Fordham International Law Journal

Volume 31, *Issue* 5 2007 *Article* 14

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Abstract

After considering the evolution and scope of the capital movement rules, this Article will examine two distinct themes: 1) the treatment of discriminatory taxation under the capital movement rules, looking in particular at whether there is a coherent approach to this issue across the Treaty "freedoms," and 2) the reaction of the European Court to the extension of the capital movement rules to third countries.

THE EVOLUTION OF THE FREE MOVEMENT OF CAPITAL

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INTRODUCTION

The free movement of capital is the only "freedom" under the Treaty Establishing the European Community ("EC Treaty") where the original Treaty rules have been repealed and replaced. The original provisions were also unique in being so drafted as to be held incapable of giving rise to rights enforceable by individuals before their national courts, so that liberalization of capital movements within the European Community ("EC") was eventually achieved in 1990, more than twenty years late, by virtue of a series of Council Directives. The Maastricht Treaty, which set out the institutional provisions relating to Economic and Monetary Union, introduced new capital movement provisions which entered into force on January 1, 1994 (the start of the second stage of Economic and Monetary Union). While, like the other freedoms, these rules are capable of direct effect, they are distinctive in two other ways: they in principle extend to movements to and from third countries as well as to movements within the EC, but on the other hand they appear to allow for a degree of differential tax treatment on the basis of residence or place of investment. Further complications arise from the fact that the European Court of Justice ("ECJ" or "Court of Justice") has consistently held that the definitions of capital movements set out in the last of the old Directives—definitions which appear to overlap with freedom of establishment and freedom to provide services—should be applied in the context of the current rules. After considering the evolution and scope of the capital movement rules, this Article will examine two distinct themes: 1) the treatment of discriminatory taxation under the capital movement rules, looking in particular at whether there is a coherent approach to this issue across the Treaty "freedoms," and 2) the reaction of the European Court to the extension of the capital movement rules to third countries.

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I. *THE ORIGINAL TREATY RULES ON FREE MOVEMENT OF CAPITAL*

The basic requirement set out in Article 67(1) of the original Treaty Establishing the European Economic Community ("EEC Treaty") was that during the transitional period, Member States should progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested, but only "to the extent necessary to ensure the proper functioning of the common market."[1] With regard to transitional and standstill arrangements, the original Article 68(1) required Member States to be "as liberal as possible" in granting such exchange authorizations as were still necessary after the entry into force of the Treaty.[2] Additionally, the original Article 71 required Member States to "endeavour to avoid introducing within the Community any new exchange restrictions on the movement of capital and current payments connected with such movements, and to endeavour not to make existing rules more restrictive."[3]

Briefly summarizing the remainder of the original version of the Title, Article 69 enabled the Council to issue directives for the implementation of Article 67, acting by a qualified majority from the beginning of the third stage (i.e. January 1, 1966). Articles 70 and 72 dealt with the question of capital movements between Member States and third countries, and Article 73 enabled protective measures to be authorized by the Commission or, under Article 73(2), to be taken by the Member State itself in case of urgency.

The legal effects of Article 67 of the original version of the EEC Treaty were considered by the European Court in *Criminal Proceedings Against Guerrno Casati*.[4] It has been seen that Article 67 differed from the other freedoms laid down by the Treaty in that it was not drafted in absolute terms. It does not require restrictions on the movement of capital simply to be abolished;

1. Treaty establishing the European Economic Community art. 67(1), Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter EEC Treaty].
2. *Id.* art. 68(1).
3. *Id.* art. 71.
4. *See* Criminal Proceedings Against Guerrno Casati, Case 203/80, [1981] E.C.R. I-2595.

rather it requires them to be abolished "to the extent necessary to ensure the proper functioning of the common market." In *Casati* it was held that the scope of that restriction might vary in time and depended on an assessment of the requirements of the common market and on an appraisal of both the advantages and risks which liberalization might entail. It was further stated that such an assessment was "first and foremost" a matter for the Council, and that the obligation to abolish restrictions on movements of capital could not be separated from the Council's assessment of the need to liberalize the category of transactions in question.

In other words, it was not a straightforward rule which a national court, or even the Court of Justice, could apply directly, but essentially a question of policy for the Council, being that the role of the Court is limited to checking whether the Council had overstepped the limits of its discretion. The Court concluded that there was no reason to suppose that, by taking the view at that stage it was unnecessary to liberalize the exportation of banknotes, the Council had in fact overstepped those limits.

With regard to the "standstill" provision in the original Article 71, the Court again noted that by stating that Member States "shall endeavour" to avoid introducing within the Community any new exchange restrictions on the movement of capital and current payments connected with such movements, and shall "endeavour" not to make existing rules more restrictive, the wording of that provision departed noticeably from the more imperative forms of wording used in the other Treaty freedoms, and did not impose on Member States an unconditional obligation capable of being relied on by individuals.

II. *THE CAPITAL MOVEMENT DIRECTIVES*

Although the original Treaty provisions themselves may not have been capable of giving rise to rights enforceable by individuals, the first Council Directive under the original Article 67 was enacted during the first stage of the original transitional period on May 11, 1960,[5] and was amended by Directive 63/21 at the end of 1962.[6] It may be observed that in their recitals, these Di-

5. *See generally* Council Directive, First Directive for the Implementation of Article 67 of the Treaty, O.J. 43/921 (1960).

6. *See generally* Council Directive No. 63/21, O.J. 9/62 (1963).

rectives claim to be made under a number of Treaty provisions, including not only Articles 67 and 69 on capital movements but also the former Article 106(2) on current payments. The basic pattern established by these Directives was to divide capital movements into four lists, with different degrees of liberalization. Member States were required to grant "all foreign exchange authorisations" for the transactions or transfers set out in List A, which included direct investments (defined so as to exclude purely financial investments) in an undertaking in another Member State, investments in real estate, certain personal capital movements, short (one year) and medium-term (one to five year) credits related to commercial transactions or provision of services, death duties, and damages to the extent they may be regarded as capital.[7] List A also included transfers in performance of insurance contracts "as and when free movement in respect of services"[8] was extended to them, authors' royalties and "transfers of moneys required for the provision of services," which would appear clearly to involve current payments rather than capital movements.[9]

The transactions and transfers in List B had to be granted "general permission" by the Member States.[10] List B largely consisted of various operations in securities, notably acquisition and liquidation by non-residents of domestic listed securities, and acquisition and liquidation by residents of foreign listed securities. On the other hand, while the transactions and transfers in List C had to receive foreign exchange authorizations in principle, Member States could maintain or reintroduce the exchange restrictions which were operative at the date of entry into force of the Directive where such free movement of capital might form an obstacle to the achievement of the economic policy objectives

7. *See* Council Directive, First Directive for the Implementation of Article 67 of the Treaty, List A, O.J. 43/921 (1960); *see also* Council Directive 63/474/EEC of July 30 1963 Liberalising Transfers in Respect of Invisible Transactions Not Connected with the Movement of Goods, Services, Capital or Persons, Annex, O.J. 125/2240 (1963) (addressing invisible transactions, which included damages which could not be considered as capital).

8. Council Directive, First Directive for the Implementation of Article 67 of the Treaty, List A, O.J. 43/921 (1960).

9. Council Directive No. 63/21/EEC, List A, O.J. 9/62 (1962) (amending the First Directive for the Implementation of Article 67 of the Treaty).

10. *Id.* at List B. Although it is only of historic interest, it might be argued that "general permission" was in fact a wider-ranging obligation than granting "all foreign exchange authorizations" under List A.

of the Member State concerned. List C included the issue and placing of securities of a domestic undertaking on a foreign capital market and of a foreign undertaking on the domestic capital market, cross-border acquisitions and liquidations of units in unit trusts, and the granting and repayment of certain long-term credits. Finally, List D set out the capital movements which did not have to be liberalized, including in particular the opening and the placing of funds on current or deposit accounts, and the physical import and export of financial assets and personal loans.

In 1986, this framework was amended by Directive 86/566,[11] which in effect merged the old lists A and B from the earlier Directives into a new List A, and added certain other elements to those lists from the former List C, notably the issue and placing of securities of a domestic undertaking on a foreign capital market and of a foreign undertaking on the domestic capital market, cross-border acquisitions and liquidations of units in unit trusts, and the granting and repayment of certain long-term credits noted above. What was left of List C was renamed List B, still subject to the power of the Member States to maintain or reintroduce the exchange restrictions which were operative at the date of entry into force of the Directive where free movement of capital might form an obstacle to the achievement of the economic policy objectives of the Member State concerned. List C also included transactions in unlisted securities, medium and long-term loans and credits not connected with commercial transactions or provision of services, and sureties and guarantees relating thereto. Finally, the old List D became List C, but still not liberalized.

