on significant economic presence, an “equalisation levy” could be considered as an alternative way to address the broader direct tax challenges of the digital economy.”<sup>39</sup> As with the DPE, the equalization levy would only be applied in case it is established that a foreign enterprise has a significant economic presence in a given jurisdiction. This, “to target the scope of the levy more closely to the situation in which a business establishes and maintains a purposeful and sustained interaction with users or customers in a specific country via an online presence.”<sup>40</sup> One of the main contra-arguments to implement this equalization levy is that it would be imposed on the gross value of the good or services provided. This would mean that it is basically an extra layer of VAT, instead of a direct tax on the profits made with the supply of digital goods and

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<sup>37</sup> OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>38</sup> See note 37, OECD interim-report, paragraph 27.

<sup>39</sup> See note 21, BEPS Action 1, paragraph 302.

<sup>40</sup> See note 21, BEPS Action 1, paragraph 303.

services. This also means that a potential conflict with WTO rules and European fundamental freedoms could possibly arise, given the fact that equal treatment of domestic and foreign companies could be jeopardized.<sup>41</sup> Furthermore, there will be a high risk of double taxation in the situation in which a foreign entity is subject to the levy at source and to corporate income tax in its country of residence or in the situation in which an entity is subject to both corporate income tax and the levy in the country of source.<sup>42</sup> This follows from the fact that the equalization levy will not be covered by double tax treaties and countries will therefore not be forced to grant a relief for any double taxation that could possibly arise. The most concerning issue would probably be that (part of) the tax burden would be shifted to consumers, which would make the equalisation levy totally ineffective.

Another option that was considered in BEPS Action 1 is the introduction of a withholding tax on payments for certain digital goods and services. This withholding tax could in theory be imposed as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online or, alternatively, as a primary collection mechanism and enforcement tool to support the application of the digital permanent establishment.<sup>43</sup> However, just as with the equalization levy, possible conflicts with WTO rules and European fundamental freedoms are expected to arise upon introduction of this alternative. Given the fact that this alternative also entails a tax on a gross basis, companies that are in a loss-making position will also be taxed despite the lack of profits. This could endanger start-up companies, which nowadays are especially engaged in the digital economy that usually have loss-making first years of their business due to high investments for product development.

## 2.4 Conclusion

As seen in this chapter, the European Commission's proposed Directive contains a definition of a digital permanent establishment in article 4. To create a nexus, the definition relies on a combination of economic thresholds related to the supply of certain digital services. Most of the recommendations from BEPS Action 1 are incorporated in the definition, which also seems to adhere to the proportionality principle. It is also seen from this chapter that the introduction of a DPE is probably the most preferred way to tax companies engaged in the digital economy given the fact that the alternatives come with a lot of side-problems and possible conflicts with WTO rules and European fundamental freedoms. One major problem with regard to the DPE however, is that it needs to be implemented in the various DTTs with third countries in order to be applicable. Given the fact that a lot of tech/digital companies are based in the U.S., they will only be subject to the DPE when the U.S. amends its DTT with the Member State in which the significant economic presence is deemed to exist. With the definition now being set and clear, it can now be assessed whether the current profit-allocation principles are suited to allocate profits to the jurisdiction of the DPE.

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<sup>41</sup> See note 21, BEPS Action 1, paragraph 306.

<sup>42</sup> See note 21, BEPS Action 1, paragraph 307.

<sup>43</sup> See note 21, BEPS Action 1, paragraph 292.

## Chapter 3: Current profit-allocation principles

### 3.1 Introduction

After a permanent establishment is deemed to exist, the next step is to determine how much to tax that PE. In order to do so, it has to get attributed some profits, which is dealt with by article 7 of the OECD MTC. This article firstly determines that the PE is deemed to be a separate entity and has to be attributed profits accordingly. This is in line with the arm's length principle as set out in article 9 of the OECD MTC. An important part thereof is to conduct a functional analysis in order to determine which functions, assets and risks of the business as a whole are carried out through the PE. The OECD provides more guidance on this area in its Transfer Pricing Guidelines, as well as on the attribution of profits in separate reports. At the same time, an internationally accepted principle is that profits should be taxed where the value is created.<sup>44</sup>

### 3.2 Authorised OECD Approach

In order to provide for a common understanding of how profits should be attributed to PEs and to prevent the risk of double taxation, the OECD favoured the Authorized OECD Approach (“AOA”) as the preferred way to attribute profits to a PE in its 2008 Report on the Attribution of Profits to Permanent Establishments. Note that despite the fact that in this context is always spoken about profits, the same principles apply to attribute losses. The AOA builds on the “functionally separate entity approach” to hypothetically treat the PE as a third party in order to apply the arm's length principle. Under the AOA a two-step analysis needs to be performed:

1. First a functional and factual analysis needs to be performed in order to assess which functions performed, risks assumed, and assets used can be attributed to both the PE and the other part of the business (the legal entity).<sup>45</sup> The AOA “attributes to the PE those risks for which the significant functions relevant to the assumption and/or management of risks are performed by people in the PE and the economic ownership of assets for which those relevant significant functions are performed by people in the PE” (the so-called “significant people functions”).<sup>46</sup> This, to get an overview of which part of the business, and to what extent, is engaged in economically significant activities and responsibilities contributing to the profit (or loss) of the business as a whole. Accordingly, this step should also result in the recognition and determination of internal dealings and the attribution of capital based on the assets and risks attributed to the PE.<sup>47</sup>
2. The second step under the AOA requires that any of those internal dealings are remunerated at arm's length (as prescribed by article 9 OECD MTC), taking into

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<sup>44</sup> Morse, S.C., *Value Creation: A Standard in Search of a Process*, Bulletin for International Taxation, 2018 (Volume 72), No. 4/5, 25 March 2018.

<sup>45</sup> OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, Paris, 22 July 2010, section B-3.

<sup>46</sup> See note 45, OECD 2010 Report, paragraph 15.

