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Multi-rate turnover taxes and state aid

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**Multi-rate Turnover Taxes and State Aid:
A Prelude to Taxes on Company Size?**

Phedon Nicolaides[1, 2]

Abstract

In order to determine whether a tax measure is selective, it is necessary to determine first the reference tax system. The General Court has recently ruled that the reference system is that which is defined by Member States and includes such components as the tax base, the tax rates, and the various bands of taxable income, profit, or revenue. The Commission may not identify a hypothetical or artificial reference system. The General Court has also ruled that differentiation of tax payers is not necessarily selective as long as it follows from the objective of the system and that the progressivity of tax rates is a form of differentiation that is not necessarily selective. In this connection, progressive tax rates on profit can be justified according to the ability to pay. This article argues, however, that progressive taxes on turnover are unlikely to correspond to ability to pay. It also warns that Member States may be tempted to target company size under the pretext of levying progressive taxation.

Key words: State aid, turnover, taxation, progressive rates, selectivity.

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[2] I would like to thank Péter Staviczky for comments on a previous version. I am solely responsible for the contents of this article. Earlier and shorter versions appeared in two articles on my state aid blog “state aid uncovered”.

Introduction

In the EU case law on state aid and in the decisional practice of the European Commission there are several hundred cases involving tax exemptions or tax reductions. By contrast, there is only a handful of cases dealing with the question whether a tax measure with several rates of tax may involve state aid for those undertakings, activities or products subject to the lower rates. And, so far, there appears to exist only one case on whether state aid can be granted through lower rates of turnover taxes. It is, therefore, not surprising that in the voluminous literature on tax state aid or fiscal state aid there is hardly any comment on turnover taxes.[3]

On 16 May 2019, the General Court examined a Polish turnover tax levied on retailers and concluded that it was justified by the objective of the tax system. As a consequence, it annulled the Commission decision that had found the tax measure in question to constitute incompatible state aid. It was the first judgment on whether a progressive turnover tax fell within the scope of Article 107(1) TFEU.

A month later, on 27 June 2019, the General Court examined a similar tax levied by Hungary on advertising turnover [the judge rapporteur was the same]. With an almost identical wording, the General Court found again that the turnover tax was justified by the objective of the tax system and annulled the Commission decision that had found it to be incompatible state aid.

The purpose of this article is to review these two judgments and argue that a progressive tax on turnover is unlikely to be justified by the intrinsic objectives of tax systems. Although the in both cases the General Court considered that a progressive turnover tax burdened more companies with more "disposal" income, this article will show that this is not necessarily the case either as a theoretical or empirical proposition. The article also considers possible implications of the General Court's judgment such as that targeting company size may not infringe Article 107(1) TFEU.

The judgment on the Polish tax does not yet exist in English. Because the two judgments are very similar, this article refers mostly to the Polish case so that it can be made more accessible and where necessary it quotes the corresponding English text of the Hungarian case.

The concept of progressivity

Member States are free to design their corporate tax systems as long as they do not grant state aid or infringe fundamental internal market freedoms. A narrower tax base, a lower tax rate, a delayed tax collection, an advance tax ruling, or any other special tax treatment that can be an exception from the application of the general tax has been found to constitute state aid. However, "a measure which creates an exception to the application of the general tax system may be justified if it results directly from the basic or guiding principles of that tax system. In that context, a distinction must be made between, on the one hand, the objectives

[3] A notable but very recent exception is J. Sinning, European Union - Turnover Taxes under State Aid Spotlight, *European Taxation*, 2019, vol.(2/3), pp. A couple of brief references to turnover taxes can be found in Pierpablo Rossi-Maccanico, State Aid Review of Member States' Measures Relating to Direct Business Taxation, *European State Aid Law Quarterly*, 2004, vol. 3(2), pp. 229-251.

attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives". Therefore, "tax exemptions which are the result of an objective that is unrelated to the tax system of which they form part cannot circumvent the requirements under" Article 107(1) TFEU.[4]

The Commission in its Notice on the Notion of State Aid, gives examples of objectives which are intrinsic in tax systems and therefore any differentiation they bring about between companies is not considered to be an exception or selective measure in the meaning of Article 107(1) TFEU. Such examples are "the need to fight fraud or tax evasion, the need to take into account specific accounting requirements, administrative manageability, the principle of tax neutrality, the progressive nature of income tax and its redistributive purpose, the need to avoid double taxation, or the objective of optimising the recovery of fiscal debts."[5]

Progressive income or profit taxes are normally justified by the redistributive objectives of tax systems. Lower rates do not confer a selective advantage to companies which have smaller profits and, therefore, can afford to contribute lower amounts to finance the machinery of the state and public policies.

Whereas progressive income or profit taxes are a fundamental feature of tax systems, progressive rates linked to product-specific taxes are rarer. The most common such tax is the excise tax on alcoholic beverages. Increasingly higher rates are levied in proportion to the alcohol content. Similar taxes are levied in the context of environmental policies [e.g. waste disposal, engine capacity of motor cars or weight of motor cars]. Nonetheless, progressive product-specific taxes may also be justified by the objectives of those taxes.

In its judgment on Gil Insurance, the Court of Justice ruled that the higher rate of tax on insurance for domestic appliances, motor vehicles and travel was justified by the objective of the system which was to prevent non-payment of the tax.[6] The lower rate of 4% was not intended to confer an advantage. Instead, the purpose of the higher rate of 17.5% was to make sure that some tax was paid whenever sellers of domestic appliances, cars and travel packages would raise the price of those products in order to compensate for lower prices, and therefore less tax, on the sale of insurance cover for those products.