A new approach was followed by Directive 88/361,[12] which finally established the basic principle of free movement of capital as a matter of Community law with effect, for most Member States, from July 1, 1990. Free movement of capital thus became the only Treaty "freedom" to be achieved in the manner envisaged in the Treaty—by the enactment of a programme of legislation—albeit twenty years after the time limit envisaged in the Treaty. Subject to its other provisions, Article 1(1) of the 1988 Directive provided that "Member States shall abolish restrictions

11. Council Directive No. 86/566, O.J. L 332/22 (1986).
12. Council Directive No. 88/361, O.J. L 178/5 (1988).

on movements of capital taking place between persons resident in Member States" and although there was still a nomenclature of capital movements annexed to the Directive, it was stated to be to facilitate its application, rather than to introduce distinctions in treatment.[13] Annex I itself stated that the nomenclature was not intended to be an exhaustive list of the notion of capital movements, and it should not be interpreted as restricting the scope of the principle of full liberalization of capital movements in Article 1. However, in the absence of a Treaty definition, the headings of the nomenclature (which in reality owe much to the previous lists) indicate the concept of capital underlying the Directive: direct investments, investments in real estate, operations in securities normally dealt in on the capital market, operations in units of collective investment undertakings, operations in securities and other instruments normally dealt in on the money market, operations in current and deposit accounts with financial institutions, credits related to commercial transactions or to the provision of services in which a resident is participating, financial loans and credits, sureties, other guarantees and rights of pledge, transfers in performance of insurance contracts, personal capital movements, physical import and export of financial assets, and "other capital movements" (defined so as to include transfers of the moneys required for the provision of services).

The introduction to the Annex further states that the capital movements mentioned are taken to cover all the operations necessary for the purposes of capital movements, i.e. the conclusion and performance of the transaction and related transfers, and should also include access for the economic operator to all the financial techniques available on the market approached for the purpose of carrying out the operation in question.

Many of the movements listed were thus clearly current payments relating to other freedoms under what was then Article 106(1)—which will be discussed in the next section of this paper—even though the Court had clearly held in the joined cases of *Luisi & Carbone v. Ministero del Tesoro* that Article 106(1) was directly effective.[14] At first sight, it might seem that to include such movements in the Directive was superfluous. However, it

13. *Id.* art. 1(1), O.J. L 178/5 (1988).

14. Luisi & Carbone v. Ministero del Tesoro, Joined Cases 286/82 & 26/83, [1984] E.C.R. I-377, ¶ 37.

might be suggested that the difficulties in distinguishing clearly between capital movements and current payments, and the narrow way in which the Court read Article 106 in *Criminal Proceedings Against R. Lambert*, holding that it was not relevant to the way an *exporter* received payment, merely being concerned to ensure that the *importer* was able to make the payment, and that it entitled the exporter only to payment in his own currency, meant that there was some practical advantage in including what were possibly current payments within the concept of liberalized capital movements.[15] Be that as it may, a problem which continues to be of relevance is that several of these definitions overlap with other "freedoms": thus "direct investments" includes "establishment and extension of branches or new undertakings belonging solely to the person providing the capital," which clearly also constitutes the exercise of freedom of establishment, and it may be suggested that the operation of current and deposit accounts, and loans, credits and sureties all involve the provision of services, to give a few examples.

III. *PAYMENTS RELATING TO OTHER TREATY FREEDOMS*

It is self evident that the free movement of goods would be nugatory if a purchaser in one Member State was not able to pay a supplier in another Member State, and the same holds true for the other Treaty "freedoms."[16] This was expressly recognized in Article 106 of the EEC Treaty as originally drafted, which was continued until January 1994 as Article 73h EC by virtue of the Maastricht amendments. Under paragraph 1 of this provision, each Member State undertook to authorize, in the currency of the Member State in which the creditor or the beneficiary resided, any payment connected with the movement of goods, services or capital, and any transfers of capital and earnings, to the extent that the movement of goods, services, capital and persons between Member States had been liberalized pursuant to the Treaty. The second paragraph further specified that in so far as movement of goods, services and capital were limited only by

15. *See* Criminal Proceedings Against R. Lambert, Case 308/86, [1988] E.C.R. I-4369.

16. Although conversely, a restriction on the freedom to provide services, justified in the general good, may also justify a restriction on correlative monetary movements. *See* Vereniging Veronica Omroep Organisatie v. Commissariaat voor de Media, Case C-148/91, [1993] E.C.R. I-487.

restrictions on payments connected therewith, these restrictions should be progressively abolished by applying, *mutatis mutandis,* the provisions of the Chapters relating to the abolition of quantitative restrictions, to the liberalization of services and to the free movement of capital; and under the third paragraph, Member States undertook not to introduce between themselves any new restrictions on transfers connected with invisible transactions, and agreed that the progressive abolition of existing restrictions should be effected in accordance with the general programme on freedom to provide services in so far as such abolition was not governed by the provisions contained in paragraphs 1 and 2 or by the other provisions of the Chapter on the free movement of capital.

The first paragraph was of particular importance in that it was held to be directly effective, giving rise to rights enforceable by individuals before their national courts, at a time when the Treaty rules on free movement of capital did not give rise to such rights.[17] This was established in *Luisi & Carbone*[18] in relation to Italian residents who had acquired more than the permitted amount of foreign currency, claiming it was to pay for various services in France and Germany. Under the capital movements directives then in force, there was no requirement to liberalize the physical transfer of banknotes, but the original Article 106 did require current payments relating to other Treaty freedoms to be authorized in the creditor's currency.[19] The Court noted that the Treaty did not define what was meant by movements of capital, and held that it was not necessarily the case that any physical transfer of financial assets constituted a movement of capital. After comparing the original Articles 67 and 106, the Court concluded that current payments are transfers of foreign exchange which constitute the consideration within the context of an underlying transaction, whilst movements of capital are financial operations essentially concerned

17. *See* Criminal Proceedings Against Guerrino Casati, Case 203/80, [1981] E.C.R. I-2595.

18. *See generally Luisi & Carbone*, [1984] E.C.R. I-377.

19. Even if Directive 63/340 on the abolition of all prohibitions on or obstacles to payments for services where the only restrictions on exchange of services are those governing such services made under Article 106(2) expressly excluded services in connection with transport and foreign exchange allowances for tourists. *See* Council Directive No. 63/340, O.J. L 86/1609 (1963).

with the investment of the funds in question rather than remuneration for a service, noting that the original Article 67(2) of the Treaty recognized that there could be current payments connected with the movement of capital. It was therefore held that the physical transfer of banknotes could not be classified as a movement of capital where the transfer in question corresponded to an obligation to pay arising from a transaction involving the movement of goods or services.

While this distinction between the consideration and the underlying transaction may seem clear, it does give rise to practical difficulties. To take the simple example of a with-profits life assurance policy, part of the premium will be used for investment purposes (presumably "capital" in the Court's definition), and part will be used to meet expenses and to pay for the life assurance (presumably both payments for services). Although the Court endeavoured to state that there was a clear distinction between movements of capital and current payments, it remains the case that the series of directives on the free movement of capital enacted under the original Article 67 of the Treaty appear to have covered both types of transactions,[20] although, intriguingly, they required transfers in respect to capital movements to be made on the same exchange rate conditions as those governing payments relating to current transactions, a terminology which appeared to recognize that there were two different concepts. In the version resulting from Directive 86/566,[21] to take a historic example, list A, which was a list of transactions which had to be liberalized, expressly included transfers in performance of insurance contracts "as and when free movement in respect of services" was extended to them. Indeed, list A did actually expressly include transfers of monies required for the provision of services, which was a clear overlap with the concept of current payments enounced in *Luisi & Carbone*, and this terminology has been carried over into the nomenclature of capital movements annexed to the 1988 Directive.

With regard to the currency in which payment may be made, the Court of Justice applied a restrictive literal approach

20. Council Directive No. 88/361, O.J. L 178/5 (1988).
21. Council Directive No. 85/566, O.J. L 332/22 (1986).

to the old Article 106 in *Criminal Proceedings Against R. Lambert*,[22] holding that it was not relevant to the way an *exporter* received payment, merely being concerned to ensure that the *importer* was able to make the payment. But it may be suggested that both aspects are equally important to the achievement of the genuine free movement of goods and services, and that this judgment takes an unduly narrow approach. It had, however, been noted by the Court in *Luisi & Carbone* that the original Article 106 only applied to liberalize current payments made in the currency of the state of the creditor, which helps explain the decision in *Casati*, since in that case Article 106 would only have justified payment in lire.