<sup>47</sup> See note 45, OECD 2010 Report, paragraph 21, last two points.

account the functions performed, assets used and risk assumed of both parts of the business.<sup>48</sup> In order to do so, a comparability analysis needs to be conducted to compare dealings between the PE and the enterprise of which it is a part, with transactions between independent enterprises (see par. 3.4.2). The OECD Transfer Pricing Guidelines (“TPG”) set forth a number of factors that influence the comparability of controlled transactions with uncontrolled transactions. These are, *inter alia*, characteristics of property or services, economic circumstances, business strategies and contractual terms.<sup>49</sup> From the degree of comparability, the most appropriate method to the circumstances of the case to arrive at an arm’s length compensation for the internal dealings can be selected and applied (see par. 3.4.3).<sup>50</sup>

### 3.3 Additional OECD guidance

In July 2010, the OECD published its “2010 Report on the Attribution of Profits to Permanent Establishments.” This additional guidance was deemed to be necessary because article 7 OECD MTC was frequently subject to different interpretation by various countries. This lack of a common interpretation created problems of double taxation and non-taxation.<sup>51</sup> In March 2018, the OECD released additional guidance on the attribution of profits to permanent establishments following from the amendments to the various PE definitions from BEPS 7 that lowered the thresholds for those PEs to arise. The 2018 guidance includes four examples that take into account the lower thresholds to create a PE status for a dependent agent and the more narrow application of the preparatory and auxiliary exemption.<sup>52</sup> Besides those, also an example dealing with the sale of advertising on a website is included, which is interesting for this thesis.<sup>53</sup> Remarkably enough, the facts look very similar to the facts in the Google Ireland vs. France case. In the example, it is concluded that the entity in the country of the advertisement sales (Google France), becomes a PE of the foreign entity (Google Ireland) since it “habitually plays the principal role leading to the routine conclusion of sales without material modification of the terms and conditions on which the customers are offered to purchase the advertising space.”<sup>54</sup>

With regard to the attribution of profits, the example in the new guidance confirms the application of the arm’s length principle and accordingly the AOA. Under step one of the AOA (functional and factual analysis), it is found that the significant people functions relevant to the assumption of the risk associated with determining the amount, type and form of advertising are performed by the personnel of the PE, since in substance, that personnel

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<sup>48</sup> See note 45, OECD 2010 Report, section B-4.

<sup>49</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, paragraph 1.36.

<sup>50</sup> See note 45, OECD 2010 Report, paragraph 44.

<sup>51</sup> See note 45, OECD 2010 Report, Preface.

<sup>52</sup> OECD (2018), *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7*, OECD Publishing, Paris.

<sup>53</sup> See note 52, OECD Additional Guidance 2018, example 3, page 19.

<sup>54</sup> See note 52, OECD Additional Guidance 2018, paragraph 61.

sells the advertising space to the customers.<sup>55</sup> Additionally, the analysis under step one of the AOA entails the recognition of an internal dealing between the PE and the head office, in this example the sale of advertising space by the head office to the PE.

Under step two of the AOA (arm's length remuneration of the internal dealing), the internal dealing would be priced the same amount that the head office of the PE would have received "if it had sold the rights to the advertising space to an third party, performing the same or similar activities under the same or similar conditions that the PE performs on behalf of the head office (attributing to such party ownership of the assets of the head office related to such functions, and assumption of the risks related to such functions)."<sup>56</sup>

### 3.4 Transfer pricing assessment

#### 3.4.1 Functional analysis

The guidance in the OECD TPG with regard to the analysis of the functions performed can be applied fairly directly in the PE context in order to determine the "activities" of the hypothesised separate and independent party.<sup>57</sup> Important functions are those that are related to decision-making, including decisions about business strategy and risks. "While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is relevant."<sup>58</sup> Important is how much value is created for the business as a whole by the functions performed, something that has to be determined from case by case.

Since a PE isn't legally separated from the other part of the business, no legal relations/contracts between the two parts of the business can exist. Therefore, in order to allocate assets to the PE, the economic ownership of those assets has to be taken into account. The part of the enterprise that performs the significant people functions relevant to the determination of economic ownership of the assets will get the assets allocated. Under the AOA, this is done by drawing up a separate "tax balance sheet" for the PE.<sup>59</sup> Because the PE isn't a separate legal entity, it is also not capable to bear legal risks that are born by the entity as a whole. However, under the AOA, the PE should be considered as assuming any risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE's location.<sup>60</sup> The amount and nature of the risks assumed by the PE also affects the amount of capital that needs to be attributed. This is because an enterprise assuming material additional risks needs to increase its capital accordingly in order to maintain the same creditworthiness.<sup>61</sup>

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<sup>55</sup> See note 52, OECD Additional Guidance 2018, paragraph 64.

<sup>56</sup> See note 52, OECD Additional Guidance 2018, paragraph 67.

<sup>57</sup> See note 45, OECD 2010 Report, paragraph 61.

<sup>58</sup> See note 49, 2017 OECD TPG, paragraph 1.51.

<sup>59</sup> See note 45, OECD 2010 Report, section D-2, part (iii).

<sup>60</sup> See note 45, OECD 2010 Report, paragraph 68.

<sup>61</sup> See note 45, OECD 2010 Report, paragraph 71.



### 3.4.2 Comparability analysis

After the functional analysis, a comparability analysis is required to be performed, focussing on the nature of the transactions between the related parties and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.<sup>62</sup> The first step in this process requires the identification of financial and/or commercial relations between the related parties and the conditions and economically relevant circumstances attaching to those relations. From there, it can be derived what every party's function is within the group (e.g. a manufacturer, distributor, etc.) and how it contributes to the value chain of the MNE.

Before making comparisons with uncontrolled transactions, the economically relevant characteristics of the commercial or financial relations need to be assessed. These can be differentiated in the following categories:

- The contractual terms of the transaction. Although in general the “substance over form” principle prevails, the starting point still remains the contractual terms of the transaction;<sup>63</sup>
- The characteristics of property transferred or services provided. Depending on the transfer pricing method, this factor must be given more or less weight. Differences in the characteristics of property or services are less sensitive in the case of the transactional profit methods (PSM and TNNM) than in the case of traditional transaction methods (CUP, resale price method and cost plus method);<sup>64</sup>
- The economic circumstances of the parties and of the market in which the parties operate. This is relevant since arm's length prices may vary across different markets even for transactions involving the same property or services.<sup>65</sup>
- The business strategies pursued by the parties. A (digital) start-up company might be (temporarily) charging a lower price for its services in order to penetrate the market to a price that is lower than the price charged for otherwise comparable products in the same market.<sup>66</sup> Therefore it is important what kind of business strategy is pursued by the company engaged in the comparable transaction.

When it is clear how the economically relevant characteristics of the commercial or financial relations between the dependent parties look like, the next step is to find sufficiently comparable uncontrolled transactions. The extent to which these are available largely influences the choice of the transfer pricing method to be applied. To find exact comparables however, would put a disproportionate burden on the taxpayer. It is therefore sufficient enough to find comparables that don't materially differ from the controlled transaction to be compared with.

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<sup>62</sup> See note 49, 2017 OECD TPG, paragraph 1.6.

<sup>63</sup> See note 49, 2017 OECD TPG, paragraph 1.46.

<sup>64</sup> See note 49, 2017 OECD TPG, paragraph 1.108.

<sup>65</sup> See note 49, 2017 OECD TPG, paragraph 1.110.

<sup>66</sup> See note 49, 2017 OECD TPG, paragraph 1.115.



