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Commission v Poland C-562/19 P: Turnover Taxation and State Aid Law

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Summary

The case concerns a Polish retail tax on the sales of goods that has the characteristic of being applied on turnover, and at progressive rates. This latter characteristic – the progressive rates – led the EU Commission ('the Commission') to consider that the tax was in fact related to the size of the undertakings affected by it rather than to their profitability, thus discriminating between companies and causing serious market distortions (CJ 16 March 2021, C 562/19 P *European Commission v Republic of Poland,* ECLI:EU:C:2021:201, paragraph 4). After a formal investigation by the Commission, it was concluded that the tax in question met all the conditions stated in Article 107(1) TFEU for classification as state aid incompatible with the internal market (Commission v Poland, paragraph 7). Most notably, the Commission argued that the progressivity of the tax implied that companies were subject not only to different marginal rates but also to different average tax rates, which constitutes a departure from the reference system. The Commission also rejected the argument used by the Polish authorities to justify the derogation from the reference system based on redistributive objectives, claiming that this would be incompatible with the idea of turnover taxation. The tax was ultimately suspended before it started being applied. In practice, therefore, no aid was recovered.

The Republic of Poland brought an action against the Commission's decision before the General Court ('GC'), which substantially upheld the position of the Republic of Poland, arguing that the progressive turnover tax in question had been wrongly considered illegal state aid under Article 107(1) TFEU (GC 16 May 2019, T 836/16 and T 624/17 *Poland v Commission*, EU:T:2019:338). This decision was subsequently appealed by the Commission before the CJ, and it is this appeal that is the subject of the present analysis. In its appeal, the Commission requested three main actions from the CJ. Firstly, to set aside the contested judgment. Secondly, to give final judgment in the case by rejecting the pleas in law put forward by the Republic of Poland against the contested decisions. Thirdly, and alternatively, to refer the case back to the GC for a decision on the pleas on which it had not yet decided. The Republic of Poland, by contrast, requested the CJ to dismiss the appeal in its entirety as unfounded, and this was the position ultimately adopted by the CJ (*Commission v Poland*, paragraphs 20-22 in relation to 47, 57-58).

Comments

The Commission based its appeal on two main arguments. First, it argued that the progressive nature of the Polish tax did not give rise to a selective advantage in favour of undertakings with low turnover and that the GC had therefore erred in law in interpreting that an infringement of Article 107(1) TFEU existed. Second, the Commission argued that by annulling the decision to initiate a formal investigation procedure, including the suspension injunction, the GC had infringed Article 108(2) TFEU and Article 13 of Regulation 2015/1589.

This commentary will refer exclusively to the substantive argument – that is, to the first plea in law referring to the issues regarding Article 107(1) TFEU – and will not consider the matters relating to Article 108(2) TFEU and Regulation 2015/1589.

First plea in law: Infringement of Article 107(1) TFEU

Progressivity of the tax and selectivity

As noted above, the main ground on which the Commission relied for its appeal before the CJ related to the progressive nature of the Polish tax. According to the Commission, the progressivity of the tax provided a selective advantage to low-turnover undertakings vis-à-vis high-turnover undertakings. The Commission argued, therefore, that the GC had erred in law when it concluded that the progressivity of the tax was part of the reference system for the purpose of assessing selectivity under the traditional state aid analysis (*Commission v Poland,* paragraphs 24 and 34).

The CJ adopted a formalistic view on this matter, providing three important reasons for dismissing the Commission's arguments as unfounded (*Commission v Poland*, paragraph 47). First, it concluded that 'Member States are free to establish the system of taxation which they deem most appropriate, meaning that the application of progressive taxation falls within the discretion of each Member State' (*Commission v Poland*, paragraph 37 in relation to CJ 3 March 2020, C 75/18 *Vodafone Magyarország*, EU:C:2020:139, paragraph 49, and CJ 3 March 2020, C-323/18 *Tesco-Global Áruházak Zrt,* ECLI:EU:C:2020:140, paragraph 69). Second,

