CONTROLLING INVESTMENTS IN COMPANIES: ESTABLISHMENT OR MOVEMENT OF CAPITAL

Grahame H J Turner

Introduction

Whilst Article 43 EC, the freedom of establishment, is restricted in its field of application to intra-Community investment, Article 56 EC prohibits, also, all restrictions on movements of capital between Member States and third countries[1]. Article 56 EC, therefore, applies also to both investments made in third countries by persons resident in Member States and to investments made in Member States by persons resident in third countries.

Thus, the question might be raised: "if a person resident in a Member State establishes a controlled company in a third country and suffers a restriction under his national law in relation to it, being a restriction that would infringe his freedom guaranteed by Article 43 EC had the controlled company been established in another Member State, can that person obtain protection from that restriction by claiming it to be a restriction to the freedom guaranteed by Article 56 EC?"

If that was to be the case for all types of restriction, there would appear to be little purpose to Article 43 EC in relation to controlling investments in companies. But that cannot be so. There is specific reference to *subsidiaries* in the first paragraph of the Article and the second paragraph provides:

> "*Freedom of establishment shall include the right…to set up and manage undertakings, in particular companies…within the meaning of the second paragraph of Article 48…*".

1 This is subject to the 'standstill' exception in Article 57(1) EC relating to national provisions in force at 31 December 1993 relating to specified types of movement of capital including 'direct investment' (which does not include 'portfolio investment' – see *Commission v Netherlands ['Golden Share']* Case C-282/04 at paragraph 19).

Conversely, Article 56 EC makes no specific reference to controlling investments in companies.

The object of this brief article is to explore where the respective fields of application of the two freedoms begin, end and overlap in relation to controlling investments in companies.

'Controlling Investments in Companies'

It is first necessary to define what is meant by this phrase.

In the context of the application of Article 43 EC, the Court consistently refers to its formulation in *Baars*[2]:

> "*…a holding in the capital of a company…which gives him definite influence over the company's decisions and allows him to determine its activities…*".

In coming to that view of the field of application of Article 43 EC, the Court stated:

> "*…a substantial holding…of at least one third of the shares in a company…does not necessarily imply* ***control or management*** *of the company, which are factors connected with the exercise of the right of establishment.*"[3]

In the more recent *Lasertec* judgment[4], the Court the Court stated:

> "*The treatment of a lesser holding which nevertheless confers a* ***dominant influence*** *over the company concerned…[demonstrates that the national legislation]…is designed to apply…to holdings giving a holder a definite influence on the decisions of the company concerned and allowing him to determine its activities…*".

This case is discussed in greater depth later in the article. The legislation in question is briefly cited in paragraph 4 of the judgment and the Court is referring to the part of that legislation that provides:

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2 See *Baars* Case C-251/98 [2000] ECR I-2787 at paragraph 22.

3 See *Baars* at paragraph 20.

4 See *Lasertec* Case C-492/07 at paragraph 22.

> *"…A shareholder…shall be treated in the same way…where he exercises, either independently or in collaboration with other shareholders, a* ***controlling influence*** *over the company…".*

The Court has recently confirmed that Article 43EC will be in point where a controlling holding of shares is held by a group of persons acting in collaboration. It said:

> *"…In the present case, it is apparent… that all shares in Columbus are held, either directly or indirectly, by members of one family. The latter pursue the same interests, take decisions concerning Columbus by agreement through the same representative at the general meeting of Columbus and decide on its activities…. It follows that the Treaty provisions on the freedom of establishment apply to a situation such as that in the main proceedings."*[5]

In the *Bosal* case[6], the Court spoke in these terms:

> *"…a parent company might be dissuaded from* ***carrying on its activities through the intermediary of a subsidiary*** *established in another Member State…".*

Accordingly, the Court is not looking simply at percentage shareholdings or, necessarily, only at voting rights in the capital. The Court is looking at the ability of the person claiming protection under Article 43 EC to **conduct his business** in the territory in which the company is established **through that company** by having the legal power to determine its operations.