### 3.4.3. OECD prescribed methods

After the comparability analysis is performed, the next step is to determine the most appropriate method to remunerate the (hypothesized) internal dealing, taking into account the complexity of the functions performed and the availability of comparable uncontrolled transactions. The OECD prefers the Comparable Uncontrolled Price (CUP) method, given the fact that it adheres the most to the arm's length principle.<sup>67</sup> To find a transaction between unrelated parties that is sufficiently comparable with the (hypothesized) internal dealing however turns out to be nearly impossible in most of the cases. However, adjustments can be made to make transactions more comparable, by eliminating the material effects of the existing differences.<sup>68</sup> Every effort should be made to adjust the data so that it may be used appropriately in a CUP method.<sup>69</sup> While the CUP method is well suited for commodity transactions where trading conditions (prices, volumes, etc.) are publicly available and comparable, for digital transactions this is absolutely not the case. Given that digital transactions and their value are highly driven by intangible property which distinct the supply of a good or service from that of a competitor, the CUP is most likely not suited to be applied to digital transactions.

When the CUP method can't be applied because of a lack of sufficiently comparable uncontrolled transactions, the next most appropriate method to the circumstances of the case should be applied. The cost plus method is probably the most suited where the controlled transaction is the provision of services.<sup>70</sup> As with the CUP, adjustments can be made to make an uncontrolled transaction more comparable, however, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method.<sup>71</sup>

Roughly speaking, the cost plus method is most likely the most appropriate method in case the PE doesn't contribute that much to the value creation of the business as a whole (by its functions performed, risks assumed and assets owned). On the other hand, there are situations where transactional profit methods are found to be more appropriate than traditional transaction methods. "For example, cases where each of the parties makes unique and valuable contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, may make a transactional profit split more appropriate than a one-sided method."<sup>72</sup>

One particular strength of the profit split method that can be of use in dealing with a digital permanent establishment, is that it is less likely to attribute extreme and improbable profits to only one of the parties since both parties are evaluated.<sup>73</sup> The current problem is that (under

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<sup>67</sup> See note 49, 2017 OECD TPG, paragraph 2.3 and 2.15.

<sup>68</sup> See note 49, 2017 OECD TPG, paragraph 2.15.

<sup>69</sup> See note 49, 2017 OECD TPG, paragraph 2.17.

<sup>70</sup> See note 49, 2017 OECD TPG, paragraph 2.45.

<sup>71</sup> See note 49, 2017 OECD TPG, paragraph 2.47.

<sup>72</sup> See note 49, 2017 OECD TPG, paragraph 2.4.

<sup>73</sup> See note 49, 2017 OECD TPG, paragraph 2.119.

other methods) most profits of digital companies are allocated to one or only few jurisdictions, leaving the user jurisdictions with no or little profits. The PSM may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction.<sup>74</sup> According to the Commission, the DPE clearly makes unique and valuable contributions by way of its active users and digital data. Looking at the current available methods therefore, it seems like the profits split method is the best method to deal with the attribution of profits to the digital permanent establishment.

### 3.5 Conclusion

As seen in this chapter, not only does the current permanent establishment definition depend on the existence of any physical presence in a given jurisdiction, but also the current profit-allocation principles. Under the AOA, significant people functions are the main criterion to attribute the connecting risks and assets to a PE and accordingly the profits that are deemed to flow therefrom. However, since the DPE can exist without any physical presence (i.e. people), new principles regarding the attribution of profits need to be developed and the definition of value creation needs to be broadened to be able to attribute profits to a jurisdiction without any physical presence of the enterprise. With regard to the method to attribute profits to a DPE, the CUP method seems the least effective method. The profit split method however seems to have the right strengths to deal with the DPE and solve the current problem in which some jurisdictions are attributed no or little profits, while also taking into account the unique and valuable contributions made by the DPE. The next chapter will deal with how value is created by the DPE and which new functions (“value drivers”) have to be established in order to effectively attribute profits to the DPE.

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<sup>74</sup> See note 49, 2017 OECD TPG, paragraph 2.115.

## Chapter 4: Value creation in the digital economy

### 4.1 Introduction

The principle that taxation should take place where value is created was one of the corner stones of the BEPS Action Plan, in which Action 8-10 recommended rules to align transfer pricing outcomes with value creation. Companies in the digital economy however, are by far the most suitable to create a mismatch between the place where value is created and the place where their profits are being taxed. This, because the digital business models rely on value creation in totally different ways than traditional (“brick and mortar”) business models. The focus on functions, assets and risks to allocate profits to a certain jurisdiction (as seen in the previous chapter) no longer appropriately reflects the way modern businesses create value. Therefore, not only an update of the permanent establishment definition is required, but also of the way value creation is determined as a basis for taxation.

### 4.2 Digital business models

BEPS Action Plan 8-10 “Aligning Transfer Pricing Outcomes with Value Creation” aimed at aligning the place where a business creates value with the place where taxation takes place. This is done by linking the place where profits should be attributed to the place where the company’s “significant people functions” are located. The place where those functions are located however, doesn’t necessary coincide with the place where value is created. This is especially true for companies in the digital economy because of their distinct characteristics. Looking back at the Google Ireland vs. France case, the reason behind the – in some views – undesirable outcome of that case is the fact that the traditional, out-dated international tax rules result in a mismatch. According to the OECD, this follows from a few characteristics mainly applicable to digital companies’ business models:<sup>75</sup>

- Through the use of internet, digital companies can provide services and sell goods in jurisdictions in which they are not physically present (so-called “cross-jurisdictional scale without mass”);
- Digital companies heavily rely on intellectual property (IP) which is situated and developed in a limited amount of countries, which is under the current rules a predominant factor to attribute profits to;
- The users that participate in the digital activities those digital companies offer determine to some extent the value created with their contributions, memberships and activity (e.g. on social media like Facebook and Twitter).<sup>76</sup>

Because of the abovementioned characteristics, businesses may create value in jurisdictions that are currently unable to tax them because of a lack of physical presence. As *Brauner* and *Pistone* mention, this situation creates an unintended tax bias in favour of going digital and remotely operating business, thus enjoying in fact more favourable tax conditions than

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<sup>75</sup> See note 37, OECD interim-report, paragraph 33-35.

<sup>76</sup> See note 37, OECD interim-report, paragraph 33-35.

traditional business players operating in a given market.<sup>77</sup> So far, taxing rights are largely allocated to the home state from which the business chooses to operate and where important management decisions are taken. This is especially the case for returns from intangible assets. The so-called DEMPE functions related to intangibles are mainly performed by significant people functions in the home state from which the business controls its worldwide operations. Therefore also the returns attributable to the intangibles are allocated to that one state. By doing so, the fact that the contributions of data and user participations in the various users jurisdictions without any physical presence also enhance and develop the intangible assets and thus create value, is ignored. Accordingly, data contribution and user participation are currently not factors taken into account for determining value creation and do not lead to allocation of profits and hence taxation. Therefore, it can only be supported that the European Commission proposed to change this in the DPE Directive.

On another hand, the new “value drivers” should merely complement the existing significant people functions, not replace them. This because, for example for an online retailer, its logistical process is still one of the most important business lines, although it is mere a physical flow of goods. Their business models heavily depend on quick delivery of the goods, which is (still) a matter of people and part of the classic value chain.

