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The compatibility of "national tax principles of the Member States" with a fully integrated market - *First Part*

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1. INTRODUCTION

1.1 The questions to be answered

I am asked to address five questions in this segment. They are as follows:

1. *What are in your opinion with respect to market access and the conditions of free and non-discriminatory competition the standards of a fully integrated market as prescribed by the Treaties of the European Union?*

2. *What is the exact extent of the territoriality principle that was briefly mentioned in the* Futura Participation *case as being compatible with the fully integrated market? In your view is this principle indeed compatible with such market?*

3. *What is the exact impact of the holding of the ECJ that resident and non-resident taxpayers are not in a comparable situation on both nationality non-discrimination and non-restriction principles? How does this holding of the ECJ compare with its decisions in similar situations in non-tax cases and is this compatible with the idea of a fully integrated market?*

4. *Do you think that it would make a difference in the application of the basic economic freedoms by the ECJ if the European legislature would be more successful in establishing European tax rules or if the national legislatures would respond to the challenge by the ECJ in a more coordinated way?*

5. *Would in your opinion a wider application of qualified majority voting in tax matters help in establishing a balance between the fully integrated market and the legitimate fiscal interests of the Member States?*

I implicitly answer questions 1 to 3 in Sections 2 to 6 of this paper. Section 2 considers the scope and application of the Treaty freedoms in the context of the single market. Sections 3 and 4 examine the concepts of nationality discrimination and of market access. Section 5 considers the application of the *Dassonville* formulation of market access in the direct tax area. Section 6 deals with the application of the Treaty freedoms in the Court's tax case law. Section 7 concludes with my answers to Questions 4 and 5.[1]

1.2 The terminology used in this paper

Before I start, I should explain my use of certain terms in this paper and say something about the language of the Court's case law.

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[1] In preparing this paper I have been fortunate to have had the benefit of reading two thought provoking theses, one by Dr Julian Ghosh and the other by Peter Halford, in which they have each considered the application of the Treaty freedoms in the direct taxation field.

The Treaty freedoms guarantee the free movement of goods, persons, services and capital within the Community. I refer to these subjects of free movement as "**products**" and "**producers**".

The Treaty freedoms comprise two principles, which I call "**the market access principle**" and "**the nationality non-discrimination principle**". I explain these in Section 2.2 below. The application of these principles to States depends upon whether a State is acting in its capacity as importer or exporter. I call an importing State the "**Host State**" and the exporting State the "**Origin State**".

In Treaty terms, the "**origin**" of goods corresponds to the "**nationality**" of persons. The Court's use of covert discrimination and of disguised restriction mean, however, that in the direct tax field origin and nationality can be equated broadly to source and residence. Products are the source of a producer's income – his goods, labour, business activities, services and capital – and have their origin in the source State; the producer's State of residence is his Origin State.

The nationality non-discrimination principle relates to the "**internal market rules**" that a State adopts to define and regulate its market. "**Market access rules**" are those rules that a State adopts to regulate entry and exit to its market. Market access rules in particular set out the terms upon which a product or producer may enter or leave the State's market and this is the sense in which I shall use the term.

What appear at first sight as internal market rules may in fact be disguised market access rules if their terms deny benefits or impose penalties on products or producers that enter or leave the State's market. In particular, national tax systems historically have sought to protect national tax revenues by denying the benefits of the internal market rules to products or producers – sources or taxpayers – who enter or leave the national tax market. Such rules can be characterised as internal market rules with market access effects or "**disguised market access rules**".

The rules of national tax systems also tend to include "**internal market rules with extra-territorial application"**. These rules most commonly appear where a producer (taxpayer) is resident in one State and the product (source) is in another. The real issue with these rules is, do they reflect genuine differences in the situation of the domestic *product* according to whether it is generated by a domestic or foreign owner or a domestic *producer* according to whether his product is at home or abroad?

Both can be characterised as involving nationality discrimination, comparing in the first case products in the same territorial market of producers from different markets and in the second case comparing producers in the same territorial market with products in different markets. The first case concerns equal treatment of products under internal market rules (the market being the territorial market for products). The second case concerns equal treatment of producers under internal market rules with extra-territorial application (the market being represented by the exercise of tax jurisdiction by the producer's Origin State).

If in the second case the effect of the rules is to withhold benefits from or penalise producers depending upon whether their *products* stay within the Origin State's territorial market or move abroad, an internal rule with extra-territorial application can be regarded as a disguised market access rule on products.