The Advocate-General in his opinion on Gil Insurance grappled with the fundamental question whether a higher rate of tax was a burden on the products bearing that tax or aid for the products bearing the lower rate(s) of tax. His conclusion was that the lower rate could not be regarded as state aid if justified by the objective of the tax.[7]

The landmark judgments in the British Aggregates, Dutch NOx and ANGED cases show that the decisive element is whether taxed and non-taxed or less taxed products, services or

[4] C-78/08, Paint Graphos, EU:C:2011:550, paragraphs 69-70.
[5] Official Journal C 262, 19 July 2006, pp. 1-50, paragraph 136.
[6] C-308/01, Gil Insurance, EU:C:2004:252, paragraphs 73-76.
[7] Opinion in case C-308/01, Gil Insurance, EU:C:2003:481, paragraphs 72-75.

activities are in a comparable situation in relation to the objective(s) of the tax.[8] If some products, services or activities do not cause pollution, for example, they are not similar to polluting ones in the context of a tax targeting pollution. Therefore, the exemption of the former is justified by the objective of that tax.

More recently, the Commission in several decisions has found that zero rates or lower rates of product-specific taxes did not constitute state aid. For example, in a case concerning a tax on water extraction in Denmark, the Commission concluded that a zero rate for small amounts of extracted water followed from the logic of the system which was to raise revenue and not to waste administrative resources in collecting small amounts.[9]

In another case concerning a tax on sugar added to beverages in Ireland, the Commission reached a similar conclusion. It found that the non-taxation of certain beverages and the lower tax rate on certain other beverages were justified either by the objective of the tax [i.e. beverages with no added sugar were not taxed] or by the fact that in some cases the tax revenue would have been less than the cost of collecting that revenue.[10]

It follows from the case law and the decisional practice of the Commission that exemptions, zero rates or lower rates of tax levied on specific products, services or activities can be justified by basically two reasons. First, the non-taxed or less taxed products are different from the taxed or more taxed products in relation to the objective of the tax itself. Second, the cost of collecting the tax would exceed the revenue generated by the tax.

Progressive rates linked to turnover taxes have been assessed in the case law almost exclusively in relation to value-added tax. After all, VAT is levied on the price charged to consumers so that it is inextricably linked to revenue or turnover. Given the high degree of approximation and harmonisation of tax rates and tax bases of VAT in the EU, any deviation from the standard rate of VAT or any exception from the VAT base is by and large examined in connection with the provisions of the relevant VAT directives.

Cases involving turnover taxes not linked to VAT are very rare. In those cases turnover was used as a proxy of company size. In 2002, the General Court found in its judgment on Ramondin that a tax incentive linked to the size of investment was a selective advantage that constituted state aid. A Spanish region made the incentive conditional on prior investment exceeding ESP 20 million. It was selective because only large companies had the capacity to make investment of that size.[11] Also in 2002, the Commission found that special tax privileges granted by the Aland Islands to "captive" insurance companies were also selective because they could only benefit companies with large turnover.[12]

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[8] Case C-487/06 P, British Aggregates Association v European Commission, EU:C:2008:757; case C-279/08 P, European Commission v Netherlands, EU:C:2011:551; and joined cases C-236/16 and C-237/16, ANGED, EU:C:2018:291.

[9] Commission decision 2018/884. The full text of the decision is published in OJ L157, 20/6/2018, and can be accessed at:
https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018D0884&from=EN

[10] See Commission decision on case SA.45862. The full text of the decision can be accessed at:
http://ec.europa.eu/competition/state_aid/cases/273201/273201_1982362_113_4.pdf

[11] Case T-103/00, Ramondin Capsules v European Commission, EU:T:2002:61.

[12] See Commission decision 2002/937, published in OJ L 329, 5/12/2002, p.22.

In what appears to be a novel application of turnover taxes, the European Commission has recently examined progressive turnover taxes levied on specific products or activities in Hungary and Poland. It found that they did confer a selective advantage to those which were subject to the lower tax rates.[13] It is perhaps indicative of the novelty of turnover taxes in the context of state aid rules that the Commission decisions cite no prior state aid case law on turnover taxes.

The decisions of the Commission have been appealed. On 16 May 2019, the General Court delivered the first judgment on those turnover taxes in joined cases T-836/16 and T-624/17, Republic of Poland v European Commission.[14] It is probably also the first judgment on the application of Article 107(1) to turnover taxes, as revealed by the absence of any citation of previous cases. The General Court annulled Commission decision 2018/160 on the grounds that the Commission committed two errors in finding that the Polish turnover tax was incompatible state aid. It had constructed a hypothetical or artificial reference system and it had ignored the progressivity of the tax system.

On 27 June 2019, the General Court, in case T-20/17, Hungary v European Commission, annulled Commission decision 2017/329 which had found that a Hungarian tax on advertising turnover was incompatible state aid.[15] The General Court also found that the Commission had committed the same two errors as in the Polish case.

These two judgments have serious implications. If higher taxation of larger companies, i.e. companies with larger turnover, is not discriminatory, then, correspondingly lower taxation for smaller companies can escape from the reach of Article 107(1) TFEU.

Poland applied for annulment of both the decision of the Commission to open the formal investigation procedure [SA.44351] and the final decision, 2018/160. The liable taxpayers were retailers regardless of their legal status. The tax base was their monthly turnover. The tax system had three rates. For turnover up to PLN 17 million, the tax rate was zero. A rate of 0.8% was charged on turnover between PLN 17 and 170 million. A higher rate of 1.4% was charged on turnover exceeding PLN 170 million.

Hungary applied for annulment of final decision 2017/329. It had earlier applied for annulment of the Commission's suspension decisions concerning a turnover tax on food

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[13] See Commission decision 2016/1846 concerning tobacco products in Hungary, decision 2016/1848 concerning food products in Hungary, decision 2017/329 concerning advertising turnover in Hungary and decision 2018/160 concerning retail turnover in Poland.