Conceptually, as recognised in the drafting of the Article itself, a controlled company is a vehicle through which the controller pursues his business[7]. Where such a company is a device that conducts no genuine economic activity, it will not constitute an 'establishment' for the purposes of Article 43 EC.[8]

Before leaving this important conceptual definition, the Court has made it clear that the power of control can be exercised indirectly. In its answer to the 'first indent' to Question 2 put to it in the *Thin Cap GLO* case[9], the Court ruled that the freedom of establishment is exercised where a company established in a third country, but

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5 See Columbus Container Services BVBA & Co Case C-298/05 at paragraphs 31 & 32.

6 See *Bosal Holding* Case C-168/01 [2003] ECR I-9401 at paragraph 27.

7 See also *Cadbury Schweppes* Case C-196/04 [2006] ECR I-7995 at paragraph 54

8 See *Cadbury Schweppes* at paragraph 68.

9 See *Thin Cap GLO* Case C-524/04 at paragraph 95.

controlled by a parent company established in a Member State, makes a loan to its subsidiary established in a Member State. The Court indicated also that it matters not how long the chain of control is provided that there is control at each level. A company that controls 40% of the shares of 'subsidiary' and 40% of the shares of another company that controls the remaining 60% of the shares in 'subsidiary' does not control 'subsidiary' even though it is entitled to 64% of its distributed profits. The chain would be broken.

The fields of application of the freedoms

The freedoms are set out in different chapters of the Treaty and it may be considered that they "*…were designed to regulate different situations and they each have their own field of application.*"[10] They may be regarded as "*…being mutually exclusive.*"[11] This said, a national provision "*…may simultaneously hinder the exercise of [two or more of] those freedoms.*"[12]

In the case where "*…one of [the freedoms] is entirely secondary in relation to the other and may be considered together with it…The Court will in principle examine the measure in dispute in relation to only one of those two freedoms…*".[13] An example of this can be found in the *Cadbury Schweppes* case in which the Court found that the "*…restrictive effects on the free movement of services and the free movement of capital…are an unavoidable consequence of any restriction on freedom of establishment and do not justify…an independent examination…in the light of Articles 49 EC and 56 EC.*"[14]

In the specific case of real property, the Court has held that Articles 43 EC and 56 EC can simultaneously apply to transactions and use.[15] This has been further clarified by the Court:

> *"…There is no doubt that such a cross-border investment is a capital movement within the meaning of…[the nomenclature of capital movements*

10 See *Fidium Finance AG* Case C-452/04 [2006] ECR I 9521 at paragraph 28 (in relation to Articles 49 EC & 56 EC).

11 See *Gebhard* Case C-55/94 [1995] ECR I-4165 at paragraph 20 (in relation to Articles 39 EC, 43 EC & 49 EC).

12 See *Fidium Finanz* at paragraph 30 (in relation to Articles 49 EC & 56 EC).

13 See *Fidium Finanz* at paragraph 34 (in relation to Articles 49 EC & 56 EC).

14 See *Cadbury Schweppes* at paragraph 33.

15 See *Konle* Case C-302/97 [1999] ECR I-3099 at paragraph 22.

> *set out in Annex I to Council Directive 88/361/EEC of 24 June 1988]…*"[16]

However :

> *"…in order for the provisions relating to freedom of establishment to apply, it is generally necessary to have secured a permanent presence in the host Member State and, where immovable property is purchased and held, that that property should be actively managed*"[17].

Because the appellant did not own the property in question "…*as part of the pursuit of its activities*…" in that Member State, nor did it even manage the property itself, the Court held that Article 43 EC had no application.

The analysis of holdings of shares in companies is similar. The general rule is that a holding of shares in a company established in a different State is within the field of application of Article 56 EC. However, where a shareholding confers "…*definite influence over the company's decisions and[allows the holder] to determine its activities…*", it comes within the field of application of the freedom of establishment.[18] Where a national provision applies in the case of both controlling and non-controlling interests in companies, separate examinations may be considered appropriate, as mentioned below.