Indeed it may be suggested that the substantive Treaty provisions relating to the "freedom" at issue may themselves have a wider scope: a hindrance on the payment for goods imported from another Member State may amount to a restriction on the free movement of those goods. The matter came to light in the case of *Commission v. Italy*,[23] in relation to an import deposit scheme. Under Italian law, in order to deter currency speculation, importers paying for goods in advance of their release from customs clearance had to lodge an interest-free security or guarantee. The Court found that although the measures in question were enacted for the purpose of preventing currency speculation, they were not specific rules for the attainment of that objective but general rules which affected normal commercial transactions where payment was made in advance. Since they were undeniably a hindrance to trade, the Italian rules were classified as measures equivalent to quantitative restrictions. The Italian government next argued that these measures could be justified under Article 30 (then Article 36) EC on grounds of public policy, since they had as their objective the safeguarding of a fundamental interest of the State, the defense of its currency. But the Court, following well-established case law, reaffirmed that Article 30 applied only to matters of a non-economic nature.

The Italian government had also, in effect, argued that the rules at issue were a matter of monetary policy, and therefore could not be subject to the rules on the free movement of goods.

22. *See* Criminal Proceedings Against R. Lambert, Case 308/86, [1988] E.C.R. 4369.

23. Commission v. Italy, Case 95/81, [1982] E.C.R. 2187, ¶ 11.

The Court pointed out, however, that the Treaty contained specific provisions (then Articles 108 and 109, now Articles 119 and 120) allowing for protective measures to counter difficulties in the balance of payments, and concluded that the requirement in the then Article 104 that each Member State should pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency did not of itself permit derogations from the free movement of goods.

IV. *THE CURRENT RULES*

The Treaty on European Union introduced new provisions on "capital and payments" with effect from January 1, 1994, the date set for the start of the second stage of Economic and Monetary Union. The fundamental rules are set out in paragraph 1 of Article 56 of the EC Treaty, which states that "[w]ithin the framework of the provisions set out in [that] Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited;" paragraph 2 states that within the same framework, "all restrictions on payments between Member States and between Member States and third countries shall be prohibited."[24]

At first sight, a fundamental distinction between these provisions and the original provisions—and indeed from the situation reached under the 1988 Directive—is that it appears that movements to and from third countries are to be treated the same way as movements between Member States. With hindsight, this can be seen as anticipating the need to reassure the international money markets with regard to the external movement and availability of the euro. However, in reality, there are differences which remain, and this issue will be discussed further in the final section of this Article.

Nevertheless, despite the fact that free movement of capital rules now apply to movements into and out of the Community, the 1988 definitions drafted to cover movements within the Community continue to be used. This was made clear when the Court confirmed that a mortgage fell within the scope of a capital movement as defined in the Directive in the case of *Trummer*

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24. Consolidated Version of the Treaty establishing the European Community art. 56, O.J. C 321 E/37, at E/63 (2006) [hereinafter EC Treaty].

v. Meyer,[25] and further held that this interpretation should continue to apply to the free movement of capital under Article 56. The present author suggested in 1994 that in the continued silence of the Treaty, the Annex to the Directive remained a useful source of illustration of the principle of the free movement of capital even after the entry into force of Article 56 to Article 60 under the Maastricht Treaty.[26] Such a view had in fact been accepted by the Austrian *Landesgericht* in *Trummer v. Mayer*, but the *Landesgericht* interpreted the Annex so as not to cover the transaction in question. For its part, the Court of Justice took the view that Article 56 "substantially reproduces the contents of Article 1 of Directive 88/361" and held that:

> [T]he nomenclature in respect of movements of capital Annexed to Directive 88/361 still has the same indicative value, for the purposes of defining the notion of capital movements, as it did before the entry into force of Article [56] et seq., subject to the qualification, contained in the introduction to the nomenclature, that the list set out therein is not exhaustive.[27]

The Court had in fact already held, in *Svensson & Gustavsson v. Ministre du Logement*, that borrowing money from a bank in another Member State to buy a house fell within the scope of the Directive.[28] Though it was subsequently suggested by Advocate-General Tesauro, in his Opinion in *Safir v. Skattemyndigheten i Dalamas Lan*, that a narrower concept of capital movements should be adopted, the Court confirmed in *Trummer v. Mayer* that a mortgage fell within the scope of a capital movement as defined in the Directive. More specifically, it was held both that the mortgage in this case was inextricably linked to a capital movement—the liquidation of an investment in real property[29]—and that the mortgage as such was a capital movement under Point IX of the nomenclature as an "other guarantee" under the heading "sureties, other guarantees and rights of pledge." In those circumstances, the Court held that an obliga-

25. *See generally* Trummer v. Mayer, Case C-222/97, [1999] E.C.R. I-1661.

26. *See* JOHN USHER, THE LAW OF MONEY AND FINANCIAL SERVICES IN THE EUROPEAN COMMUNITY 19 (1994).

27. *See Trummer*, [1999] E.C.R. I-1661, ¶ 21.

28. *See generally* Svensson & Gustavsson v. Ministre du Logement, Case C-484/93, [1995] E.C.R. I-3955.

29. *See* Council Directive No. 88/361, Annex I, O.J. L 178/5, at II (1988).

tion to have recourse to the national currency for the purposes of creating a mortgage must be regarded, in principle, as a restriction on the free movement of capital within the meaning of Article 56 of the EC Treaty.

However, there has been a lack of consistency in determining whether an activity falling within the lists in the Annex to the Directive should be categorized as a capital movement or as falling within the scope of another "freedom." In *Criminal Proceedings Against Andre Ambry*,[30] it was held that for France to require the compulsory financial security provided by a travel agent to be guaranteed by a credit institution or insurance company situated in France breached the Treaty rules on freedom to provide services—although it may be observed that the list in the Annex to the 1988 Capital Movements Directive expressly includes guarantees granted by non-residents to residents.[31] Nevertheless, in *Commission v. Italy*,[32] it was held that an Italian requirement that undertakings engaged in the provision of temporary labor established in other Member States had to lodge a guarantee with a credit institution having its registered office or a branch office in Italy was a breach both of the freedom to provide services under Article 49 and of the free movement of capital under Article 56; it was held to restrict the free movement of capital on the basis that under point IX of Annex I to Directive 88/361, guarantees granted by non-residents to residents or by residents to non-residents constitute movements of capital, which should therefore be liberalized under Article 56(1).

A similar potential for overlap may also be seen in the relationship between free movement of capital and freedom of establishment: in *Staatssecretaris van Financiën v. B.G.M. Verkooijen*[33] receipt by a resident of one Member State of dividends on shares in a company whose seat was in another Member State was treated as free movement of capital falling under Directive 88/361, whereas in *Metallgesellschaft & Hoechst v. Inland Revenue &*

30. Criminal Proceedings Against Andre Ambry, Case C-410/96, [1998] E.C.R. I-7875.

31. *See* Council Directive No. 88/361, Annex I, O.J. L 178/5, at IX(A) (1988).

32. *See generally* Commission v. Italy, Case C-279/00, [2002] E.C.R. I-1425.

33. *See generally* Staatssecretaris van Financiën v. B.G.M. Verkooijen (Verkooijen), Case C-35-98, [2000] E.C.R. I-4071.

H.M. Attorney General,[34] the payment of dividends by a subsidiary company to a parent company resident in another Member State was treated as a question of freedom of establishment. Similarly, in *N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*,[35] N. moved from the Netherlands to the United Kingdom, which constituted a notional (and taxable) disposal of his shares under Dutch law. Since it was a substantial shareholding it was held to fall under the establishment rules—yet the Explanatory Notes to the Annex to the 1988 Directive state that "direct investments" under the Directive include:

> [I]nvestments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or maintain lasting and direct links between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made available in order to carry on an economic activity.[36]

Nevertheless, the Grand Chamber stated in *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* that:

> [N]ational provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment.[37]

Yet, in *Commission v. Germany*,[38] concerned with "golden shares" in Volkswagen, the Grand Chamber referred to the nomenclature Annexed to the 1988 Directive, and declared that:

> [M]ovements of capital within the meaning of Article 56(1) EC . . . include direct investments, that is to say, as that nomenclature and the related explanatory notes show, investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertak-

34. *See generally* Metallgesellschaft & Hoechst v. Inland Revenue & H.M. Attorney Gen., Joined Cases C-397/98 & C-410/98, [2001] E.C.R. I-1727.

35. *See generally* N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo, Case C-470/04, [2006] E.C.R. I-7409.

36. Council Directive No. 88/361, Explanatory Notes, O.J. L 178/5 (1988).

37. *See generally* Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue, C-524/04, [2007] E.C.R. I-2107, ¶ 27.

38. *See* Commission v. Germany, Case C-112/05, [2007] E.C.R. __ (ECJ Oct. 23, 2007) (LEXIS, Eurcom Library, Cases File).

