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The digital economy and its implications: does the OECD's Pillar One Proposal challenge the principles of law within International and EU tax law?

by

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Summary

Change is the only constant; yet, as we step into the brave new world of taxing the digital economy, it might seem like the need and development of principles and rules for adequate profit allocation has only begun.

This thesis discusses the profit allocation rules under the Unified Approach of the OECD Pillar One Proposal Amount A in relation to three identified principles of law in international and European tax law. In this cross-disciplinary approach, the principles of ability-to-pay, territoriality, and State Aid rules are qualified through review of their development in both realms of law. These principles of law are consequently used as benchmarks to review the objective of fair profit redistribution within the digital economy. As such, the study relies on the OECD Report on Pillar One Blueprint 2020 and the OECD Progress Report on Amount A of Pillar One 2022 to guide the discussion on the applicable rules.

In review of the first principle, the progressive turnover tax of the Proposal is scrutinised as it largely deviates from the traditional qualification of the ability-to-pay principle based on adjusted corporate income tax. However, this qualification is contrary to the novel formulation of the Court of Justice of the European Union to both expand not only the ability-to-pay principle but also the principle of extraterritoriality to accommodate market state taxing rights and growing digital business structures.

A domino effect occurs as the development of the ability-to-pay principle and extraterritoriality indirectly affects the EU State Aid rule regarding selectivity and taxing rights of states. Therefore, the thesis argues that the proposed tax measure is questionable in practice as there are conflicting outcomes with the although this direction is seen as an ongoing progressive step towards equalised distribution in the international and EU legal realm in the eyes of the Court.

Preface

I will always be immensely thankful for the people who accompanied and carried me during the writing of this thesis. This work stands as testament to the invaluable support of my family, friends, and classmates. Lastly, I would like to extend my gratitude to my supervisor Cécile for the dedication, vigour, and passion brought to every lecture and step within the research process.

This has been one of the most challenging yet rewarding academic endeavours. I hope with the completion of this thesis and my master's studies that it is not a personal terminus but a continuum of exploration in the field of tax law.

Dankie

Abbreviation list

AG	Advocate General
ALP	Arm's Length Principle
ADS	Automated Digital Services
BEPS	Base erosion and profit shifting
CFB	Consumer Facing Business
CIT	Corporate Income Tax
CJEU	Court of Justice of the European Union
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
DST	Digital Service Tax
DTT	Double Tax Treaty
EC	European Commission
EU	European Union
EUR	Euros
GAAR	Generally Accepted Accounting Standards
GDP	Gross Domestic Product
IP	Intellectual Property
IFRS	International Financial Reporting Standards
MTC	Multilateral Tax Convention
MNE	Multinational entity
OECD	Organisation for Economic Cooperation and Development
PC	Parent company
PE	Permanent establishment
TP	Transfer Pricing
TPG	Transfer Pricing Guidelines
TFEU	Treaty of the Functioning of the European Union
UA	Unified Approach under Pillar One
US	United States

1 Introduction

1.1 Background: a cross-disciplinary approach

It is undoubted that the digitalisation of business and commerce has ushered in great advances for the consumer and Multinational entities (MNEs) alike. Digitalisation is a driving force of new productivity, entrepreneurship, and has an enormous impact on the global standard of living. Particularly, the rise of digital channels through the internet has brought an increase of open market competition which sequentially lowered barriers amongst states and increased chances of profitability.[1]

However, this change is not always positive as innovation moving away from local production and consumption has created a myriad of issues for taxation to occur based on the fluidity of where and how profit is generated. Notwithstanding these issues, concerns have also given rise to Corporate Income Tax (CIT) base erosion, profit shifting (BEPS) and the change to the process of value creation that allows for profits to disappear into thin air despite well-defined state territories and existing allocation rules.

The result of this is due to inadequacy in current taxing right and profit allocation rules drafted almost a century ago and gaps within the transfer pricing (TP) rules that fail to recognise the elements of digital and intangible value creation in market jurisdictions. In this regard, the Organisation for Economic Co-operation and Development (OECD) has raised concern that associated entities in MNE groups establish non-routine assets like value and profit generating intangibles in more desirable locations with lower rates of taxation or without any tangible nexus out of the wilful intention to shift the risks and costs outside the scope of corporate taxation.[2]

In the light of these novel developments, the emergence of the OECD Pillars and other Digital Service Taxes (DST) across Europe came as a global front against digitalisation and new business models. The main question arises if the current OECD Proposal Pillar One, which will regulate taxation of income from digital business activities, upholds or challenges the legal principles within the realm of International and European Union (EU) tax law? And from this outcome, what is the consequent status and impact of the Proposal's new allocation rules on these principles of law?

Answers to these questions are of utmost importance as Member States (MS) will, once ratified, need to implement the Proposal into their own corporate income tax domestic laws and will need to consider the impact and potential friction the new allocation rules might have with existing judicial norms in the EU legal sphere. Moreover, when looking at the recent

[1] OECD, 'Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint' (OECD Publishing 2020), p. 10, hereafter 'Pillar One Blueprint'.

[2] Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) available at: https://www.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en (accessed on 30 April 2023), p. 14.

adoption of the EU Pillar Two Directive[3], the rules will not provide full harmonisation amongst present direct tax measures as states may seek to garner more tax basis with possibility of conflict with principles of law. In this way, MS will need to consider the fundamental norms of the International and European order to determine the outcome of the proposed revamp to the international tax system.

At first glance, there might be uncertainty as to why this research question would be of research merit, yet the topic holds considerable promise for rich discussion to highlight the importance of the role principles of law play in scrutinising new rules emerging on international and European level. Moreover, principles of law are of importance as the main goal of the OECD digital tax law reform stems from the importance of 'fair' taxation. From this, the first sub-question arises as to what is defined as fairness and how are the bounds expressed through legal principles. This will be an initial catalyst for the research to follow within the thesis.

1.2 Aim

The aim of the thesis is to review the OECD Pillar One Proposal and three relevant principles of law. This is done by setting the benchmarks as defined by the goal of the Proposal to reach the notion of 'fairness'. From this notion, the thesis endeavours to answer the legal question: does the OECD's Pillar One Proposal conflict or align with the principles of law within International and EU tax law? The study will thus look at the principle of (i) ability-to-pay, (ii) territoriality and extraterritoriality, (iii) and the State Aid as benchmarks of equal treatment. Moreover, as the proposal skirts against the taxing rights and profit allocation rules of international Double Tax treaties (DTT), the TP standard of the Arm's Length Principle (ALP) will also be commented on. With these aims the discussion will allow for an interpretation of the legal nuisances of the new allocation rules on the current principles of law.

1.3 Method and material

To achieve the aims of the thesis, a legal-dogmatic research method will be employed.[4] This method will involve a systematic and critical analysis of the relevant international and European legal principles and concepts relevant to the OECD Pillar One.

The goal of the legal-dogmatic method will be to derive the *lege lata*[5] and the *de lege ferenda*[6] which is derived from the relevant benchmarks to describe and interpret the Proposal provisions. This would involve a systematic approach to understanding the identified legal principles to

[3] Council Directive on the on ensuring a global minimum level of taxation for multinational groups in the Union (2021), hereafter 'EU Pillar Two'.

[4] Jan B.M. Vranken, 'Methodology of Legal Doctrinal Research: A Comment on Westerman' in Mark van Hoecke (ed) *Methodologies of Legal Research: Which kinds of Disciple?* (Hart Publishing 2011), p. 111.

[5] As the law is now.

[6] As the law should be.

extract the derived applicable law (*de lege lata*). The final conclusions drawn in the thesis depend on a comprehensive analysis of the application of the principles to the Proposal of Pillar One (*de lege ferenda*).

The analysis will be guided by the principles of the ability-to-pay, territoriality, the ALP as well as State Aid rules found within legal material such as the OECD Model Tax Convention (MTC)[7], the OECD Transfer Pricing Guidelines 2022 (TPG)[8], the OECD publications on Pillar One and the Treaty on the Functioning of the European Union (TFEU) to lay the course of the discussion.[9] Furthermore, case law judgements of the European Court of Justice and Advocate General opinions will aid to substantiate the arguments made.

It will also be purposeful to utilise other academic literature and reports as a source to understand the existing body of knowledge on the topic and gain an insightful view on the main aspects of the Pillar One Proposal and legal principles which will serve in identifying the gaps and areas for further research.

1.4 Delimitation

This study is focused on the OECD Pillar One Proposal Unified Approach (UA) as it is drafted at the time of conducting this inquest into its allocation rules. Importantly, due to the ongoing changes to the structure and content of the Proposal, and specifically Amount A of the UA, the discussion will largely rely on the OECD Blueprint 2020[10] and the Progress Report of 2022[11] to examine the structure and aims of the proposal.[12]

The merit of the discussion will lie in analysing the proposal rules as if the Proposal will be enacted into EU law. Moreover, the focus will exclude any discussion into the content, rules or application of the OECD and EU Pillar Two Directive.[13] In addition, the study will not delve into any accounting rules or political and economic factors and perspectives relevant to the topic. Lastly, the topic will not address elements of compatibility or infringements of fundamental freedoms of the EU or any intricacies of an MS domestic tax laws.

1.5 Outline

The thesis is structured into 6 chapters, each focusing on a unique aspect of the OECD Pillar One Proposal and the central legal principles it interacts

[7] OECD Model Tax Convention on Income and on Capital: Condensed Version (OECD Publishing 2017).
[8] OECD, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022' (OECD Publishing 2022).
[9] European Union, Consolidated version of the Treaty on the Functioning of the European Union (2012) OJ C 326/47, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT (accessed 12 May 2023).
[10] OECD Blueprint, n 1, p. 14.
[11] OECD, 'Progress Report on Amount A of Pillar One' (OECD Publishing 2022).
[12] Collectively referred to as 'the Proposal' throughout the study.
[13] EU Pillar Two, n 3.

with. The content in each chapter will have a linear development and builds on one another to draw a conclusion regarding the main legal question.

After the introduction, the second chapter opens with the legal background regarding the new allocation rules of the OECD proposal's UA that will act as the framework to discuss the structural point and rules of the Proposal. The chapter will conclude with an understanding of general principles of law and the conflict that can occur with the Proposal.

This is followed by an analysis of the ability-to-pay principle in chapter 3 by focusing on its development in concept, legal origin, and application throughout case law. The principle is then assessed against the new allocation rules. Thereafter, the discussion in chapter 4 turns to the principle of territoriality as defined in international customary law, treaty agreements and transfer pricing rules. This assessment is then challenged by the Proposal rules by analysing the developments in the European legal order through further case law analysis.

After that and being aware of the new legal trends in the realm of extraterritoriality and the ability-to-pay principle, the discussion homes in on the State Aid rule in European law in chapter 5. The focus shifts to the benchmark of State Aid rule and the potential clash that could occur with rules of advantage, selectivity, and de facto selectivity once the Proposal finds direct application within domestic legislation.

Finally in chapter 6, based on the conclusions made in the previous chapters, a summative conclusion can be drawn regarding the interaction of the OECD Pillar One Proposal within the framework of legal principles in the current EU and international tax law context.

2 Theoretical framework

2.1 Introduction to the OECD Pillar One Proposal

This chapter's analysis centres on the current proposal for allocation of profit and taxing rights amongst jurisdictions under the Unified Approach of Pillar One. Particularly, the focus will be placed on Amount A as the main proposal of consultation.