The freedoms of establishment and movement of capital in relation to company participations

The Court has recognised that there is no definition of 'movement of capital' in the EC Treaty. However, it has recognised also that a definition can be construed from "*the nomenclature annexed to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty*". In the *Dutch 'Golden Share'* case[19], two types of investment were described: "Direct Investments", being holdings of shares that confer the possibility of effectively participating in the management of the issuer; and "Portfolio Investments", being the acquisition of shares on the capital market solely with the intention of making a financial investment without having any intention of influencing the management and control of the issuer.

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16 See ELISA Case C-451/05 at paragraphs 59 & 60

17 See ELISA at paragraph 64.

18 See *Uberseering* Case C-208/00 [2002] ECR I-9919 at paragraph 77.

19 See *Commission v Kingdom of the Netherlands* Case C-283/04 at paragraph 19: words slightly adapted.

The distinction between the two is important for the purposes of Article 57(1) EC (the 'standstill' provision for obstructive national provisions in force on 31st December 1993).

The priority of Article 43 EC (where applicable) over Article 56 EC indicated by the Court in the *Uberseering* case appears to be entrenched in the EC Treaty itself. Article 58(2) EC specifically states that the provisions of the Chapter in the EC Treaty relating to the freedom of the movement of capital "*…shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.*"

Thus, if a national provision creates an obstruction to the exercise of the freedom of establishment, but is permitted, it cannot then be examined in relation to the freedom of movement of capital unless "*…the national provision at issue is such as to involve a separate restriction, where the Treaty provisions concerning freedom of establishment do not apply.*"[20]

In the *X and Y* case, such a situation arose in relation to the Swedish share reorganisation rules "*…where…Article 43 EC does not apply having regard to the insufficient level of participation of the transferor in the transferee company established in another Member State.*"[21]

A more recent case in which the national provision could be separately examined under both freedoms was the *FII GLO* case involving the UK's provisions for taxation of dividends.[22] The UK provisions do not distinguish between controlling and non-controlling interests in companies. UK source dividend income is exempt from tax in the hands of a UK resident company but foreign source dividend income is subject to taxation but with credit relief for foreign withholding taxes and for foreign underlying tax borne by the payor (directly or indirectly) in the case of holdings of 10% or more.

Where the national measure is of a kind that deters foreign investors generally, such as the special terms of the Dutch Government's participation in the privatised companies considered in the *Dutch 'Golden Shares'* case, a restriction to the freedom of establishment is considered to be a "*…direct consequence of the obstacles to the free movement of capital…to which [it is] inextricably linked.*"[23] This is discussed further below.

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20 See *X and Y* Case C-436/00 [2002] ECR I-10829 at paragraph 66.

21 See *X and Y* at paragraph 68.

22 See *FII GLO* Case C-446/04 at paragraph 36.

23 See *Commission v Netherlands* at paragraph 43.

The relevance of the purpose and scope of the national provision in determining the freedom infringed

In the case of *X and Y* and *FII GLO*, the national provisions are designed to apply regardless of whether the holding of shares is a controlling interest. In both cases, the shareholder suffers a disadvantage if invested in foreign companies. In the instance of the Swedish reorganisation rules examined in the *X and* Y case, reorganisation tax relief was denied if there was a foreign element, such as a non-Swedish transferee. In the instance of *FII GLO*, profits distributed by foreign companies to UK corporate shareholders might be subjected to a higher level of UK tax than profits distributed by UK companies to such investors. In both cases, a higher domestic tax bill might arise in consequence of investing 'abroad'. Because the provisions apply regardless of the level of participation, examination in relation to both freedoms was held to be appropriate.