and as a consequence of the above, the CJ concluded that the characteristics of the tax, including its progressivity, 'define the reference system or the "normal" tax regime'. In other words, state aid law cannot preclude Member States from adopting progressive rates, especially when they intend to take into account the ability of taxpayers to pay (*Commission v Poland*, paragraph 40). Third, the CJ concluded that turnovers are 'a criterion of differentiation that is neutral and a relevant indicator of the taxable person's ability to pay' (*Commission v Poland*, paragraph 41, citing also *Vodafone Magyarország*, paragraph 50, and *Tesco-Global Áruházak*, paragraph 70).

The CJ is right to conclude that Member States are free to determine the characteristics of their own tax systems in areas not harmonised under EU tax law. Similarly, the CJ correctly assesses that the use of progressive tax rates falls within the discretion of Member States, which may ultimately opt for progressive taxes to ensure that taxation reflects taxpayers' ability to pay. However, the CJ makes a mistake – or, at least, an unconscious omission – when it considers that any one economic indicator is enough to determine the ability to pay. Indeed, a progressive tax is generally characterised by a measure that truly represents taxpayers' ability to pay. This is why *net income* (rather than gross income) generally constitutes a more reliable – or proper – representation of the ability to pay. In this regard, it is worrying, to say the least, that the CJ argues that *turnover* – without any distinction between gross and net turnovers – is just another indicator of ability to pay, and the fact that *profits* constitute a 'more precise indicator than turnover' is simply irrelevant for the purposes of the state aid's selectivity analysis (*Commission v Poland*, paragraph 41). If this new notion of 'progressivity' upheld by the CJ is accepted, it should not come as a surprise that any 'graduation' applied on a tax base – ultimately reflecting the ability or inability to pay – may be welcome in the near future, including if related to gross turnover and digital services taxes (s*ee* Ruth Mason & Leopoldo Parada, *The Legality of Digital Taxes in Europe*, 40 Virginia Tax Rev. 1, 2020, p. 213).

Comparability and objective of the tax

As part of its first ground of appeal, the Commission also argued that, in the appealed decision, the GC was not entitled to 'examine the comparability of the undertakings subject to that measure in the light of an objective other than the fiscal objective of that measure' (*Commission v Poland*, paragraph 24). In other words, the Commission argued that the GC should have limited its analysis to determining whether undertakings in a similar legal and factual situation were treated similarly, considering the objective of the tax.

The CJ did not rule on this matter, and that was for good reasons. The comparability analysis makes sense only to the extent that the Court agrees that the reference framework used by the Commission was correct. However, it is important to analyse this argument, especially because of the extensive analysis devoted to it by Advocate General Kokott ('AG Kokott') in her opinion on the present case (Opinion of AG Kokott 15 October 2020, C 562/19 P *European Commission v Republic of Poland,* ECLI:EU:C:2020:834, paragraphs 71-79), but also because of its potential implications for other turnover taxes, specifically digital services taxes ('DSTs'), the popularity of which has lately increased across Europe.

The main question here touches upon whether the Polish retail tax differentiates between low and high-turnover taxable persons and, therefore, grants a selective advantage to low-turnover undertakings vis-à-vis high-turnover undertakings in light of the objective of the tax. The Commission's main argument was that the objective of a tax is generally to raise revenue for the national budget in order to satisfy public needs. Based on this objective, the volume of turnover would be irrelevant, and lower taxation on low-turnover undertakings could not be justified. AG Kokott considered this line of argumentation unacceptable for various reasons. First, she argued in her opinion that the objective of a tax cannot be reduced exclusively to the generation of revenues. Second, she argued that the crucial factor here is the specific tax objective pursued by the legislature 'which is evident by way of interpretation from the nature of the tax and its design' (*Opinion of AG Kokott*, paragraph 75).