Perhaps the most confusing word, however, is "**discrimination**". At first glance the Court does not always appear consistent or particularly careful in its use of this word.[2] It appears to use the word not only to refer to nationality discrimination but also in a more general sense of any difference (of which nationality discrimination is but one example) that affects market access. As a result, it is not always clear whether the Court regards the discrimination as involving a breach of the nationality non-discrimination principle or of the market access principle.

There are reasons for this, which I shall explain. In doing so, I shall endeavour in this paper to be precise in my language. "**Nationality discrimination**", qualified in places by "**overt**" or "**covert**", refers solely to discrimination on grounds of origin or nationality involving a breach of the nationality non-discrimination principle. Nationality discrimination relates in particular to internal market rules including internal market rules with extra-territorial effects.

"**Market access discrimination**" and "**a difference in treatment**" refer to any difference that identifies a measure as relating to an actual or a potential cross-border movement, raising the question whether there is a breach of the market access principle. In particular, market access discrimination may identify an internal market rule as one that is in reality a disguised market access rule. True market access rules are not usually discriminatory at all.

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[2] A point that commentaries and articles and, indeed, the case law of Member States, may then reflect.

1.3 A word on Marks & Spencer

Finally by way of introduction and as I must necessarily deal with it in the context of this paper, I should say something about *Marks & Spencer* v *Halsey*.[3] Readers should not be surprised to find that the paper opens with the proposition that the Commissioners reached the correct decision in that case.[4] Elsewhere in this paper, I refer as appropriate to the Commissioners' answers on particular issues where that relates to the analysis in this paper.[5]

2 – The Single Market Principles of the EC Treaty

2.1 The relationship of Community and national law in direct taxation

Throughout its case law, the Court of Justice of the European Communities (hereafter "the Court" or "ECJ") has consistently stated the relationship between Member State and Community competence in direct taxation in these terms [6]—

> "Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law"

The Court has accordingly drawn a line – and has done so consistently – between:

- the power to tax (or not) – which is exclusively a matter for Member States – and
- the manner in which Member States choose to exercise their powers – which is a matter that falls within the dual competence of the Member States and the Community.

Briefly, the issue is how a Member State exercises its taxing power; not whether or not it chooses to do so.

The Community may not deny a Member State the right to tax; nor may it require it to do so.

If a Member State refrains from exercising its taxing power, by not taxing at all or by drawing the boundaries of its taxing jurisdiction at a particular point, the Community acquires no competence to act. In this respect there is a distinction between a case in which the State has drawn its taxing jurisdiction so that a product or producer is outside that jurisdiction and those cases in which products and producers are within the scope of its jurisdiction but exempt from tax. The latter – but not the former – corresponds to abstaining from action or failing to take adequate measures.[7]

The Community cannot create for itself a competence to act in direct tax matters by requiring that a Member State exercise its taxing power in a particular respect when it has chosen not to do so.[8] This would shift the Community's competence in taxation from negative integration to positive harmonisation.[9]

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[3] [2003] Simon's Tax Cases (Special Commissioners' Decision) at page 70.

[4] The author was one of the Special Commissioners.

[5] It bears stating for those unfamiliar with English judicial proceedings, that a decision in any case cannot be divorced from the way in which the parties have chosen to put their case to the Tribunal. The terms of the Commissioners' decision therefore necessarily reflect the arguments put by both parties for and against the proposition that Community law allowed Marks & Spencer the right to claim group relief for the losses of its foreign subsidiaries.

[6] Case C-279/93 *Schumacker*, [1995] ECR I-225, paragraph 21. The ECJ cites Case C-246/90 *Commission* v *UK*, paragraph 12 as its authority. That case concerned the nationality requirements enshrined in sections 13 and 14 of the UK's Merchant Shipping Act 1988. Paragraph 12 of the decision states that "powers retained by the Member States must be exercised consistently with Community law (see most recently Case 57/86 *Hellenic Republic* v *Commission* [1988] 2855, at paragraph 9, and in Case 127/87 *Commission* v *Hellenic Republic* [1988] ECR 3333, at paragraph 7)."

[7] See in another context Case C-265/95 *Commission* v *France (Spanish Strawberries)* [1997] ECR I-6959, paragraphs 30 – 32. Products and producers that would be within the State's jurisdiction but its having agreed to exclude them under a bilateral tax treaty are not outside the scope of the State's exercise of jurisdiction but rather exempt. The entering into the bilateral treaty is in effect an exercise of the State's jurisdiction.