To analyse the proposal's changes to the international tax system of profit allocation and fair taxation, the chapter will map out the theoretical framework to prompt further discussion on the relationship of the proposal with legal principles. The discussion will firstly supply a breakdown of the background, structure and aim of the new allocation rules. This is done by looking at the building blocks of Amount A's and its formulary appointment method.

The chapter will conclude with an outline of what the background and role of general principles is in international and EU law that would provide a backdrop for the inspection into the OECD Pillar One Proposal's framework.

2.2 The building blocks of Amount A

Pillar One includes two proposals that together form the bedrock of the UA in terms of an Amount A and B to allocate profits to market jurisdictions to tax where value is created.[14] Amount A provides for the distribution rules for non-routine residual profit and new taxing rights whilst Amount B provides for the remuneration of routine profit for baseline marketing and distribution activities within a MNE's internal transactions.[15]

For the thesis, Amount B will not be discussed as this proposal is less contentious than Amount A as it simply seeks to streamline the existing rules of the allocation under the ALP rather than suggesting new rules and taxing rights. According to the OECD, the overarching outcome of Amount A is thus to be applied as a canopy rule over the existing transfer pricing and profit allocation rules.[16]

The application of the Amount A will start with the threshold tests.

2.2.1 The revenue and profitability tests

The novel jurisdictional taxing rights do not apply automatically to all MNE and depend on whether the MNE is covered by the scope of Pillar One. If an MNE group can be regarded as falling in the scope of the proposal is based on the outcome of a two-pronged test looking at the revenue and profitability of the MNE.[17]

The first 'revenue test' is applied to determine the size of the entire MNE and accordingly filter out all small MNEs. As per the writing of this thesis, a minimum threshold amount of an annual turnover revenue is currently set at EUR 20 billion.[18] In addition to the threshold, the second test requires MNEs to achieve a profit margin of 10% prior to tax (i.e., the consolidated profit before tax is 10% of the turnover which is calculated by dividing the group's earnings before tax by the total revenue, expressed in a percentage).[19] These thresholds are determined at the group level of the total MNE.[20] Such a high threshold would limit the scope of application to MNE with stronger presence on the market to take advantage of the consumers and data within that jurisdiction.[21]

Initially, the test to determine if a MNE fell within the proposal's scope relied on an 'activity test', yet the Progress Report no longer focuses on the certain sectors or activities applicable to the proposal.[22] The activity test

[14] OECD, Pillar One Progress Report, n 11.
[15] OECD, Pillar One Progress Report, n 11.
[16] OECD, Pillar One Progress Report, n 11.
[17] Article 1(2) of the OECD Progress Report 2022, n 11, p. 10.
[18] Article 1(6)(d) of the OECD Progress Report 2022, n 11, p. 10.
[19] Article 1(6)(e) of the OECD Progress Report 2022, n 11, p. 11.
[20] OECD, 'Progress Report on Amount A of Pillar One: Frequently asked questions' (OECD Publishing 2022), p. 2.
[21] Ibid, p. 2
[22] See the OECD Blueprint, n 1.

aimed to include companies that participated in a sizable manner through "sustained and active participation of business in the economy of that jurisdiction" where the digital entity sells its goods or services.[23] Participation in this sense refers to the increase in value of products, services, and eventually profits.[24] Thus, activities were in-scope of the proposal regardless of having a physical presence in the market jurisdiction. These encumbered activities consisted of Automated Digital Services (ADS) and Consumer Facing Businesses (CFB).

One would wonder why this approach was excluded in the Progress Report on Amount A as a test to be utilised. By looking at the OECD Blueprint, it can be said that the test could complicate the determination of the necessary scope and nexus requirements due to ambiguous definitions of the activities. This indicates that allocating income profits arising from either ADS or CFB models lacked consensus amongst Member States (MS) to the Inclusive Framework and did not clearly crystalise in common understanding. It therefore made it impossible for separating the digital economy from the real economy for tax right allocation.[25]

After the threshold has been established, one can move onto the nexus requirement.

2.2.2 Nexus requirement

The first Pillar founds a new taxing right within the market jurisdiction through a novel 'nexus' rule. The rule serves not only to create a causal link between the multinational and the place of value creation, but also to strengthen the rights of countries excluded within the virtual chain of production and uphold their economic stability.[26] Essentially, the causal link aimed to protect and further the interests of smaller or developing nations and shelter tax revenues from evasive behaviours of taxpayers causing base erosion and profit shifting (BEPS) which MS viewed as stemming from digitalised business structures.[27]

Due to the elimination of the two categories involving digital business activities, the nexus is forthwith established only through the marker of turnover profit. The only distinction made by the proposal between excluded and included corporate taxpayers is based on the size of the economies.[28] Ergo, a nexus with the market jurisdiction is deemed to exist to the extent that the income generated is attributable to that jurisdiction with a pecuniary sum of EUR 1 million.[29] However, the threshold is lowered to EUR 250

[23] OECD, 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy', (OECD Publishing 2020), p. 11-12.
[24] OECD Blueprint, n 1, p. 19.
[25] OECD Blueprint, n 1, p. 19.
[26] Article 3 of the OECD Progress Report 2022, n 11, p. 13.
[27] OECD Blueprint, n 1, p. 64.
[28] OECD Blueprint, n 1, p. 161; Article 3 of the OECD Progress Report 2022, n 11, p. 13.
[29] Article 3(1) of the OECD Progress Report 2022, n 11, p. 13

thousand if the market jurisdiction has a Growth Domestic Product (GDP) of less than EUR 40 million.[30]

2.2.3 Determining the tax base

Contrary to the general tax rule of the ALP computing the tax base for profit distribution on a 'separate entity approach', the tax base will be determined based on the consolidated financial account of the entire group of entities in the MNE.[31] This allows for the determination of the total qualifying group income prior to taxation. However, it can be important to note the consistency of different accounting standards amongst different states poses a contentious issue within the drafting of the proposal.[32]

The OECD aims to resolve this dilemma through the use of a general starting point with the International Financial Reporting Standards (IFRS) and accepting any consolidated financial statements prepared under the Generally Accepted Accounting Standards (GAAP).[33] However, it should be kept in mind that Pillar One does not have binding effect and that countries enact tax laws based on legal perspective, meaning that Amount A's tax base will be interpreted by the individual jurisdictions applying the rules.[34]

Consequently, accounting standards have may have global irregularities that serve state's tax policy objectives,[35] such as the GAAR in the US focusing largely on either stakeholder interests, whereas the IFRS grants discretion to interpreting the relevant principles.[36] This indicates that countries could have ample room for autonomous interpretation regarding the current layout of the proposal such as expenses, dividends and equity gains.[37] This margin of discretion may change the stance of the OECD in future drafting of the proposal regarding the tax base determination. However, there could be merit in assessing the accounting standards with legal principles yet any further discussion on the matter would fall outside the scope of discussion of this thesis.

2.2.4 Revenue sourcing rules

As per the current allocation rules found in Double Tax Treaties (DTT), profits are allocated largely on the supply side of the business chain, namely where physical presence, management activities or staff is located.[38] This is overhauled by Amount A of the UA. The sourcing rules thus shifts the focus

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[30] Article 3(2) of the OECD Progress Report 2022, n 11, p. 13.
[31] OECD Progress Report 2022, n 11, p. 23.
[32] Marcelo H.B. Moura and Abhishek Padwalkar, 'Amount A and Its Design So Far: Feasibility in Sight?' (2023) 30 International Transfer Pricing Journal 2, p. 69
[33] Ibid, p. 100.
[34] Moura and Padwalkar, n 32, p. 69.
[35] Ulrich Schreiber, Dirk Simons, Stefan Greil and Martin Lagarden, 'Why the Arm's Length Principle Should Be Maintained' (2020) 27 International Transfer Pricing Journal 6, p. 414.
[36] Moura and Padwalkar, n 32, p. 69.
[37] Ibid, 69.
[38] Article 7 of the OECD Model Tax Convention, n 7, p. 10-11.

onto the location of demand, namely where final goods are significantly value-generating and where operations of the MNE are consumed.[39]

To illustrate a simple example, the profit following the download of a mobile application should be allocated and taxed in the jurisdiction where the user of the application is situated, not in the resident state of where the application is created or sold from.

After all these incremental steps have been passed and the threshold, nexus and tax base have been determined, the next step lies in the allocation of the profit.

2.2.5 Formulary allocation of taxable profit

The formulaic allocation of profit envisages a three-step method, namely with (1) a profitability threshold; (2) a redistribution percentage; and (3) an allocation key.[40]

The first step of a profitability threshold acts as a pre-tax fixed margin of 10% of the consolidated qualifying income and will detach the residual profit from routine income regulated by Transfer Pricing (TP) principles and Amount B.[41] Only the amount that exceeds the threshold of 10% will be regarded as residual profit to be allocated by Amount A at 25% to the market jurisdiction.[42] Thus, the interaction of Amount A with "remuneration from routine activities" is limited.[43]

In essence, the proposed rules are aimed to be incorporated into the corporate income tax system to tax the generated income where it originates from in the market country based on the gross turnover revenue of the MNE.

2.3 General principles of law

Within the contextual background of the research question, legal principles refer to an agreed unwritten source of law that are used by judges and legislators as a decisional, rather than directional benchmarks.[44] Here the understanding of principles need to be addressed as starting points of assessment within the law that guide decisions without providing acute conclusions.[45] Rules on the contrary denote absolute conclusions though an "all-or-nothing" application.[46]

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[39] Aitor Navarro, 'The allocation of taxing rights under Pillar One of the OECD Proposal' in F. Haase & G Kofler (eds), *OUP Handbook of International Tax Law* (Oxford University Press 2021 Forthcoming), p. 7.
[40] OECD Blueprint, n 1, p. 123.
[41] OECD Blueprint, n 1, p. 123
[42] Article 6 of the OECD Progress Report 2022, n 11, p. 16.
[43] OECD Blueprint, n 1, p. 123.
[44] Cécile Brokelind, 'Chapter 1: Introduction' in C. Brokelind, *Principles of Law: Function, Status and Impact in EU Tax Law* (2013), p. 2.
[45] Ibid, p 2.
[46] Ibid, p 2.

From a realism perspective, principles are perceived and defined within the context of their development that courts use to fill in the gaps present in legal rules.[47] Thus, the role principles play allows courts to guide interpretation of norms and add to the lacunas that rules might have. Dworkin opposes the notion that principles are weaker forms of rules and defines them as standards to be observed in deciding which rules apply and is a requirement of justice and fairness.[48] This corresponds with the notion of principles in the EU as they possess a "coercive force", since principles can be found in the founding treaties of the EU.[49] Moreover, these principles possess the ability to apply simultaneously and even contradictory to one another.[50] This may be the case when assessing the interaction of the Proposal might spark conflict in principles.

In the EU context, general principles of law are not only restricted to the scope of tax law yet also find application within the broader field of law such as the principle of territoriality or proportionality.[51] On the other hand, principles also specific to tax law have developed as 'sub-principles' in law such as the ability-to-pay principle within the realm of equality in taxation.[52] It must be clarified that both these categories of principles find application to the Pillar One Proposal, as digital business structures exist and operate within the European Community and its eventual adoption into international and EU law will lead to interaction with these principles within the Community's legal sphere.

2.4 Conclusion

The proposal brings about large changes to the international taxing system and its legal principles regulating profit allocation.