#### 4.3 Commission’s proposal

In its Council Directive proposal, the Commission recognizes that the current framework (i.e. the criterion of significant people functions) needs to be adapted to reflect the way value is created by digital activities.<sup>78</sup> This because of the fact that a DPE can exist without any physical presence and hence significant people functions. Without adjusting the current way of capturing value creation, the DPE would not be entitled to any profits (given the lack of physical presence), which would make the introduction of a DPE useless. The Commission proposes to take into account the value created by users, which will also reflect value in the enhancement of the business’ intangible assets. While the Commission’s proposal doesn’t go further into detail, this shift from value created by the enterprise to taking into account value created by users, is a concept of value creation that is currently not captured by the existing tax framework.<sup>79</sup> With regard to this, I agree with *Hey*, who argues that if value creation becomes the ultimate overruling criterion for the allocation of taxing rights, it is necessary to understand how this deviates from the existing allocation rules.<sup>80</sup>

As *Verlinden* mentions, “the traditional concept of value creation for transfer pricing purposes focuses primarily on functions, assets and risks in a country-specific and transactional context. In the past, value creation was a function of economies of industrial scale: mass

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<sup>77</sup> Brauner, Y. and Pistone, P., *Some Comments on the Attribution of Profits to the Digital Permanent Establishment*, Bulletin for International Taxation, 2018 (Volume 72), No. 4a/Special Issue.

<sup>78</sup> See note 24, DPE Directive, Explanatory Memorandum, page 8.

<sup>79</sup> See note 21, BEPS Action 1, paragraph 386.

<sup>80</sup> Hey, J., “*Taxation Where Value is Created*” and the OECD/G20 Base Erosion and Profit Shifting Initiative, Bulletin for International Taxation, 2018 (Volume 72), No. 4/5.

production and the high efficiency of repeatable tasks.”<sup>81</sup> After the BEPS project, and more specific Action 8-10 thereof, the development, enhancement, maintenance, protection and exploitation (the so-called “DEMPE” functions) of intangible property are taken into account in determining what creates value in a certain business. However, with the introduction of the DPE and the gain of importance of value created by users and data, the guidance in BEPS Action 8-10 seems already out-dated. A first step in understanding how the different business models of today create value is therefore to understand what value creation is.

#### 4.4 Value creation through the DPE

“The concept of value creation is a source principle and can be traced back to the benefit principle as one, if not the fundamental, justification for countries levying taxes. The benefit principle is a concept born in public finance but is also a guiding principle when it comes to the international allocation of taxing rights among jurisdictions and is said to lead to international equity” (i.e. balanced allocation of taxing rights).<sup>82</sup> If a country provides and finances public goods, which contribute to the creation of value, taxing the income generated by the use of its public goods serves as compensation.<sup>83</sup> Or stated differently: the more one benefits from the goods provided by the government (such as highways, education, etc.), the more tax one should pay. Value creation is also strongly linked to the territoriality principle, in which a country has the right to tax the profits that are accrued within its territory. A wrong or different interpretation of value creation could hence lead to two countries taxing the same income, resulting in double taxation and harming the balanced allocation of taxing rights.

The fact that there is little consensus about what value creation is, is mainly caused by the subjective and individual specific nature of the definition of “value”. Different people may attach different amounts of value to the same good/services, depending on their needs and desires. In our modern society, when reference is made to the value of a good/service, usually the monetary value is referred to as a way to express the subjective value in a more objective way. With regard to “creation”, this implies that something is realized that did not exist before the action that is deemed to have created it. When an individual decides to create something, rational behaviour from an economic point of view would be that one only does so when the (monetary) expected value: (1) exceeds the costs that are necessary for the creation; and (2) is higher than the value of the closest alternative currently available. For the remaining of this thesis, I will therefore define value creation as: “the process of creating something which did not exist before, of which the outcome is better than the closest alternative available, for which individuals are willing to exchange a monetary amount”.

Following from the above definition, *Lepak* finds that individuals can create value by creating new goods/services that are perceived to be of value by a target user (e.g. a client or customer) relative to his needs and when the monetary amount realized for this service is

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<sup>81</sup> Verlinden, I. and Markey, B., *From Compliance to the C-Suite: Value Creation Analysed Through the Transfer Pricing Lens*, Intertax, Volume 44, Issue 10.

<sup>82</sup> See note 80, Hey.

<sup>83</sup> See note 80, Hey.

greater than what might be derived from an alternative source producing the same goods/services.<sup>84</sup> One of the main consequences of digitalization is that value is not only created by the company providing the good/services anymore, but that the users of those goods and services can create value for the company and other users. In other words, within the digital economy customers don't have the sole role of user/consumer anymore, but switch between producer (of content) and user (of content created by others and the company). The literature has at least three perspectives on user participation as value creation for the industry:<sup>85</sup>

- a. Value creation from user networking, updating and content contribution;
- b. Value creation as contributing to development and innovation; and
- c. Value creation from the user's personal trail of information (profiling) that can be sold to advertisers.

To that extent, the first category requires active user participation and probably leads to the most value being created. However, even without active participation, companies are able to collect data anyways, which can create value for the company after it is processed and categorized. This is for example the case when an individual uses a search engine (e.g. Google), after which his search data is used to target advertisements to him. As mentioned by *Bechmann*, research has continuously demonstrated that this last category of passive and less demanding usage patterns is by far the most common.<sup>86</sup> In determining how users create value for a company, it is therefore necessary to distinguish between the different ways that users can contribute and their degree of participation, in order to correctly take into account the value they have created. Therefore, in the functional analysis, the active users (i.e. the first category above) should have a higher weight than data gathered from passive users.

With regard to user participation, think of a social media platform, which only exists because of the content and activity of its active users. However, it is the combined quantity of active users that results in value creation, not the mere individual users separately. The more users are active on a social media platform, the more content is created by them, which attracts even more users. Participating in a social media platform however, is usually for free and doesn't generate any profits for the business as such. The revenues from a social media platform stem from the sale of advertisements, which with the expanding of the user base, grow along. In other words, the more active users, the more targets to display advertisements, the more valuable the social media platform becomes. This concept in itself however is not solely applicable to the new digital companies. For example, a radio station or TV channel also heavily depends on its users. The more people listen to a radio station, the more people will hear the commercials, and hence the more value is created. The OECD recognises this by stating that: "since the degree of user participation may not closely correlate with the degree of digitalisation, a pure focus on data and user participation without reference to other

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<sup>84</sup> Lepak, D.P., Smith, K.G., Taylor, M.S., *Value Creation and Value Capture: A Multilevel Perspective*, *Academy of Management Review* 2007, Vol. 32, No. 1, 180–194.

<sup>85</sup> Bechmann, A., Lomborg, S., *Mapping actor roles in social media: Different perspectives on value creation in theories of user participation*, *New media & society* 15(5) 765–781.

