

# **A case study on initiating disputes in fiscal law matters: the example of Hungarian local trade tax**

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## I. Introduction

The question whether the law on Hungarian local trade tax that has remained in force following the date of Hungary's EU accession is consistent with the Sixth Council Directive on harmonized value added tax seems to be at a glance of substantive law character. It is simply to decide on whether the Hungarian tax in its current form is in conformity with its Community law counterpart. However, in order to find a complete answer, this question need be complemented with further ones, to be discussed below. Not to mention them, even the substantive law issue is of methodological nature.

Although, thanks to ECJ, a number of criteria have been developed as to which a national tax can be assessed, compared to the harmonized European system of value added tax, it can be answered on a casual basis only whether the national tax under discussion may hinder the smooth operation of harmonized value added tax. It is not only a problem one has to face that national law and Community law are in motion. It is also interesting that it cannot be determined but subsequently whether a national tax, be it indirect or direct, is consistent with the harmonized European system of value added tax, knowingly an indirect tax. Ironically, the operation of harmonized value added tax can be hampered even by a direct tax introduced in a Member State. This way, the question of consistency, or rather coherence cannot be answered by merely referring to the formal criteria as to which one can say about a tax whether it is direct or indirect. Apparently, such a situation entails the lack of predictability and transparency. On the European scene, due to the interaction of national jurisdictions and Community legislation with each other, one need miss a close system where legal provisions, or related meta-legal norms, have a particular value, to be calculated in accordance with their unique position held in a legal system. In such circumstances, parties are invited occasionally to seek for balance, consistency and coherence in the rule of games applicable to their case.

In the conditions of the life-world as described by Jürgen Habermas, the emergence of ethical or legal values cannot necessarily be explained simply by the relevant norms to be followed. This way, particular attention can be given to the processes of meta-ethics. This is because the classification of norms as to their contents, and the application of substantive norms are faded and the question arises why the areas are growing where regulations are not predictive longer. A growing body of research and experience in the field of law and business ethics suggests that the real culprits are not simply compliance systems. The fundamental constraint on the practical enforcement of justice comes from the lack of relevant information (people are restrained by the "veil of ignorance").

## II. Legal avenues to enforce taxpayer rights

In Hungary, in connection with the question whether local trade tax is consistent with the harmonized European system of value added tax, the question can be raised of how to find avenues for the enforcement of Community law-protected rights. A Hungarian registered company, being liable to pay to the competent local government large amounts of local trade tax, may be interested in the examination whether the relevant Hungarian tax law is consistent with Community law. Citizens in the EU are entitled to raise before a national court the question whether national law is in conformity with Community law. Then they can suggest to the national court that the European Court of Justice answer in a so-called a preliminary ruling procedure (as regulated by Article 234 of EC Treaty) the questions referred to it by the national court concerning the interpretation or application of Community law in the specific case.

There are several ways of testing the current Hungarian law on local trade tax in the light of Community law. First, it must not be precluded that a decision of the local government authority on the advance payment of local trade tax (a notice to pay) is challenged with a view to seeking for review in an administrative procedure, finally even before a court. Secondly, it would be possible to bring a legal action against the Republic of Hungary, by carrying on a civil lawsuit, seeking for compensation for the damages suffered as a result of the continuous payment of local trade tax, not compatible to Community law, made since the date of Hungary's accession to the EU. Finally, a letter of complaint can be lodged before the European Commission by initiating an investigation procedure as to the conformity of Hungarian local trade tax with Community law. Then the Commission may decide on a so-called infringement procedure (as regulated by Article 228 of EC Treaty).

Being imminent opportunities, and complex professional issues, the initiation in an administrative procedure of the review of the tax authority's decision and the civil lawsuit carried on against the Republic of Hungary for compensation of damages will be highlighted below. In connection with these avenues, it is important to give particular consideration to the substantive law issue of the compatibility of local trade tax with harmonized value added tax as well as to the problem whether Hungary has been granted derogation by the EU accession treaty to temporarily apply local trade tax. Certain important aspects will not be mentioned in this respect: e.g., the law on the reference for preliminary ruling will not be discussed, or the possible scope of an ECJ judgment will not be dealt with.

As an alternative to challenging the public authority's decision on a notice to pay advance tax, it is possible to file a tax return with zero liability to pay local trade tax, and then challenge the tax authority's decision. However, in this case, the taxpayer has to face the risk of the adverse consequences associated with the discovery of tax arrears. Bringing a legal action against the Republic of Hunga-

ry for compensation of damages does not ensure such a risk because tax has been duly paid before.

With a view to avoiding the risk of tax arrears, one further option for challenging the effective Hungarian law on local trade tax would be fully to pay the tax due for a fiscal year, but a tax return with zero tax liability would be lodged at the same time. However, discrepancy between tax return and tax payment liability in respect of the same type of tax at the same time period is questionable in Hungarian law. The tax liability corrected upon self-audit is due on the same date when the underlying tax return is filed [Sec. 51 (1) of Taxation Order Act]. Hence, tax return and tax payment liability cannot be different from each other.

Truly, over-payment of tax is not precluded. The taxpayer is then entitled to dispose of the amounts of over-payment by duly instructing the competent tax authority, responsible for the management of the individual taxpayer's fiscal account [Sec. 43 (6)]. For the lack of disposition, however, the claim arising from the over-paid tax will be cancelled automatically by force of law [Sec. 43 (5)]. Over-payment is not associated with the time when the liability to pay tax is due. The flow of tax payment and the development of fiscal rights and obligations are different things. Over-payment of tax is at least good to reduce the amount of tax arrears.