[8] Nor can taxpayers seek to invoke Community competence by requiring the Member State to extend its taxing jurisdiction further than it has chosen to do so. This, briefly, was the basis of the Commissioners' decision in *Marks & Spencer plc* v *Halsey* [2003] STC (SCD) 70. The UK had chosen not to tax the foreign subsidiaries of Marks & Spencer and the Commissioners therefore decided that Marks & Spencer could not invoke Community law to oblige the UK to give relief for their losses. The fact that the UK allowed Marks & Spencer to claim relief for the losses of those subsidiaries or branches over which the UK *had* exercised its taxing power did not oblige the UK to extend relief to losses of foreign subsidiaries over which it

Once a Member State has exercised its taxing power, however, the Community's competence is engaged. The question then becomes to what extent does Community law dictate the manner of its exercise?

To answer that question, I need to examine the basis for Community competence in taxation matters as expressed in the Treaty and interpreted by the case law of the Court.

2.2 The basis of the single market

The single market is founded upon the principle of the free movement of goods and of the factors of production. The Treaty Articles that give effect to the free movement of goods, persons, services and capital have a common basis in the principles in Part 1 of the Treaty establishing the European Community. In this paper I use the terms "**products**" and "**producers**" rather than goods, persons, services and capital. The words "products" and "producers" in my view better convey the essential character or quality of the good, person, service or capital for which the Treaty guarantees free movement.[10] They also reflect the basis upon which States internationally allocate taxing rights by reference to residence (producers) and source (products).

Each of the Treaty freedoms in its own terms encapsulates the abolition of obstacles to the free movement of products and producers and the prohibition of discrimination on grounds of origin (products) or nationality (producers). I refer to these two single market principles as "**the market access principle**" – *the abolition of any obstacle to the movement of products and producers between the different markets of the Member States* – and "**the nationality non-discrimination principle**" – *the ability to compete on equal terms with local products and producers within the market of each Member State*. I refer to these principles collectively as "**the Treaty freedoms**".

As a matter of expression, the principles appear in the Treaty in terms of "an abolition of obstacles" and "a prohibition on discrimination on grounds of nationality". I have, however, underlined the key aspect of differentiation. The market access principle involves the removal of obstacles *between* markets notwithstanding their differences (which, as I shall explain, is not the same as a requirement for Member States to establish common markets). The nationality non-discrimination principle involves the removal of discrimination on grounds of origin or nationality *within* the market of a particular Member State.

In the Treaty, the Treaty freedoms first appear as separate principles. The market access principle is found in Article 3(1)(a) and (c) [11] and the nationality non-discrimination principle derives from Article 12.[12] Together they form part of the mechanisms through which the Community seeks to fulfil the task it has set itself in Article 2 of the Treaty. [13] In Community terms, they are therefore closely related.[14]

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had not exercised its taxing power. As the relief applies to *tax* losses (not accounting or commercial losses as such), the relief in question requires a positive assertion of taxing jurisdiction for the losses to have any existence.

[9] The approximation of laws is one of the means recognised in Article 3(1)(h) for achieving the task set by the Community in Article 2. The approximation is only to the extent required for the functioning of the common market and is subject to the overriding principle of subsidiarity recognised in Article 5. Articles 94 to 97 make clear that the approximation of laws, including direct taxation, is a matter for legislative agreement between the Member States rather than action by the Court.

[10] In particular, the word "products" suggests the similarities that can exist between goods, services and capital where services represent the outcome of productive effort and capital the product of saving. "Producers" illustrates in a tax context the differences that arise between the indirect taxation of products and the direct taxation of those who produce them.

[11] "(1) For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein: (a) the prohibition, as between Member States, of customs duties and quantitative restrictions on the import and export of goods, and of all other measures having equivalent effect; (c) an internal market characterised by the abolition as between Member States, of obstacles to the free movement of goods, persons, services and capital;" Article 14(2) describes the internal market as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty."

[12] "Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited." The origin of products is equivalent to nationality for producers.

[13] "The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious and balanced and sustainable development of economic activities, a high level of employment and social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States."