[14] EU:T:2019:338. The full text of the judgment in languages other than English can be accessed at: http://curia.europa.eu/juris/liste.jsf?oqp=&for=&mat=or&jge=&td=%3BALL&jur=C%2CT%2CF&num=t-836%252F16&page=1&dates=&pcs=Oor&lg=&pro=&nat=or&cit=none%252CC%252CCJ%252CR%252C2008E%252C%252C%252C%252C%252C%252C%252C%252C%252C%252C%252Ctrue%252Cfalse%252Cfalse&language=en&avg=&cid=5309457

[15] EU:T:2019:448. The full text of the judgment can be accessed at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=215549&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=8496209

inspection and tobacco products. In April 2018, the General Court dismissed the application in cases, T-554/15 and T-555/15, Hungary v European Commission.[16]

The Hungarian tax on advertising revenue was levied on the media that promoted the advertisement; i.e. newspapers, broadcasters and other media. The tax rates varied according to the turnover band, as follows:
0% for turnover below HUF 0.5 billion.
1% for turnover between HUF 0.5 billion and HUF 5 billion.
10% for turnover between HUF 5 billion and HUF 10 billion.
20% for turnover between HUF 10 billion and HUF 15 billion.
30% for turnover between HUF 15 billion and HUF 20 billion.
40% for turnover above HUF 20 billion.

In addition, taxable persons whose pre-tax profits for the financial year 2013 were zero or negative could deduct from their 2014 taxable amount 50% of the losses carried forward from the earlier financial years.

The larger number of bands, the much higher tax rates and the loss carry forward facility were the main differences between the Hungarian and the Polish measures.

In its final decision on the Polish measure, 2018/160[17], and in its decision on the Hungarian tax, 2017/329[18], the Commission found the taxes to be selective because, in its view, the higher rates could not be justified in the context of a turnover tax. It considered that the turnover tax could not be progressive because the companies with the higher turnover paid tax at higher average rates, in addition to higher marginal rates, and could also have higher costs. For example, if a tax system levies a rate of 1% for a band up to 100 of turnover and a rate of 5% for turnover above 100, then a company with turnover of 200 pays a total of 6 in tax or an average of 3%. By contrast, a company with turnover of 100 pays on 1 on the first 100 or an average of 1%.

This meant that, unlike a tax on profit, which is the difference between revenue and costs, a progressive turnover tax did not necessarily impose a higher burden on companies with a higher ability to pay. The system, according to the Commission, simply discriminated against larger companies. In fact it found that only a handful of companies paid tax at the highest rate. Since, in the Commission's view, a turnover tax could not be progressive, it defined the reference system to be a turnover tax with a single rate. In its decision on the Hungarian turnover tax, the Commission explained that it did not object to turnover taxes with a single rate because single-rate taxes ensured that everybody paid the same proportion of their turnover.

The main pleas of both Poland and Hungary was that their taxes were general, non-selective measures. The different rates were an integral part of the reference system which was made up of the tax base, taxable persons and the various tax rates. The progressivity of the rates

[16] EU:T:2018:220.
[17] OJ L 29, 1 February 2018, pp. 38-49. The full text of the decision can be accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018D0160
[18] OJ L 49, 25 February 2017, pp. 36-49.

could not be regarded as a derogation from the reference system because they were an intrinsic component of that system.[19]

Poland and Hungary also contended that their taxes had the twofold objective of providing the state with tax revenue while distributing the tax burden equitably among the taxable persons according to their ability to pay.[20]

The selectivity test

The General Court began its analysis by recalling that a tax measure by which the public authorities grant certain companies favourable treatment that places them in a more favourable financial position than other taxpayers constitutes state aid.[21]

More specifically, a tax measure is selective when it favours certain undertakings in relation to others which, in light of the objective pursued by the tax system, are in a comparable factual and legal situation.[22]

Then it outlined the well-known three-step test for determining the selectivity of tax measures [the same principles are stated in the Hungarian judgment]:
1. identification of the common, normal or reference system of taxation;
2. existence of a derogation from the common, normal or reference system for certain tax payers which are in a comparable situation to others;
3. assessment of whether the derogation or differentiation is justified by the nature or economy of the system.

Perhaps it should be explained that the identification of the reference system is not limited to the delineation of the applicable tax base and listing of the relevant tax rates. It also requires identification of the undertakings which are in a comparable situation according to the purpose of the tax.

At this point the General Court made a useful clarification. According to the Court, the "nature" of the normal system means its objective or purpose whereas the "economy" of the normal system encompasses its tax rules. The Court cited case C-88/03, Portugal v Commission, EU:C:2006:511, paragraph 81, and case T-210/02, RENV, British Aggregates v Commission, T:2012:110, paragraph 84.[23] The same observation is made in paragraph 77 of the Hungarian judgment.

The clarification of the General Court is indeed important, but the passages from the two cited cases merely make a distinction between objectives which are extrinsic to a tax system, such as support of SMEs, and mechanisms which are inherent in the system, such as depreciation rules. The Court, however, continued in the same paragraph to emphasise that

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[19] Joined cases T-836/16 & T-624/17, Poland v European Commission, EU:T:2019:338, paragraph 42.
[20] T-836/16 & T-624/17, paragraph 46; T-20/17, paragraph 20.
[21] Ibid., paragraph 58. Since the judgment does not yet exist in English, this article necessarily summarises the relevant part of the judgment instead of quoting the precise text.
[22] Ibid., paragraph 59.
[23] Ibid, paragraph 62.

the concept of the objective or nature of the normal tax system refers to the fundamental or guiding principles of the tax system and does not refer to policies which may be financed from the tax revenue [such as family policy], nor to the aims of the exceptions, deviations or derogations from the tax system. This is of course what was stated in the two cited cases.

The reference system

Next, the General Court turned its attention to the definition of the normal or reference tax system in the case at hand.