<sup>86</sup> See note 85, Bechmann.

characterising factors may imply that the tax challenges affect only a specific, more limited group of digitalised businesses”.<sup>87</sup> The new “functions” of users and data should therefore only complement the existing functions, risks and assets, in the functional analysis, not replace them.

Besides users, data is the second new factor of value creation that has to be taken into account to effectively attribute profits to the DPE. Following *Brauner* and *Pistone*, the functional analysis should take into account various activities, including the transfer of data, their purchasing and selling, further processing or transformation, all of which have a significant value for highly digitalized businesses.<sup>88</sup> An online retailer for example uses data gathered from people’s search-history on the internet to target its advertisements specific to that (potential) customer. That retailer can obtain such data itself but can also purchase it from third parties, specialized in gathering and further processing/transforming that information. According to *Brauner* and *Pistone*, the processing of raw data per se does not generate much value, because it only gathers and reclassifies data using apposite servers and statistical software, with the final output being information that was already present.<sup>89</sup> The real value stems from the quantity of information combined and the statistical conclusions that can be drawn therefrom.

In a way, this isn’t substantially different from the classic way of gathering information on (potential) customers by conducting surveys or feedback.<sup>90</sup> The only difference is that the process is less dependent on human (active) input, which increases the speed and volumes of data able to be gathered and processed. With quantity being one of the main factors that determine the value of data, data has become much more valuable. The fact that data now is less dependent on human input also results in the fact that it is not tied to one jurisdiction anymore. The data can be gathered from users in one country, analysed in another country and used to enhance the services for customers in yet another country. The lack of people needed for this process also means that the “significant people functions” are useless to take into account the value generated by it. Under the new profit-allocation factors for the DPE, data has therefore be taken into account including a split to be made between the different countries, based on which activity (gathering, analysing, processing, etc.) creates the most value for the company in question.

#### 4.5 Conclusion

As seen in this chapter, the digitalization of the economy changed the way businesses operate and create value. No longer are only the company and its employees creating value, but more and more value is created by its customers/users that gained a new role as “producer” which they switch with their “old” role as user. A user can for example create value for the company

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<sup>87</sup> See note 37, OECD interim-report, paragraph 40.

<sup>88</sup> See note 77, Brauner, Y. and Pistone, P.

<sup>89</sup> See note 77, Brauner, Y. and Pistone, P.

<sup>90</sup> Larking, B., *A Review of Comments on the Tax Challenges of the Digital Economy*, Bulletin for International Taxation, 2018 (Volume 72), No. 4a/Special Issue.

by creating content on social media. This content and the active user participation attracts again other users, leading to an expansion of the platform and the amount of users that advertisements can be displayed to. In the functional analysis, the amount of active users should therefore be taken into account and serve as a function to attribute profits to. Next to users, also data should be taken into account in the functional analysis. Here, a differentiation should be made between countries in which the data is gathered, countries in which the data is processed and countries in which the processed data is used to enhance the provided services. Because data is easily transferable, the jurisdiction in which it is processed should not be entitled to a large portion of the profits, since that would provoke base erosion and profit shifting. In that context, BEPS Action 8-10 seems already out-dated since the DPE can exist without significant people functions and the new functions users and data are not covered therein. Finally, a common understanding and consensus on how users and data create value, is essential to prevent double taxation to arise.



## Chapter 5: Attribution of profits to the DPE

### 5.1 Introduction

As seen in chapter 3 of this thesis, for the attribution of profits to the traditional permanent establishment, currently the Authorized OECD Approach is leading. However, since this approach heavily relies on the significant people functions, a problem arises when to apply this approach to the digital permanent establishment. The AOA also heavily relies on the arm's length principle, on which the five OECD preferred transfer pricing methods are based. The question is however whether the ALP is suited to deal with the new functions of users and data. To find sufficient comparables for these functions might be impossible, which would render the current transfer pricing methods inapplicable. The Directive in which the European Commission proposes the definition of a digital permanent establishment also contains an article dealing with the attribution of profits. Therein, the profit split method is appointed as the most favoured method to attribute profits to the DPE. With the ALP probably hard to apply to users and data, a method that doesn't rely on sufficient comparables might be a better option. This would require a departure from the ALP and a movement towards formulaic apportionment.

### 5.2 Commission's proposal

Article 5 of the DPE Directive starts by stating that “the profits that are attributable to or in respect of a significant digital presence in a Member State shall be taxable within the corporate tax framework of that Member State only”.<sup>91</sup> It then adopts the “separate entity approach” and arm's length principle in paragraph 2 by mentioning that “the profits attributable to the DPE shall be those that it would have earned if it had been a separate and independent enterprise, in particular with its dealings with other parts of the enterprise.”<sup>92</sup> Paragraph 3 requires, just as under the AOA, the performance of a functional analysis to determine the economically significant activities undertaken by the enterprise through a digital interface related to data or users. Those activities include, *inter alia*:

- The collection, storage, processing, analysis, deployment and sale of user-level data or user-generated content;
- The sale of online advertising space;
- The making available of third-party created content on a digital marketplace;
- The supply of any digital service not listed above.<sup>93</sup>

The above-mentioned activities shall be considered to attribute risks and the economic ownership of assets to the DPE. To that extent, paragraph 4 requires that also part of the so-called DEMPE functions related to intangible assets shall be allocated to the DPE. Finally, in paragraph 6 of article 5, the Commission proposes to use the profit split method, unless an alternative method is more appropriate with regard to the outcome of the functional analysis.

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<sup>91</sup> See note 24, DPE Directive, article 5, paragraph 1.

<sup>92</sup> See note 24, DPE Directive, article 5, paragraph 2.

<sup>93</sup> See note 24, DPE Directive, article 5, paragraph 5.

As splitting factors, the proportion of R&D expenses could be suitable, as well as the number of users in a Member State and data collected per Member State.<sup>94</sup>

Favouring the profit split method is remarkable since the Explanatory Memorandum of the DPE Directive states that “The challenge of identifying and valuing intangible assets (e.g. user data) as well as determining their contribution to value creation within a group requires *new methods* for attributing profit that better capture value creation in the new business models.”<sup>95</sup> The Commission thus implies that the current attribution of profit methods are not capable of capturing the value created by digital companies, but still favours the profit split method (which is one of the current five possible applicable methods under the OECD TPG). What was actually meant, is probably that the significant people functions related to assets and risks are hard to capture the value created by digital companies and therefore new “functions” (active users and data) need to be taken into account. Also the strong statement that the Authorised OECD Approach remains the underlying principle for attributing profits to a significant digital presence is hard to substantiate since it is so dependent on the ALP, which has been questioned more and more lately, especially in the context of digital transactions.