[14] See Case 270/83 *Commission* v *France* (the *Avoir Fiscal* case), paragraph 15 (emphasis added): "It thus appears that the two submissions put forward by the Commission, namely that concerning discrimination in French law against branches and agencies of insurance companies established in other Member States vis-à-vis companies established in France and that concerning the restriction of the freedom of foreign insurance companies to establish branches and agencies, *are closely linked*. They must therefore be considered together." To understand this paragraph one has to appreciate that the right to choose whether to establish as a branch or a subsidiary is a facet of the market access principle, preventing Origin and Host

2.3 The relationship between the Treaty freedoms

The Treaty freedoms are closely related because the Treaty Articles dealing with the free movement of goods, persons, services and capital give effect to both principles in their particular areas of application. This combination of the Treaty freedoms in Titles I (free movement of goods) and III (free movement of persons, services and capital) of Part 3 (Community Policies) of the Treaty reflects that they are a single expression of a Community founded on the free movement of products and producers.

By definition, any product or producer that is of different origin or nationality has to come into a market to experience discrimination *within* that market, i.e. nationality discrimination. Discrimination by reference to nationality or origin in the way in which products or producers are treated *within* a market is almost certainly bound to inhibit access to that market to a degree, and therefore movement between markets.[15]

The extension of nationality discrimination from **overt** discrimination based on origin or nationality *in law* to **covert** forms of nationality discrimination based on other criteria of differentiation that lead *in fact* to the same result,[16] has further muddied the waters between the market access principle and the nationality non-discrimination principle.

In law, covert nationality discrimination is *not* nationality discrimination at all. It can therefore only involve a breach of the Treaty freedoms because the effect of a covertly discriminatory measure is *in fact* to impede market access. In effect, covert nationality discrimination breaches the Treaty freedoms because the criteria of differentiation that lead to the breach identify the measure with the cross-border issues of market access and the discrimination involved in fact impedes access. In those circumstances it may seem unnecessary to decide in any particular case whether covert discrimination is truly nationality discrimination in the same sense as *overt* nationality discrimination or represents a form of market access discrimination, the effect of which is to breach the market access principle.[17]

The distinction between the Treaty freedoms is yet more confusing in the direct tax field. This is because the scope and application of a State's taxing jurisdiction may not correspond to the territory represented by its national borders. In other words, in the taxation field a State frequently exercises an extra-territorial jurisdiction. Movements into and out of the State's taxing jurisdiction may not coincide with movements into and out of its national territory. For this reason, as I shall explain, the principles of market access and nationality non-discrimination can appear to overlap in the direct tax field.[18]

2.4 The essential difference between market access and nationality non-discrimination

Notwithstanding these close and potentially confusing relationships, the essential distinction between the Treaty freedoms is this. In determining whether there is a breach of the market access principle the question is whether *the effect of any measure* is to inhibit or impede the movement of a product or producer *between* markets. Is the product or producer seeking to enter or leave a market and, if so, does this measure impede its entry or exit? As such, discrimination is not a necessary feature of the market access principle. Once a product or producer is *within* a market, the focus shifts to the State's internal market rules. Those internal market rules must not incorporate any form of nationality discrimination.

Nationality discrimination is therefore different from market access discrimination. Nationality discrimination always involves comparing how the internal market rules treat two similar or competing products or producers of different origins or nationalities. All that market access discrimination involves is a difference in the way the State's rules operate according to whether the product or producer stays within its market or moves to another market.

States impeding the movement of products or producers *between* their markets. For this reason the attempted French justification that foreign insurers could always incorporate a French subsidiary was doomed to failure. The nationality discrimination of which France was guilty by taxing the branches of foreign producers less favourably than local producers (including local subsidiaries owned by nationals of other Member States) concerned the nationality non-discrimination principle that applied to France as the Host State *within* whose market the product or producer was found.

[15] For the expression of this, see Joined Cases C-267/91 and C-268/91 *Keck* and *Mithouard* [1993] ECR I-6097, paragraph 16 (emphasis added), "… national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade *between* Member States …, *so long as* those provisions apply to all relevant traders operating within the national territory and so long as they affect *in the same manner*, *in law and fact*, the marketing of domestic products and of those from other Member States."

[16] Case 153/73 *Sotgiu* v *Deutsche Bundepost* [1974] ECR 153, paragraph 11.

[17] This is presumably one reason why the Court has allowed public interest justifications to extend to both covert nationality discrimination and market access. The only justification for overt nationality discrimination remains one of those specified in the Treaty.

[18] See Section 2.6 below.

Market access discrimination serves to identify particular measures with movements between markets, leading to an enquiry as to whether their effect is to impede movement. Market access discrimination is not, however, a necessary feature of the market access principle. Thus, the market access principle applies both to market access rules that simply lay down the terms on which products or producers may move between markets and to internal market rules that involve no nationality discrimination but which in fact impede market access.