It agreed with Poland that the tax rates could not be excluded from the content of a tax system, as the Commission had done. Regardless of whether the tax has a single rate or multiple rates, the level of the rate, charge or levy is, like the base, part of the fundamental characteristics of the legal regime of the tax. The Commission itself states in the Notice on the Notion of Aid that the reference regime is based on elements such as the tax base, the taxable persons, the chargeable event and the tax or taxation rates.[24] The General Court considered that, in the absence of indications as to the rate that would determine the economy of the "normal" scheme, it was impossible to examine whether there was a derogation for the benefit of certain undertakings. Therefore, if, under the same tax measure, some companies are charged different tax rates, it is necessary to determine what is the "normal" situation which is part of the "normal" system.[25] The same findings are made in paragraph 80 of the Hungarian judgment.

For the Court it was clear that the Commission sought to identify a normal system with a certain tax structure. According to the Commission, the normal system was made up of a single rate. However, the Court did not accept the Commission's reasoning because the normal single-rate system was a hypothetical system constructed by the Commission, not the Member State. Indeed the Court did not see how the Commission's construct followed from the Polish legal text. The Court insisted that the analysis of the selective or non-selective nature of a tax advantage had to be carried out on the basis of the actual characteristics of the tax system, and not according to assumptions that the competent Polish authority did not make.[26]

The Court concluded its review of the tax system with the finding that the Commission identified a normal system which was either incomplete, with no tax rates, or was hypothetical, with a single tax rate, which in either case constituted an error of law.[27] The Court reached the same conclusion in paragraph 82 of the Hungarian judgment.

This was a stern rebuke for the Commission. The Commission, in effect by reconstructing the Polish turnover tax, tried to go beyond the legal text of the tax. It was attempting to apply the principle enunciated in case C-106/09 P, European Commission v Gibraltar, according to which:

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[24] Official Journal C 262, 19 July 2006, pp. 1-50, paragraph 134.

[25] Joined cases T-836/16 & T-624/17, Republic of Poland v European Commission, EU:T:2019:338, paragraph 65.

[26] Ibid., paragraph 66. See also Hungarian judgment, paragraph 81.

[27] Ibid., paragraph 67.

> The "case-law does not make the classification of a tax system as 'selective' conditional upon that system being designed in such a way that undertakings which might enjoy a selective advantage are, in general, liable to the same tax burden as other undertakings but benefit from derogating provisions, so that the selective advantage may be identified as being the difference between the normal tax burden and that borne by those former undertakings."
> "Such an interpretation of the selectivity criterion would require, contrary to the case-law …, that in order for a tax system to be classifiable as 'selective' it must be designed in accordance with a certain regulatory technique; the consequence of this would be that national tax rules fall from the outset outside the scope of control of State aid merely because they were adopted under a different regulatory technique although they produce the same effects in law and/or in fact."
> "Those considerations apply particularly with regard to a tax system which, as in the present case, instead of laying down general rules applying to all undertakings from which a derogation is made for certain undertakings, achieves the same result by adjusting and combining the tax rules in such a way that their very application results in a different tax burden for different undertakings."[28]

In essence, the Commission seemed to want to prove that the different rates of the Polish tax were inherently discriminatory in the same way that the Gibraltar system was designed on purpose to exclude offshore companies. The Commission may still succeed in this respect when it argues the case before the Court of Justice, but it will have to resolve a fundamental problem. As it itself acknowledges in its Notice on the Notion of State Aid, progressive tax rates are not necessarily discriminatory. Therefore, the Commission will need to explain why progressive turnover taxes are discriminatory, while progressive income taxes are not.

The General Court went on to stress that the only normal system was the tax in the retail sector itself, with its structure including its progressive rate scale and its turnover bands including the tax-free band of turnover from PLN 0 to 17 million. This tax-free band was a de facto part of the tax structure and, although exempt from taxation, the corresponding activity fell within its sectoral scope of application.[29]

We now have a fundamental conflict between two apparently opposite principles. On the one hand, the Court of Justice has said that in order to determine whether certain companies receive an advantage we must look at whether the tax system results in a "different tax burden", not at its structure or regulatory technique. In the case of the Polish turnover tax, the different tax rates resulted in a differentiated tax burden simply because larger companies paid more tax on average. On the other hand, the General Court says that the objectives of the tax system, as designed or intended by the tax authorities, cannot be disregarded. The Commission had to accept that the Polish turnover tax had three rates and none was the standard or benchmark rate that corresponded to the normal tax system.

In principle, the General Court is right that it is the prerogative of Member States to design their tax systems as they see fit, as long as they do not grant state aid through surreptitious

[28] EU:C:2011:732, paragraphs 91-93.
[29] Joined cases T-836/16 & T-624/17, Republic of Poland v European Commission, EU:T:2019:338, paragraph 68.

discrimination. But how can discrimination be discovered or discounted when the tax system merely sets three rates with no further explanation as to which one is the standard rate? In order to answer this question, we must first see how the General Court took into account the objectives of the Polish tax system.

The objectives of the system

The first of the two objectives of the Polish measure was to raise revenue. A zero rate of tax is ineffective for that purpose. Therefore, the zero rate cannot be consistent with the objective of the measure. While it is true that all liable taxpayers would obtain the same benefit for the band to which the zero rate applied, the fact remains that a zero rate cannot be justified by the objective of that system. This leaves the other two rates. In this connection, the General Court in effect said that, since no standard or benchmark rate could be identified, both of those rates were the standard or benchmark rate. But this necessarily means that the zero rate was a deviation from those two rates precisely because it was not consistent with the objective of raising revenue. However, the zero rate and the other two could still be justified by the other objective of the tax system which was progressivity according to ability to pay.