While the over-payment of tax does affect tax arrears, it does not concern the amount of the so-called tax differential established to the debit of the taxpayer [Sec. 170 (2)]. Tax differential can be expressed in monetary terms. It is an amount of the tax payable as discovered by the tax authority, comparable to the amount of tax, which was, or would have been, declared by the taxpayer. Tax differential [Sec. 178 (3)] must not be in discrepancy with the development of the liability to pay tax by law. One can conclude therefrom that Hungarian fiscal law must not allow in any case deviation in filing for tax returns from the effective liability to pay tax. It is thus not possible to pay tax with the reservation of the right to challenge the legal basis for the liability to pay tax. As well, the taxpayer is prevented from opting out of the system of self-assessment, by asking for the imposition of tax in an administrative procedure, to be completed by a formal decision the tax authority may take.

### **III. Easy enforcement of the rights to be protected by Community law in an administrative procedure**

The possible arguments the local public authority (as a defendant) may mobilise in a lawsuit of public administration can be summarized as follows:

- Challenging the validity of the legal provisions on local trade tax due to their alleged non-conformity with the relevant Community law, the claimant should have filed for a tax return with zero tax liability before. The tax authority, de-

ciding prospectively for advance tax, is bound to the tax return following the past fiscal year and would allegedly not be able to depart from the tax return filed, properly indicating the liability to pay tax.

- Since the claimant has paid subsequently the whole amount of the tax under discussion, which was due for the fiscal year under dispute, following the release of the tax authority's decision on a notice to pay advance tax, the fiscal law dispute has been over.

For better understanding the tax authority's position, some background information may be useful. According to the relevant Hungarian law, local trade tax must be reported by 31 May following the year for which the tax is payable. Based on the tax return lodged, the local tax authority releases after then prospectively – in the form of a public authority's decision – a notice to pay advance tax biannually. This decision, like other formal decisions of public authority, can be challenged, finally even before the court. Releasing the notice to pay, the tax authority must take into account the financial particulars the taxpayer has communicated by the respective tax return as well as the changes, if any, in laws concerning the basis and rate of, or the reductions in, local trade tax.

From the perspective of the taxpayer, one can argue that the claimant, negotiating a legal dispute by filing a zero tax return, would incur the unjust burden of the adverse tax consequences associated with the discovery of tax arrears. Instead of preferring upfront denial, the taxpayer may initiate a tax law dispute concerning the tax authority's decision on a notice to pay advance tax, while making reference

- to the provision of the law on local rates on the tax authority's obligation to take into account the changes in the relevant law, if any, while prescribing tax liability [Sec. 41 (3) of Local Taxes Act]; and
- to the provision of tax administration law on the legal basis for the imposition of advance tax [Sec. 31 (1) of Taxation Order Act].

Bearing in mind the above considerations, the taxpayer may contend that the tax authority could not avoid taking a particular standpoint on the legal issue on its merits, no matter whether the taxpayer has made an annual tax return, and if so, with what contents. Once the tax authority has realised that Hungarian law is not consistent with the relevant Community law, it is the obligation of the tax authority "ex officio" to take away the legal provisions, not consistent with Community law. As a consequence of this removal, in the absence of effective legal provisions on the liability to pay tax, the status held by the taxpayer need be terminated as well.

Since the date of Hungary's EU accession, national public authorities are obliged in all instances of legal disputes to interpret and apply national law in the light of the relevant Community law. A public authority will act therefore against the law, while establishing its decisions on the standpoint that the public authority's actions cannot be considered illegal as long as they are consistent with the statutory national laws, not repealed or declared as unconstitutional. The very

same national law institutions may be interpreted after accession in a way, different from that applicable before accession. In the light of the “*acquis communautaire*”, the tax authority cannot be sure longer of avoiding legal discussion, insisting on being bound to tax returns, while taking into account that the impediment of the enforcement of rights to be protected by Community law means an infringement of Community law, taken by itself. Furthermore, citizens are entitled to enforce the individual rights protected by Community law directly even where these rights are enshrined in a Council directive (which are addressed not to citizens, but to their Member States), provided that a Member State has failed to fulfil its obligation to implement Community law properly.

It is a possible reaction of the public authority to the taxpayer, having challenged the tax authority’s decision, to invite the taxpayer to lodge a tax return with zero liability to pay local trade tax. Such an approach taken by the public authority would ensue, however, that the taxpayer would be compelled to incur the burden of the adverse consequences to be associated with the possible identification of tax arrears. The restrictive practice the public authority is to follow would definitely be considered as an obstacle to the enforcement of the individual taxpayers’ rights to be protected by Community law.

The public authority may argue that in its decision it does not hesitate to examine all the legal issues raised by the taxpayer. This way, the tax authority may hold that the Hungarian law on local trade tax cannot be considered incompatible with Community law. On this basis, the tax authority may argue further that the taxpayer is not invited in fact to file a tax return with zero tax liability. This is simply an opportunity the taxpayer may make use of. Furthermore, since the taxpayer has subsequently reported the local trade tax payable for the past fiscal year, the tax authority may feel to be reassured that it is not in a position to depart from this declaration, while prescribing the advance tax payable biannually in the year following the year of declaration. The taxpayer may object to this, however, by saying that the explanation the tax authority delivers would not be of relevance after the time that the tax authority had declared to be prevented from opening a legal dispute. Also, it is questionable whether the tax authority is really bound to the tax return as lodged. One can argue that a procedure of public administration is inserted at the end of which the tax authority takes a formal decision on a subject independent of that as communicated in the tax return, while releasing a notice to pay tax.