In a sense, therefore, the market access principle has priority. The enquiry into whether a particular measure infringes the Treaty freedoms can always be conducted in terms of whether the effect of the measure is to impede market access, on the basis that it will always have that effect if it involves nationality discrimination.[19] Eliding the two aspects of the Treaty freedoms in this way, however, masks differences in the way they apply from the perspective of a Host and an Origin State. Greater clarity is achieved, therefore, if the two principles are dealt with separately while recognising their close relationship. On this basis, covert nationality discrimination concerns the application of the nationality non-discrimination principle to the internal rules of a Member State's market notwithstanding its market access overtones or associations.

2.5 The field of application of the Treaty freedoms

The market access principle poses the question whether the effect of a measure is to impede the movement of the product or producer between markets; the nationality non-discrimination principle poses the question whether the product or producer is discriminated against on grounds of origin or nationality within a market. *Both questions have to be answered by reference to the market of the particular Member State whose measure is said to involve the breach and the rules that it adopts to regulate its market.* The questions cannot be answered by reference to something that is not within that market (and is not seeking to enter it) but is comprised in the market of another Member State or by comparison with how other Member States regulate their markets.[20]

As this suggests, an important preliminary issue is to define the field of application of the Treaty freedoms, i.e. *the market by reference to which the issues of access and nationality discrimination have to be answered*. In other words, what lies within the market and what lies (or has moved) outside it,

a. into or out of which access is sought in the case of the market access principle, or

b. by reference to which nationality discrimination is determined?

2.6 The field of application in tax matters

In the tax field, because they can decide whether and to what extent they should exercise their taxing powers, Member States can in effect define the scope of their markets within which Community law operates by the way in which they choose (or not) to exercise their taxing powers.

This presents little difficulty for taxes on products because a State usually only exercises taxing powers in respect of products within the borders of its national territory.[21] It is different in the case of producers. States usually exercise extra-territorial taxing rights against producers that are based in its territory in respect of what they produce both at home and abroad.[22]

The key to understanding the Court's case law in the direct taxation field is the recognition that direct taxes are taxes on producers in respect of the outcome of their production. The direct tax base, in effect, incorporates both products and producers within it. Indirect taxes, by comparison, only incorporate products and not producers within its tax base.[23]

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[19] See Joined Cases C-267/91 and C-268/91 *Keck* and *Mithouard* [1993] ECR I-6097, paragraph 16 cited in footnote 15 above.
[20] Case C-384/93 *Alpine Investments BV* v *Minister van Financiën* [1995] ECR I-1141, paragraph 27, "A prohibition such as that at issue in the main proceedings does not constitute a restriction on the freedom to provide services within the meaning of Article [49] solely by virtue of the fact that other Member States apply less strict rules to providers of similar services established in their territory (see the judgment in Case C-379/92 *Peralta* [1994] ECR I-3453, paragraph 48)."
[21] This is because it usually has no practical way in which it can enforce its tax claims while products are abroad.
[22] In practical terms this is usually a great deal easier in the case of natural persons than it is for legal persons, such as companies and other legal entities, whose association with a particular State may be tenuous and easily changed.
[23] There is an important relationship here with the issues of income and consumption taxation. Economic income comprises both consumption and savings (i.e. current and future consumption). The consumption tax base comprises only consumption. Accordingly, for every problem encountered in defining and taxing consumption for consumption tax purposes there is a counter-part in the income tax base (which includes consumption). The problems of defining and taxing savings, however, are unique to the income tax base. The difficulties of income taxation internationally derive significantly from the savings component of the tax base and therefore have no counterpart in consumption taxes. In the present context, the territorial

As a result, an internal market rule with extra-territorial application for a *producer* may be a disguised market access rule when viewed from the perspective of the *product*. In other words, in the direct taxation field, it may be necessary to consider the application of market access and nationality non-discrimination principles from the perspective of both products and producers by reference to the market created by the State's exercise of extra-territorial taxing powers and the impact of its internal market rules on the territorial location of products.

The diagram below reflects the relationship between jurisdiction in direct tax systems and the national territory of Host and Origin States. OS represents the territory of the Origin State from which a product or producer originates. HS and HS/OS represent the territory of a Host State within which the Host State can exercise its taxing jurisdiction over products and producers coming from OS. HS/OS represents that part of the Host State's territory in which the Origin State claims jurisdiction to tax the product of producers that remain based in OS. HS is the territory of the Host State outside the taxing jurisdiction of the Origin State, where the Origin State makes no claim to tax products and producers that originated from its territory.