In the light of the unique nature of digitalised MNE's structures and the lack of material presence in the market jurisdiction, traditional sourcing and nexus rules still focus on the element of a physical presence to determine the tax base and the resulting tax burden. This inevitably fails to capture the element of value creation and overlooks the profits generated from operations in the target jurisdiction. With the introduction of the Pillar One proposal, the main goal is to overcome this issue made impossible by current tax law by allocating and distributing a share of an MNE's profits to the market jurisdiction where value is created, or where profits are generated.

It is therefore of interest to look at the relationship of the principles of law with the Pillar One proposal and determine if the new allocation rules tailored for the digital economy uphold or confront relevant principles. According to the OECD Pillar One Blueprint, attaining 'fairness' in the digital economy justifies a change to the international tax system which is

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[47] Ibid, p3.
[48] Ibid, p 3.
[49] Ibid, p. 3.
[50] Brokelind, n 44, p 3.
[51] Juliane Kokott, 'EU Tax Law: A Handbook' (Hart Publishing 2022), p. 21.
[52] Ibid, p 21.

supported by the EU through its Digital Services Taxes (DST).[53] It is thus first necessary to understand what is meant under the ideal of 'fairness' and how this notion is found in legal principle so that it can be framed within the context of the digital economy.

3 The Ability-to-Pay Principle and the OECD Pillar One

3.1 Introduction

As posed in the previous chapter, the OECD's harbours a reference to attaining fairness in the digital economy which spurs a global incentive to justify changes to the international tax system which is understood to lack the laudable ideal of taxpayers paying their fair share.[54] Before continuing the analysis, it is necessary to establish a baseline of what is meant with 'fairness' and how it underlines the objective of equitable profit distribution, specifically in the extent of Pillar One.

Fairness in taxation is an elusive and abstract concept. One thing for certain is that tax should be fair, yet how is its parameters defined in law? *Debelva* points out that the general objective of tax systems is to collect revenue, redistribute wealth and to regulate abusive tax behaviours.[55] Fairness is connected to these factors as a quality which is taken into account to reach these objectives.[56] However, this understanding of equitable taxation is largely depending on the stance taken either as a political, philosophical, economic, or policy-based outlook, to which the origin, definition, and bounds of 'fairness' will inevitably vary.

Considering the vagueness of its conceptualisation and for the scope of discussion, the analysis will remain within the realm of international and European tax law and its guiding principles. Hence the chapter will be able to understand what is meant by the fairness *modus operandi* of the OECD and the EU through a judicial outlook. It will be necessary to turn to applied and existing tax law developments to understand how 'fairness' is benchmarked and how it would relate to the taxation of digitalised MNEs.

As a preliminary indicator for the avenue of discussion that needs to follow, *Pirlot* points out that defining the idea of fairness in terms of the principle of equality and tax law regulation of the digital economy requires looking at the benefit and ability-to-pay principle.[57]

3.1.1 The benefit principle

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[53] OECD Blueprint, n 1, p. 10-11.
[54] OECD Blueprint, n 1, p. 10-11.
[55] Filip Debelva, 'Fairness and International Taxation: Star-Crossed Lovers?' (2018) 10 World Tax Journal 4, p. 564.
[56] Ibid, p. 564.
[57] Alice Pirlot, 'A Discursive Analysis of the Commission's 'Fair Tax Agenda' (2020) 48 Intertax 4, p. 408.

The benefit principle expresses the notion that any economic relationship with a state (the ability to generate business income within that jurisdiction) constitutes a benefit but also a burden of responsibility towards that state for the public good received.[58] The corollary of this is a proportional tax burden enforced through a corporate income tax for the goods and services received.[59] Thus, making use of government expenditure should result in the obligation to repay or compensate the jurisdiction.

However, despite the theory appearing to strive for ‘fairness’ there are a plethora of flaws within its application, particularly in regard to the digital economy such as the reliance on nexus rules of a physical presence and the difficulty to quantify the benefits received.[60] In his article, *Schön* argues that continued application of the principle simply muddies the water of sourcing rules as the principle leaves more questions than answers.[61] The argument made is that digitalised businesses benefit from the infrastructure provided by both the jurisdiction where goods and services are created (the residence country) and the jurisdiction where customers reside (the destination country).

Consequently, the destination state would have little to no right to tax as no benefit is given in terms of public services, meaning the enjoyment of public benefits is more closely linked to the entity’s physical presence ('mass') rather than where its revenue is generated ('scale').[62] From this, it is conceivable that a more plausible assessment of determining ‘fairness’ in digital taxation lies in the analysis of the ability-to-pay principle.

3.1.2 An alternative benchmark: the ability-to-pay principle

The ability-to-pay principle has long been part of the bedrock of tax theory and can be seen as a general yardstick for levying a fair share of the tax burden on taxpayers.[63] Vanistendael terms it as “one of the oldest and most fundamental concepts in taxation”.[64] According to the principle, the shouldered tax burden should reflect the capacity to pay or contribute to the revenue collection of a particular state.[65] What is reflected by the principle

[58] Maarten de Wilde, *Sharing the Pie: Taxing Multinational in a global market* (PhD thesis, Erasmus University Rotterdam 2015), p. 43.
[59] Pascal Pistone, Jennifer Roeleveld, Johann Hattingh, João Félix Pinto Nogueira, and Craig West, *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Ta Administration* (IBFD 2019), p. 10.
[60] Filip Debelva, n 55, p. 570.
[61] Wolfgang Schön, ‘One Answer to Why and How to Tax the Digitalized Economy’ (2019) 47 Intertax 12, p. 1005.
[62] Ibid, p. 1005.
[63] Kokott, n 51, p. 136.
[64] Frans Vanistendael, ‘Ability to Pay in European Community Law’ (2014) 3 EC Tax Review 121, p. 122.
[65] Daniel Deak, ‘Hungarian Tax on Digital Advertising Services in the Spotlight of Challenges’ (2023) 51 Intertax 4, p. 314-315.

is that income tax should encompass all revenue and expenses linked to a source that allows for a tax burden to exist in a "symmetrical fashion".[66]

Notwithstanding the principle lacking any reference within EU primary or secondary law, as already expressed elsewhere[67], the Court found in the *Bevola* case that the principle still qualifies as a general principle of EU law as EU secondary legislation can be tested against the principle. Therefore, it can be raised as justification for discriminatory tax schemes[68], and take preference over national law.[69]

Despite its judicial recognition as an unwritten principle of equity, the difficulty arises as to its parameters. Specifically, it is arduous to determine who the principle should apply to and if corporations fall within its scope as a beneficiary thereof. This can be a hard task to undertake as there are concerns that the principle can only be applied to individual taxpayers. Because most progressive tax systems only levy a tax on the net income and allow for individual taxpayers to adjust their tax burden in accordance with familial or personal factors, this will reduce the total tax base amount and reflect the true capacity to pay.[70]

The ability-to-pay principle as applicable to individual taxpayers was first reflected in the case of *Schumacker*[71] and later in *Lakebrink*[72] that allowed for the granting of benefits that acknowledged personal and familial circumstances. In the cases to follow, the ability-to-pay principle was recognised to inextricably form part of the personal situation of both resident and non-resident individual taxpayers.[73] Likewise, the Court's interpretation of the principle mirrored the understanding of the principle embedded in most constitutional orders of MS.[74] However, can the ability-to-pay principle be abstracted from that of an individual to corporate taxpayers if the ability to pay is not stemming from income but from business profit?

Looking at the discussion of *Lang and English*, it is proposed that an extension of the scope of the principle is possible to include corporate taxpayers based on the indicators that legal persons own property and generate income as self-directed and standalone entities.[75] Two further approaches to this stance support the ability-to-pay principle's pertinence within the independence of a corporate tax burden. It can be held that with

[66] Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)' (2009) 1 World Tax Journal 1, p. 72.
[67] Rita Szudoczky and Balázs Károlyi, 'Progressive Turnover Taxes under the Prism of the State Aid Rules: Effective Tools to Tax High Financial Capacity or Inconsistent Tax Design Granting Selective Advantage?' (2020) 3 European State Aid Law Quarterly 3, p. 260
[68] Case C-650/16 *Bevola* (2018), para 39; p. 49-53.
[69] Kokott, n 51, p. 135.
[70] Szudoczky and Károlyi, n 67, p. 260.
[71] Case C-279/93 *Schumacker* (1995), para 41; see also Vanistendael, n 64, 122-123.
[72] C-182/06 *Lakebrink* (2007), para 31.
[73] Vanistendael, n 64, p. 131-132
[74] Kokott, n 51, p. 134.
[75] Joachim Lang and Joachim Englisch, 'A European Legal Tax Order Based on Ability to Pay' in A. Amutucci (ed) International Tax Law (2nd edn, Kluwer 2012) 267.

an aggregate view that the operating individuals of the corporate entity, namely its shareholders, form the sum of the entity[76] and secondly that corporations are real legal persons with their own set of economic resources and judicial capabilities.[77]

These arguments for expanding the scope of the ability-to-pay principle to corporate taxpayers can be taken further by the tax benefits which corporate taxpayers can utilise to reduce their tax base though exemptions and deductions. In this way, corporate taxpayers' burden is placed in similar terms as individuals. In the case of *Marks and Spencer[78],* the court dealt with inter-company transfer of losses from a subsidiary to a parent company to offset profits. Despite the outcome that a new justification emerged from the case to limit the exercise of the fundamental freedom of establishment due to a fear of unlimited permission to transfer losses, the Court indirectly recognised the relevance of the application of the ability-to-pay principle in the corporate income tax realm.[79]

The Court rejected the argument that resident and non-resident companies are not in comparable situations. Moreover, corporations are found to deduct business expenses and that any amount of income in the host or destination state should be taken into account.[80] Thus, it may be found that the principle does find application to corporate taxpayers.

In this way, the ability-to-pay principle can be closely related to the net profits of the company through the corporate income tax (CIT) payable as the entity is able to reduce its gross income before tax similar to that of individuals.[81] Yet, the crux of the matter lies with whether the principle finds possible application in cross-border transactions and if the digital economy is consistent under the principle. This scenario of taxation is especially complex as the Court indirectly recognised the application of the principle to corporations, yet its scope of application to cross-border transactions is contentious.

The ability-to-pay principle can easily be seen in the principle of single taxation where cross-border income should be taxed at least once.[82] The premise of recognising income with a limited range of deductions for expenditure and the application of a progressive tax rate implicitly fall under a single jurisdiction's taxing powers.[83] This makes sense as single tax systems are created to differentiate between resident and non-resident taxpayers. Residents are taxed according to the ability to pay based on the world-wide income that can be reduced for profits or losses in the resident states, whereas non-residents' income are 'compartmentalise' in the destination state and only taxed based of the benefit received from the

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[76] Reuven S. Avi-Yonah, 'Corporatations, Society, and the State: A Defence of the Corporate Tax' (2004) 90 Virginia Law Review 5, p. 1200.
[77] Ibid, p. 1208.
[78] Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes*, (2005) EU:C:2005:763, para 40
[79] Vanistendael, n 61, p. 131-132.
[80] Case C-446/03 *Marks & Spencer*, n 75, para 40.
[81] Szudoczky and Károlyi, n 67, p. 260.
[82] Kokott, n 51, p. 137.
[83] Schön, n 66, p. 72.

jurisdiction in question without reference to personal circumstances to capture the capacity to pay.[84]

This result is due to the personal relationship that exists between a resident taxpayer and the state which grants access to the circumstantial information surrounding the income.[85] Thus, when it comes to defining the tax base or income, the principle is surely applicable with domestic taxation, but it is not openly compatible with destination-based taxation. AG *Kokott* agrees with this understanding of the principle, as the principle only supports tax advantages for adjusting income for residents, and not for non-residence engaging in possible 'double dipping'.[86] However, in *Bevola* the Court justified using the principle in cross-border loss deductions for an MNE.[87] This signifies that a state typically without the taxing right to allow for deductions could grant benefits outside of its borders, rendering the ability-to-pay principle applicable to cross-border taxation.