Because of the assumed infringement of the taxpayer’s right to initiate the tax authority’s examination of the question concerning the legal basis for the liability to pay local trade tax, this issue can be raised independently of the question whether local trade tax is compatible with the harmonized European system of value added tax. Even if the current Hungarian tax will not be considered as incompatible with the harmonized system of value added tax, Hungary as a Member State may be condemned to the extent that taxpayers do not have easy access

to the enforcement of their rights, with particular regard to the missing opportunities of making reservation or opting out of self-assessment.

Arguably, the claimant's action cannot be considered as illegal, or to be taken in bad faith or without due care, being reluctant to file for a tax return with zero tax liability. Neither is the respective tax return illegal unless explicitly identified as such by the competent tax authority. Has the defendant tax authority doubts as to the legality of the claimant's actions, the defendant could have suspended the procedure of tax administration by raising the issue to a higher authority for clarification.

The subject of the procedure of tax administration, that is, the legal basis for the liability to pay local trade tax, cannot be taken out of consideration, and the administrative procedure cannot be terminated, even if the taxpayer makes a declaration of agreement or lodges a tax return resulting in fact in the payment of tax. During an administrative procedure, the public authority is obliged, whether upon request or "ex officio", to enforce the rule of law and promote the exercise of rights, including those to be protected by Community law.

#### **IV. The assessment of Hungarian local trade tax in the context of the relevant Community law, based on a functional approach**

Like the Italian regional tax on productive activities, called IRAP, as discussed before ECJ under No. C-475/03,<sup>1</sup> Hungarian local trade tax has also been subject to controversies. Unlike IRAP, the Hungarian tax under dispute may arguably be considered to fall under the authority of the prohibition as provided for by Article 33 (1) of the Sixth Council Directive. Namely, it is a tax which is clearly proportional to sales receipts and the burden of tax is typically shifted by the taxpayer to the consumer. Even if two opinions of advocate generals on IRAP have been eventually disregarded by ECJ, they are authoritative for the purposes of the assessment of the trends of development in interpreting Article 33 of the Sixth Council Directive.

As Advocate General Dr Christine Stix-Hackl explains in Para 29 of her opinion,<sup>2</sup> there are two aspects to the Court's approach on the issue under dispute. First, one can raise a fundamental concern as how to protect the principles underpinning the VAT system and to preclude interference with it. Secondly, a desire can be communicated to define, more formally and in the interests of legal certainty, criteria whereby national taxes may be clearly identified as incompati-

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<sup>1</sup> Judgment of the EC Court of 3 October 2006 (not yet reported).

<sup>2</sup> Delivered on 14 March 2006 in C-475/03, *Banca Popolare di Cremona*. It has been preceded by a first Advocate General's opinion delivered by Advocate General F. Jacobs on the same case on 17 March 2005.

ble with the VAT system. Making an assessment of the tax under discussion, the Advocate General asserts in Para 35 of her opinion that the EC Court has rightly taken the view that a tax need not be identical to VAT in all respects in order to be caught by the prohibition. However, it must in any event be regarded as being caught if it exhibits the essential characteristics of VAT. She thinks, what is necessary to find for each of those individual characteristics is not strict and absolute identity but essential, substantive identity.

Even more importantly, in Para 57 the Advocate General holds that Article 93 of the EC Treaty apparently cannot provide a valid legal basis for Community harmonization of direct taxation. Yet, just as clearly, it can provide such a basis for Community legislation prohibiting national taxation likely to jeopardise the functioning of a form of harmonized indirect taxation, such as VAT. It is not necessary to require a different legal basis simply because the national levy in issue may have at least some characteristics of direct taxation. What matters is whether it possesses features, which are likely to jeopardise the functioning of the VAT system, regardless of whether it also possesses others, which are not. She continues in Para 58 that Article 93 EC does not allow Community legislation to encroach on Member States' fiscal sovereignty in the field of direct taxation. Conversely, it does not allow Member States to adopt, in their exercise of that sovereignty, measures likely to jeopardise agreed harmonization of indirect taxation.

Following the EU accession, it is a challenge for the public authorities in Hungary to apply Community law and assess the legal consequences, based on the functional comparison between Community and national law. The legal meaning of national legal provisions cannot be explicated in a static view, but in the context of the Community law, reflecting the internal market as it stands at a certain place and time. The authoritative relationship between Community law and national law cannot be explored unless it is clear what the impact of the national legislation is on the operation of a Community law institution like the harmonized value added tax. The assessment of the same features of national legislation (e.g., the national law on local trade tax) may vary, depending on the influence national law may exercise on the operation of the approximated Community law. Inversely, the accents moving to national legislation may be changed in their application, depending on the relevant Community law policy as it stands.