The favouring of the profit split method, with as splitting factor for example the number of active users, could be seen a shift towards formulary apportionment, away from the arm’s length principle. This because it no longer relies on what independent parties would have agreed upon in comparable circumstances (at arm’s length), but it will be based on the value drivers (number of active users and data) to split the profits between the enterprise and the DPE. The OECD agrees that allocating the profits based on the division of functions is the preferred way in case there is no direct evidence of how independent parties would have split the profit.<sup>96</sup> While the OECD still considers this in line with the ALP, apportionment of profits based on value drivers tends more to FA.

### 5.3 The arm’s length principle

The arm’s length principle is the international transfer pricing standard that the OECD member countries have agreed upon, and which should be used for tax purposes by both taxpayers and tax authorities according to the OECD.<sup>97</sup> The OECD has always been a strong advocate of the ALP and even devotes a whole chapter of its 2017 Transfer Pricing Guidelines to this principle in which it reaffirms its status as international standard. Tomas Balco, head of the OECD’s transfer pricing unit, stated that the ALP “performs two main functions – that of an anti-abuse provision, which should prevent base erosion and profit shifting, but also to assure fair allocation of taxing rights between jurisdictions with a view to prevent double taxation.”<sup>98</sup>

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<sup>94</sup> See note 24, DPE Directive, Explanatory Memorandum, page 9.

<sup>95</sup> See note 24, DPE Directive, Explanatory Memorandum, page 2.

<sup>96</sup> See note 49, OECD TPG 2017, paragraph 2.117.

<sup>97</sup> See note 49, OECD TPG 2017, paragraph 1.1.

<sup>98</sup> Angvik, L., *The future of the arm’s length principle*, TP Week, December 08, 2017.

It follows from the definition that the ALP heavily depends on the availability of comparable transactions, to compare the “tested transaction” with and base the pricing thereof on the comparable uncontrolled transaction, hypothesizing the tested party as a separate entity. Therefore, the OECD admits that the ALP is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods.<sup>99</sup>

On this point, *Avih-Yonah* has a fair point when he says that “in an integrated economy, it does not make sense to attribute profits and expenses to individual jurisdictions using separate-entity accounting.”<sup>100</sup> This because it just does not reflect reality and one of the main reasons MNEs exist is to benefit from their integration by way of synergies. Also with regard to unique intangibles, and/or in the provision of specialised services, the OECD admits that applicability of the ALP is rather limited.<sup>101</sup> Since companies in the digital economy heavily rely on unique intangible assets (data and users) to create value, the OECD more or less admits that the ALP is not well suited to apply to companies in the digital economy. After all, as *Verlinden* points out, the arm’s length principle originates from an era in which human insight, education and creativity were not yet seen as crucial income-generating factors.<sup>102</sup> These factors however are today the biggest value drivers for modern businesses, especially in the digital economy.

According to *Koomen*, the ALP was initially developed to remunerate the PE for its services and leave the residual economic profit in the state of residence of the MNE.<sup>103</sup> With the purpose of the DPE to leave the residual profit in the source state (i.e. user jurisdiction), this is another sign that the arm’s length principle is most likely not suitable in the context of the digital permanent establishment.

#### 5.4 Formulary apportionment

The AOA and the OECD TPG, including the five prescribed methods, all build on the arm’s length principle as a foundation. While the OECD still seems convinced of the effectiveness of this principle, more and more criticisers call for a departure from the ALP, for example to be able to tax companies in the digital economy more effectively. The OECD, being such a strong advocate of the arm’s length principle, argues that global formulary apportionment would not be acceptable in theory, implementation, or practice.<sup>104</sup> However, the Commission’s choice to prescribe the profit split method in relation to profits of the DPE, feeds the discussion whether the ALP should be abandoned and replaced, or at least complemented, by formulary apportionment.

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<sup>99</sup> See note 49, OECD TPG 2017, paragraph 1.9.

<sup>100</sup> *Avi-Yonah, R.S., Advanced Introduction to International Tax Law*, Edward Elgar Publishing, ISBN 9781781952313, page 73.

<sup>101</sup> See note 49, OECD TPG 2017, paragraph 1.1.

<sup>102</sup> *Verlinden, I., Markey, B., From Compliance to the C-suite: Value Creation Analysed Through the Transfer Pricing Lens*, *Intertax* 44, Issue 10, 2016.

<sup>103</sup> *Koomen, M., Transfer Pricing in a BEPS Era: Rethinking the Arm’s Length Principle – Part II*, *International Transfer Pricing Journal*, July/August 2015.

<sup>104</sup> See note 49, OECD TPG 2017, paragraph 1.15.

Under formulary apportionment, profits are allocated on a consolidated basis among the associated enterprises in different countries of an MNE, based on a predetermined and mechanistic formula.<sup>105</sup> The OECD recognizes a three-step approach in applying formulary apportionment:

1. First, the unit to be tax has to be determined. This can for example be all the subsidiaries and branches of the whole group on a worldwide level, or different levels within the group (e.g. only entities in Europe);
2. Secondly, the (global) profits have to be accurately determined;
3. Finally, the formula to allocate the profits has to be established, based on different factors that create value for a certain business/industry.<sup>106</sup>

The CCCTB proposal also includes the formulary apportionment method in order to allocate the consolidated profits on EU-level amongst the various Member States.<sup>107</sup> There, labour, assets and sales are proposed as allocation factors, each with an equal weight. With regard to the profit allocation of DPEs, allocation factors should include the amount of data and number of active users, with variable weight factors to properly take into account the way value is created by those factors.

In contrast to the profit split method, as favoured by the European Commission, formulary apportionment applies to the business as a whole. This has as an advantage that synergy effects will be taken into account by allocating the profits between the various entities, where the profit split method only looks at each transaction on a stand-alone basis. The mainstream transfer pricing methods are often not well-suited to capture or allocate integrated effects and in practice the related returns often automatically flow to the non-tested party under one-sided methods, according to *Verlinden*.<sup>108</sup> The arm's length principle therefore ignores synergy effects because it looks at two independent parties that are, because of their independency, unable to create synergies.

Another advantage of formulary apportionment compared to the arm's length principle is that it gives taxpayers more legal certainty. The arm's length principle, although a leading principle for decades now, still remains a relatively vague concept with little foreseeability. Unsurprisingly, this has led to an explosion of disputes between tax authorities and taxpayers worldwide on what an arm's length remuneration of a certain transaction should be. In other words, what would two independent parties have agreed on in the same transaction under the comparable conditions? This is impossible to determine with 100% certainty and therefore likely to be subject of different interpretations. With formulary apportionment however, the taxpayer knows before hand what factors will be taken into account to allocate the profits and

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<sup>105</sup> See note 49, OECD TPG 2017, paragraph 1.17.

<sup>106</sup> See note 49, OECD TPG 2017, paragraph 1.17.

<sup>107</sup> European Parliament legislative resolution of 15 March 2018 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2016)0683 – C8-0471/2016 – 2016/0336(CNS)).