> ings to which that capital is made available in order to carry out an economic activity.[39]

Furthermore, "shareholdings in new or existing undertakings, as those explanatory notes confirm, the objective of establishing or maintaining lasting economic links presupposes that the shares held by the shareholder enable him . . . to participate effectively in the management of that company or in its control."[40] The Grand Chamber therefore concluded that measures which were liable to deter such investment constituted a restriction on the free movement of capital.

Indeed, the broad use of the capital movement rules to deal with issues which might be thought to involve questions of freedom of establishment is very clearly shown in the series of decisions in relation to "golden shares,"[41] where measures designed to enable the public authorities to limit the size of shareholdings or restrict the disposal of assets in privatized companies were held to amount to restrictions on investment in breach of the rules on the free movement of capital. Recent examples include the 2005 case of *Commission v. Italy*,[42] which involved Italian rules suspending voting rights attributed to shareholdings greater than two percent of the capital of companies in the electricity and gas sectors held by public undertakings. This was held to breach the capital movement rules in that it excluded these public undertakings from participating effectively in the management and control of Italian gas and electricity undertakings. Similarly in *Commission v. Netherlands*,[43] special shares held by the Netherlands State in privatized undertakings giving it special rights to approve certain management decisions were held to breach the capital movement rules.

A particularly striking example is the recent decision involving the 1960 privatization legislation governing the Volkswagen

39. *Id.* ¶ 18.

40. *Id.*

41. *See* Commission v. United Kingdom, Case C-98/01, [2003] E.C.R. I-4641; Commission v. France, Case C-483/99, [2002] E.C.R. I-4781; Commission v. Portugal, Case C-367/98, [2002] E.C.R. I-4731; Commission v. Belgium, Case C-503/99, [2002] E.C.R. I-4809.

42. *See generally* Commission v. Italy, Case C-174/04, [2005] E.C.R. I-4933.

43. *See generally* Commission v. Netherlands, Joined Cases C-282/04 & C-283/04, [2006] E.C.R. I-9141.

company.[44] This involved limiting, in derogation from the general law, the voting rights of every shareholder to twenty percent of Volkswagen's share capital; secondly, it required a majority of over eighty percent of the shares represented for resolutions of the general assembly, which, according to the general law, required only a majority of seventy-five percent; and thirdly, in derogation from the general law, it enabled the Federal State and the Land of Lower Saxony each to appoint two representatives to the company's supervisory board. The Commission brought its action on the basis that these provisions were liable to deter direct investment and for that reason constituted restrictions on the free movement of capital within the meaning of Article 56 EC. In its judgment, the Grand Chamber noted that the Land of Lower Saxony, for its part, still retained an interest in the region of twenty percent, so that the Volkswagen Law thus created an instrument enabling the Land authorities to procure for themselves a blocking minority allowing them to oppose important resolutions, on the basis of a lower level of investment than would be required under general company law, and that by capping voting rights at the same level of twenty percent, the Volkswagen Law supplemented a legal framework which enabled the Land authorities to exercise considerable influence on the basis of such a reduced investment. It concluded that this situation was liable to deter direct investors from other Member States, holding that this finding could not be undermined by the argument advanced by the Federal Republic of Germany to the effect that Volkswagen's shares are among the most highly-traded in Europe and that a large number of them are in the hands of investors from other Member States. It was further found that the right of the Federal State and the Land to appoint two representatives each on the supervisory board enabled them to participate in a more significant manner in the activity of the supervisory board than their status as shareholders would normally allow, and that therefore the influence of the other shareholders might be reduced below a level commensurate with their own levels of investment. The conclusion, therefore, was that by restricting the possibility for other shareholders to participate in the company with a view to establishing or maintaining lasting

44. Commission v. Germany, Case C-112/05, [2007] E.C.R. ___ (ECJ Oct. 23, 2007) (LEXIS, Eurcom Library, Cases File).

and direct economic links with it such as to enable them to participate effectively in the management of that company or in its control, the Volkswagen Law is liable to deter direct investors from other Member States from investing in the company's capital—which brings us back to the debate about the dividing line between free movement of capital and freedom of establishment.

V. *THE TAX ISSUE*

At first sight, Article 58(1)(a) EC appears to allow certain forms of tax discrimination, leading to a possible negative result from classifying an operation as a capital movement. It states that the provisions of Article 56 (i.e. the liberalization of capital movements and payments inside and outside the Community):

> [S]hall be without prejudice to the right of Member States:
> (a) to apply the relevant provision of their tax law which distinguish between tax-payers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested; . . . .[45]

This appears to be a clear authorization to discriminate in the tax system between residents and non-residents, and no doubt reflects the fact that residence is widely used to determine the national legislation to which a taxpayer is subject. It could however allow discrimination against non-residents, and against those investing in other Member States, which could clearly conflict with the fundamental Treaty freedoms relating to establishment, provision of services and movement of workers. Nevertheless, Article 58(1)(a) is subject both to the caveat in Article 58(3) that such measures shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56 and to a Declaration made by the Member States when the Maastricht Treaty was signed, stating that:

> The Conference affirms that the right of Member States to apply the relevant provisions of their tax law as referred to in [Article 58(1)(a)] of this Treaty will apply only with respect to the relevant provisions which exist at the end of 1993. However, this Declaration shall apply only to capital movements between Member States and to payments effected between

45. EC Treaty, *supra* note 25, art. 58(1)(a), O.J. C 321 E/37, at E/64.

Member States.[46]

It may be suggested that this at the least amounted to a political commitment not to introduce any new measures of the type at issue in the context of monetary movements between Member States. Be that as it may, the classification as a capital movement of an economic activity which could be regarded as involving freedom of establishment or freedom to provide services has the potential to give rise to awkward tax questions, and further problems might be thought to arise from Article 50 EC (stating that services are only "services" if they do not fall under one of the other freedoms) and Article 51 EC (subordinating banking and insurance services to the liberalization of the movement of capital).

While it may be wondered how the wording of Article 58(1)(a) may be reconciled with the concept of a single market for financial services, and more particularly how it may be reconciled with the principle of non-discrimination underlying the Treaty provisions on free movement of persons and provision of services, it was made clear in 2004, in the case of *Petri Manninen*,[47] that the prohibition of arbitrary discrimination in Article 58(3) enables Article 58(1)(a) to be interpreted in line with the case-law on tax discrimination under the other Treaty freedoms. Before that decision, however, various other approaches had been suggested. The most straightforward was to argue that Article 58(1)(a) is only concerned with monetary movements as such,[48] and that it does not apply to situations governed by the other Treaty freedoms. It may be submitted, however, that this straightforward approach does not appear to take account of Articles 50 and 51 of the Treaty mentioned above. However, while it had long been assumed that the effect of Articles 50 and 51 was to make services a residual concept, the Court took a different view in *Safir v. Skattemyndigheten i Dalarnas Lan*.[49] It was there

46. Treaty on European Union, Declaration on Article 73d of the Treaty establishing the European Community, O.J. C 191 (1992).

47. *See generally* Petri Manninen, Case C-319/02, [2004] E.C.R. I-7477.

48. *See* Frans Vanistendael, *The Consequences of* Schumacker *and* Wielockx*: Two steps Forward in the Tax Procession of Echternach*, 33 COMMON MKT. L. REV. 255, 263-265 (1996); Peter J. Wattel, *The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law*, 33 COMMON MKT. L. REV. 223, 223-31 (1996).

49. *See generally* Safir v. Skattemyndigheten i Dalarnas Lãn, Case C-118/96, [1998] E.C.R. I-1897.

held that for Sweden to impose a different tax regime for insurance policies purchased from providers outside Sweden, which would have the effect of deterring Swedish residents from taking out such policies, even though it was intended to achieve tax neutrality between policies purchased inside and outside Sweden, was a breach of Article 49, and that since it concerned the provision of services, there was no need to consider the capital movement provisions. Such an approach is difficult to reconcile with the wording of the Treaty—though it may be suggested that the wording of the Treaty is hardly appropriate in the context of the fifteen States sharing a single currency—but it was subsequently followed in *Rolf Dieter Danner*.[50] The Grand Chamber has rationalized this in *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht*,[51] where it held that the residual nature of "services" under Article 50 is a matter of definition, and does not establish an order of priority between services and capital. However, it seems to accept that the same national measure may relate to services and capital at the same time, but it will in principle consider a measure in relation to only one of those freedoms if it appears that one of them is entirely secondary in relation to the other.

Be that as it may, earlier case law on services had indicated that differentiation on the basis of place of investment might be justified. In *Bachmann v. Kingdom of Belgium*,[52] the Court held that tax deductions on life and sickness insurance premiums could be limited to payments made to insurers established in Belgium, on the basis that there was no other way of preserving the coherence of the tax system (which required tax to be paid on the ultimate benefits). It might be observed that if a requirement that a provider of a financial service should be established within the jurisdiction of the Member State concerned really was the only way of ensuring that a Member State's tax legislation is observed, it indicated a need for a considerably greater degree of cooperation between the tax authorities of the Member States. It also had the effect of making provision of services, in the Treaty sense, impossible.