Although AG Kokott's approach has been supported by the CJ in the past (CJ 19 December 2018, C 374/17 *A-Brauerei*, EU:C:2018:1024, paragraphs 48 and 49; CJ 26 April 2018, C 233/16 *ANGED*, EU:C:2018:280, paragraph 55), this approach is not exempt from criticism, especially because of the wider scope of action granted to Member States. Indeed, if this approach is accepted, it is clear that Member States could deliberately design a tax measure in a manner arbitrarily favouring certain undertakings and escape the scope of the state aid prohibition simply by referring to a well-devised tax objective. This was precisely what Hungary seemed to do in *Tesco-Global,* where it justified its retail store trade tax by including in the legislative draft that the objective of the tax was taxing 'taxpayers whose ability to contribute to the costs of public expenditure exceeds the general obligation to pay tax' (*Tesco-Global Áruházak,* paragraph 70. See more on this argument in: Rita Szudoczky, *Vodafone Magyarország* C-75/18 and *Tesco-Global Áruházak* C-323/18, in: *CJEU – Recent*

Developments in Direct Taxation 2018, Lang et al. (eds), Linde 2019). Moreover, and even if such a specific objective of the tax is accepted, the argument works only to the extent that turnover is agreed to be a valid and reliable indicator of the ability to pay, which is a conclusion certainly very much open to debate.

Justification of the tax measure

As well as not ruling on the comparability and objectivity of the tax, the CJ did not rule on justification of the tax measure, which arises only if a different treatment of comparable taxable persons is assumed to exist (*Opinion of AG Kokott*, paragraph 81); that is, only if the CJ considered that a different treatment, connected with the different average rate of the progressive tax, had been applied (*Opinion of AG Kokott*, paragraph 82). It is interesting to mention this issue here, however, because it was one of the alternative arguments used by the Commission in its plea in law (*Commission v Poland*, paragraph 24) and may also have implications for future challenges regarding turnover taxes under state aid law.

In brief, the Commission argued that the GC considered the different average rate between low and high-turnover taxpayers to be justified by the principle of taxation according to the ability to pay and the objective of redistributing the tax burden between taxable persons with greater economic capacity and taxable persons with less economic capacity (*Commission v Poland,* paragraph 24 in relation to *Opinion of AG Kokott*, paragraph 83). In the opinion of AG Kokott, this argument cannot be criticised from a legal perspective. First, because the volume of turnover 'indicates (without manifest error at least) a certain financial capacity' (*Opinion of AG Kokott,* paragraph 84), an issue that could also be seen in the Commission's proposal for a digital services tax, where turnovers 'can also be seen as a (slightly rougher) indicator of greater economic power, and thus greater financial capacity' (*Opinion of AG Kokott,* paragraph 84). Second, because progressive taxation imposes a heavier burden on those taxpayers with greater economic capacity, which would be justified by the principle of a welfare state, as recognised in Article 3(3) TEU.

Although AG Kokott may be right regarding the principle of the welfare state and progressive taxation in general, the argument turns on a more fundamental question: Are turnovers *automatically* an indicator of ability to pay or do they just form part of the equation used to determine taxpayers' real economic capacity? AG Kokott endorses the idea that turnover indicates a 'certain financial capacity'. If that is the case, could we also argue that gross income

reflects ‘certain financial capacity’ for individual income tax purposes, just as net income, too, does?