Thus, it can be concluded that the intrinsic difficulties of applying the ability-to-pay principle to cross-border transactions stems from the complexity to assess and interpret the financial capacity across jurisdictions and different tax systems. This is coupled with the additional difficulty to acquire details of non-resident taxpayers. Yet, the current bounds of the ability-to-pay principle are expanded by judicial interpretations of the Court to cross-border recognition of capacity to pay in the EU.

3.2 Is there a conflict with the Pillar One Proposal?

As the digital economy is a constraint on the current tax system as its limits aggravate the scope of taxation for large profits to be undertaxed, the Pillar One tax might be challenging the current understanding of the ability-to-pay principle. As we have established, the ability-to-pay principle is regarded as the fair way of taxing based on the taxpayer's current financial capacity to pay the tax levied in a sufficient and comfortable manner. Thus, the tax burden reflects the true capacity to pay based on income and profits in a given period with deducted expenses.

However, the OECD Pillar One proposal has a distinctive take on MNEs ability to pay. Looking back at the discussed criteria for thresholds of application and establishing the tax base in the building blocks of Amount A, it is seen that the group company's total turnover and profitability is used to determine their ability to pay. This would allow for the consequent formulary apportionment to follow.

This is a deviation from the established understanding of the ability to pay as it introduces total turnover of EUR 20 billion and consistent profitability marked at a 10% profit margin into the understanding of the principle and determination of the tax burden. Therefore, it does not rely on the capacity to pay from immediate income or profit such as with CIT.[88] A crucial

[84] Case C-279/93 *Schumacker*, n 71, para 41.
[85] Schön, n 66, p. 72.
[86] Kokott, n 51, p. 136.
[87] Case C-650/16 *Bevola*, n 68, paras 39, 59.
[88] Szudoczky and Károlyi, n 67, p. 261.

question arises as to whether this can be considered a turnover tax and if turnover taxes are compatible with the ability-to-pay principle.

In direct taxation, turnover taxes apply to specific sectors or economic activities with the legislative intent to tax businesses directly.[89] Pillar One falls within this scope. As the Pillar One tax is based on turnover, the nature of the tax as progressive remains open to consideration. The significance of the matter lies in the statement of AG *Kokott* that sets out that progressive taxes cannot indisputably be maintained as aligning with the ability to pay. It can be deduced from this statement that traditionally viewed progressive taxes would apply to income which would predictably mirror the capacity to pay as the amount of progression would be parallel to the income earned. However, as digital taxes focus on revenue, its compatibility could be questioned. Specifically, the structure of Proposal as a progressive tax is not prima facie obvious.

Looking at the framework of the Proposal, the introduction of threshold tests creates a de facto progressivity.[90] Notably, although applied at a single rate, the thresholds exempt smaller MNE while larger MNE are subjected to the provision. This implicit progressivity thus allows for smaller revenue to be excluded that mirrors the ability to pay to which progressivity is attached. Yet, as the thresholds are based on gross turnover, one would assume that turnover taxes would be inconsistent with the ability-to-pay principle as expenses are not deductible from the income. Then the upshot would be that the turnover could not be a clear indicator of capacity to pay or that the MNE has earned any profits at all.[91]

However, this is not the understanding of the CJEU or the Hungarian legislators in the *Hungary v European commission* case on advertisement and digital taxes.[92] The Court emphasised that both profit and turnover are only a 'relative indicator of ability to pay'.[93] This reflects the understanding of turnover in both the *Vodafone*[94] and *Tesco*[95] cases as a neutral marker compatible with EU law to differentiate between taxpayers' and their ability to pay.[96] Accordingly, the Hungarian law on advertisement tax on extraterritorial digital advertisements within the country is still in force to determine the ability-to-pay based on turnover.

This is an interesting development for not only the ability-to-pay principle and its relation to the Pillar One proposal, but also the implications for the EU when the proposal is finalised and transposable through secondary law, such as the EU Pillar Two Directive.[97] The stance of the Court supports the notion that larger companies with high turnover will presumably have higher profits which will reflect a higher capacity of paying. Moreover, it

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[89] Szudoczky and Károlyi, n 67, p. 251.
[90] Balázs Károlyi, 'Progressive Turnover-Based Taxes and Their Legal Repercussions Under EU Law' (2020) 29 EC Tax Review 6, p. 271.
[91] Schön, n 66, p. 74.
[92] Case C-596/19 P *Hungary v European commission* (2021) EU:C:2021:202.
[93] *Hungary v European commission,* ibid, para 48.
[94] Case C-75/18, *Vodafone Magyarország* (2020) EU:C:2020:139, para 50.
[95] Case C-323/18, *Tesco-Global Áruházak* (2020) EU:C:2020:140, para 70.
[96] Case C-596/19 P *Hungary v European commission,* n 92, para 48.
[97] EU Pillar Two, n 3.

appears that as long as there is an indirect link between turnover and financial capacity in this way, MS cannot be precluded from designing tax systems in line with Pillar One.[98] In this way, using Pillar One to determine the ability-to-pay on turnover is thus in line with the EU's stance on the ability-to-pay based on either capacity to pay or the capital intensity of the business falling under the tax ambit.

This argument can be contentious as the tax liability that ensues from turnover as a basis for capacity might be disproportionate in relation to the true capacity to pay. *Szudoczky and Károlyi*'s observations reflect this stance that the Court falls short of issues as profits within developed tax systems have rules to precisely calculate the corporate income tax base and is not a relative estimation to indicate profit and capacity.[99] Thus, the consistency between the court-approved EU and subsequent Pillar One turnover-based estimations and the ability-to-pay principle becomes unconvincing.

An additional counterargument is to be made that Pillar One potentially balances out the use of turnover through other mechanisms such as the exclusion of residual profit in the formulary allocation step. However, this can also not be the case.

It can be maintained that the exclusion in the Proposal assumes that all profit over the profit margin is completely detached from routine activities without considering the circumstances surrounding that profit. By disregarding the circumstances of the profit goes against the integral elements of the comparability and functional analysis usually seen at the core of other allocation rules such as the ALP as a general tax rule[100] and the ability-to-pay principle in CIT. In terms of transfer pricing, the term routine and non-routine relates to the functions performed by the entity at hand.[101] Thus, the profits generated by the profits are distinguished by the levels of risk, function, assets, and value creation associated with the profit as either routine (simple) or non-routine (important).[102]

By assuming that 10% of the excess profits are generated from non-routine profits (that bear high levels of risk, significant value and are from intangible assets) without the use of clear guidance to the details related to the profit would leave room for over-stating the percentage of profitability. This would result in an imbalanced treatment amongst taxpayers holding different levels of functions, risks and assets that might not be attached to the 10% margin. Inevitably, the outcome might not reflect the true capacity to pay as per the benchmarked ability-to-pay principle as the full and comprehensive recognition of income is not reverberated.

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[98] Opinion of AG Kokott in Case C-75/18, *Vodafone Magyarország* (2019) EU:C:2019:492, para 121; Szudoczky and Károlyi, n 64, p. 261.

[99] Opinion of AG Kokott in Case C-75/18, *Vodafone Magyarország*, n 98, para 183; Szudoczky and Károlyi, n 67, p. 261.

[100] Schreiber et al, n 35, p. 411-412.

[101] Mostly applicable in the TP methods such as the Profit Split Method, see Jérôme Monsenego, 'Introduction to Transfer Pricing' (Wolter Kluwers 2022), p. 31-32.

[102] Monsenego, ibid, p. 31-32; Joel Cooper, Randall Fox, Jan Loeprick and Komal Mohindra, 'Transfer Pricing and Developing Countries: A Handbook for Policy Makers and Practitioners' (World Bank Group 2016), p. 168.

3.3 Conclusion

It can be concluded in the interim that the ability-to-pay principle has extended from single system-based taxation into cross-border taxation to determine the fair tax burden to be carried by individual and corporate taxpayers. Moreover, it found that in order to determine the capacity to pay falls largely on the immediate income or profit generated to evenly provide for the tax levied to be paid.

However, recent developments within the EU have rendered turnover-based taxation to fall within the remis of the principle by recognising the turnover revenue to reflect the capacity to pay on the same nivea as profit within corporate income taxation. Within the digital economy this is a step towards the approach followed by the Pillar One proposal as turnover and profitability of the economies of scale are the indicators of ability-to-pay and tax base determination.

This is a questionable development that determines the ability or capacity to pay on estimated indicators rather than calculated profits and adjusted expenses.

Considering that digital activities are not tied to a geographical location; it becomes necessary to look towards the principle of extraterritoriality to further examine the scope of the ability-to-pay principle and the territorial scope of a state's right to allocate profits. Also bearing in mind the multi-layered judicial roots of the ability-to-pay principle in both international and European law, it is necessary to understand the concept of extraterritoriality's impact on the principle in both contexts.

4 Territoriality principle and the OECD Pillar One Proposal

4.1 Territoriality or Extra-territoriality

The principle of extraterritoriality occurs in international tax law as a state extends its jurisdiction and powers to tax onto non-resident persons by acting outside its own territory.[103] This notion is contrary to the international principle of sovereignty (*cuius regio, eius reigio*), as it rules that a state may, within its territory, freely set tax systems in accordance with its own policy interests and what it considers as being more consistent with its other priorities.[104] Sovereignty of states reflects a fundamental aspect of territoriality and is unconstrained by international law, as a state may tax residents and non-residents following the precedent set in the *Lotus* case.[105] Yet, a state's sovereignty remains bound to territory through a 'nexus'

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[103] Deak, n 65, p. 312.

[104] Marco Greggi, 'Rise and Decline of the Westphalian Principle in Taxation: The Web Tax Case' (2020) 29 EC Tax Review 1, p. 7.

[105] *The Case of the S.S: Lotus* (*France v Turkey*) (1927), Permanent Court of International Justice, Series A, No. 10, para 10, available at www.worldcourts.com/pcij/eng/decisions/1927.09.07_lotus.htm (accessed 15 May 2022).

which essentially prevents a clash of powers between rival states.[106] The nexus limits the state's power to the "personal, spatial, temporal and material" elements of its legal order.[107] The principle is thus the theoretical underpinning of which persons or companies (the taxpayer), in which territory, in which moment and what subject matter (the facts contributing to the connection) are covered by the state's sovereignty and domestic tax laws.[108]

In this way, territoriality points out the taxing interest of a particular state when a foreign linking element points out the interest of another state.[109] In the state of residence, the connecting factor would be the physical presence expressed where the effective management of the MNE takes place.[110] On the other hand, the source state expresses taxing rights through the physical presence of a permanent establishment (PE) as a fixed place of business in its territory.[111] Accordingly, *Kokott* points out that claiming taxing powers in line with the requirements of territoriality is the main rule, whereas extraterritoriality requires a justification for extending powers outside of a jurisdiction's borders.[112] Thus, the principle of territoriality should serve as a benchmark for allocation taxing powers between the MS through the nexus requirement.