A statement of the second Advocate General's opinion can be used as an answer for the question posed by the referring Hungarian court to the EC Court concerning the Hungarian case of local trade tax as follows. On a correct interpretation of the Sixth Council Directive, what are the criteria on which a tax may be considered not to be characterized as a turnover tax for the purposes of Article 33 of the Sixth Council Directive?<sup>3</sup> In Para 41, Advocate General Stix-Hackl

<sup>3</sup> Reference for a preliminary ruling from the Zala Megyei Bíróság, Hongrie, lodged on 29 June 2006 – Kőgáz Rt. and others in C-283/06, OJ C 212 (02.09.06), p. 23. Another case has been added to this case under No. C-312/06, OJ C 327 (30.09.06), p. 6, as a result of

concludes in her analysis that a tax is not likely to jeopardise the functioning of harmonized value added tax

- if it does not apply generally (taxes confined to specific categories of goods or services are not likely to interfere with the system as a whole);
- if it is not levied at each stage in the production or distribution chain (such taxes may affect a particular stage in the chain, but not the whole system);
- if it is not proportional to the value added at each stage, and thus to the overall price at each stage (flat-rate taxes can in general coexist in parallel with proportional taxes); and
- if it is not capable of being passed on to the consumer.

The national court, drafting the above question, suggests an answer, which seems to be in the negative rather than in the affirmative. That is, the national court enumerates in the reasoning of its order on preliminary ruling<sup>4</sup> the features of Hungarian local trade tax, which resemble a tax other than a turnover tax for the purposes of the Sixth Council Directive:

- local trade tax is allegedly not of general character (this statement of the referring court is diametrically opposite to the opinion of the Advocate General; see reference to Para 84 below);
- the subject of local trade tax is the entrepreneurial (trade) activities and the taxpayer is the entrepreneur (notably, the basic subject of tax is under the law on local rates the economic – not the entrepreneurial (trade) – activities; this is a case which is also true for VAT);
- the basis for local trade tax is the sales receipts adjusted with certain items while, exceptionally, a kind of lump-sum tax is applicable (suggesting by the court that this tax is different from VAT);
- the determination of tax liability may be departed for various reasons from general rules due to the wide application of tax relief measures (suggesting by the referring court that this tax is different from VAT); and
- local trade tax need not be indicated in a document comparable to an invoice; the shift of the burden of tax to the consumer would not be automatic; the tax included in the sales price cannot be deducted (it is not mentioned in the order of the national court that the basis for local trade tax may be adjusted by certain items with a result comparable in the aggregate to the input tax deduction, calculable with VAT in respect of each single transaction).

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the reference for a preliminary ruling made by the Hungarian Republic's Supreme Court concerning the same legal issue. The Supreme Court reiterated the question the earlier national court has posed regarding the scope of derogation (by its decision No. Kfv. I.35.021/2006/8), lodging on 18 July. However, the second question of the Supreme Court, which covers the substantive law issue, has been converted. Namely, it concerns directly the national tax under discussion. Thus, the Supreme Court asks whether Hungary is not prevented by Article 33 of the Sixth Council Directive from maintaining a tax like the local trade tax in its current form.

<sup>4</sup> Zala Megyei Bíróság, I.K.21.703/2005/13.

Where the scrutiny of a local trade tax is put in the context of the purpose of the European harmonization of indirect taxes, it is not the legal qualification of the national tax under discussion, taken by itself, what is interesting. It is more importantly to seek to receive an answer for the question whether the national tax under dispute jeopardises in its specific form and the harmonized European system of value added taxation. Accordingly, the meaning of Article 33 of the Sixth Council Directive cannot be explored unless it is taken into consideration that

- under Article 93 of EC Treaty, with regard to the smooth operation of the common market, it is prohibited to maintain a national tax which is not compatible with the harmonized indirect taxes;
- according to Article 2 of the First Council Directive,<sup>5</sup> it is prohibited to maintain a national tax which is levied on the added value in a non-cumulative manner.

In the case of Hungarian local trade tax, the requirement that a national tax should be levied on the added value cannot be met in a way only that a tax levied in an earlier stage could be deductible. Instead, this objective can be achieved in a way that sales receipts can be reduced by the costs of purchases, based on the aggregate data of the turnover recorded for tax purposes from time to time. The meaning of Article 33 suggests more than the common system of value added taxation as introduced by the Sixth Council Directive. While implementing Article 93 of EC Treaty, Article 33 does not prescribe that it is prohibited to maintain a national tax that can be characterised by the uniform system of value added taxation as introduced by the Sixth Council Directive. It provides for that it is prohibited to maintain a national tax which is levied on the added value in proportion to the price charged by the taxable person in the instance that the tax payable is the same, irrespective of the number of transactions.

Since the way in which Article 33 is drafted is permissive to the extent that Member States are not prevented from maintaining national taxes that cannot be considered as turnover taxes for the purposes of that Article, the idea of prohibition as covered by Article 33 arises from the very concept of the harmonized value added tax. It is then not reasonable to seek for comparability with the harmonized system of value added tax, strictly speaking, as introduced by the Sixth Council Directive, with particular regard to the expected calculation of tax at each stage of the process of the supply of goods or services and to the deductibility of the input tax levied on an earlier stage as provided for by Article 17 (2) of the Sixth Council Directive. Article 33 need be interpreted, based on Article 93, or even on Article 10, of the EC Treaty: Member States must not jeopardise the attainment of the objectives of the internal market set out by the EC Treaty. Where upon the assessment of a national tax, the common system of value added taxation as introduced by the Sixth Council Directive would serve as a basis

<sup>5</sup> Directive 67/227/EEC, OJ 71 (14.04.67), p. 1301.

of comparison, the purpose of the prohibition as provided for by Article 33 would actually be lost. This is because the question whether a national tax is compatible with harmonized European value added tax has been raised precisely for the reason that the national tax under dispute does not look just the same as the harmonized European value added tax, although it is comparable with it, being levied on the added value in a non-cumulative manner. Paradoxically, a tax resembles the more the harmonized value added tax as introduced by the Sixth Council Directive, it is all the less likely that it would hamper its operation (Para 36).