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50. *See generally* Rolf Dieter Danner, Case C-136/00, [2002] E.C.R. I-8147.

51. *See generally* Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht, Case C-452/04, [2006] E.C.R. I-9521.

52. *See generally* Bachmann v. Belgium, Case C-204/90, [1992] E.C.R. I-249.

However, that was not the end of the story. The Court of Justice returned to the matter in *Wielockx v. Inspecteur der Directe Belastingen*.[53] This involved a Belgian national resident in Belgium who was a partner in a business established in the Netherlands and whose entire income was earned in the Netherlands. He paid money into a pension reserve in the Netherlands, and claimed tax relief on that part of his income. This was refused on the basis that relief was only given to Dutch residents, and the Netherlands government invoked the *Bachmann* case to argue that in the case of a Belgian resident, the Netherlands authorities would grant the tax relief on the pension contributions but the Belgian authorities would collect the tax on the pension when it was received. However, the Court, while accepting that in principle the situations of residents and non-residents are not generally comparable, held that a non-resident taxpayer who receives all or almost all his income in the state where he works is objectively in the same situation as concerns income tax as a resident of that state. Furthermore, on the question of tax cohesion, the Court followed Advocate-General Léger in noting that the arrangements between the Netherlands and Belgium resulted from a double taxation convention following the Organization for Economic Co-operation and Development ("OECD") model under which a state taxes all pensions, irrespective of their source, received by residents, but waives the right to tax pensions received abroad, irrespective of their source. It therefore held that tax cohesion was to be established not at the level of one individual taxpayer but in the reciprocity of the rules applicable in the Contracting States. The Netherlands could not therefore justify a discriminatory refusal of tax relief in this case.

While subsequent case law has continued to make reference to *Bachmann* as authority for the principle that the need to safeguard the cohesion of the tax system may justify rules which are liable to restrict fundamental freedoms, there has in fact been no subsequent example of such discriminatory tax treatment being held to be justified. Indeed, in *Danner*, it was held that coherence of the tax system did not justify a Finnish refusal to grant tax relief to a Finnish taxpayer on pension contributions

53. *See generally* Wielockx v. Inspecteur der Directe Belastingen, Case C-80/94, [1995] E.C.R. I-2493.

paid in Germany—facts which appear to be very similar to those at issue in *Bachmann.*

With regard to the overlap with freedom of establishment, there is a long line of case law indicating that differential tax treatment based on residence or place of investment may infringe on Article 43 EC.[54] In the context of freedom of establishment, if an undertaking does establish a permanent presence in another Member State, then whatever form that establishment takes, it has been clear since *de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie,* that Member States may not treat companies differently for tax purposes depending on the type of establishment present within their jurisdiction. It was there held, in the context of French legislation granting shareholders' tax credits to French insurance companies but not to branches or agencies in France of foreign insurance companies, that France could not treat branches of foreign insurance companies whose main offices were in other Member States differently from those insurance companies which took the form of French-based companies which were subsidiaries of those foreign insurance companies. In other words, branches (which are a part of the foreign undertaking in another Member State) and subsidiaries (which are formed under local law but controlled by the foreign undertaking) had to be treated the same way, both being forms of establishment recognized in what is now Article 43 EC. Furthermore, it was made clear in that case that there was no way restrictions could be imposed on the freedom of establishment in order to prevent tax evasion.[55]

When the question of different treatment on the basis of residence did arise in the context of freedom of establishment in *Queen v. Inland Revenue Commissioners* ex parte *Commerzbank AG,*[56] it was held that a German company which traded in the U.K. through a branch established there but which was fiscally non-resident in the U.K., was entitled to receive interest on the repay-

54. *See, e.g.*, Metallgesellschaft & Hoechst v. Inland Revenue & H.M. Attorney Gen., Joined Cases C-397/98 & C-410/98, [2001] E.C.R. I-1727; C. Baars v. Inspecteur der Belastingen Particulerien, Case C-251/98, [2000] E.C.R. I-2787; Queen v. Inland Revenue Comm'rs *ex parte* Commerzbank AG (Commerzbank), Case C-330/91, [1993] E.C.R. I-4017.

55. *See generally* de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, Case C-9/02, [2004] E.C.R. I-2409.

56. *See generally Commerzbank*, Case C-330/91, [1993] E.C.R. I-4017.

ment of tax which should not have been charged to it, if an undertaking resident in the U.K. would have received interest on such a repayment—and it made no difference that the only reason for the repayment of the tax was the fact that the German company was not resident in the U.K. A similar approach has been taken in *Imperial Chemical Industries v. Colmer*,[57] where tax relief for a holding company depended on the residence of its subsidiaries. Subsequently, in *Baars*,[58] it was held that Dutch legislation which gave an exemption from wealth tax for Dutch residents with a controlling shareholding in a company established in the Netherlands but did not give that exemption for a controlling shareholding in a company established in another Member State (in that case Ireland), breached the Treaty rules on freedom of establishment, and in *Metallgesellschaft & Hoechst*, the subjection of the payment of dividends by a subsidiary company to a parent company resident in another Member State to advance corporation tax when no advance corporation tax was required on payments of dividend to a parent company resident in the U.K. was held to be a breach of the Treaty rules on freedom of establishment.

A further step has been taken by the Grand Chamber in its judgment in *Marks & Spencer, PLC v. Halsey*[59] in the context of freedom of establishment. The case involved U.K. rules on group tax relief under which relief was only allowed for losses incurred in the United Kingdom, whereas Marks & Spencer wished to set off losses incurred by its subsidiaries in Belgium, Germany and France. The ECJ accepted that in principle the U.K. rules were a justified restriction on freedom of establishment in so far as they were intended to protect a balanced allocation of the power to impose taxation between the various Member States concerned, to avoid the risk of the double use of losses, and to avoid the risk of tax avoidance which would exist if the losses were not taken into account in the subsidiaries' Member States (the ECJ took the view that within a group of companies, losses might be transferred to the companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest).

57. *See generally* Imperial Chem. Indus. v. Colmer, Case C-264/96, [1998] E.C.R. I-4695.

58. *See Baars*, [2000] E.C.R. I-2787, ¶ 43.

59. *See* Marks & Spencer PLC v. Halsey, Case 446/03, [2005] E.C.R. I-10837, ¶ 61.

However, the ECJ also considered that the U.K. rules would be disproportionately restrictive where the non-resident subsidiary had exhausted the possibilities available in its State of residence of having the losses taken into account in its State of residence for the relevant accounting periods, and there was no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary had been sold to that third party. The ECJ therefore concluded that where in one Member State the resident parent company demonstrates to the tax authorities that those conditions are fulfilled, it is contrary to freedom of establishment to preclude the possibility for the parent company to deduct from its taxable profits in that Member State the losses incurred by its non-resident subsidiary.

Moving from deduction of losses made by a foreign subsidiary to taxation of a foreign subsidiary, *Cadbury Schweppes PLC v. Commissioners of Inland Revenue*[60] involved the taxation of "controlled foreign companies" under U.K. legislation. U.K. companies were taxed on their own worldwide profits (including agencies and branches), but not on the profits of subsidiaries unless they are "controlled foreign companies", i.e. subject in their State of establishment to a lower level of taxation, subject to a series of exceptions and a "motive" test. The case involved subsidiaries set up to take advantage of the low tax rates of the Dublin International Financial Services Centre. It was held that seeking to take advantage of lower tax rates cannot deprive a company of its Treaty rights, and the U.K. rules breached Articles 43 and 48 on freedom of establishment unless they could be justified in relation to "wholly artificial arrangements." It was held that arrangements would not be artificial if there was an actual establishment and pursuit of a genuine economic activity. However, neither an objective of obtaining tax relief or the fact that the work could have been done in the home State made the activity wholly artificial.

With regard to free movement of workers, in *Finanzamt*

60. *See* Cadbury Schweppes PLC v. Commissioners of Inland Revenue, Case 196/04, [2006] E.C.R. I-7995, ¶ 76.