The diagram illustrates that the tax territory of any Member State (within which it exercises its taxing jurisdiction) need not coincide with the physical borders of its territory.[24] Furthermore, each Member State is free to decide how far (if at all) to extend its taxing jurisdiction beyond its national territory. The existence and size of the area covered by the OS/HS territory accordingly represents the exercise of powers that are within the States' exclusive competence. Community law may say whether an Origin State has exercised its jurisdiction in a valid way but may not dictate that the Origin State reduce or extend the HS/OS area.

It will also be appreciated that the provisions of bilateral tax treaties between OS and any of the four Host States represented in the diagram will affect the way in which any of those State taxes within the lines of the diagram relative to the territory of the particular State. A bilateral tax treaty between OS and any of HS may have the effect of extending OS's exclusive jurisdiction beyond its territory into HS territory (where HS allows OS exclusive taxing rights) or the HS area (where OS allows HS exclusive taxing rights). In either case, the HS/OS area of double taxation will be reduced. The Treaty may also affect the way OS or HS apply their tax rules to particular products or producers within the HS/OS area.

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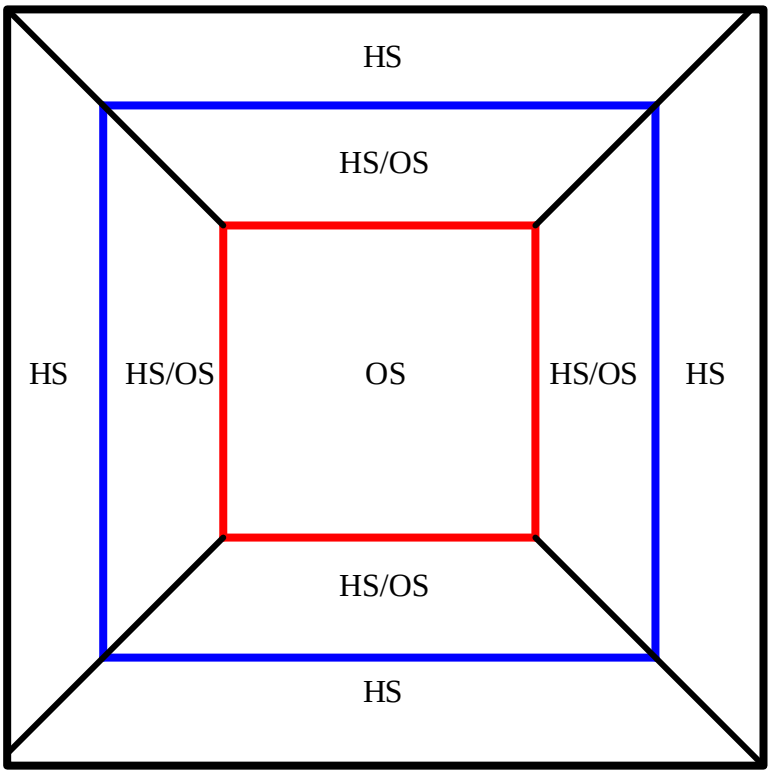
jurisdiction exercised by a State represents the common element of both direct and indirect taxation. The extra-territorial taxing jurisdiction exercised by a State represents the unique aspect of direct taxation and corresponds to the savings component of the income tax base.

[24] Thus, although HS/OS and HS can be regarded as representing the national territory of HS, HS may choose not to exercise its taxing rights over products or producers that enter its territory.



It is important to understand that while the agreement of a bilateral tax treaty may reduce or eliminate the HS/OS area that does not involve redrawing the lines of the diagram in terms of the exercise or not of a State's taxing powers. The agreement of a bilateral treaty represents the exercise by the State of its tax jurisdiction.[25]

To the extent that a State has chosen to exercise its taxing powers, the market access issue is whether, having done so, the consequences of coming within or leaving the State's taxing jurisdiction have the effect of impeding a product's or producer's entry or exit from that State.

The diagram illustrates that, in the case of products, this will be by reference to the tax consequences of the product entering or leaving the territory of the State. In other words, when the product leaves OS and enters either HS or HS/OS even though, while it remains within HS/OS, it remains part of the tax base in the Origin State of a producer based in OS.