The Hungarian tax under discussion is surely of general nature. It is based on a national law. Despite the fact that a local government may decide on whether to introduce it, and if so, at what rate (the legal maximum is 2%), typically the tax is introduced, and even at a maximum rate, all over in the country.<sup>6</sup> In contrast to VAT, it is not levied on single transactions. The tax is levied on the value added to be determined from year to year cumulatively. Namely, it applies on the sales receipts, reduced by the goods sold, by certain production costs and by the costs of mediated services as calculated in commercial accounts. However, the way in which the tax payable is calculated is indifferent for the purpose of comparison. While with VAT input tax can be deducted in respect of each transaction, with local trade tax the taxable basis is adjusted by law from year to year. Importantly, local trade tax is levied on sales receipts, like VAT. The subject of taxation is economic activities [Sec. 4 (d) of Local Taxes Act] precisely in the same way as with VAT. The term of economic activities is not defined under the law on local rates independently, unlike the VAT law. Even though differences can be discovered in respect of particular rules on the calculation of tax base, it is sales receipts in both cases, which is the starting point for calculating tax base [Sec. 39 (1) of Local Tax Act; Sec. 22 (1) of VAT Act]. The costs of local trade tax taxpayers incur are in practice typically shifted to consumers while including it to sales prices, even if the expense of paying local trade tax can be deducted by law from corporate tax base. It comes from the foregoing that all the criteria the Advocate General applies can be used to define a tax in the context of the Hungarian case, which can be characterized as turnover tax for the purposes of Article 33 of the Sixth Directive.

The main problem with the standpoint the national court has taken on, presenting local trade tax in case No. C-283/06 is not that it suggests arguments for the compatibility of local trade tax with the harmonized European system of value added tax. The national court poses to the EC Court a question that cannot actually be answered. This is because the national court seeks in essence to be ad-

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<sup>6</sup> According to the Hungarian Government, a tax is not of general application if it is levied at a local or regional level, in particular if it is optional and/or the local or regional authority may determine the rate levied. Advocate General Stix-Hackl does certainly not agree with this opinion (Para 84). She thinks, the question is rather whether the tax is general within its area of application, be that area national or merely local.

vised on the referred legal case in abstract terms as to whether it would be precluded once and for all that the Hungarian law on local trade tax is not compatible with harmonized value added tax. The starting point for studying the problem is Article 93 of EC Treaty, which is the higher legal basis for the assessment of the question of incompatibility. As the second Advocate General of the IRAP case explains (in Para 58 of her opinion), it comes from Article 93 that no national legal measures can be introduced, which would jeopardise the smooth functioning of the internal market, in particular of the harmonized value added tax. Article 93 clearly represents in this respect limits on the national jurisdiction, whether to introduce direct or indirect taxes. However, it can be explored from case to case only whether the particular national law is consistent or not with the relevant Community law. Thus, the Republic of Hungary cannot expect from the EC Court to release a kind of negative clearance for Hungarian local trade tax.

It is possible to give an answer for the question what the features of a tax are that resemble those of a turnover tax for the purposes of the Sixth Council Directive. The EC Court has done the necessary scrutiny in respect of various national taxes. In the present case, the EC Court should put his assessment of Hungarian local trade tax in this line of its judgments. The EC Court should thus change the question the national court has posed to it in order to make itself able to do an assessment of Hungarian local trade tax on its merits as to whether it is compatible with harmonized value added tax.

In the IRAP case, as regards the second essential characteristic of VAT, the EC Court has observed (in Para 30) that, whereas VAT is levied on individual transactions at the marketing stage and its amount is proportional to the price of goods or services supplied, IRAP is, in contrast, a tax charged on the net value of the production of an undertaking in a given period. Its basis of assessment is the difference appearing in the profit and loss account between the “value of production” and the “production costs” as defined by Italian legislation. It includes elements such as variation in stocks and depreciation, which have no direct connection with the supply of goods or services as such. In those circumstances, IRAP cannot be considered proportional to the price of goods or services supplied. The Hungarian local trade tax is not a tax that would be levied on productive activities. In contrast, it is strictly levied on turnover. Although in the IRAP case the EC Court held that the Italian tax under discussion is not incompatible with the harmonized European value added tax, the Hungarian case can be judged differently. This is because Hungarian local trade tax is different from IRA to the extent that IRAP can be levied not only on sales receipts, but also on the increase in the trading stock and in the stock of the own performance.

## V. Interpreting derogation

In its first question the referring national court seeks to get clarification concerning the scope of derogation in respect of local trade tax. That is, the national court asks

- whether the Republic of Hungary has been granted temporarily to maintain local business tax as such (broad interpretation of derogation); or
- it comes from the Act of Accession,<sup>7</sup> providing for the possibility of provisionally maintaining local business tax reductions, that Hungary has been temporarily granted to maintain local business tax (narrow interpretation of derogation; in the English version: “a tax on economic activities”).

The second question concerning the case on its merits is subject to an answer the EC Court may give only where the EC Court’s answer for the first question is completely in the negative.