In contrast, in the instance of the national provision examined in the *Cadbury Schweppes* case, the Court observed that

> "*…the legislation on CFCs concerns the taxation…of the profits of subsidiaries established outside the United Kingdom in which a resident company has a controlling holding. It must therefore be examined in the light of Articles 43 EC and 48 EC*".[24]

The Court made a similar observation in the *Thin Cap GLO* case:

> "*Legislation…which is targeted only at relations within a group of companies, primarily affects freedom of establishment…*".[25]

In both cases, the shareholder suffered a disadvantage if he made a controlling investment in a company resident in another Member State. In both cases, the national provision took account of the activities of, or transactions with the controlled company. And in both cases, the UK parent could suffer a UK tax charge in consequence of exercising the freedom of establishment.

The UK provisions examined in the cases of *ICI*[26] and *Marks & Spencer*[27] are more aligned with *X and Y* in that the taxpayers were denied advantages under the UK group relief scheme because of their foreign participations although, in contrast to the Swedish share reorganisation provisions, the UK's group relief provisions apply

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24 See *Cadbury Schweppes* at paragraph 32.

25 See *Thin Cap GLO* at paragraph 33.

26 See *ICI v Colmer* Case C-264/96

27 See *Marks & Spencer v Halsey* Case C-446/03

only to groups of companies. In the instance of *ICI*, a UK company was denied advantages under the consortium relief provisions where the majority of the consortium company's subsidiaries were resident outside the UK and, in the instance of *Marks & Spencer*, the UK parent was denied offset for the losses incurred by its non-resident subsidiaries. In both cases, the commercial risk resulting from investing in subsidiaries established outside the UK was greater because of the danger of accruing losses that could not be relieved against other group profits. Accordingly, the disadvantage was incurred only when exercising the freedom of establishment.

In contrast, the special provisions inserted into the constitutional documents of the two companies privatised by the Dutch government and considered by the Court in the *Dutch 'Golden Shares'* case, which gave the Dutch Government a disproportional control over the management and control of the companies in the sense of having a veto over many major decisions, were viewed by the Court as impairing the attractiveness of the companies' shares as investments.[28] Shareholders at all levels of investment had imperfect influence over the companies and the companies themselves had constrained powers to issue shares to increase capital or to make acquisitions. Whilst these provisions equally disadvantaged Dutch investors discrimination is not necessary for there to be a restriction of the movement of capital.

In the *Dutch Shipping* case[29], the restriction created by the national provision interfered with the business of established ship owning companies in that they could not register ships under the Dutch flag if their ownership or management structures did not meet the requirements prescribed by the Dutch legislation and it was of no relevance that the restrictions prescribed did not discriminate against Community or EEA nationality.

By way of example, a French ship owner could not register its ship in The Netherlands unless two thirds of its shares were owned by Community or EEA nationals and that is a clear interference with the right of establishment of the French company. In this example, the freedom is engaged by the direct interference in the right to establishment not the indirect constraint on share ownership of such companies by third country persons.

In the *Lasertec* case, which concerned Germany's thin capitalisation rules[30], the freedom of establishment was engaged because the German provisions, like the UK provisions considered in the *thin Cap GLO* case, were held to "*…apply…to holdings giving the holder a definite influence on the decisions of the company concerned and*

28 See *Commission v Netherlands* paragraphs 21-28.

29 See *Commission v Netherlands* (Shipping) Case C-299/02

30 See also *Lankhorst-Hohorst* Case C-324/00 [2002] ECR I-11779

allowing [it] to determine its activities."[31] The lender and holder of the controlling interest was a Swiss company and, thus, did not qualify to obtain protection under Article 43 EC. And, whilst the national provisions might be an obstruction to the free movement of capital, "*…such effects must be seen as an unavoidable consequence of the restriction on freedom of establishment…*".[32] This reproduces the *Fidium Finance* decision[33] in the context of Articles 43 EC and 56 EC.

Shortly after delivering the *Lasertec* judgment in May 2007, the Fourth Chamber of the Court delivered its judgment in the *Holbock* case[34], which also involved a Swiss holding company. Mr Holbock, an Austrian resident, owned two thirds of the share capital of a Swiss company that, in turn, held 100% of the share capital of a trading Austrian company of which, he was the manager. The offending national provision provided that dividends received by an Austrian individual from Austrian companies are taxed at a reduced rate but dividends received by such an individual from 'foreign' companies are taxed at the full rate of income tax.