However, despite support for the principle to fairly allocate profits, there is no accepted uniform notion of what a true nexus is.[113] To determine if states comply with the international law to prohibit taxation of income in the absence of a nexus is an arduous undertaking that thus requires looking at the accepted practices of states in direct tax matters.[114] As the thresholds of a nexus differ amongst states and the tax at hand, state's practice would reflect the limits which nexus carries. As Pillar One specifically aims to depart from the ALP rules to allocate profit distribution for the digital economy, it is relevant to define nexus purely in this manner. Further discussion on the auxiliary international definition of nexus will be set aside.

As a proviso to the discussion and the concern of an autonomous EU ALP that differs from the OECD allocation rules, it should be stated that the Court in *Fiat* rejected this stance.[115] Although the ALP "could be deducted

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[106] *The Case of Nottebohm*, (1955) I.C.J Reports, para 23, available at www.icj-cij.org/public/files/case-related/18/018-19550406-JUD-01-00-EN.pdf (accessed 15 May 2022).
[107] Stjepan Gadžo, 'The Principle of 'Nexus' or 'Genuine Link' as a Keystone to International Income Tax Law: A Reappraisal' (2018) 46 Intertax 3, p. 196.
[108] Gadžo, ibid, p. 199.
[109] Gadžo, n 107, p. 196.
[110] Jérôme Monsenego, 'Nexus for Transfer Pricing Purposes Before and After BEPS 2.O: From Form to Substance, and Back to Form?' in Edoardo Traversa (ed) Tax Nexus and Jurisdiction in International and EU Law' (IBFD Publications 2022), p. 78.
[111] Ibid, p. 78.
[112] Julianne Kokott, 'Public International Law and Taxation: Nexus and Territoriality' in Edoardo Traversa (ed) *Tax Nexus and Jurisdiction in International and EU Law* (2022), p. 14.
[113] Monsenego, n 110, p. 77.
[114] Gadžo, n 107, p. 200.
[115] Joined Cases C-885/19 P and C-898/19 P *Fiat Chrysler Finance Europe and Ireland v European Commission* EU:C: 2022:859, para 93.

from the general principle of equal treatment in the EU with regard to equality between standalone entities and related group companies"[116], it would lead to harmonisation in disguise by the EC that would infringe on the sovereignty of the MS.[117] It therefore remains relevant to observe the OECD TP allocation rules for its recognised international merit in allocating profit and nexus rules.

4.2 Overview of Transfer Pricing

A transfer price is the transactional fee payable within a multinational group between its separate entities.[118] The price charged is a remuneration for certain activities, functions and risks the respective entity performs within the division of the group. These transactions can usually entail the exchange of goods, services, intercompany financing, or licensing of intangible assets.[119] When 'associated' companies engage in cross-border activities, it is required to organise the amount of its transactions on an equitable basis.[120] To monitor these transactions allows the business to make decisions regarding the functioning and fiscal outcome of each of its entities.

However, companies have discretion with regards to the setting of expenses and as such, affiliated business units within the group need to be regarded as independent from another.[121] This can be assumed as a necessity when companies are regarded as profit-driven, seeking to artificially lower their taxable profit in high tax jurisdictions through intentional manipulation of internally charged prices which in turn impacts a resident countries taxable base.[122]

The international transfer pricing rules embedded in the OECD Transfer Pricing Guidelines[123] not only ensure equal competition but also to monitor and align controlled transactions with that of independent companies' prices which are directly influenced and defined by market forces, such as supply and demand, which non-independent companies lack.[124] Transfer pricing thus serves as an assessment tool to safeguard a goal of market stability in the face of conceivable abusive practices, and allows tax authorities to

[116] Carmen Roth, 'Analysing Recent EU Leading Transfer Pricing Cases' (2023) 30 International Transfer Pricing Journal 3, p. 4.
[117] Isabel Verlinden, Stefaan De Baets, Jeroen De Deurwaerder and Victoire Timmermans, 'Fiat State Aid Case Putting the EU Arm's Length Principle to Bed?' (2023) 30 International Transfer Pricing Journal 3, p. 5.
[118] Micheal Lang, Giammarco Conttani, Raffaele Petruzzi and Alfred Storck, *Fundamentals of Transfer Pricing: A Practical Guide* (Wolter Kluwers 2019), 5.
[119] Monsenego, n 101, p. 6-7; Cooper, n 102, p. 3.
[120] Stefan Greil, Michael Overesch, Anna Rohlfing-Bastian, Ulrich Schreiber, and Caren Sureth-Sloane, 'Towards an Amended Arm's Length Principle: Tackling Complexity and Implementing Destination Rules in Transfer Pricing' (2023) 51 Intertax 4, p. 275.
[121] Lang et al, n 75, p. 6.
[122] Monsenego, supra n 101, p. 7.
[123] OECD, Transfer Pricing Guidelines, n 8.
[124] Monsenego, n 101, p. 5.

regulate double taxation.[125] Two essential parts need to be met for the measure to apply: the exchange of pecuniary means must firstly occur amongst related parties and, secondly, a cross-border element must be present.[126]

4.3 Establishing the nexus requirement through the Arm's Length Principle

The cornerstone of transfer pricing, known as the ALP, is enshrined within the internationally authoritative context of Article 7 and 9 of the OECD Model Tax Convention.[127] The ALP requires that all intercompany transactions and its associated prices to be on a comparable footing as what independent companies would have been in similar circumstances.[128] This comes from the rationale that interactions should reflect the forces of the free market. The affiliate relationship between these entities would cause a potential inconsistency in comparison to normally agreed-upon terms by third party entities directly driven by market factors. In doing so, the ALP acts as a tool to prevent these arrangements through a separate entity approach and allows the market prices to indicate fair exchange of business activities.[129] MNEs are thus split into separate taxable subjects irrespective of its function in the group to easily recognise the transaction for its purpose.[130]

In order to establish a nexus, *Monsengo* writes that the ALP typically triggers profit allocation to jurisdictions where the unit in the group performs its functions, assumes risk or uses and owns assets.[131] Consequently, the nexus is established based on the degree of importance of these functional aspects.[132] Simply put, the PEs would be given the correct number of profits from the exchange of goods and services based on how and what function is performed.

This is a noteworthy deviation from establishing corporate residence or the existence of a PE usually based on a threshold as TP concerns itself with the substance rather than the form of the activity performed.[133] Thus, the control over risks and DEMPE functions (development, enhancement, maintenance, protection, and exploitation) provide for the substance of the function. Simply put, corporate income stems from where value is created, the value creation is where the risks, assets and functions are executed, and the performer of the functions has ability to carry out those functions leading to

[125] Pablo Mahu Martínez, 'Distributive Profit Allocation Rules: A New Approach for an Old Problem' (2021) 49 Intertax 2, p. 147.
[126] Monsenego, supra n 101, p. 18.
[127] OECD, 'Model Tax Convention, n 7.
[128] OECD, Transfer Pricing Guidelines, n 8, para 1.35.
[129] Greil, n 120, p. 275.
[130] Aitor Navarro, 'The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing.' (2018) 10 World Tax Journal 3, p. 354.
[131] Monsenego, n 110, p. 78.
[132] Monsenego, n 110, p. 78.
[133] Monsenego, n 110, p. 78.

a nexus for taxation. Once an element in this approach is missing, the nexus and taxing rights are weakened.[134]

In the light of the digital economy, applying these rules have become an issue. While the OECD Guidelines have been updated in 2022, no additional adjustments were made for what determines the nexus for digitalised business functions.[135] This means that if a MNE has a PE in multiple countries, the lack of importance attached to the functions performed would be insignificant to allocate taxing rights.

To understand this phenomenon, a brief illustrated hypothetical example will be used to see how the ALP interacts with the TP principles establishing a nexus. The example will show a web-based online platform MNE selling new and second-hand goods and the TPG will be used to guide the analysis.

4.4 Analysing the application of the ALP to the digital economy

A well-established online store has been developed by Company X in jurisdiction A operating in jurisdictions A, B and D. Company X is the Parent Company (PC) and bears most of the financial risks, responsibilities, and assets in the group. Company X also owns two subsidiaries. Company Y acts as a holding company in jurisdiction B, owning the rights to an intangible asset without any staff.

Furthermore, the company automatically collects data from users which Company X sells to 3rd party marketing entities. Company Z consists of a centralised brand-management and marketing team in jurisdiction C which provides services to Company X and improves the IP of the group companies through the data collected by Company Y. In terms of participation on the digital market through content postings, downloads, and user engagement, 30% of the consumer shares are in the jurisdiction of country A, 10% in country B and 60% in country D.

[134] Monsenego, n 110, p. 79.
[135] Monsenego, n 110, p. 79.

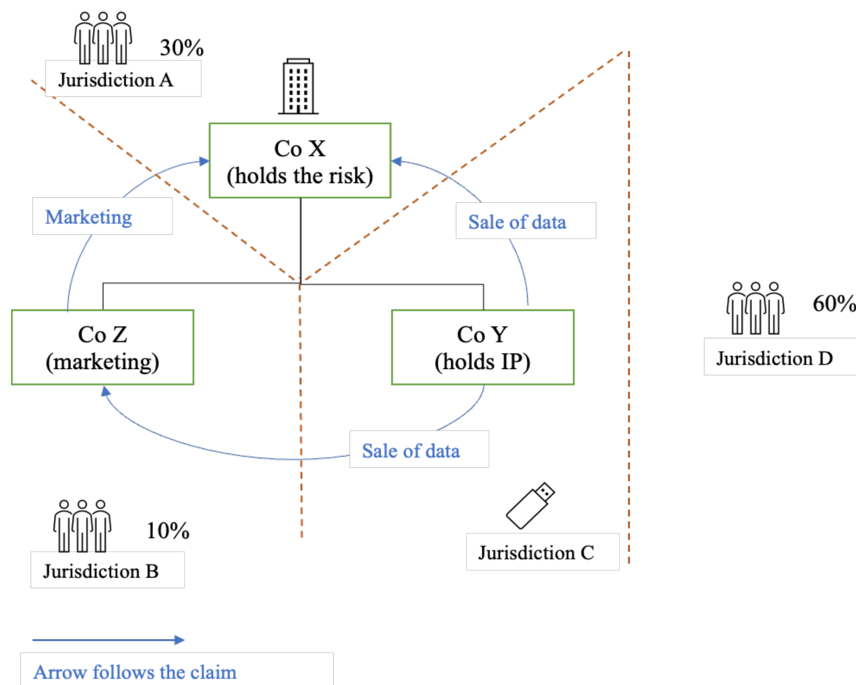

Figure 1. Profits and consumers in a digitalised business structure.[136]

4.4.1 Functional analysis

In the first step of applying the TP rules according to the TPG, a functional analysis is performed to describe as precisely as possible the functions performed, and the accompanying risks taken by each of the related parties.[137] The value which is added to the chain of entities resulting from the function performed is paramount: the more limited or complex a function is, the less risk is assumed which would result in less profit in remuneration attributable to the group entity. In turn, the more intricate the function, the higher responsibility is assumed and a higher compensation for the dependent entity will be reflected as the activity is supplementary to the respective entity's ability to exercise control over a risk.[138] The transaction effectively becomes more economically significant regarding the assets used, responsibly taken and risks assumed.[139]

Looking at the example, three different entities perform different tasks regarding the intangible asset at hand. Company Y owns the intangible assets yet bears no financial risk or assets to establish a nexus for the functional analysis, whereas Company X bears all the risk and meets the permanent establishment threshold of a physical presence but neither owns, nor develops the intangible from the data collected from the users. This means it cannot be assigned to Company X with the TP allocation rules. Company Z plays the biggest role in creating value for the intangible asset but does not own it, yet internally profits from its value.