The market access principle will also operate for producers by reference to when they leave or enter the taxing jurisdiction of a State, which will usually involve their moving out of the Origin State's territory. In this case, however, it is not every occasion on which a producer moves across national borders that involves it leaving the taxing jurisdiction of their Origin State or entering the Host State's taxing jurisdiction.[26] And their entry and exit from the taxing jurisdiction of either State, when it occurs, may be unrelated to where their products are

[25] Thus, a branch establishment will be within HS/OS even in those cases in which OS has agreed under a bilateral treaty not to tax its producer in respect of the establishment's profits. For a branch establishment to be outside HS/OS OS must effectively choose not to tax its producers extra-territorially. Similarly, a foreign subsidiary is usually within HS as a national of HS over which OS exercises no taxing powers. Only if OS extends its taxing jurisdiction to foreign subsidiaries will the subsidiary fall within HS/OS. In this respect, the exercise by OS of its taxing jurisdiction over its nationals in their capacity as shareholders does not bring the subsidiary within OS' taxing jurisdiction.

[26] The same point is true for products but it is more apparent in the case of producers because most taxes on products are territorial taxes while those on producers are not.

located.[27] Thus a move from HS/OS to HS marks a market exit from OS that engages the market access principle.[28]

While it is within the scope of a State's taxing jurisdiction, however, the product or producer is within the internal market rules of that State. At that point, the issue is whether its tax rules involve nationality discrimination, including covert nationality discrimination by not according the producer equal treatment at home and abroad.

Later Sections of this paper consider these issues further. It is implicit in this analysis, however, that the exercise or not of the Member State's taxing power, is outside the scope of Community law. Thus, the definition of tax residence and source are not matters that fall within the competence of Community law.[29] Otherwise Community law would be able to dictate what a State can and cannot tax rather than the manner in which it taxes products and producers within the jurisdictional tax market it has chosen.

Once a Member State has determined its jurisdictional tax market, Community law can intervene. As I noted in relation to the diagram, one Member State may agree with another to modify their domestic rules on residence and source through a double taxation convention. The Treaty freedoms then apply by reference to their agreement, which may alter the boundaries of the State's taxing jurisdiction and therefore the application of the market access principle in a particular case. Furthermore, if a State has agreed to surrender its taxing power over a particular product or producer, it cannot devise internal market rules to compensate for what it has given up. Community law in effect holds it to its agreement and the Community law consequences that flow from it.[30]

2.7 Cohesion and comparative advantage in a single market

The Treaty freedoms permit (without the need for justification) any internal market rules that apply without nationality discrimination and without being a disguised market access rule. The essential question, not finally resolved by current case law, is whether in the tax field—

- an internal market rule
- that applies without nationality discrimination
- but which has an extra-territorial territorial application

involves a breach of the market access principle on the basis that its extra-territorial application necessarily impedes the movement of products or producers between markets.

The Court has not had to resolve this issue because every tax case has clearly involved either a disguised market access rule or nationality discrimination. The case that perhaps comes closest to illustrating this issue is *Bachmann,* which concerned an internal market rule (the rules concerning the taxation of Mr Bachmann as a Belgian resident) with extra-territorial application (dealing with his deduction of payments for services sourced outside Belgium).[31]

The decision in *Bachmann* can be approached as a decision that Belgium (as Host State) could justify taxing imported services differently to the equivalent domestic services to ensure equal treatment of those services within its domestic market. Because a Host State does not usually tax imported services,[32] it can only secure equal treatment indirectly by applying a different internal market rule to consumers that choose foreign rather than domestic services.[33] Accordingly, the internal market rule has an extra-territorial application. If, however, the rule does produce a level playing field in the Host State on which the providers of services can compete,[34] is

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[27] For example, an individual (producer) resident in OS may already be working (product) in HS/OS when she moves her residence to HS.
[28] This will usually apply to natural persons but may apply to legal persons if they are capable of moving their seat from one State to another, see Article 48 and Case 81/87 *Daily Mail*. This will be possible for the *Societas Europaea* under the European Company Statute. The conversion of a taxable foreign branch into a non-taxable local subsidiary does not involve the market exit of a producer from OS but the export of its productive capacity from HS/OS to a new producer in HS.
[29] Case C-336/96 *Gilly.*
[30] Case C-80/94 *Wielockx*.
[31] Case C-204/90 *Bachmann* v *Belgian State* [1992] ECR I-249.
[32] It only taxes if the service provider establishes itself in the Host State.
[33] Note that "consumers" may also be producers in the case of financial services, where the product is a savings instrument of some sort.
[34] Or, as the Court decided, any market access effects that arose from the perspective of the product – the supply of services sourced abroad rather than at home – are justified as securing the cohesion of the Host State's tax system from its internal market perspective.

there nevertheless a breach of the market access principle given the extra-territorial effects of the internal market rules?