Indeed, the Court cautioned that even though the Commission erred in the identification of the applicable normal tax system, it still had to be ascertained whether the conclusion to which it arrived was justified by other reasons which were capable of proving the existence of a selective advantage for certain undertakings.[30]

The General Court noted that the Commission did not merely consider that the progressive structure of the tax at issue derogated from a normal system but, basing its reasoning on the Gibraltar judgment, also found the system was designed to confer a selective advantage for companies with low turnover. In the Commission's view, the structure of the retail tax and its progressive rates were contrary to the revenue-raising objective of that tax. Poland, the Commission argued, had deliberately designed the tax in such a way as to arbitrarily favour certain undertakings. The General Court wanted to ascertain whether the Commission's assessment was well founded.[31]

The Court found the reasoning of the Commission to be faulty for the following reasons. First, all taxes aim to raise revenue. However, the progressive structure of tax rates cannot in itself be contrary to the objective of collecting revenue.[32]

Second, the aim of the Polish authorities was to introduce a sectoral tax based on the principle of redistribution.[33] In other words, the General Court was telling the Commission that it had to respect the objective of the tax as defined by the national legislature.

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[30] Ibid., paragraph 69.
[31] Ibid., paragraph 70.
[32] Ibid., paragraph 72.
[33] Ibid., paragraph 73.

Third, although the turnover tax was presented as a means of financing family policy measures, it was intended to raise revenue for the general budget.[34]

Fourth, even though the tax was levied on turnover, it could still be consistent with its progressive objective because a larger company could enjoy economies of scale ["économies d'échelle"] resulting in costs which could be proportionately lower than those of a smaller company, leading to more disposal revenue and enabling it to pay proportionally more in respect of a turnover tax.[35] The critical words here are "disposal revenue" ["revenu disponible"] which are analysed below.

A similar statement is made in paragraph 89 of the Hungarian judgment, which for the sake of clarity it is worth quoting in full: "However, contrary to the Commission's submissions, the scheme of the advertisement tax, characterised by a progressive tax structure, was a priori consistent with the Hungarian authorities' objective, even though the tax at issue was a turnover tax. It may reasonably be presumed that an undertaking which achieves a high turnover may, because of various economies of scale, have proportionately lower costs than an undertaking with a smaller turnover — because fixed unit costs (buildings, property taxes, plant, staff costs for example) and variable unit costs (raw material supplies for example) decrease with levels of activity — and that it may, therefore, have proportionately greater disposable revenue which makes it capable of paying proportionately more in terms of turnover tax."

On the basis of the this reasoning, the General Court confirmed the position of Poland that the objective of the tax was to introduce sectoral taxation on turnover with a redistributive logic and that the Commission made second error by assigning to the retail sales tax a different objective from that defined by the Polish authorities.[36] The same second error is found in paragraph 90 of the Hungarian judgment.

The statement of the Court on the economies of scale corresponding to "disposable revenue", i.e. the ability to pay, is partly true and partly false. It is true if you compare companies selling the same product [e.g. a large furniture shop and a small furniture shop]. But it is probably false when you compare companies with the same turnover in different retail sectors, such as, for example, a furniture shop with a fast-food shop generating the same amount of turnover. The furniture shop requires a large exhibition area and needs to hold a large inventory [resulting in large turnover and a small margin], while the fast-food shop needs no more than a counter and does not have to hold more than a day's stock [resulting in large turnover and a large margin]. The same problem emerges when comparing different advertising media with different technologies.

In fact, this simple example demonstrates the difficulty of establishing the equivalence between companies even of the same turnover. Let us consider whether, for example, a furniture shop and a restaurant of the same turnover are in a truly similar situation. The furniture shop requires a large exhibition space, but even a large restaurant is different because it needs to have refrigeration facilities and procedures for safe food handling. The

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[34] Ibid., paragraph 74.
[35] Ibid., paragraph 75.
[36] Ibid., paragraphs 76-77.

similarity of their turnover says nothing about the revenue they can afford to forgo and therefore their ability to pay. It follows that a turnover tax discriminates against companies which incur higher costs to generate the same amount of turnover. The same can be said for companies of the same turnover but relying on different technologies to advertise such as printed media and electronic media.

More seriously, the approach of the General Court leads to a legal error. Since any two companies with the same turnover may not have the same cost structure, a progressive turnover tax, which is based on the presumption that companies with the same turnover have the same ability to pay because they have the same "disposable revenue", in fact treats in the same way companies that are in a dissimilar situation. This is another form of discrimination. Therefore, a progressive turnover tax favours companies that experience a steeper reduction in their average cost as they grow or, conversely, penalises companies that experience a lower reduction in their average cost. Moreover, according to the three-step test of selectivity in the case law, there is nothing intrinsic in a turnover tax that can justify modulation of the tax according to costs.

In an article published on 30 July 2019, I show with the help of numerical examples that economies of scale need not lead to higher ability to pay.[37]

A profit tax treats all companies of the same profit equally. In fact, economic theory suggests that risk-adjusted profit rates eventually converge. Sectors with high profits attract new companies until profit rates decline to the level that prevails in other sectors. In this sense, profit is the outcome when everything else is taken into account and, therefore, is a much better indicator of the ability to pay than turnover.

At any rate, the purpose of the Court's reference to economies of scale was to show that companies with larger turnover could afford to pay more in taxes. In other words, the Court implicitly conceded that a tax that claims to be redistributive has to be consistent with the principle of ability to pay and has to target the resources that a company can afford to pay in taxation. After all, ability to pay means resources one can afford to forgo, i.e. to do without, which the Court itself identified as "disposable". The rich can pay a euro without pain, while the poor depend on that euro. But this is exactly what a profit tax does. It targets resources that can be forgone or disposed. By contrast, a revenue tax directly taxes size and only indirectly and incidentally taxes resources that a company can spare.

Progressive tax rates

Then the General Court went on to examine whether despite the double error of the Commission, there could still be selective elements to be found in the Polish and Hungarian taxes. As a reminder to the reader, the first error of the Commission was to identify a standard rate in an artificial system, when according to the two countries there was none. The second error was to ignore the redistributive aim of the tax.