Chapter 7 (1) of Annex X to the accession treaty makes reference to the Sixth Council Directive, while not containing derogation in respect of Article 33. The provision of Chapter 4 (3)(a) on competition policy of Annex X, making reference to Article 87 of EC Treaty, must not concern the Sixth Council Directive. Application of this derogation rule to Article 93 of EC Treaty and, via this treaty Article, to Article 33 of the Sixth Council Directive, would entail broad interpretation of the accession treaty. This is not justifiable, however, based on the wording of the accession treaty, and with respect to the very sense of the accession treaty that an accession treaty must not modify the EC Treaty, but exceptionally. Even if that would be the case, amendment to the EC Treaty would be possible within specific conditions as provided for by the accession treaty itself only. Immunity from the EC Treaty, by invoking an accession treaty, cannot be accepted by way of the accession treaty’s indirect interpretation. It is thus not possible to conclude merely from the provisions of the accession treaty on local trade tax reductions that Hungary would be granted to maintain local trade tax.

In another Hungarian case concerning the compatibility with Community law of local trade tax (Lakép),<sup>8</sup> the Court determined (in Para 6 of its order) the Community law relevant to the case, which is the taxation chapter, containing derogation in respect of Article 12 (3)(a)-(b) and Article 28 (3)(b) of the Sixth Council Directive only. It comes from this decision of the EC Court that the compatibility of Hungarian local trade tax can be interpreted, exclusively based on the taxation chapter, not containing derogation for Article 33. Hence, it is not possible to conclude from the accession treaty that local trade tax would not fall within the authority of the prohibition of Article 33 on the introduction of taxes, not compatible with harmonized value added tax.

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<sup>7</sup> OJ L 236 (23.09.03), p. 846.

<sup>8</sup> Lakép and others in C-261/05, OJ C 154 (01.07.06), p. 4.

According to Article 49 of the Treaty on European Union, a European state may apply to become a member of the Union, while respecting the principles set out in Article 6 (1). An accession treaty cannot be interpreted as an exception to the EC Treaty. In case of doubts, an accession treaty must be interpreted strictly because the acceding country is willing to accept fundamental freedoms, and the relating institutions, the scope of which cannot be restricted, except as otherwise provided.<sup>9</sup> Since an acceding country does not have an enforceable right to accede, an accession treaty must eventually be interpreted in the light of the “*acquis communautaire*”.

As appears from the ECJ practice, the derogation as provided for by Article 216 of the Portuguese accession treaty must not be interpreted so as to empower a host country to maintain restrictions on the labour market, although the host country may examine from case to case if the home country did not make an abuse of the accession treaty.<sup>10</sup> A host country is obliged to release a residence permit legally employed therein already before the accession, even though restrictions on the national labour market can provisionally be maintained according to Article 216 of the Portuguese accession treaty.<sup>11</sup> The provisions of the Community law must be applicable from the date of accession as such (*ab initio et in toto*), and derogation can be accepted where explicitly provided for by the accession treaty.<sup>12</sup> A Member State is not allowed to extend the scope of derogation to a case not explicitly covered by the accession treaty even where derogation rules can be circumvented, and so the envisaged derogation becomes dysfunctional.<sup>13</sup>

## VI. Tort liability

A claim for compensation for the damages caused by the Republic of Hungary by introducing legal provisions not consistent with the relevant Community law may be enforced. The damages caused is equal to the local trade tax due since the date of Hungary's EU accession, which has been paid, based on the public authority's final decision, but which would not have been paid if the Republic of Hungary had not maintained in effect following the date of accession the legal provisions on local trade tax, not consistent with Community law. The Republic of Hungary infringed the Community law, and so its conduct is illegal.

Based on the judiciary practice developed in Hungary before the EU accession, the liability for the damages caused by legislation was not enforceable. It

<sup>9</sup> Article 6 (1) of the EU Treaty, OJ C 325 (24.12.02), p. 1.

<sup>10</sup> ECJ C-113/89 *Rush Portuguesa* [1990] ECR I-01417, Par 13; ECJ 9/88, *Mario Lopes da Veiga* [1989] ECR 02989, Par 10.

<sup>11</sup> ECJ 9/88 *Mario Lopes da Veiga* [1989] ECR 02989, Par 10.

<sup>12</sup> ECJ C-258/81 *Metallurgiki Halyps* [1982] ECR 04261, Par 8.

<sup>13</sup> ECJ 3 December 1998, C-233/97 *KappAhl Oy* [1998] ECR I-08069, Par 19.

was thus not possible under H<sup>14</sup> that clearly cannot be preserved following the EU accession. According to the EC Court, the full effectiveness of Community rules would be impaired and the protection of the rights which they grant would be weakened if individuals were unable to obtain reparation when their rights are infringed by a breach of Community law for which a Member State can be held responsible (Francovich, Bonifaci in C-6/90, C-9/90).<sup>15</sup> The obligation to make good damage caused to individuals by the breach of Community law cannot depend on domestic rules as to the division of powers between constitutional authorities (Brasserie du Pêcheur, Factortame in C-46/93, C-48/93, Para 33).<sup>16</sup> In international law, a state whose liability for breach of an international commitment is in issue will be viewed as a single entity, irrespective of whether the breach which gave rise to the damage is attributable to the legislature, the judiciary or the executive (Para 34). The fact that, according to national rules, the breach complained of is attributable to the legislature cannot affect the requirements inherent in the protection of the rights of individuals who rely on Community law and, in this instance, the right to obtain redress before national courts for the damage caused by that breach (Para 35).