The tax case law dealing with services should be viewed from a market access perspective rather than from the perspective of equal treatment of domestic consumers. Different taxation of Host State consumers according to whether they buy at home or abroad is a market access issue and not one of nationality discrimination under the internal market rules that apply to consumers.[35]

You can understand the rationale for this by reference to the competitive basis for the single market.[36] Consumers should be free to access the cheapest services available in the single market. It is not for the Host State to counteract the comparative advantage enjoyed by foreign goods and services by raising the cost of those services to protect its domestic goods and services. In this context it was unexceptional for the Court to say in *Eurowings* that—

> "Ant tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State."[37]

The same arguments do not necessarily apply from the Origin State's perspective.[38] Thus it is possible to think about the extra-territorial taxation of *producers* (rather than consumers) by an Origin State in terms of nationality discrimination. Thus, from the perspective of a foreign insurance company, bank or lessor, the issue is whether the internal market rules of their Origin State, in order to secure equal treatment in its market, can tax its producers differently in respect of services supplied abroad as compared with services supplied in the domestic market. I return to this issue in Section 3.3 below.[39]

2.8 Determining what the Treaty freedoms permit

From this discussion, consideration of whether the Treaty freedoms permit particular internal market rules might be approached in five stages—

1. First, identify the market by reference to which the matter is to be determined. In tax terms, this depends on the extent to which the Member State has exercised its taxing powers (including the surrender of those powers by agreement with another Member State).

2. Is the measure a market access rule (explicitly dealing with the terms of entry and exit from that market) or part of the State's internal market rules (defining and regulating the economic activities of products and producers within that market)? In the tax field—

   - a market access rule is one that sets out the terms on which a product or producer comes within or leaves the State's taxing jurisdiction, and

   - an internal market rule is one that determines the liability to tax of those products and producers over which the State has exercised its taxing jurisdiction.

3. Notwithstanding that the rule appears to be part of the internal market rules for determining liability to tax, are its terms such that it is in fact a disguised market access rule?

4. If it is an internal market rule (with or without extra-territorial application), does it in fact apply without giving rise to nationality discrimination?

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[35] This is clearly reflected in the case law, see Case C-204/90 *Bachmann*; Case C-484/93 *Svensson and Gustavsson*; Case C-118/96 *Safir*; Case C-294/97 *Eurowings*; Case C-55/98 *Bent Vestergaard*; Case C-136/00 *Danner*; Case C-422/01 *Skandia*.
[36] As represented by the economic theory of comparative advantage.
[37] Case C-294/97 at paragraph 44.
[38] This is not to say that the Origin State can disadvantage its suppliers in respect of their foreign services. Provided, however, the Origin State affords equal treatment to their domestic and foreign services, they cannot complain if that leaves them in an uncompetitive position in the Host State. This is an aspect of reverse discrimination, which is in effect what the Host State is doing when it leaves its producers at a competitive disadvantage to imported goods and services, as in the case law cited in footnote 35.
[39] The answer is likely to be that the Origin State cannot apply a different internal market rule in such circumstances where the Host State either does not seek to exercise or has agreed under a Treaty not to exercise any taxing jurisdiction over the services. In those circumstances, the less favourable taxation of services supplied abroad is effectively an export restriction by the Origin State, see Case C-251/98 *Baars*; Case C-35/98 *Verkooijen*.

5. Even if it is an internal market rule with extra-territorial application that is applied without nationality discrimination, does it nevertheless have the effect of impeding the movement of products or producers between markets?

In many cases it is unnecessary to disentangle nationality discrimination and market access in this way. In analytical terms, however, the importance of doing so lies in ascertaining the breach, the justification and the remedy in any particular case. This, in the current tax case law most internal market rules with extra-territorial application have been found to constitute disguised market access rules that fall at stage 3. Stage 4 has largely concerned internal market tax rules without extra-territorial application. It is important to understand why the Court has adopted this perspective, if only to understand what is needed to correct the breach and ensure no future breach.

The issues of breach, justification and remedies stem from the application of each principle according to whether the State concerned is acting in its capacity as importer or exporter. I call an importing State the "**Host State**". The exporting State I call the "**Origin State**", being the State from which products and producers originate.

All States are simultaneously Host and Origin States but this does not affect the importance of analysing in what capacity a State is acting as a means of seeing how the principles affect the exercise of its competences. I therefore analyse nationality discrimination and market access from both perspectives in Sections 3 and 4.