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[136] Structure made by author; images sourced from Microsoft Power Point.
[137] OECD TPG, n 8, papa 1.51.
[138] OECD TPG, n 8, para 1.56; Monsenego a, n 101, p. 25.
[139] OECD TPG, n 8, para 1.52.

Considering the element of digital users in the example, the value generated from the users in jurisdiction B and D will not be considered in the establishment of a nexus in the functional analysis as the user engagement in production or value creation is disregarded in TP rules.[140] This means that the value generated from jurisdictions B, C and D will not be assigned to any of the entities as there is a lack of physical presence and the value of consumers is not quantifiable. This is one of the issues raised in the OECD Final Report 2015 for difficulty in taxing the digital economy with the TP rules despite the growing role users play in value creation.[141]

Moreover, the functional analysis will not consider the value creation of developing the IP in jurisdiction B as no risks or assets are held in the state. The data collected and sold by Company Y will also fall outside the scope of the analysis as the passive value attached to the intangible assets is not seen as real value stemming from a jurisdiction where risks and capital are situated.[142]

4.4.2 Compatibility analysis

The second step of the TP allocation rules entails a compatibility analysis which hinges on the profile of functions created in the first step.[143] Consequently, a comparison of controlled transactions with uncontrolled transactions can occur that would allow for a price to be set, defining the conditions of the transaction.[144] This subsequent analysis permits for a full picture of how remuneration between associate parties should occur against those of comparable independent parties based on either internal or external comparables.

The compatibility analysis inherently, yet indirectly, acknowledges the territoriality principle as it seeks to align MNE's profit to the location where the economic functions generated revenue. Thus, the value created remains confined within the borders of a given jurisdiction as prices are matched with those performed within the same jurisdiction.

The emergence of these business structures and the changes in the economy threatening the arm's length principle appears as an inadequate measure to regulate the taxing rights and profit distribution. However, with emphasis placed on the change to nexus rules, the AG *Kokott* brought a thought-provoking stance to the mix with the opinion that an aspect such as language was a sufficient territorial link for establishing a nexus.[145]

All things considered, it can be concluded that following the expression of AG *Kokott* and these examples shown, the physical presence as a nexus indicator is becoming no longer relevant for levying taxing rights for the

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[140] Monsenego, n 110, p. 80.
[141] OECD *Addressing the Tax Challenges of the Digital Economy, OECD BEPS Action Plan 1 - 2015 Final Report* (OECD Publishing 2015), p. 102.
[142] Monsenego, n 110, p. 80.
[143] Greil, supra n 120, p. 3.
[144] OECD TPG, n 8, para 1.6; Monsenego, supra n 101, p. 32.
[145] Opinion of the Advocate General Kokott (2019), Case C-482/18, *Google Ireland Limited v Nemzeti Adó-és Vámhivatal Kiemelt Adó-és Vámigazgatósága* EU:C:2019:728, para 48.

digital economy and deviations from the existing rules is being pursued. The question now turns to how the EU has developed the notion of nexus and its relevance for the implementation of the OECD Pillar One rules.

4.5 Developments of the nexus requirement in EU law

As seen in the discussion above, the prevailing view in international law is that territoriality poses limits to the individual taxing powers of states based on the requirement of a causal connection, yet the digital value created and externally earned income disrupts the general principle. It can additionally be said that DTTs and the ALP are limited to the scope of taxation it regulates, meaning that states could exercise their taxing rights outside of its territory if no international rules preclude it.[146] Thus, any absolute territorial claims of a jurisdiction on digital profits outside of the scope of the DTT and the ALP are seen as obsolete.[147]

Following Article 5 TFEU and the reasoning of AG *Kokott*, the EU does not have exclusive tax sovereignty and that direct taxation squarely falls into the competence of MS to define domestic tax laws in line with EU law.[148] In *Vodafone Magyarország*, the Court concurs with this stance as MS have free discretion to establish their own tax systems in the field of unharmonised taxes.[149] In spite of the formation of the EU, the understanding of territoriality in EU law thus echoes the similar auspices of territoriality as international tax law discussed above.

Nonetheless, the fading scope of state sovereignty in relation to territory in the EU is an increasing matter seen particularly in the extra-territoriality exercised in the digital services taxes. This is particularly seen in new legislative developments in domestic law of MS that enhance market jurisdiction's claim to extraterritorial revenues.[150] Accordingly, a deeper look to EU case law is required to understand the EU's plan on the impact and status of extraterritorial claims on the principle of territoriality and nexus requirements.

4.5.1 Expanding territorial scope of taxing rights through Court interpretations

A year after the initial BEPS project, the Hungarian Government imposed the special sector law No XII in 2014 to fully establish taxing rights that target all advertisements published as taxable persons within the territory of Hungary either physically or virtually per the internet with extraterritorial effect.[151] In the case of *Hungary v European Commission*, the main issue hinged on the progressive tax rates applied annually to the digital turnover revenue generated by the advertisements that, *inter alia*, constituted a claim

[146] *The S.S: Lotus case*, n 105, para 19.
[147] Deak, n 65, p. 312.
[148] Kokott, n 51, p. 135.
[149] Case C-75/18 *Vodafone Magyarország*, n 94, para 49.
[150] Kokott, n 112, p. 17.
[151] Case C-596/19 P *Hungary v European Commission*, n 92, paras 3-4; Focus will only be placed on the digital taxation ruled in the judgment.

of State Aid by the EC.[152] However, the issue of extra-territoriality was not raised and only found a direct address within the Hungarian courts.[153]

Nevertheless, after the taxpayer was found liable for advertisements due to its digital presence, it raised the argument that the Hungarian law could only imposes tax liability on non-resident service in accordance with DTTs non-discrimination clause and that the Hungarian domestic judicial act to extend the scope of territory would breach this provision[154], not to mention the international legal principle of territoriality. The CJEU recognised this by stating that the scope of the Act was bound to Hungarian territory.[155] Moreover, the applicant in the case considered its activities extraneous to the country's borders as the advertising activity occurred outside of Hungary.[156] The taxpayer was only identifiable in Hungary due to the result of the available publication and therefore had no identifiable nexus between the taxpayer and the state as no Hungarian or international rule recognised this effect.[157]

The Kúria Court found that the territorial scope of the Act relied on the result of the publication and that the place of activity in the market jurisdiction cannot be of relevance since the acts of digital service on the internet cannot be used to determine a nexus to a state's territory.[158] This understanding of nexus, tied to the market jurisdiction through hybrid taxes mirrors the Opinion of the AG *Kokott* in *Google Ireland*.[159] According to the expressed opinion, a MS's taxing authority would only be limited by international and EU law if no connection to the state existed at all.[160] It can be deduced that the AG took a revered look at the taxing right by implying that if the internet did not exist, the advertisements made in the country would have been taxed in that state as the revenue would directly stem from the state's population engaging with the service.[161] Therefore, a substantial territorial link in the common understating of sourcing rules under the principle of territoriality is no longer tied to location but rather from the factors that limit engagement with a particular population such as language or target publications to a state's population. This opinion renders the fact moot that the taxpayer does not have to be resident in the country to escape its obligation to pay tax. As the CJEU did not comment on this issue, it is unsure if the paucity on the matter translates into a tacit agreement with this sign of accepted extraterritoriality in taxing the digital economy.

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[152] C-596/19 P *Hungary v European Commission,* n 92, paras 7, 29.
[153] Deak, n 65, p. 309.
[154] Deak, n 65, 310; See the judgment No. 40.K.703.724/2020/4 of Fővárosi Törvényszék, (2020), as corrected by its order No. 40.K.703.724/2020/9, yet due to a lack of English source or translation the study follows the explanation made by Deak.
[155] C-596/19 P *Hungary v European Commission,* n 92, para 4.
[156] Ibid.
[157] Deak, n 65, p. 311.
[158] See the Kúria judgment No. Kf. 40.185/2020/8 (2020), para 9 as explained by Deak, n 65, p. 311.
[159] Opinion of the Advocate General Kokott (2019), Case C-482/18, *Google Ireland Limited*, n 145, para 45.
[160] Ibid, para 45.
[161] Ibid, para 49.

Deak however agrees that the EU jurisprudence has recognised the need for extraterritoriality as the outcome of the cases have answered this issue as designing legal regulations and judicial results require special consideration of new and ongoing developments.[162] Clearly, the authors and the case law display an overriding aspect that is central to the applying legal principles, namely its malleability. *Gadžo* describes this aspect through the words of *Simma and Müller*[163] that legal principles endorse a "flexible and differentiated approach, combining a series of factors such as the nature of the subject; the individual interests of affected states vis-à-vis the interest of the international community as whole; and the risks of under-allocating jurisdiction…". In this way, the EU legal order recognises the need for adaptability of principles as justifiable deviation from the norm. Once the rules bound to territoriality are ascribed to be inadequate, it should not be held that the rules of extraterritoriality are a rigid model to be followed in assessment of taxing rights.[164]

Therefore, it can be concluded from the tendencies of the EU and the plan to tolerate tax legislation beyond national borders aligns with the aim to tax the development of the digital economy. Moreover, the justifications shown serves to protect the national tax bases with factors that link the market jurisdiction to the economic activities generating revenue whilst protecting MS individual sovereignty.

4.6 Does the Proposal deviate from the principle of territoriality?

When looking at the new allocation rules, it seems that the Proposal departs from the traditional understanding and scope of the principle of territoriality and aligns with the understanding of the EU. The new rules lack a requirement for physical presence and a functional approach to allocate profits to the country of residence as followed by the ALP. The residence state activities are therefore immaterial and move towards a source state approach where the goods and services are finally consumer or used. However, a sufficient nexus is still required to attribute profits to the market jurisdiction, yet it is not reliant on current factors of establishing presence. The nexus is rather created through the thresholds to qualify if a MNE is subject to the Amount A as per the revenues and profitability in the source state.

Monsenego states that this line of allocating profit through the Proposal moves from a substance-based approach, usually seen in DTT and the ALP, to a focus on the form of the transaction.[165] This is interesting considering the example of a digitalised business structure given where functions and

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[162] Deak, n 65, 312.
[163] Stjepan Gadžo, 'Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy' (IBFD Doctoral Series 2016), chp 2, p. 6. As referring to Bruno Simma and Andrea Müller, Exercise and Limits of Jurisdiction in James Crawford and Martti Koskenniemi (eds), *The Cambridge Companion to International Law*, (Cambridge University Press 2015), p. 147.
[164] Gadžo, supra n 163, p. 6.
[165] Monsenego, n 110, p. 82.

intangible assets could be moved by the MNE to jurisdictions where the ALP rules would not find application. Despite the introduction of the DEMPE rules for intangibles (development, enhancement, maintenance, protection, and exploitation), a large majority of value and profit is attributed to the PC in lower tax jurisdictions, instead of the market of the foreign subsidiary or PE holding the asset and generating its value.[166] In this way, the new allocation rules would not be bound to the functions but will follow the supply chain to where the actual sales occur.