The provisions of the Sixth Council Directive may have direct effect where the Republic of Hungary maintains its legal rules, not consistent with Community law. Since the free movement of goods principle is impaired to the extent that harmonized value added taxation cannot operate smoothly due to a tax in competition with it, the maintenance of the legal provisions on local trade tax ensues the infringement of fundamental freedoms as enshrined in the EC Treaty. Where the provisions of a directive are clear, precise and unconditional, they may be referred to against any national legal measure, provided that the latter is not in conformity with Community law.

Whilst the Sixth Council Directive undoubtedly confers upon the Member States varying degrees of discretion as regards implementing certain of its provisions, individuals may not for that reason be denied the right to rely on any provisions which owing to their particular subject-matter are capable of being severed from the general body of provisions and applied separately. This minimum guarantee for persons adversely affected by the failure to implement the directive is a consequence of the binding nature of the obligation imposed on Member States by the third paragraph of (old) Article 189 of the EC Treaty. That obligation would be rendered totally ineffectual if Member States were permitted to annul it (Ursula Becker, in case 8/81, Para 29).<sup>17</sup> As regards the administrative difficulties of a more general nature, which are alleged to result from the application of the exemption provided for by the directive, in a situation, in which

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<sup>14</sup> BH 312/1994, BH 264/2002.

<sup>15</sup> ECR (1991), p. I-05357.

<sup>16</sup> ECR (1996), p. I-01029.

<sup>17</sup> ECR (1982), p. 53.

the tax legislation and administrative practice have not yet been adapted so as to take account of the new factors introduced by Community law, if such difficulties were to arise, they would be the consequence of the Member State's failure to implement the directive in question within the period prescribed for that purpose. The consequences of that situation must be borne by the administrative authorities and may not be passed on to taxpayers who rely on the fulfilment of a precise obligation which has been incumbent on the state under Community law since 1 January 1979 (Para 47), the date from which on the Sixth Council Directive has taken into effect.

The damages caused by legislation is imputable to the Republic of Hungary, the government of which could have raised during the accession negotiations that it should have been granted derogation for Article 33, although it had claimed [in Chapter 7 (6) of Annex X], and received, derogation for Article 12 (3). Following the accession, the defendant would have had the opportunity to ask for the opinion of the European Commission concerning the compatibility of local trade tax with harmonized value added tax. However, the defendant has missed this opportunity as well, maintaining the breach of Community law. The liability for the damages caused by legislation can be identified under the practice the EC Court has developed so far, no matter if negligence can be imputed to the Member State, provided that the damages sustained are serious (*Brasserie du Pêcheur*, Para 80).

The causal link as envisaged by the Civil Code on tort liability between the breach of law, imputable to the Republic of Hungary, on the one hand, and the damages caused, on the other hand, can be demonstrated with reference first to the claimant's actions in good faith, trying to complete the dispute as soon and as simply as possible, secondly to the defendant who did not really approach the issue as raised by the claimant in a constructive way. In addition, the damages the claimant has suffered can be traced back to the defendant in the instance as well that the defendant maintains such a legal order of tax administration where the enforcement of Community law is impaired. The claimant asked the tax authority in a procedure of tax administration to confirm that the legal meaning of the effective legal provisions on the determination of the basis and rate of local trade tax has been changed due to the EU accession. In such a case, the tax authority should have arrived at a decision, according to which the liability to pay tax was to be terminated. The appeals made by the claimant in several legal cases have not been accepted well. After then the claimant sued the tax authority by asking before the court the review of the tax authority's decisions.

In the legal cases as initiated, the Finance Ministry instructed local governments, by not only taking the standpoint on the compatibility with Community law of Hungarian local trade tax, but also by encouraging local public authorities to avoid making review of the legal issues generated by the public authority's decisions. In accordance with the stubborn position the Finance Ministry

held, public authorities invited the taxpayer to get involved by filing for tax returns with zero liability in legal disputes, which are much more burdensome due to the likely adverse consequences of the declaration of tax arrears. Constituting obstacles to the legal dispute concerning the conformity of the effective Hungarian law with the Community law results in breach of Community law taken by itself. The Finance Ministry, releasing the above instructions to local public authorities, cannot avoid incurring the responsibility for this failure. The Finance Ministry hampered this way local governments from pursuing legal disputes in a simple and fast way. Hence, the damages caused can certainly be imputed to the Republic of Hungary.

According to the established practice of the EC Court, any provision of a national legal system and any legislative, administrative or judicial practice which might impair the effectiveness of Community law by withholding from the national court having jurisdiction to apply such law the power to do everything necessary at the moment of its application to set aside national legislative provisions which might prevent, even temporarily, Community rules from having full force and effect are incompatible with those requirements, which are the very essence of Community law (Gervais Larsy in C-118/00).<sup>18</sup> Also, according to the EC Court, it is contrary to Community law for a national court to refuse or reduce a claim brought before it by a resident subsidiary and its non-resident parent company for reimbursement or reparation of the financial loss which they have suffered as a consequence of the advance payment of corporation tax by the subsidiary, on the sole ground that they did not apply to the tax authorities in order to benefit from the taxation regime which would have exempted the subsidiary from making payments in advance and that they therefore did not make use of the legal remedies available to them to challenge the refusals of the tax authorities, by invoking the primacy and direct effect of the provisions of Community law, where upon any view national law denied resident subsidiaries and their non-resident parent companies the benefit of that taxation regime (Metallgesellschaft in C-397/98, Hoechst in C-410/98).<sup>19</sup>

Under the established Community law practice, the enforcement of compensation for damages cannot be made dependent on the requirement that before the enforcement of the compensation for damages the EC Court should have confirmed that the litigant Member State had already committed infringement of Community law. Similarly, there is no preliminary condition for the decision on compensation for damages whether according to the European Commission it is reasonable to initiate an infringement procedure under Article 226 of EC Treaty (Brasserie du Pêcheur, Para 95.). The identification of the breach of Community law, underlying the liability for compensation of damages, is a legal issue.