<sup>108</sup> See note 81, *Verlinden*, I.

what weight is attached to each of those factors. No dispute is likely to arise from this since the factors and their weights will be laid down in “hard law” and will be undisputable.

An often-heard counter-argument against FA is that it would favour jurisdictions that have large populations by applying allocation-factors that largely depend on a country’s population. If for example, sales, users or payroll will be used as allocation factors, automatically large countries will get a large share of the consolidated profits while those jurisdictions didn’t necessarily contribute to the value creation for the company in the same proportion. In applying this line of reasoning to the factor “active users” for a DPE however, this argument not valid at all. Of course larger countries will have more active users than smaller countries. But since more users equals more content and activity and hence value creation, it is perfectly fair that those jurisdictions will be attributed a larger part of the profits.

Imagine a social media platform, only active in the 5 European countries as indicated in the table below. As part of the allocation formula, “active users” is appointed as one of the allocation factors. Assume, for the simplicity of this example, that the company has determined that their total active user base has contributed for € 1.500.000 to the total profits that are made in the past fiscal year, by way of their contributions and active participation thereby enhancing the functioning of the platform.

Allocation factor “active users”				
Country	# Population	# Active users	Share in # users	Allocated profit
<b>Denmark</b>	5.700.000	1.600.000	4.50%	€ 67.500
<b>France</b>	67.000.000	13.400.000	38.10%	€ 571.500
<b>Germany</b>	82.700.000	9.100.000	25.85%	€ 387.750
<b>Netherlands</b>	17.000.000	8.800.000	25.00%	€ 375.000
<b>Sweden</b>	9.900.000	2.300.000	6.55%	€ 98.250
<b>Total</b>	<b>182.300.000</b>	<b>35.200.000</b>	<b>100.00%</b>	<b>€ 1.500.000</b>

From the above table, it follows *inter alia* that although Germany’s population is almost 5 times as big as the Netherlands’, they are allocated about the same amount of profits. This is due to the high number of active users in the Netherlands, which equals a large part of the total contributions to the social media platform and hence value creation. It is therefore a logical outcome to attribute also a large part of the profits to the Netherlands, perfectly in line with value creation.

Formulary apportionment also better reflects the economic reality than the arm’s length principle, which is based on a hypothetical comparable transaction. With the DPE being defined with more economic thresholds (i.e. revenue, users and business contracts), allocation on the basis of those factors would be in line with the new definition. By linking profit allocation to factors that reflect economic activity, it also bridges the gap towards value creation, something which the ALP fails to establish.

Crucial to the success of formulary apportionment however, is that consensus is reached with regard to the application of it and the factors that have to be taken into account. While this is nearly impossible on a global level (especially with the strong opposition from the OECD), within the European Union it could be possible to reach to a consensus and come to a harmonised understanding. The discussion on this point however, is already going on for years within the EU in light of the CCCTB and only little progress has been made to this day. The conflict of interest between labour intensive countries that want a high weight on labour and payroll and countries whose economies are more driven by technology and innovation, seems to frustrate the introduction of FA.

While the ALP heavily relies on comparables, that is the most true with regard to the traditional methods (CUP, cost-plus and resale minus) and less for the transactional methods (profit split and TNNM). The Commission's preference of the profit split method in connection with profits of the DPE, is a first sign that comparability (and thus arm's length) becomes less important. However, in case there are no comparables, *Avi-Yonah* points out that you cannot prove that the result reached by a certain method (like formulary apportionment) was not what unrelated parties would have done at arm's length.<sup>109</sup> In other words, despite the lack of comparables, the outcome of formulary apportionment can still be at arm's length, while it can be applied without comparables.

Finally, formulary apportionment could limit the ways MNEs use to shift profits to low tax jurisdictions and erode the taxable base in high tax jurisdictions. "While MNEs may freely decide where to locate production, IP rights and distribution, the decision where to serve their customers is far less flexible/mobile."<sup>110</sup> "Profit allocation based on where the customers are located would therefore be less arbitrary and sensitive to base erosion and profit shifting. If customers are perfectly immobile, sales-based profit taxation ensures global tax neutrality."<sup>111</sup> To think that FA would put an end to profit shifting in a definitive way however, would be quite naïve. This because also the allocation factors are potentially subject to manipulation and will create new opportunities for cross-border tax planning.<sup>112</sup> Putting in place anti-avoidance rules would – as with any other kind of measure – therefore be necessary to ensure effective taxation by FA.

Formulary apportionment is not mere a theoretical idea, it has been successfully used in practise in the United States and Canada for many years to allocate the profits of companies between the various states.<sup>113</sup> Given the success over there, it functioned as an example for the apportionment formula in the CCCTB proposal. In the Explanatory Memorandum, the

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<sup>109</sup> See note 100, *Avi-Yonah*, page 71-72.

<sup>110</sup> Schreiber, U., *Sales-Based Apportionment of Profits*, Bulletin for International Taxation, 2018 (Volume 72), No. 4/5, 14 March 2018.

<sup>111</sup> See note 110, Schreiber, U.

<sup>112</sup> Sánchez, A.S., *The apportionment formula under the European Proposal for a Common Consolidated Corporate Tax Base*, European Taxation, 2018 (Volume 58), No. 6.

<sup>113</sup> See note 112, Sánchez, A.S.

European Commission seems highly convinced of the effectiveness of the CCCTB (hence formulary apportionment):

*“the CCCTB features as an effective tool for attributing income to where value is created, through a formula based on three equally weighted factors (i.e. assets, labour, and sales). Since these factors are attached to where a company earns its profits, they are more resilient to aggressive tax planning practices than the widespread transfer pricing methods for allocating profit.”<sup>114</sup>*

Given the critics on the ALP in its application to companies in the digital economy and the particular strengths of FA in this area, a different approach than currently applied could be recommendable. As a compromise between the arm’s length principle and formulary apportionment, *Avi-Yonah* proposed to use formulary apportionment in the context of the arm’s length principle by using it to allocate the residual profit in the profits split method.<sup>115</sup> A combination of both the ALP and formulary apportionment, combining the best of two worlds, could perhaps be the ultimate solution. In the next paragraph, *Avi-Yonah*’s approach is taken as a basis and applied in the context of a digital permanent establishment.

## 5.6 Possible solution

To propose to abandon the ALP and make a complete shift towards formulary apportionment would be overambitious and unrealistic. Both methods have their own strengths and weaknesses. To effectively attribute profits to a DPE in line with value creation however, a combination of both the ALP and FA could be a step in the right direction. By favouring the profit split method, a method that is already widely used, the European Commission took a conservative approach that in itself is not bad. Out of the five current “OECD preferred” methods, the PSM is probably the most suited to deal with the digital economy. This because it has the least dependency on comparables (which are hard/impossible to find in the digital economy) and because it is a two-sided method, taking into account both parties in the controlled transaction.