Adopting a new set of allocation rules along with the ALP seems to be plausible although the theoretical application of the nexus requirement differs in nature. As Amount A will apply as a canopy rule over the present transfer pricing and profit allocation rules, it will only strengthen the outcome of preventing aggressive tax planning if both sets of rules adhere to the principles of either territoriality for brick-and-mortar businesses and extraterritoriality for digital profits. Although this could cause issues of compliance and practicality, it could solve gaps in the current nexus rules. However, it falls outside the current discussion on the legal question to address this topic of pragmatic shortcomings and solutions to the issues presented surrounding the ALP.

4.7 Conclusion

It can be concluded that the principle of territoriality has evolved from international law to establish the concepts of sovereignty and taxing rights within the border of states. This is achievable through the use of a nexus or sufficient link between the MNE and the state claiming rights to tax. Despite the uncertainty to the bounds of principle in international and European law, it has manifested in multiple DTTs and TP rules that allocate profits within the scope of residence and function. Notwithstanding the developments in the global digital economy, these rules pose a dilemma for market states unable to claim profits derived from the value creation and user engagement where the final sale and consumption occurs.

On analysing the case law developments within the EU and its MS, it can clearly be observed that the direction of the strict application of the territoriality principle is loosened for taxing digital MNE outside of the residence state. Accordingly, the OECD Pillar One Proposal rules align with this reshaping of the lines by the EU and the OECD through its application to accommodate shortcomings in existing nexus rules. Moreover, it finds accordance with the changing shape of the principle to equally allocate profits where value is created, intangible assets are held, and where goods and services are consumed in market jurisdictions. Thus, the levying of Amount A does not deviate from the investigated principle as taxing in the market state would sufficiently trigger a connection or link to the market state as the perception of paying a fair share in the place where profits are earned is upheld by the changing scope of international and EU principles.

[166] Schreiber et al, supra n 35, p. 413.

5 EU State Aid rules and the OECD Pillar One Proposal

5.1 Introduction

As the last segment in the thesis, the discussion will move into a more specific principle in EU law as it is important to investigate the notion of 'fair' taxation in the light of EU State Aid rules to ascertain if a deviation by the OECD Pillar One Proposal occurs. It is therefore of interest to look at the standard of equality that State Aid rules establish within the internal market. This will be the final benchmark to investigate the Proposal rules.

According to the writing of *Pirlot*, the EU lacks the competence to establish what is fair taxation amongst MS.[167] This brings into doubt the current fairness agenda touted by the EC that would impact the OECD Pillar One in taxing the digital economy considering that MS would find inspiration from the Proposal once adopted by the MS and the EU has largely based its DST on the Proposal.[168]

Nevertheless, Article 115 TFEU provides for the competence of the EU to consolidate and align direct tax systems of domestic tax laws to achieve a degree of harmonisation with the goal to improve the functioning of the internal market.[169] Yet, the EC has endorsed the notion of fairness into its efforts of State Aid actions although it is not mandated in this duty. With reference to the Commissioner Margrethe Vestager, it is stated that tax fairness is an integral part of the State Aid rules and that the notion of paying a fair share is integral to the working operation of the internal market.[170]

Consequently, the first question arises if EU State Aid rules enforce and ensure fairness in the taxation in and of itself? To answer this, one needs to ask what legal principle is the legal basis of fairness in State Aid rules and what is it bounds?

5.2 Benchmarking the EU State Aid rules

In the creation of the EU, one of the main goals of the community was the economic cooperation amongst MS that would ensure compatibility with the establishment and freedoms of a single and open market.[171] In this regard, tax systems play an important role for national economies through the collection of revenue and the funding of the economy.[172]

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[167] Pirlot, n 57, p. 402.
[168] Commission, 'Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence' (2018) COM/2018/0147 final.
[169] Pirlot, n 57, p. 402
[170] As seen in Pirlot, n 57, p. 405, referring to Commissioner Margrethe Vestager, 'Why Fair Taxation Matters', speech delivered at the Copenhagen Business School (2016).
[171] Edouard Fort, EU State Aid and Tax: An Evolutionary Approach' (2017), 57 European Taxation 9, p. 370.
[172] Ibid, p. 370.

However, the pioneering legislators of the founding treaties to the EU recognised that any deviating tax system can unbalance the aimed cooperation within the internal market which would be spurred on by state aid and selectivity granted by governments seeking to further its own pecuniary interests.[173] Without rules it would be expected that tax revenue flow could be redirected to states perpetuating state aid in regimes of taxation.

In this way, the primary framework regulating the scope of State Aid is manifested in Title VII of the Treaty of the TFEU.[174] Article 107(1) TFEU contains the main property of the principle of prohibition of State Aids. The article constitutes that:

> …any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

The Court in *Banco Exterior* reflects this by stating that fiscal State Aid not only includes a positive benefit granted to subsidiaries, but also any aid which distorts competition on the internal market by favouring certain undertakings through implemented direct tax measures.[175] Creating a different tax system to only tax certain companies would possibly trigger Article 107 TFEU. Consequently, the Court established that Article 107(1) TFEU did not determine State aid based on the cause or aims (form) of the measure, rather that the effect of the measures was determinant of illegal aid.[176]

Therefore, for state aid to exist, the following must occur: (i) the tax benefit obtained should involve the granting of an economic advantage, financed by the intervention of the State or through State resources; (ii) affect trade between Member States; (iii) confer a 'selective advantage' on certain undertakings or the production of certain goods; and (iv) distort or threaten to distort competition.[177]

Károlyi lifts an interesting point by stating that State Aid rules and fundamental freedoms seem to "reflect two-sides of the same coin". In terms of state aid, a tax advantage spurred on by state intervention, similarly, raises a question of unfavourable treatment to other taxpayers in terms of freedoms embedded in the TFEU.[178] This is a noteworthy statement as State Aid rules and fundamental freedoms serve two distinct functions within EU law that can cause conflict if both violations occur simultaneously in

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[173] Werner Heyvaert, Recent Developments in the Field of EU Fiscal State Aid: Three Cases Concerning Benelux Tax Schemes and the Position of the United States – Foreword' (2020), 60 European Taxation 5, p. 173.
[174] TFEU, n 9.
[175] Case C-387/92, *Banco Exterior v. Ayuntamiento de Valencia*, ECLI:EU:C:1994:100, para 13.
[176] Joined case C-106/09 P and C-107/09 P *European Commission and Spain v Gibraltar and the UK,* para 87; Alexandra Miladinovic, 'Selectivity and the Arm's Length Principle' (IBFD 2023), p. 48.
[177] Case C-596/19 P Commission v. Hungary, n 92, para. 33; Case C-562/19 P Commission v. Poland, EU:C:2021:201, para. 27.
[178] Károlyi, n 90, p. 273.

application.[179] However, despite this conflict, the required elements for application of the two principles are worlds apart, yet at the same time, both legal regimes are meant to achieve the goal of market integration and revolve around the same concept of prohibited discrimination.[180] This is namely the unjustified different treatment of objectively comparable situations.[181]

Considering this statement, one can look towards the case of *Commission v Hungary*,[182] from which a clearer conceptualisation can be drawn of what equal taxation in state aid rules means. The result sought by the State Aid rules is to allow every transaction made by each of the entities in the MNE group within the EU to be taken into consideration in the same manner within each of the MS.[183] This means that the discretionary powers granted to MS to regulate their own domestic tax systems remains unaffected as different tax treatment only stems from the economic activities that are tax differently within the MS. To put it more concretely, the income from the transaction or activities are recognised and allocated in the same way regardless of the MNE legal form whilst the tax consequences that flow from the activities may differ according to the MS tax systems.[184] Only when the notion of selectivity in the tax advantage within the MS arises, then the notion of unequal treatment would arise. This understanding of unequal treatment aligns with understanding of the Court as it would lead to discernible discrimination.[185]

Following this conceptualisation, to understand if the Pillar One Proposal might trigger state aid, the Proposal should be analysed by how close the allocation rules come to this benchmarked standard if adopted into national laws by MS as the draft currently stands. By reason of the existing deviation from traditional allocation rules by the Proposal, an examination is necessary to investigate three dimensions of state aid. The contribution will not aim to address all issues that can arise in state aid matters but will be a valuable exercise in trying to clarify the new rules considering relevant case law.

5.3 Does the Proposal deviate from the benchmark of State aid?

5.3.1 Does the Proposal grant a tax advantage?

In the *British Aggregates Association* case, the court states that a measure constitutes an advantage or exceptional tax benefit if it is granted to certain undertakings in comparison with others which are in a comparable legal and factual situation.[186] Regarding this point, this would be an advantage that

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[179] Kokott, n 51, p. 170.
[180] Károlyi, n 90, p. 273.
[181] Ibid, p. 273.
[182] Cases T-778/16 and T-892/16 *Ireland and Others v European Commission* EU: T: 2020:338.
[183] C-596/19 P *Hungary v European Commission*, n 92, para 34.
[184] Ibid, para 34.
[185] Ibid, para 34.
[186] Case C- 487/06 P *British Aggregates Association v Commission of the European Communities and United Kingdom* (2008) EU:C: 2008:757, para 82; Wolfgang Schön, 'The

would not be granted under normal market circumstances but only ensues due to the state's intervention.[187] The notion of advantage looks for a benchmark of 'normal' to compare situations based on the effect it has and not its form.[188] Accordingly, it can be concluded that if a tax measure grants certain comparable taxpayers a tax exemption or other benefit, it would put specific taxpayers at an advantage in comparison to other similar taxpayers within the same branch or market. Thus, it would constitute state aid in terms of Article 107(1) TFEU.

In terms of Pillar One Proposal, no direct advantage can be seen in the fact that some MNE's are excluded from the scope of the tax. As per the Progress Report of 2022, the differentiation between different digital taxpayers subject to the rules under the categories of ADS or CFB have been removed from the Proposal. As a consequence, the only threshold test that applies is in regard to turnover and profitability. By eliminating these tests, the new allocation rules would apply to all digital MNEs regardless of the activities it performs. Competitors within the same field of digital services that would have fallen in the carve-outs or narrow scope of the tests are thus not included and shall not benefit by paying less than those that would have fallen in the scope if the tests were kept. Therefore, no prima facie advantages are granted, and thus no notion of state aid is triggered under Article 107.

However, the Court points out that state aid can consist even if it concerns an entire economic sector.[189] This would require looking at the objective pursued by the tax regime[190], namely the allocation and taxation of MNE profits. Thus, the objective of the special tax can explain and justify why certain taxpayers in the ambit of the Proposal should be subjected to the allocation rules.[191] Regarding the objective pursued by special sectoral taxes seen in the EU, these taxes are issued beyond the mere collection of revenue and are collected for environmental or health protection reasons.[192] In this way, its carve-out for the mining sectors can be seen as aligning with existing EU laws as it ensures the profits from resources extracted in that state remain where the sources are found.[193]

Nonetheless, when observing the main aim of the Proposal, it can be regarded as an attempt to create a nexus devoid of a requirement for physical presence. Therefore, the brick-and-mortar businesses providing

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notion of 'Aid' with respect to tax' in Leigh Hancher, Tom Ottervanger and Piet Jan Slot (eds), *EU State Aid* (Sweet & Maxwell 2016), p 407.