Köln-Altstadt v. Schumacker[61] and *Commission v. Grand Duchy of Luxembourg*,[62] it was made clear that discrimination cannot be justified where the taxpayer benefits from the rules on free movement of workers, and in *Asscher v. Staatssecretaris van Financiën*,[63] it was made clear that discrimination cannot be justified where the taxpayer benefits from the rules on freedom of establishment. In the *Schumacker* case, it was held that where the state of residence could not take account of the taxpayer's personal and family circumstances because the tax payable there was insufficient to enable it to do so, the Community principle of equal treatment required that in the state of employment the personal and family circumstances of a foreign non-resident be taken into account in the same way as those of resident nationals, and the same tax benefits should be granted. In *Commission v. Luxembourg*, it was held that it was a breach of the rules on the free movement of workers for Luxembourg to retain and not repay excess amounts of tax deducted from the earnings of Community nationals who resided or worked in Luxembourg for less than the whole tax year; and in *Asscher*, the Netherlands could not impose a higher income tax liability on a non-resident to compensate for the fact that he paid social security contributions in another Member State. On the other hand, it was accepted by the Court of Justice in *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*[64] that a frontier worker may have to accept less than perfect equality of treatment under a double taxation agreement.

On the face of it, there is, therefore, a conflict between the Treaty rights of freedom of establishment, freedom to provide services and free movement of workers as interpreted in *Commerzbank, Wielockx, Schumacker, Commission v. Luxembourg* and *Asscher*, and Article 58(1)(a) EC if it really does authorize discriminatory tax treatment. The problem however was eventually resolved by the Court in the judgment of its Grand Chamber in *Manninen*[65] through a strict interpretation of Article 58(1)(a)

61. *See* Finanzamt Köln-Altstadt v. Schumacker, Case 279/93, [1995] E.C.R. I-225, ¶ 60.

62. *See* Commission v. Luxembourg, Case 151/94, [1995] E.C.R. I-3685, ¶ 12.

63. *See* Asscher v. Staatssecretaris van Financiën, Case 107/94, [1996] E.C.R. I-3089, ¶ 65.

64. *See* Gilly v. Directeur des Services Fiscaux du Bas-Rhin, Case 336/96, [1998] E.C.R. I-2793, ¶ 55.

65. *See* Petri Manninen, Case C-319/02, [2004] E.C.R. I-7477, ¶ 29.

read in conjunction with the prohibition of arbitrary discrimination in Article 58(3). This approach had been foreshadowed in *Verkooijen*,[66] where the Court suggested that Article 58(1)(a) had been anticipated by its judgment in *Bachmann* and that before its entry into force, distinctions based on the residence of taxpayers would be compatible with Community law if they applied to situations which were not objectively comparable or could be justified by overriding reasons in the public interest, in particular in relation to the cohesion of the tax system; it was emphasized that a desire to promote the domestic economy by encouraging domestic investment could not be such an overriding interest, nor could a loss of tax revenue.

The *Manninen* case arose from the refusal of the Finnish authorities to grant a Finnish taxpayer a tax credit in relation to dividend received from a Swedish company, which had been taxed in Sweden, when such a credit would have been granted on a dividend received from a Finnish company taxed in Finland. In principle, the Court held this to be a restriction on the free movement of capital prohibited by Article 56 EC, on the basis that the Finnish tax legislation had the effect of deterring fully taxable persons in Finland from investing their capital in companies established in another Member State. It also found that such a provision had a restrictive effect as regards companies established in other Member States, in that it constituted an obstacle to their raising capital in Finland: since revenue from capital of non-Finnish origin received less favorable tax treatment than dividends distributed by companies established in Finland, the shares of companies established in other Member States would be less attractive to investors residing in Finland than shares in companies which had their seat in that Member State.

The Court then turned to the question whether this restriction was capable of being justified under Article 58(1)(a). It started by observing that this provision had to be interpreted strictly, as a derogation from the fundamental principle of the free movement of capital, and that it "cannot be interpreted as meaning that any tax legislation making a distinction between taxpayers by reference to the place where they invest their capi-

66. *See* Verkooijen, Case C-35-98, [2000] E.C.R. I-407, ¶ 57. It should be noted that the facts in this case arose before the entry into force of Article 58(1)(a).

tal is automatically compatible with the Treaty."[67] It emphasised that a distinction must therefore be made between unequal treatment, which is permitted under Article 58(1)(a), and arbitrary discrimination, which is prohibited by Article 58(3), and stated that its case law showed that, for national tax legislation like that at issue to be capable of being regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must concern situations which are not objectively comparable or be justified by overriding reasons in the general interest, such as the need to safeguard the cohesion of the tax system. The Court also added a proportionality test, as under the other "freedoms," stating that in order to be justified, the difference in treatment between different categories of dividends must not go beyond what was necessary in order to attain the objective of the legislation.

Observations had been submitted by the Finnish, French and United Kingdom governments, which argued that the dividends paid were fundamentally different in character according to whether they came from Finnish or non-Finnish companies. However, the Court took the view that the Finnish tax legislation was designed to prevent double taxation of company profits by granting to a shareholder who receives dividends a tax advantage linked to the taking into account of the corporation tax due from the company distributing the dividends, and that shareholders fully taxable in Finland found themselves in a comparable situation, whether they received dividends from companies established in that Member State or from companies established in other Member States.

The three governments further argued that the Finnish tax legislation was objectively justified by the need to ensure the cohesion of the national tax system, citing *Bachmann*. In this context, the Court explained its judgment in *Bachmann* on the basis that it had acknowledged that the need to preserve the cohesion of a tax system might justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty. However, for an argument based on such justification to succeed, a direct link had to be established between the tax advantage concerned and the offsetting of that advantage by a particular tax deduction, and it declared that the *Bachmann* judgment was based on the

67. *See Manninen*, [2004] E.C.R. I-7477, ¶ 28.

finding that, in Belgian law, there was a direct link, in relation to the same taxpayer liable to income tax, between the ability to deduct insurance contributions from taxable income and the subsequent taxation of sums paid by the insurers. The Court also emphasized that an argument based on the need to safeguard the cohesion of a tax system must be examined in the light of the objective pursued by the tax legislation in question,[68] repeating that the Finnish tax legislation was designed to prevent double taxation of company profits distributed to shareholders. In this context, it concluded that the granting to a shareholder who was fully taxable in Finland and who held shares in a company established in Sweden of a tax credit calculated by reference to the corporation tax owed by that company in Sweden would not threaten the cohesion of the Finnish tax system, pointing out that when the shareholder fully taxable in Finland received dividends, the profits distributed had already been subject to taxation by way of corporation tax, irrespective of whether those dividends come from Finnish or from Swedish companies. Therefore the objective pursued by the Finnish tax legislation, which was to eliminate the double taxation of profits distributed in the form of dividends, could be achieved by also granting the tax credit in favor of profits distributed in that way by Swedish companies to persons fully taxable in Finland.

The Court recognized that for Finland, granting a tax credit in relation to corporation tax due in another Member State would entail a reduction in its tax receipts in relation to dividends paid by companies in other Member States, but it pointed out that it had been consistently held in the case-law that reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom.[69]

The Court's ruling therefore was that Articles 56 and 58 EC preclude legislation whereby the entitlement of a person fully taxable in one Member State to a tax credit in relation to dividends paid to him by limited companies is excluded where those companies are not established in that state. Interpreted in this

68. *See* de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, Case C-9/02 [2004] E.C.R. I-2409, ¶¶ 64, 67.

69. *See* Rolf Dieter Danner, Case C-136/00, [2002] E.C.R. I-8147, ¶ 56; *Verkooijen*, [2000] E.C.R. I-4071, ¶ 59.

way, it may be suggested that there is little real prospect of a difference in treatment of tax discrimination under Article 58(1)(a) and its treatment under the rules governing freedom to provide services, freedom of establishment and free movement of workers, where the taxpayers concerned can be regarded as being in a comparable situation.

However, the Court has made it clear in *Kerckhaert v. Belgische Staat*[70] that the capital movement rules will only be breached by national tax legislation if there is discrimination, and it is not enough that there is a deterrent effect on free movement: thus a refusal by Belgium to grant a tax credit to a Belgian taxpayer for tax paid in France on a dividend on shares in a French company did not breach the capital movement rules if no tax credits would have been given in respect of dividends paid by a Belgian company (even if the reason was that no tax would have been deducted at source, since dividends in Belgium were taxed as income). Indeed it has been argued that in the context of all the Treaty freedoms, national tax legislation will only breach the Treaty if it is discriminatory in its effect.[71] Some recent case law will give an overview of the extent to which differential tax treatment is or is not permitted in EC law on the basis of residence. Discrimination on the grounds of residence raises more difficult issues, since residence is a common connecting factor in tax systems. However, in *Centro di Musicologia Walter Stauffer v. FZA München*[72] it was held that Germany had to give resident treatment to an Italian charitable foundation. The Italian foundation owned commercial premises in Munich, and the question arose whether it should be taxed on its rental income when a German charitable foundation would be exempt. This was treated as a question of free movement of capital in that it involved investment in real estate. It was held that if the foundation met the local requirements for charitable status, it could not be denied equal treatment, though Germany was entitled to ascertain in a precise manner whether the foundation met those conditions. In response to one German argument, it was expressly stated that there cannot be a general assumption of crim-

70. *See* Kerckhaert v. Belgische Staat, Case C-513/04, [2006] E.C.R. I-10967, ¶ 17.