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[37] See P. Nicolaides, The Problem with Turnover Taxes, StateAidUncovered. It can be accessed at: http://stateaidhub.eu/blogs/stateaiduncovered/post/9543

The General Court, first, recalled that according to the case law, progressive tax structures, non-taxable amounts, maximum taxable amounts or other differentiation mechanisms do not necessarily indicate the existence of selective advantages.[38]

Perhaps it is revealing that no specific case was cited either in the Polish or Hungarian judgment that referred explicitly to progressivity. An analysis of the texts of the cited cases indicates that only in the Opinion of the AG on Paint Graphos is there an oblique reference to progressivity: "In practice, the Commission has accepted that justification may be found in the nature and overall scheme of the system where the tax is progressive in nature, where there is no taxation in the absence of profits, and where non-profit making organisations receive special treatment."[39] [At this point there is a footnote citing Commission Notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10/12/ 1998, p. 3.]

Nonetheless, after reviewing several seminal judgments, the General Court deduced that when an advantage is directed at a particular economic sector in relation to other tax payers or a particular form of business or stems from differentiated treatment contrary to the purpose of the tax, it has a selective character. However, the objective of a tax can itself include a differentiation mechanism aimed at spreading the tax burden or limiting its impact.[40]

The General Court sought to demonstrate that indeed the case law allowed for differentiated treatment without that necessarily being selective. Such differentiation or variation stems from the nature of the tax.

The Court went on to identify three conditions that exclude the presence of selectivity. There is no selectivity if:
First, the differences in taxation and the benefits that may arise result from the application, without any derogation, of the "normal" system.
Second, comparable situations are treated in a comparable manner.
And, third, the differentiation mechanisms are not contrary to the objective of the tax.[41]

To put it rather simplistically, everything must flow from the objective of the normal system.

Then the Court returned to the issue of progressivity of tax measures. It stated that progressive tax structures, including those with significant non-taxable limits, bands or amounts, which are not exceptions to tax systems, do not imply the existence of state aid. There is nothing to limit this conclusion, as the Commission did in its final Polish decision and Hungarian decision, to profit taxes and to exclude turnover taxes. The case law does not require Member States to limit differentiation mechanisms only to redistribution of wealth or the counteracting and prevention of certain negative effects [e.g. environmental pollution]. What is necessary is that the desired differentiation is not arbitrary, that it is applied in a non-discriminatory manner and that it remains consistent with the objective of

[38] Ibid., paragraph 80; and paragraph 92 of the Hungarian judgment, T-20/17.
[39] Opinion of AG, C-78/08, Paint Graphos, EU:C:2010:411, paragraph 90.
[40] Ibid., paragraph 83.
[41] Ibid., paragraph 89. See also paragraph 101 of case T-20/17.

the tax concerned. Moreover, it cannot be ruled out that a redistributive logic may also justify the progressive nature of a turnover tax. A redistributive logic may even justify a total exemption for certain companies.[42]

Consequently, the Commission could not infer the existence of a selective advantage only from the progressive structure of the turnover tax because taxation above a certain threshold, even high, may correspond to the wish to tax the activity of an undertaking only when that activity reaches a certain level.[43]

But the General Court also warned that the tax measure in question could still be selective if it were shown that the progressive tax structure in practice was adopted in a manner which largely contradicted the purpose of that tax measure.

It found that the Commission had confined itself to considering that the principle of progressive taxation gave rise to a selective advantage which, according to the Court, was an error of law.[44]

Although the Court acknowledged that the Commission had shown that different companies bore different tax burdens, the Court insisted that the variation in the average effective rate and the marginal rate according to the size of the tax base [i.e. amount of turnover] was inherent in any progressive tax system and such a system could not, for this reason alone, give rise to selective advantages. Moreover, where the structure of a progressive tax reflects the objective pursued by that tax, it cannot be considered that two undertakings having a different tax base [i.e. different levels of turnover] are in a comparable legal or factual situation with regard to that objective.[45]

Consequently, the Court found that the Commission had failed to establish the existence of a selective advantage resulting in different treatment between operators who, in relation to the objective assigned by the Polish legislature to the retail tax and the Hungarian legislature to the advertising tax, were in a comparable factual and legal situation. The errors of the Commission, in defining the normal tax system, the objective of the tax system and the existence of selective advantages, in its view, in the structure of progressive taxation of turnover, did not allow it to verify whether the progressive structure, in connection to its objectives, differentiated between companies which were in the same factual and legal situation. For these reasons, the Court annulled the final Commission decision.[46]

The General Court also annulled the opening decision of the Commission.

Deductibility of losses carried forward

[42] Ibid, paragraph 91. See also paragraph 103 of case T-20/17.
[43] Ibid, paragraph 92. See also paragraph 104 of case T-20/17.
[44] Ibid., paragraph 96.
[45] Ibid., paragraph 99. See also paragraph 110 of case T-20/17.
[46] Ibid., paragraphs 102-103.

In the Hungarian case, the General Court went on to assess the reduction of the taxable amount due to the deductibility in 2014 of 50% of the losses carried forward for loss-making undertakings in 2013.

"(117) The question is solely whether the reduction in the taxable amount for non-profitmaking undertakings in 2013 introduces into that system an element contrary to its objective and discriminatory, conferring a selective advantage".[47]

"(118) In that regard, in the light of what has been stated in paragraphs 95 and 101 above, it must be borne in mind that even if not stemming from the actual nature of the reference tax system, that is from its objective, certain tax variations, taking into account specific situations, must not be analysed as constituting a selective advantage if those provisions do not contravene the objective of the tax in question and are not discriminatory."[48]

"(119) In the present case, first, it is incorrect to consider, as the Commission essentially does in recital 62 of the contested decision, that the reduction in the taxable amount could as a matter of principle confer a selective advantage on the ground that, since taxation of turnover is concerned, 'costs are normally not deductible from the tax base of a turnover tax'."[49]