[187] Schön, n 186, p. 407.

[188] Alexander Milandinovic, 'The State Aid Provsions of the TFEU in Tax Matters' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Staringer (eds), *Introduction to European Tax Law on Direct Taxation* (5th ed, Spiramus Press 2019), p. 115.

[189] Joined Cases C-78/08 to C-80/08 *Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v Paint Graphos Soc. coop. arl (C-78/08), Adige Carni Soc. coop. arl, in liquidation v Agenzia delle Entrate and Ministero dell'Economia e delle Finanze (C-79/08) and Ministero delle Finanze v Michele Franchetto (C-80/08)* EU:C:2011:550, para 53.

[190] Ibid, para 54.

[191] Szudoczky and Károlyi, n 67, p. 255.

[192] Szudoczky and Károlyi, n 67, p. 255.

[193] OECD, 'Progress Report on Amount A of Pillar One: Frequently asked questions' n 20, p. 2.

local digital services with a physical presence cannot be in a comparable situation to digital MNE as their services do not reach farther than the residence's jurisdiction borders. This means that local businesses would not garner revenue from sales of goods and services that do not permeate in the market state. Therefore, state aid cannot be triggered in this regard.

Therefore, it can be concluded that the mere advantage is not seen as state aid as it falls within the logic of the system[194] and extends to all undertakings that are in objective comparable situations.

5.3.2 Is the Proposal *de iure* selective?

The next step to constitute state aid goes beyond a mere advantage and requires that the advantage is selective in nature. The test for selectivity is different from advantage as it aims to find distinctions between general measures (such as general tax breaks) and selective measures (benefit or aid given to certain recipients on the grounds of arbitrary discriminatory criteria).[195]

To determine the selectivity of a measure, the CJEU has developed a three-step analysis.[196] The first step is to correctly identify the 'normal' system of reference to be used as a benchmark. Secondly, the measure needs to derogate from that system to differentiate between comparable MNEs. If that be the case, the measure would be considered prima facie selective. In that case, a third step is necessary to verify whether the derogation can be justified by the nature or the general scheme of the system of reference.[197]

In the first step, it has been established in the previous section in the chapter that taxing digital MNE based on a progressive tax on turnover is not against the logic of the tax system as it seen as upholding the ability-to-pay principle and aligns with the sovereignty of MS to create their own tax systems.[198] Therefore, it can be argued that the Proposal progressivity is the 'normal' system of reference because implementing a progressive rate, albeit de facto through a threshold and applied to turnover, is a characteristic of the legal tax regime that does not breach EU law. Moreover, it cannot be implied that a single rate tax system is the 'normal' point of reference as it would impede on the sovereign freedom of MS to create differing internal tax structures.[199]

After having assessed the system of reference, it is essential to determine if a derogation has occurred, meaning a discernment made in tax regime between undertakings that are in a comparable factual and legal situation.[200] One would perceive the exemption of smaller taxpayers as a selective advantage, as the smaller taxpayers do not fall within the same tax base as larger MNE included in the thresholds. It is thus possible to identify an

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[194] Schön, n 186, p. 409.
[195] Szudoczky and Károlyi, n 67, p. 263.
[196] Joined Cases C-78/08 to C-80/08 *Paint Graphos*, n 189, para 49; C-596/19 P *Hungary v European Commission,* n 92, paras 37-38.
[197] Milandinovic, n 188, p. 119.
[198] C-596/19 P *Hungary v European Commission,* n 92, paras 44, 46-47.
[199] Szudoczky and Károlyi, n 67, p. 256.
[200] Milandinovic, n 188, p. 119.

advantage granted as smaller comparable MNEs that provide the same service in the digital realm would otherwise have been part of the state's revenue collection yet are exempted from the scope due to a smaller turnover.

However, in the *Commission v Poland* case regarding retail sales tax exemptions for small businesses, the court found that the mere fact that a measure has an exemption does not automatically render the tax as contrary to State Aid rules. [201] Moreover, looking at the judgment laid down in *Hungary v European Commission,* the aspect of size excluded from the de facto progressive turnover taxes corresponds to the held understanding of ability-to-pay principle based on revenue and the objective of the tax which would justify an exclusion from the scope of the tax at hand.[202] In turn, the allocation rules of the Pillar One Proposal follow suit.

Thus, after applying the relevant test for selectivity the new allocation rules are not prima facie *de iure* selective in nature as the first two requirements have not been met.

5.3.3 Is the Proposal *de facto* selective?

As one follows the internal developments within the EU, a new question arises as to the de facto selectivity of a measure. The notion of selectivity and the scope of application of State Aid rules have been expanded to include *de facto* selectivity as a means for the EC to combat BEPS.[203] Initially, State Aid rule only found application in certain instances of preferential tax schemes. Thus, selectivity remained limited to the occurred deviation from the 'normal' tax regime. Yet this changed with the judgment in *Gibraltar*.[204]

Forthwith, the CJEU held the notion that to determine selectivity, it necessitates comparing the tax burden of different entities within an ostensibly 'normal' tax regime constituting as a reference framework.[205] Yet a general tax scheme may still be selective despite the fact that no derogations. Occur from the reference system.[206] Following the stance taken by the Court to search for the effect of the measure, the pure existence of a derogation is not a prerequisite for state aid.[207] Even a measure which is found on criteria that are in themselves of a 'normal' nature may be selective if it in practice discriminates between companies that are in a comparable situation in the light of the objective of the tax system concerned.[208]

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[201] Case C-562/19 P *Commission v Poland,* n 177, para 89.
[202] C-596/19 P *Hungary v European Commission,* n 92, paras 47-48.
[203] Rita Szudockzky "A European tax law agenda in direct taxation" in Leopoldo Parado (ed), *A Research Agenda for Tax Law* (Elgar 2022), p. 163; Joined case C-106/09 P and C-107/09 P *European Commission and Spain v Gibraltar and the UK*, para 72.
[204] Joined case C-106/09 P and C-107/09 P *European Commission and Spain v Gibraltar and the UK,* n 203.
[205] Ibid, para 36.
[206] Szudoczky and Károlyi, n 67, p. 257.
[207] Szudoczky and Károlyi, n 67, p. 257.
[208] Szudoczky and Károlyi, n 67, p. 257.

The objective of the tax should be used to determine if two groups of taxpayers are in comparable situations. If they are found to be comparable, the differentiation made will constitute a discrimination and result in selectivity.[209] Thus, the crux lies in the objective of the tax to determine de facto selectivity. According to *Szudoczky and Károlyi* in analysing the *Gibraltar* case, there also needs to be an 'inconsistency' present in the system, meaning the tax benefit for certain taxpayers is not a random consequence but a deliberate effect, the system grants. [210] Therefore, there needs to be an inconsistency between the objective of the tax and the comparability of the different groups to establish state aid.[211]

In terms of the Proposal, a distinction is made between taxpayers based on turnover and profitability. As has been established in chapter 3, these two elements are linked to the objective of equitable redistribution of profits based on the capacity or ability to pay. In order to find selectivity, there needs to be an inconsistency between the de facto progressive turnover tax and the internal objective to tax based on the ability to pay.

Although the Court supports the notion that larger companies with high turnover will presumably have higher profits, which will reflect a higher capacity of paying, it cannot be held that this reflects a consistent concern to attain the objective of equal distribution. There is a large inconsistency between the ability to pay and turnover as turnover cannot be held to showcase financial capacity without the possibility of a reduced tax base. Considering the stance taken by the Court it seems to reflect a more lenient stance with regard to unharmonised EU secondary legislation when reviewed directly, as the CJEU's approach to evaluating provisions based on primary law and principles is more open to justifications and moderate grounds.[212] When considering direct taxation and the multiple DST's in the EU, the field of taxing digital tax services is not fully harmonised.[213] However, with the implementation of the Proposal, the step towards harmonisation would be a plausible ground to review turnover as an inadequate indicator to determine capacity to pay when other means are accessible and more accurate in setting a threshold.

Therefore, it can be concluded that on the grounds of the abovementioned criteria and case law judgments, the Pillar One Directive would fall outside the ambit of State Aid rules as no inconsistency would be present. However, there is a tenable argument to be made that the issue becomes more complex as long as the capacity to pay is equated to the overall financial wealth of the taxpayer, instead of the ability to pay based on the CIT actual ability to pay. Without a clear indicator to showcase a business's capacity, this could be exploited and lead to the probability that the true aim of the Proposal is

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[209] Joined case C-106/09 P and C-107/09 P *Commission v Gibraltar*, n 203, para 101.
[210] Szudoczky and Károlyi, n 67, p. 259; Joined case C-106/09 P and C-107/09 P *Commission v Gibraltar,* n 203, para 106.
[211] Szudoczky and Károlyi, n 67, p. 259.
[212] Case C-14/16, *Euro Park Service* EU:C:2017:177, para. 19.
[213] Rita Szudoczky, 'The relationship between primary, secondary and national law' in Panayi, Haslehner and Traversa (Eds.), 'Research Handbook on European Union Taxation Law' (2020), p 115.

usurped and the legislators' intention would be expressing a conflicting outcome with the ability-to-pay principle and State Aid rules. Unfortunately, the Court nor the AG took this position in the EU DST cases.[214]

6 Concluding remarks

The OECD Pillar One Proposal does not provide for exact surety on its alignment with international and European principles of law. As the thesis illuminates specific areas of law which delve into the objective of fair redistribution and allocation of taxing rights, the outcome varies due to the novelty of the digital economy and the burgeoning case law on the matter. In the scope of the Proposal, three main benchmarks are identified to display whether the new allocation rules uphold or challenge the general and specific principle of law.

From the ability-to-pay principle, the Proposal sets out to determine the thresholds of application and nexus based on the financial capacity of the MNE through accumulated wealth in turnover taxes. However, this is a discrepancy with the CIT ability-to-pay principle as reductions based on tax benefits granted to the corporate taxpayer is disregarded and disputably seen as a relevant indicator of capacity to pay. Moreover, the assumption made by the formulary apportionment using a 10% profit margin clashes with the principle as no substantive indicators are used to demarcate the profit as non-routine profit. These elements cumulatively collide with the ability-to-pay principle yet the judgement in case law has taken another route.

In addition, the Court expands the notion of territoriality to accommodate the market jurisdiction for untaxed value creating profit. After this development of digital taxes in the EU, it can be argued that the nexus rules do not collide with the advanced principle. This is the only principle upheld in its deviation from the norm towards the objective of fair distribution as other allocation rules such as the TP ALP largely fail in this regard.

However, the analysis has shown that the outcome of the evolving principles has created an apparent domino effect as the expanded qualification of the ability-to-pay impacts the EU State Aid rules. It should follow from this that the de facto selectivity test needs to be further defined as the lacuna of consistency is open to expressing a conflicting outcome for allocation rules and principles. Even though a measure does not appear *de iure* selective in nature, the deviation from the CIT ability to pay usurps the function of preventing state aid. This is because the indicator used to signify selectivity is based on the broad economic capacity rather than the actual ability to pay defined in the CIT principle. Thus, it can be concluded that the Proposal results in prolific conflict with principle of law despite the advancements made in Court.

[214] C-596/19 P *Hungary v European Commission,* n 92; Case C-562/19 P *Commission v Poland*, n 177.

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