71. *See* Jukka Snell, *Non-discriminatory Tax Obstacles in Community Law*, 56 INT'L & COMP. L.Q. 339, 339-45 (2007).

72. Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften, Case C-386/04, [2006] E.C.R. I-8203.

inal activity if a foundation is established in another Member State!

On the other hand, differential treatment was accepted in *D. v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen.*[73] This concerned a Dutch wealth tax imposed on the worldwide assets of Dutch residents, and on the Dutch assets of non-residents, but subject to a tax-free allowance for residents. D. was a German resident who had invested in Dutch real estate (and therefore fell within the capital movement rules), and who claimed that he should receive the allowance given to Dutch residents. However, it was held that residents taxed on their worldwide assets and non-residents taxed only on their Dutch assets are not in a comparable situation, and it was not a breach of the capital movement rules not to grant the allowance to someone who only had a small part of his wealth in the Netherlands. It was also held that the special treatment accorded to Belgian residents under a double taxation agreement did not need to be extended to residents of Member States not party to that convention.

In *N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, N. moved from the Netherlands to the U.K., which constituted a notional (and taxable) disposal of his shares under Dutch law. Since it was a substantial shareholding it was held to fall under the establishment rules, and in principle it was held to be disadvantageous treatment compared to a resident.[74] However, it was also held to be justified as allocating between Member States, on the basis of territoriality, the power to tax increases of value in company holdings. Nevertheless, it also involved an obligation to give a guarantee, which was held to go beyond what was necessary, and full account was not taken of reductions in value.

In *Blanckaert v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen*,[75] Blanckaert owned a holiday home in the Netherlands, thus falling within the capital movement rules, and giving rise to a tax liability. He claimed the tax credit available to Dutch residents in relation to national insur-

73. D. v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen, Case C-376/03, [2005] E.C.R. I-5821.

74. *See* N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo, Case C-470/04, [2006] E.C.R. I-7409, ¶¶ 35, 41, 51, 55.

75. *See* Blanckaert v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen, Case C-512/03, [2005] E.C.R. I-7685, ¶ 50.

ance contributions, although as a non-resident he was not so insured. It was held that there was an objective difference between those insured and those not insured under the Dutch scheme.

Finally, in *FKP Scorpio Konzertproduktionen GmbH v. Finanzamt Hamburg-Eimsbuettel*, it was accepted by the Grand Chamber that the services rules do not preclude retention of tax at source on payments made to non-resident providers of services, though they did require that business expenses could be deducted from the tax retained when resident service providers could deduct business expenses from their tax liability—but the services rules could not be invoked by a national of a non-Member State, which leads on to a discussion of the third-country effects of the capital movement rules.[76]

VI. *CAPITAL MOVEMENTS AND THIRD COUNTRIES*

As mentioned earlier in this Article, serious legal issues arise from the classification as a capital movement of an economic activity which might otherwise be regarded as a service; a similar need for clarification was seen to arise in the relationship between free movement of capital and freedom of establishment. There is therefore clear potential for overlap with other Treaty freedoms and the question then arises as to whether the current capital movement provisions effectively extend the other freedoms to third country nationals or residents. It does not take much imagination to envisage the possible consequences of this approach to the capital movement provisions if, for example, they are interpreted broadly so as to include activities which might economically be regarded as the provision of services (such as the provision of mortgage credit or of guarantees). Does it mean that a borrower resident in the Community has an enforceable Community law right to take out a mortgage with a provider in a third country, and does it mean that a lender in a third country has an enforceable Community law right to offer a mortgage to a borrower in a Member State? Conversely, does it mean that a lender in the Community has an enforceable Community law right to offer a mortgage to a borrower in a third country, and that a borrower in a third country has an enforceable Community law right to take out a mortgage with a provider

76. *See* FKP Scorpio Konzertproduktionen GmbH v. Finanzamt Hamburg-Eimsbuettel (FKP Scorpio), Case C-290/04, [2006] E.C.R. I-9461, ¶ 70.2.

in the Community (and therefore presumably the right to enter the Community for that purpose)? It is in this context that the relevance of Article 57 EC may be seen. Under Article 57, the provisions of Article 56 are stated to be without prejudice to the application to third countries of any restrictions which existed on December 31, 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment (including investment in real estate), establishment, the provision of financial services or the admission of securities to capital markets; in other words, they do not require pre-1994 lawful restrictions to be abolished in these areas which, apart from direct investment, expressly overlap with freedom of establishment and freedom to provide services. It may in fact be suggested that the very wording of this provision implies that those who drafted it were influenced in their concept of capital movements by the nomenclature Annexed to the 1988 Directive, and expected that these definitions could apply in the context of capital movements to and from third countries.

It is also the case that there are other restrictions limited to third countries. Under Article 59, where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Central Bank, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary. Finally, by virtue of Article 60, the Council may take urgent measures under Article 301, where Community action to interrupt or reduce economic relations with one or more third countries is required by a common position or in a joint action adopted under the European Union provisions on a common foreign and security policy, in relation to the movement of capital and on payments as regard the third countries concerned; indeed, pending such measures, Member States themselves may, under the second paragraph of Article 60, take unilateral measures against a third country with regard to capital movements and payments "for serious political reasons."[77] The freedom is therefore not abso-

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77. EC Treaty, *supra* note 25, art. 60(1), O.J. C 321 E/37, at E/65.

lute.

Be that as it may, to the extent that a payment or capital movement is not excluded, Article 56 has been held to be directly effective even with regard to capital movements to third countries such as Switzerland and Turkey.[78] This in itself is an interesting development, given the Court's reluctance in earlier case-law automatically to extend concepts developed in the context of the internal market to situations governed by similar language in relations with third countries. So, for example, in *Polydor Ltd. v. Harlequin Records Shops Ltd.*,[79] in the context of the free movement of goods, it was held that even where a free trade agreement does expressly prohibit not only quantitative restrictions but also measures having effects equivalent to quantitative restrictions, the same interpretation of that phrase need not be given in the context of trade with a non-Member State as will be given in the context of trade between States, since there is no intention to create a single market under free trade agreements.

A synthesis of the approach to the direct effect of provisions of international agreements was given in the context of an agreement between the Community and Portugal in the *Hauptzollamt Mainz v. C. A. Kupferberg & Cie KG a.A.*[80] The Court started from the principle that it is open to the Community and the third country to agree what effect the provisions of the agreement are to have in the internal legal order of the contracting parties, and that the matter fell to be decided by the courts only in the absence of express agreement on the point, emphasizing however that it was open to the courts of one contracting party to consider that certain provisions were directly effective even if that view was not shared by courts of the other contracting party. It then went on to consider whether the provision at issue could be regarded as unconditional and sufficiently precise to have direct effect in the light of the object and purpose of the agreement, concluding that the provision at issue imposed an unconditional rule against discrimination in matters of taxation, dependent

78. *See generally* Criminal Proceedings Against Lucas Emilio Sanz de Lera, Raimundo Diaz Jimenez & Figen Kapanoglu, Joined Cases 163, 165, 250/94, [1995] E.C.R. I-4821.

79. Polydor Ltd. v. Harlequin Records Shops Ltd., Case 270/80, [1982] E.C.R. I-329.

80. *See generally* Hauptzollamt Mainz v. C. A. Kupferberg & Cie KG a.A., (Kupferberg) Case 104/81, [1982] E.C.R. I-3641.

only on a finding that the products affected were of like nature, so that it could be applied by a court and produce direct effects throughout the Community. The Court did emphasize, however, that despite the fact that the provision at issue had the same object as Article 95 (now Article 90) EC, each of these provisions should be interpreted in its own context, and that the interpretation given to Article 90 could not be applied by way of simple analogy to the corresponding provision of an agreement on free trade. However, in *Sanz de Lera*, the judgment does not discuss these issues, and simply holds Article 56 to be directly effective in itself and on its own terms.