"(120) The Court held in the judgment of 15 November 2011, Commission and Spain v Government of Gibraltar and United Kingdom (C-106/09 P and C-107/09 P, EU:C:2011:732, paragraphs 77 to 83), that the capping of taxation established on the basis of objective criteria irrespective of the choices of the undertakings concerned, in other words of random events, was not selective, including where those criteria were unconnected with the basis of assessment in question, as is apparent in particular from paragraphs 81 and 83 of that judgment. It may be observed that one of the criteria conferring entitlement to the cap on the tax examined and held not to be selective in that judgment was precisely not having generated any profit, while the basis of assessment for the tax concerned was different. The same should logically apply in the case not of a cap, but of a reduction in the basis of assessment, as in the present case. In addition, the concern which the Hungarian legislature sought to address, …, cannot be considered contrary to the advertisement tax's objective … . The latter includes a redistributive purpose with which the reduction in the basis of assessment chosen in order to reduce the tax burden on undertakings that were loss making the tax year preceding the year of taxation is consistent."[50]

"(121) It is apparent also from the judgment of 15 November 2011, Commission and Spain v Government of Gibraltar and United Kingdom (C-106/09 P and C-107/09 P, EU:C:2011:732, paragraphs 77 to 83), that the Commission incorrectly maintains, …, that the measure introduces in the present case an arbitrary differentiation between different groups of undertakings in a comparable legal and factual situation in so far as the possibility of deducting from the taxable amount of the advertisement tax for 2014 50% of the losses carried forward was restricted to undertakings not having generated profits in 2013."[51]

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[47] T-20/17, Hungary v European Commission, EU:T:2019:448.
[48] Ibid.
[49] Ibid.
[50] Ibid.
[51] Ibid.

"(122) The distinguishing criterion chosen by the Hungarian authorities of not having generated profits in 2013 is objective. It is whether the undertakings concerned met that criterion which is random. Lastly, in the light of the Hungarian legislature's objective of introducing sectoral taxation with a redistributive purpose, that criterion, which is intended to ensure in the first year of the advertisement tax's introduction a moderate tax burden for taxable persons in an unfavourable situation, establishes a difference in treatment between undertakings not in a similar situation: the profit-making undertakings in 2013 and undertakings not having made profits that year. It may indeed be found that the distinguishing criterion chosen by the Hungarian legislature can, in the light of certain specific situations of undertakings with losses of the same order for 2013 and the preceding years, result in the existence of 'threshold' effects if they were also close to equilibrium in 2013, but such effects are inherent in numerous variation mechanisms which necessarily involve limits, and it cannot be inferred from that fact alone that such mechanisms confer selective advantages."[52]

"(123) Lastly, the fact that the advantage at issue was laid down only for the tax for the first tax year in which the tax at issue was applied, not the following tax years, cannot support the finding that undertakings which benefited from that advantage that first year were assisted compared with undertakings which could have benefited from the same advantage had it been retained for the following years. The legislature is not required to prolong a tax advantage and, in that regard, the situations between two different tax years cannot be compared. Moreover, the Commission did not defend that idea in the contested decision, but only advanced it in the rejoinder."[53]

Consequently, the General Court annulled this part of the Commission decision as well.

In essence what the Court said was that it is the prerogative of Member States to set tax thresholds and tax bands that may appear to have an element of arbitrariness and to determine limits to tax liability that may appear to have a degree of randomness. However, the problem is that paragraphs 117-123 of the judgment in the Hungarian case do not explain how the deductibility of the losses carried forward stemmed from the objective of the system which was to tax turnover. Tax rates and tax bands are inherent in the concept of taxation. When one establishes a progressive tax, one necessarily has to determine different rates which in turn necessarily require the definition of tax bands. But the deductibility of the carry-forward losses does not necessarily follow from the progressive nature of the Hungarian tax.

An assessment and implications

The General Court was correct in censuring the Commission for constructing an artificial reference system. However, apart from the reference to economies of scale, the General Court did not really explain how a turnover tax related to ability to pay and supported a redistributive tax objective, as claimed by Poland and Hungary. In fact, the reasoning behind the reference to economies of scale was that, first, larger turnover correlated with larger companies and, second, that it corresponded to ability to pay because of more disposal revenue. As already explained, neither the correlation, nor the correspondence was proved.

[52] Ibid.
[53] Ibid.

They could hold is some cases, but not in all cases. In fact, the General Court itself failed the selectivity test by not demonstrating how companies with the same turnover were in a "similar legal or factual situation" with respect to the objectives of progressivity and redistribution.

The core question is whether a turnover tax can be progressive without being discriminatory in the sense that companies with the same turnover have the same ability to pay. As already noted above, there is a large element of arbitrariness in progressive tax systems when it comes to setting the level of the various tax rates and the thresholds for the various income, profit or turnover bands. I am not aware of any case at EU level where EU courts have declared a rate, say of 25% to be selective in relation to a higher rate of 40%, or a band of EUR 30,000 to be selective in relation to a higher band of EUR 100,000. Member States do enjoy a wide margin of discretion in deciding their rates and bands. But apart from this rather ad-hoc setting of rates and bands, the essence of progressive systems and the principle of ability to pay are predicated on the core axiom that those who have more can afford to pay more.

This article has argued that the zero-rate band was not consistent with the revenue-raising objective of the Polish tax and Hungarian tax. One may retort that the zero rate was justified by the progressive objective of the two taxes. The General Court's only explanation of why a progressive turnover tax could be congruent with a progressive objective was the presumption that more turnover implied more disposable income and therefore greater ability to pay. This article has explained why this presumption is wrong as a general statement. A tax on turnover only incidentally correlates with ability to pay. In fact, it is rather more likely that companies with the same turnover do not have the same ability to pay. This is, of course, an empirical statement whose veracity can only be confirmed with a proper market study. But both casual observation and theoretical analysis suggest that that is the case not just in Poland or Hungary, but in any modern economy.