The Court distinguished the national provisions under consideration from those considered in *Cadbury* Schweppes and *Thin Cap GLO* and observed in the *Holbock* case that

> "*…the Austrian legislation…is not intended to apply only to those shareholdings which enable the holder to have a definite influence on a company's decisions and to determine its activities.*"[35]

The Court further stated that where the tax rate applied under the national provisions is determined "*…irrespective of the extent of the holding…*", that national legislation "*…may fall within the scope of both Article 43 EC…and Article 56 EC…*".[36]

The Court inevitably ruled on the Article 43 EC claim as it had in the *Lasertec* case that the freedom does not apply to establishments made in third countries. The claim under Article 56 EC failed also because the Austrian provisions were regarded as

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31 See *Lasertec* at paragraph 22.

32 See *Lasertec* at paragraph 25.

33 The Court held in *Fidium Finance* that the provision of credit facilities is essentially a service and that any obstruction created by the German compliance regulations to the free movement of capital was an inevitable consequence of the obstruction to the freedom to provide services. As Fidium Finanz was a Swiss company having no establishment in the Community, it had no protection under Article 49 EC.

34 See *Winfried L Holbock v Finanzamt Saizburg-Land* Case C-157/05

35 See *Holbock* at paragraph 23

36 See *Holbock* at paragraph 24

having been in existence on 31 December 1993 for the purposes of Article 57(1) EC and were, accordingly, permitted.

Summary and Conclusions

The freedoms that will be engaged in any situation will depend upon what is sought to be done by the claimant and by the purpose and scope of the national provisions obstructing him.

In the instance of investments in companies, the case-law of the Court reviewed above appears to provide the following guidance:

1. The *Uberseering* case clarifies that the general rule is that investments made in companies come within the field of application of Article 56 EC but subject to the overriding application of Article 43 EC in the specific case of controlling investments and the *Lasertec* case makes it clear that such will be the case even if no relief can be obtained under Article 43 EC because of the involvement of a third country.

2. If the national provision makes investment in a company unattractive to all persons regardless of nationality, Article 56 EC will be engaged and Article 43 EC will be infringed as an unavoidable consequence in relevant situations (*Dutch 'Golden Share'*);

3. If the national provision applies regardless of the size of the holding to disadvantage a person investing in a 'foreign' company, the provision may be examined under both Articles according to the circumstance of the claimant (*X and Y, FII GLO, Holbock*);

4. If the national provision is designed to apply only in the instance of a controlling investment and disadvantages the holder of that investment by reason of his exercise of establishment (*Marks & Spencer, ICI*) or by reference to the transactions, profits or activities of the establishment (*Cadbury Schweppes, Thin Cap GLO, Lasertec*), Article 43 EC will be engaged and will be exhaustive. Any infringement of Article 56 EC will be an unavoidable consequence of the infringement of that Article;

5. If the national provision is designed to interfere in the business sought to be conducted by a company established in another Member State, Article 43 EC is engaged and will be exhaustive even if the interference is triggered by the nature or structure of the share ownership of the company (*Dutch Shipping*).

This is by no means an exhaustive list but it is sufficient to answer the question posed in the introduction. This question was originally considered in the context of the UK's CFC legislation and the *Cadbury Schweppes* case, albeit that, like in the case of *Holbock*, Article 57(1) would apply.

The answer is that, where the national provision is designed or intended to apply only to controlling investments in companies, Article 43 EC is engaged and is exhaustive (*Marks & Spencer, Cadbury Schweppes, Thin Cap GLO*).

If, such as in the *Lasertec* case, Article 43 EC cannot have any application because of the involvement of a third country, the national provision does not infringe Community law.[37]

37 See also *ICI* at paragraphs 32 & 33.