Leaving aside the specific restrictions, the question which arises is whether the broad concept of capital movements overlapping with other Treaty freedoms, and in particular the case law on taxation, applies to transactions with third country traders and residents. The question did begin to surface in the decision of the Grand Chamber in *Fidium Finanz*,[81] which involved a Swiss firm offering credit on the internet into Germany. The Court expressly noted the difference between the capital movement rules and the services rules with regard to third country providers, but accepted that the activity of granting credit on a commercial basis concerns both the freedom to provide services and the free movement of capital. However, it took the view that the German rules at issue, which related to authorization of financial service undertakings and required a permanent establishment (therefore by definition breaching the services rules) should be categorized as restrictions of the freedom to provide services—which could not be invoked by a Swiss company (at the time the facts occurred). It further held that any restriction on free movement of capital was "merely an unavoidable consequence of the restriction on the freedom to provide services," and therfore did not decide the third-country point.[82] Similarly in *FKP Scorpio*, it was accepted by the Grand Chamber that the services rules do not preclude retention of tax at source on payments made to non-resident providers of services, though they did require that business expenses could be deducted from the tax retained when resident service providers could deduct busi-

81. Fidium Finanz AG v. Bundesanstalt fur Finanzdienstleistungsaufsicht, Case C-452/04, [2006] E.C.R. 3641, ¶¶ 43, 46, 48.

82. *Id.* ¶ 48.

ness expenses from their tax liability—but the services rules could not be invoked by a national of a non-Member State.[83]

With regard to the overlap between capital movements and freedom of establishment, it was pointed out by the Grand Chamber in relation to U.K. tax legislation in *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* that:

> Article 43 EC has no bearing on . . . a situation in which both the lending company and the common parent company are resident in a non-member country, nor does it have any bearing on a situation in which a lending company which is resident in another Member State and does not itself control the borrowing company grants the loan through a branch established in a non-member country, where the common parent company is also resident in a non-member country.[84]

However the application of the capital movement rules in relation to tax issues involving third countries was considered by the Grand Chamber in *Skatteverket v. A.*[85] This involved Swedish legislation which gave a tax exemption (subject to a number of specific conditions) for dividends distributed in the form of shares in a subsidiary. This tax exemption applied initially to profits distributed by Swedish companies, and was later extended to the distribution of shares by a foreign company which corresponds to a Swedish limited liability company and is established in a State within the European Economic Area ("EEA")[86] or in a State with which the Kingdom of Sweden has concluded a tax convention that contains a provision on exchange of information. The case, however, involved a proposed distribution by a Swiss company (Switzerland not being in the EEA), and in answering the questions put by the Swedish court, the Grand Chamber expressly considered both the scope of Article 56 in the context of transactions with third countries, and the restrictions that might be imposed under Articles 57 and 58.

83. FKP Scorpio, Case C-290/04, [2006] E.C.R. I-9461, ¶ 70.1.

84. Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue, Case C-524/04, [2007] E.C.R. I-2107, ¶ 100.

85. Skatteverket v. A., Case C-101/05, [2007] E.C.R. __ (ECJ Dec. 18, 2007) (LEXIS, Eurcom Library, Cases File).

86. The European Economic Area ("EEA") comprises the European Union ("EU") plus Norway, Iceland and Liechtenstein. *See* Eur. Free Trade Assoc., Introduction, http:secretariat.efta.int/Web/EuropeanEconomicArea/introduction (last visited Apr. 8, 2008).

The Grand Chamber recognized that in *Criminal Proceedings Against Lucas Emilio Sanz de Lera, Raimundo Diaz Jimenez & Figen Kapanoglu*, the Court had recognized the direct effect of Article 56(1) EC, without drawing a distinction between the categories of capital movement which are covered by Article 57(1) EC and those which are not so covered, and repeated that Article 56(1) EC, in conjunction with Articles 57 EC and 58 EC, may be relied on before national courts and may render national rules that are inconsistent with it inapplicable, irrespective of the category of capital movement in question. It stated expressly that:

> [E]ven if the liberalisation of the movement of capital with third countries may pursue objectives other than that of establishing the internal market, such as, in particular, that of ensuring the credibility of the single Community currency on world financial markets and maintaining financial centres with a world-wide dimension within the Member States, it is clear that, when the principle of free movement of capital was extended, pursuant to Article 56(1) EC, to movement of capital between third countries and the Member States, the latter chose to enshrine that principle in that article and in the same terms for movements of capital taking place within the Community and those relating to relations with third countries.[87]

Rather, the way in which account was taken of the fact that the objective and the legal context of the liberalization of the movement of capital differ according to whether relations between the Member States and third countries or the free movement of capital between the Member States is in issue, was through the safeguard clauses and derogations which apply specifically to the movement of capital to or from third countries, and through the way in which Article 58 is interpreted in cases involving third countries. Furthermore, the Grand Chamber accepted that a Member State may be able to demonstrate that a restriction on the movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States.

Turning to the facts of the case, the Grand Chamber noted that the effect of the Swedish legislation was to discourage tax-

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87. *Skatteverket*, [2007] E.C.R. __, ¶ 31 (LEXIS).

payers residing in Sweden from investing their capital in companies established outside the EEA, and that this entailed a restriction of the movement of capital between Member States and third countries which, in principle, was prohibited by Article 56(1) EC. It then considered whether the dividends related to "direct investments" under Article 57(1), in relation to which Sweden could maintain restrictions which had been in force in 1993, declaring that a restriction on capital movements consisting of a less favorable tax treatment of foreign-sourced dividends is covered by the concept of "direct investment" under Article 57(1) EC in so far as it relates to investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity—reflecting the case law on the nomenclature attached to the 1988 Directive. While leaving determination of that question for the Swedish court, in the absence of any relevant findings of fact, the Grand Chamber did accept that the Swedish rules could be regarded as having continued in force since the end of 1993.

Dealing next with the general restrictions on the free movement of capital which can be justified under Article 58, the Grand Chamber considered whether there was a justification for giving the tax exemption to distributions by companies outside the EEA only where they were established in a State with which the Kingdom of Sweden has concluded a tax convention that contains a provision on exchange of information. Here it noted that although it had been frequently held, with regard to national legislation restricting the exercise of one of the freedoms, that a Member State cannot rely on the fact that it may be impossible to seek cooperation from another Member State in conducting inquiries or collecting information in order to justify a refusal to grant a tax advantage, "that case-law, which relates to restrictions on the exercise of freedom of movement within the Community, cannot be transposed in its entirety to movements of capital between Member States and third countries, since such movements take place in a different legal context."[88]

The conclusion therefore was that:

Where the legislation of a Member State makes the grant of a

88. *Id.* ¶ 60.

> tax advantage dependent on satisfying requirements, compliance with which can be verified only by obtaining information from the competent authorities of a third country, it is, in principle, legitimate for that Member State to refuse to grant that advantage if, in particular, because that third country is not under any contractual obligation to provide information, it proves impossible to obtain such information from that country.[89]

The situation with regard to capital movements involving third countries may therefore be said to be that the basic liberalization under Article 56 applies in the same way as it does inside the EC, but subject to the special restrictions permitted under Article 57, and subject to a possible difference in interpretation of the public policy requirements of Article 58.

CONCLUSION

As was indicated at the outset of this Article, the rules governing monetary movements represent a unique evolution of regulatory technique from detailed secondary legislation to directly effective Treaty principle. However, the definitions of capital movements and payments created in the context of liberalization by secondary legislation have been continued into the era of directly effective Treaty provisions on freedom of capital movements. While those definitions were created in the context of rules which applied only within the internal market, they are now being applied in the context of rules on the free movement of capital which are unique (in the context of EC Treaty freedoms) in that they are not limited to the internal market. Furthermore, these definitions have a clear potential for overlap with other Treaty freedoms, notably freedom to provide services and freedom of establishment, with intriguing (and unresolved) consequences for the relationship of free movement of capital to other Treaty freedoms. In particular, the question is raised as to whether, under the guise of free movement of capital, a third country economic operator may offer services or exercise freedom of establishment within the EC. Many such activities would clearly be subject to the restrictions permitted in Article 57 of the EC Treaty, but such restrictions depend on the substantive scope of national law rather than Community law. Even within

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89. *Id.* ¶ 63.

the internal market of the EC, the broad definitions of capital movements have blurred the distinctions between the freedoms, and the European Court has found itself reinterpreting the hierarchy of freedoms set out in the EC Treaty: in a way that is not perhaps immediately obvious from the wording of Article 50 of the Treaty, it has held that freedom to provide services is not subordinate to the other freedoms, and that what matters for the purposes of classification is the essential nature of the transaction or situation. However, the Court has now resolved what had been thought to be one of the most problematic aspects of this overlap between the freedoms, the fact that the wording of Article 58 on capital movements allows for tax discrimination on the basis of the taxpayer's residence or on the basis of the place of investment. If taken at face value this could have made the achievement of a single market for financial services a legal impossibility, but following the judgment in *Manninen*, it now appears that the criteria for determining whether tax discrimination is justifiable in the context of free movement of capital are comparable to those used in the context of freedom of establishment, freedom to provide services and free movement of workers. It may be suggested that this will lead to another incremental step in the development of the single internal market, requiring Member States in some circumstances to take account of tax paid in other Member States and to give tax relief for payments made in other Member States. In this area, the internal market is still on the move.