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<sup>18</sup> ECR (2001), p. I-05063, Par 51.

<sup>19</sup> ECR (2001), p. I-01727, Par 107.

As such, it does not require any proof of facts or extra evidence to be shown before the court.

The defendant Member State may challenge the claimant taxpayer's presentation of the damages to be compensated. In particular, the defendant may insist on that the taxpayer has not suffered loss due to tax payment because – as the taxpayer asserted – the tax paid by the taxpayer can be shifted to the consumer. It is questionable, however, whether the financial benefit arising from the shift of tax burden can be substantiated by exact calculation in monetary terms. It must also be taken into account that where the tax payable results in the increase in prices, this is to deteriorate the taxpayer's competitiveness. This is because it is doubtful if in specific cases the taxpayer is able to shift the burden of tax to the consumer, and even if so, how much and in what conditions. No direct relationship can thus be interpreted between the taxpayer's practice to try to shift the burden of tax to the consumer and the reduction, if any, in the loss the taxpayer has suffered. Shifting over the burden of tax is a matter of several factors that cannot necessarily be connected with the shift over of damages. It must be explored from case to case what are the real factors owing to which the burden of tax is shifted over in fact.

One can explicitly confirm that that taxpayer was liable to pay tax and that the taxpayer would have been released from this liability if the defendant Member State had been careful enough to take measures in order to bring into harmony with the "acquis communautaire" the relevant national tax rules. One can assert that the damages the taxpayer has suffered are certain, specific and quantifiable. It is thus clear that there has been tax liability in reality. However, the question whether the burden of it can be switched over is uncertain because it cannot be directly connected with the financial benefit interpretable for the purposes of the civil law on tort liability. That would be possible only where the local trade tax could be mentioned on an invoice and the burden of tax could be recorded in commercial books as an expense. The latter is true for VAT where the tax payable cannot be considered for accounting purposes as income. Neither can the tax deductible be seen as an expense. The burden of local trade tax does not appear, however, in a closed system where the calculation of tax could be separated from the accounting of income and expenses. Simply speaking, while the burden of local trade tax can be passed over economically, this event cannot be interpreted legally.

The above feature of local trade tax does not make it doubtful that local trade tax may well be compatible with VAT from the perspective of a functional analysis. Ironically, for the purposes of making comparison between local trade tax and VAT, it is enough to show that the taxpayer is able to shift over the burden of tax to the extent that local trade tax is levied on sales receipts, no matter which way the tax payable is accounted for. However, the particular financial benefit stemming from the possibility of shifting over the burden of tax cannot be pre-

sented unless the calculation of tax is distinguished from the recording of income and expenses and it can be indicated on an invoice independently.

It comes from the teleological interpretation of local trade tax that it is not precluded that the incompatibility with VAT of local trade tax is found even where in respect of shifting over the burden of tax, local trade tax cannot be compared with VAT. Thus, the national court may conclude that local trade tax is not compatible with harmonized value added tax despite the fact the former cannot be shifted over to the consumer. This case, the reduction in the loss the taxpayer would have suffered due to the payment of local trade tax is obviously precluded.

The litigant taxpayer's statement that the sum of the damages suffered can be equal to the tax, which should not have been paid, provided that national law does not breach Community law, is widely accepted in the Community law practice. As an examples for this can be mentioned the case of Lindöpark where the taxpayer brought proceedings against the Swedish State, seeking for the sum of damages representing the input tax charged to Lindöpark who was not entitled to deduct it due to the fact that the Swedish State failed to implement the Sixth Council Directive correctly.<sup>20</sup> The EC Court agreed that that the taxpayer identified a claim for compensation of damages, equal to the sum of input tax which was not deductible due to the breach by national legislation of Community law in a certain time period starting from the date of Sweden's EU accession. The occurrence of damage was not subject to special verification, not to mention that the taxpayer has missed the opportunity of deducting VAT due to the failure of the Member State to maintain legislation in conformity with Community law.

## VII. Conclusions

The major lesson that can be drawn from the story of Hungarian local trade tax, comparable to the harmonized European system of value added tax, is that controversies may have occurred due to the following insufficiencies of the current Hungarian legal system:

- the local trade tax to be levied on sales receipts, even if adjusted in several instances, may be considered in competition with harmonized value added tax; upon making an assessment, it is crucial to look at the impact this tax may exercise on the smooth operation of VAT, instead of focusing on the question of mere dogmatism if it can be categorized as direct or indirect tax;
- since it is not clear whether Hungarian local trade tax is based on self-assessment or it is of significance that an administrative procedure is inserted which ends with a public authority decision, it is disputable whether a public authority's notice to pay advance tax can directly be challenged by means of legal

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<sup>20</sup> C-150/99, ECR (2001), p. I-00493, Par 13.

actions or filing for a tax return with zero tax liability is required in order to initiate a legal dispute; the Hungarian legal system lacks the facility of opting out of the system of self-assessment; furthermore, it lacks the opportunity for the taxpayer to lodge a tax return with the reservation of title; and

- while the EU accession treaty provides for temporary reductions in local trade tax, it is doubtful if it is possible to conclude from this fact that local trade tax as such would have received special treatment in terms of derogation.