By first splitting the profits between the head office and the DPE using the PSM, the routine profit of that transaction is allocated. In order to allocate a part of the residual profit to the DPE in the different user jurisdictions the PSM could be complemented with FA. The formula has to take into account the number of active users and the amount of digital data collected from users of the digital service that can be assigned to the DPE. Since the contributions by active users are more valuable than the mere collection of data, a weight of 3/5 for the factor “active users” and a weight of 2/5 for the factor “data” could be considered. Taking the same example as before, assume that the company has determined that a share of € 1.500.000 of the residual profits that are made in the past fiscal year are due to the active participation of its users and from the data collected from its total users (active and passive).

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<sup>114</sup> See note 107, CCCTB proposal, Explanatory Memorandum.

<sup>115</sup> *Avi-Yonah, R.S., Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, World Tax Journal, February 2010.

FA based on “active users” and “data collected”					
Country	Active users	% Users	# User data	% Data	Allocated profit
Denmark	1.600.000	4.50%	2.500.000	3,73%	€ 62.880
France	13.400.000	38.10%	23.500.000	35,02%	€ 553.020
Germany	9.100.000	25.85%	28.900.000	43,07%	€ 491.070
Netherlands	8.800.000	25.00%	9.500.000	14,16%	€ 309.960
Sweden	2.300.000	6.55%	2.700.000	4,02%	€ 83.070
<b>Total</b>	<b>35.200.000</b>	<b>100.00%</b>	<b>67.100.000</b>	<b>100,00%</b>	<b>€ 1.500.000</b>

By first applying the PSM and complementing it with FA, perhaps a suitable method is found to allocate profits to the DPE, in line with value creation. Please note that the above attribution of profits to the DPE based on user-generated content and digital data has to be seen separate from the allocation of some DEMPE functions and profits attached to those to the DPE. The mechanics for that part should however be largely the same. Perhaps the valuation question on how much the enhancement by users to the company’s IP actually contributed to the total profits in the fiscal year is much harder to determine.

## 5.7 Conclusion

As seen in this chapter, the effectiveness of the arm’s length principle – and thereby the application of the AOA and the traditional five transfer pricing methods – is questionable in the context of the DPE. This because it is highly dependent on the existence of sufficiently comparable transactions and it fails to recognise residual profit in highly integrated businesses with unique intangibles, thereby leaving the residual profit in the state of residence. An alternative would be to use formulary apportionment, whereby a formula based on the number of active users and the amount of digital data collected would allocate the profits between the various user jurisdictions. However, since both methods (ALP and FA) have their pros and cons, and an abolishment of the ALP is not realistic, a combination of both would perhaps be the ultimate solution to attribute profits to the DPE. One possible solution could be to first use the PSM to allocate the routine profit between the head office and the DPE, following the existent methodology. To allocate the residual profit, “active users” and “digital data” should be taken into as allocation factors. Since the contributions by active users are more valuable than the mere collection of data, a weight of 3/5 for the factor “active users” and a weight of 2/5 for the factor “data” would seem reasonable. This should result in an effective allocation of profits to the user jurisdictions in which a DPE is deemed to exist, in line with the value created by the users of the digital services.



## Conclusion

To conclude this thesis, the research question is answered and other conclusions that can be drawn after the research in this thesis are made. Please note that for a summary of this thesis reference is made to the executive summary in the beginning of this thesis.

The proposal of the European Commission to introduce a digital permanent establishment definition was the inspiration to write this thesis. While the definition of a DPE is clear from the Directive, there is doubt whether the current profit-allocation principles are effective to attribute profits to the DPE and hence the user jurisdictions (as is the aim of the DPE Directive). The research question of this thesis therefore was:

*“Do the current profit-allocation principles need to be adjusted after the introduction of the digital permanent establishment?”*

After the research as part of writing this thesis, the following conclusions can be drawn:

- The current definition of a permanent establishment is not effective to deal with companies engaged in the digital economy, given their distinctive characteristics and lack of physical presence in jurisdictions in which they create value;
- The recommendations in BEPS Action 7 that lower the thresholds for a PE to exist are a step in the right direction but still require some sort of physical presence and therefore don't go far enough;
- The introduction of a DPE is urgently needed to end the mismatch that digital companies currently exploit between the jurisdiction where value is created and the jurisdiction in which their profits are taxed;
- The recommendations in BEPS Action 8-10, emphasising the importance of significant people functions are already out-dated and are impossible to apply to the digital permanent establishment;
- New value drivers related to “active users” and “data” gathered from passive need to be introduced and taken into account in the functional analysis to complement the current functions, assets and risks in order to effectively attribute profits to the digital permanent establishment;
- The profit split method is most likely the most suited method currently available to deal with the attribution of profits to the DPE.
- A deviation from the arm's length principle is probably required to allocate the residual profits derived from digital transactions. Formulary apportionment could be the solution to complement the PSM and ensure that profits are attributed to the users jurisdictions in line with value creation.

Finally to answer the research question, the current profit-allocation principles do need to be adjusted and complemented with “active users” and “data” derived from passive users as value drivers, to take into account the value created in the user jurisdiction. With regard to the method to attribute profits to the DPE, a combination of the PSM and formulary apportionment could be a solution to effectively tax companies in the digital economy and ensure profit-allocation in line with value creation.

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## Annex I

### ANNEX II

#### List of services referred to in Article 3(5)(f):

- (a) website hosting and webpage hosting,
- (b) automated, online and distance maintenance of programmes,
- (c) remote systems administration,
- (d) online data warehousing where specific data is stored and retrieved electronically,
- (e) online supply of on-demand disc space,
- (f) accessing or downloading software (including procurement/accountancy programmes and anti-virus software) plus updates,
- (g) software to block banner adverts showing, otherwise known as Bannerblockers,
- (h) download drivers, such as software that interfaces computers with peripheral equipment (such as printers),
- (i) online automated installation of filters on websites,
- (j) online automated installation of firewalls,
- (k) accessing or downloading desktop themes,
- (l) accessing or downloading photographic or pictorial images or screensavers,
- (m) the digitised content of books and other electronic publications,
- (n) subscription to online newspapers and journals,
- (o) weblogs and website statistics,
- (p) online news, traffic information and weather reports,
- (q) online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such data as continually updated stock market data, in real time),
- (r) the provision of advertising space including banner ads on a website/web page,
- (s) use of search engines and Internet directories,
- (t) accessing or downloading of music on to computers and mobile phones,
- (u) accessing or downloading of jingles, excerpts, ringtones, or other sounds,
- (v) accessing or downloading of films,
- (w) downloading of games on to computers and mobile phones,
- (x) accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another,
- (y) automated distance teaching dependent on the Internet or similar electronic network to function and the supply of which requires limited or no human intervention, including virtual classrooms, except where the internet or similar electronic network is used as a tool simply for communication between the teacher and student,
- (z) workbooks completed by pupils online and marked automatically, without human intervention.