In the case law, most references to turnover are linked to the value-added system of taxation because VAT is levied on turnover which is another term for revenue which is the retail price multiplied by the units sold. In the VAT system "input" tax [i.e. taxes paid on purchased raw materials, supplies and services] is subtracted from "output" tax [i.e. the tax added to the total cost plus profit of the product that is sold]. This is because the value which is added to a product or service is the difference between the price of inputs and the "output price" which is the sale price of the final product or service in question. In order to calculate the value added by any economic activity, one has to subtracted the value of inputs. Similarly, in order to derive a company's ability to pay, one has to subtract what the company owes to others [e.g. suppliers, workers, creditors, etc]. By definition, raw revenue, i.e. turnover, does not take into account what the company owes to others. Therefore, this simple theoretical analysis indicates that a turnover tax cannot correspond to ability to pay.

What the General Court has not said is that all of the components of a tax measure must be justified by all of the objectives of the reference tax system. In other words, the General Court has not said, for example, that the zero-rate band had to be justified by both the objective of raising revenue and, at the same time, the objective of spreading the tax burden according to the principle of ability to pay. Obviously, the zero-rate band cannot satisfy simultaneously both of those objectives of the tax system. In fact, I am not aware of any judgment that has

required the simultaneous conformity of all components of a tax measure with all of the objectives of the reference system.

In the absence of more general guidance by the General Court on the link between turnover taxes and ability to pay, what then are the possible consequences of these two important judgments? Although they are ostensibly about turnover taxes which are not widely used by Member States, the judgments are likely to impact significantly on the design of national tax systems in three respects.

First, the Commission has to accept the tax system as defined by Member States, including all its components such as base, rates, bands, etc. The Commission may not identify a hypothetical or artificial reference system. Member States would do well to ensure that all the components of the system are consistent with the overall objective of that system.

Second, differentiation of tax payers is not necessarily selective as long as it follows from the objective of the system.

Third, progressivity is a form of differentiation that is not necessarily selective.

But suppose now a Member State that wants to levy a turnover tax wishes to strengthen its defences against a possibly negative assessment by the Commission. Instead of having a zero-rate band, it defines a very wide band with a very low rate and a second band above a very high threshold with a substantially higher rate. In this way, it can argue that its objective of raising revenue is demonstrated by the levying of a tax on all retailers, while the width of the low-rate band ensures that the tax is genuinely predicated on the principle of ability to pay.

The Commission may try to apply the logic of the Gibraltar judgment in order to show that the structure itself of the measure is intended to discriminate against larger companies.

But what will happen if that Member State, wishing to escape from the Gibraltar logic, defines narrower bands with rates that do not differ substantially. Then it will encounter a different problem. If the argumentation in this article against progressivity is correct, it will have hard time justifying the progressivity of the tax. The closer the bands and the rates, the more likely that companies with similar turnover will in fact be quite different companies. The wider the bands and the more distant the rates, the more likely that the system favours small companies or, conversely, discriminates against large companies.

The only sure way of avoiding the contradiction arising from the alleged progressivity of turnover taxes is to have a system with a single rate. Apparently, the Commission considers that a single-rate turnover tax does not constitute state aid. Until, that is, someone can argue convincingly that a turnover tax in fact discriminates against companies whose business model relies on a large volume of transactions generating a wafer-thin margin.

But, our hypothetical Member State may be willing to take a risk and instead of a turnover tax, levy a tax on company size, defined in terms of assets, capital or some other measure of size. Will such a tax be free of state aid?

One of the reasons why the Commission concluded that the Polish tax and similar taxes in Hungary were selective was that they hit hardest large multinational companies. They appeared to protect smaller, domestic companies, although, it must be said that both Poland and Hungary have denied that they intended to discriminate in favour of small, mostly national, companies. They have argued, instead, that domestic companies also paid tax at the highest rate. If the Commission cannot use state aid rules, it may be able to use internal market rules to prevent covert discrimination. Ultimately, it may make no difference how the integrity of the internal market is safeguarded. But it still leaves unanswered the question whether Member States are now free to tax company size and target large multinational retailers such as Amazon.

Recently, a number of papers have examined the issue of taxation of digital transactions or internet-based commerce.[54] Opinion on whether such taxes are effective or desirable is divided. Regardless of which side of the argument one stands, the underlying suspicion is that the covert of aim of digital taxes is to target large, mostly American, companies. The fact that the General Court has found progressive turnover taxes not to constitute state aid may embolden Member States to design tax systems that are especially punitive to companies generating a large volume of revenue.

At any rate, the present judgments represent a defeat for the Commission, although it does not necessarily follow that it is also a major setback for the Commission. They have elements that the Commission may use to correct the decisions that were annulled by the General Court. The Commission has lost two battles, but it may not have lost the war. And, of course, the Commission may appeal.

In conclusion, the General Court has ruled that a progressive turnover tax [i.e. a tax with several rates, rather than a single rate] is not selective if the rates and bands of the tax are consistent with the logic of the tax. The two judgments have wider repercussions. Differentiation of tax payers is not selective either if it is also consistent with the logic of the tax.

[54] A number of authors have commented on the feasibility and/or desirability of taxes on the revenue of internet-based multinational companies. See, for example, Maarten Floris de Wilde, 'Comparing Tax Policy Responses for the Digitalizing Economy: Fold or All-in, *Intertax*, 2018, vol.46(6/7), pp. 466–475; Ruth Mason and Leopoldo Parada, Digital Battlefront in the Tax Wars, *Virginia Law and Economics Research Paper* No. 2018-16, January 2019; Leopoldo Parada, EU loss in Polish State aid case may be a win for digital services tax, *MNE Tax*, 17 May 2019 [it can be accessed at: www.mnetax.com]; https://estal.lexxion.eu/journal/ESTALSteven Verschuur, Melina Stroungi, State Aid and Tax Rulings - the Commission's Approach to Virtual Payments: Equal Treatment of Multinationals? *European State Aid Law Quarterly*, 2017, vol. 16(4), pp.598-606.