Interestingly, the only argument that appears to support the alleged link between turnover and ability to pay is the reference to ‘economies of scale’. Indeed, both AG Kokott in her opinion on the case under analysis (*Opinion of AG Kokott,* paragraph 76) and the GC in the appealed decision (GC *Poland* v *Commission*, paragraph 75) argue that, because of economies of scale, companies with high turnover have proportionally lower costs than companies with lower turnover. Therefore, the former (i.e. companies with high turnover) would be capable of paying more taxes. In other words, higher turnover would correlate with larger companies, and that would then correspond to the ability to pay because these companies have higher revenues at their disposal. However, and as also argued elsewhere, neither the correlation nor the correspondence has actually been proved. This is a crucial issue because if this correlation/correspondence proves to be true in all cases, it could simply be concluded that two companies with the same turnover have the same ability to pay, which is something that economic reality tends to disprove. (See more on this argument in: Phedon Nicolaides, *Multi-rate Turnover Taxes and State Aid: A Prelude to Taxes on Company Size*, European State Aid Law Quarterly (ESTAL) 3, 2019, pp. 226-238). This does not mean that turnover tax has nothing to do with the ability to pay. Instead, and in contrast to what the CJ and AG Kokott suggest, the correlation would seem to be purely coincidental. Indeed, a progressive turnover tax would not seem to correlate to the ability to pay simply because it does not consider what the company owes to others, including suppliers, creditors and its own workers, among other actors (Nicolaides, p. 237). In other words, turnovers are not ‘real income’ but only a presumption of real income that becomes real only when the costs incurred in the particular economic activity are taken into consideration. (In this respect, see also: Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax Journal, 1, 2019, sec. 2.2.1.1; Julia Sinnig, Turnover Taxes Under State Aid Spotlight, 59 European Taxation, 2/3, 2019, p. 110). Indeed, it is following the same logic that a VAT, for example, considers deducting the tax on what a company paid others for raw materials (‘input VAT’) from the tax added to the cost of production (‘output VAT’) in order to determine the value added to a particular economic activity, as suggested by some commentators. (Nicolaides, p. 237).

Other issues: The legal nature of turnover taxes

An issue mentioned by the CJ, but which has passed by almost unnoticed is the question regarding the legal nature of turnover taxes. On this matter, the CJ concluded categorically that the 'tax measure at issue, introduced a tax on the retail sector based on the monthly turnover generated by that activity, which, contrary to what the Commission maintains, is a direct tax' (*Commission v Poland*, paragraph 44).

Although this issue might not have much relevance for the purposes of the decision under analysis, it is of significance for the challenges that some new forms of turnover taxes may face in the future, particularly with regard to DSTs. Indeed, both the original project of the DST Directive and the unilateral DSTs now being imposed by several Member States have always been presented to the public as indirect taxes. Presenting them in this way has one simple purpose: to avoid conflicts with existing double tax treaties and the obligations arising from them, particularly those concerning relief from double taxation. Therefore, the CJ's conclusion that turnover taxes are categorically 'direct' taxes can be seen as positive by those who argue that DSTs do indeed fall within the scope of double tax treaties. Although this conclusion is evidently not enough to claim victory, it is an important step in clarifying the fact that international agreements cannot be bypassed just because a Member State's legislative text labels a tax in a certain manner. (For more on this issue, see, for example, Georg Kofler, Gunter Mayr and Christoph Schlager, *Taxation of the Digital Economy: "Quick Fixes" or Long-Term Solution?,* 57 European Taxation, 12, 2017, arguing how digital taxes may conflict with tax treaties); Wolfgang Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, 72 Bulletin for International Taxation, 4/5, 2018 (highlighting how countries have escaped international obligations by labeling digital taxes as indirect taxes).

Final remarks

The CJ has undeniably set an important precedent regarding where to look in order to determine a reference system for the purpose of state aid analysis by rejecting the Commission's intention to use a fictitious reference system. Similarly, the CJ has rightfully stated that the progressivity of taxes can indeed be part of the characteristics of a domestic tax system and should not, therefore, be regarded *per se* as a derogation. However, the CJ has failed to provide a complete and accurate answer to two fundamental issues. First, it does not explain how any type of graduation can be equivalent to progression. Second, it does not explain – at least not

convincingly – how turnover tax actually reflects an ability to pay. This raises concerns regarding the wider scope of action that Member States may enjoy from now on, particularly with regard to the potential abuse by Member States wishing to make their turnover taxes appear immune to state aid claims. Could a 'Gibraltar approach' be enough to avoid any potential abuse in this regard? This is something that only time will tell.

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A different version of this draft has been published as Leopoldo Parada, *Commission v Poland C-562/19 P: Turnover Taxation and State Aid Law,* Highlights & Insights on European Taxation [XX] (2021).