THE ECJ JURISPRUDENCE ON THIRD COUNTRIES' MOVEMENT OF CAPITAL RIGHTS: IS A CONSPIRACY IN PLACE?

António Pedro Braga[1]

List of Abbreviations

EC	European Community
ECJ	European Court of Justice
ECT	European Community
EU	European Union
FMC	Freedom of Movement of Capital
FoE	Freedom of Establishment
FoS	Freedom to Provide Services
MS	Member State
TC	Third Countries
TFEU	Treaty on the Functioning of the European Union

1. Introduction: The significance of the issue

One of today's hottest topics in the domain of EU direct taxation is the definition of the scope of TC rights vis-à-vis the prohibition of *"all restrictions"* on movements of capitals between TCs and MSs, laid down in article 63 of the Treaty on the Functioning of the European Union (TFEU)[2]. No great effort is needed to grasp the significance to TCs of the extension of the FMC in the EU: besides ensuring a

1 *The author is a Managing Associate at the Tax Department of Morais Leitão, Galvão Teles, Soares da Silva, a Portuguese law firm, and this article is based on an essay written for the* Master of Arts *in Taxation of the Institute of Advanced Legal Studies of the University of London.*

2 Any non-identified articles regard the TFEU.

territorial range which encompasses all countries, from the biggest to the smallest[3], and a *material* scope that includes from the buying of foreign currency to the acquisition of shares in public companies, the FMC is the product of a one-sided willingness of the EU to open its capital markets to TCs and also to foster outbound capital movements by EU persons which necessarily does not find, on the part of TCs, a comparable openness.

Furthermore, persons and companies from TCs which could claim FMC rights are probably not as aware of those rights and of their economic virtues as the EU citizens and entities, and that circumstance may explain why only recently direct tax cases on this subject began being referred to the ECJ more frequently.

For a large part of the EU direct tax law doctrine[4] it appears, though, that in the ECJ's view, the extension of the FMC to TC's is a sort of unilateral "Munich Pact" enshrined in the EU's foundational law, but whose non-reciprocal generosity should be mitigated in the field of direct tax via a very restrictive hermeneutical approach. Indeed, many authors have expressed, with varying intensity, their skepticism and disagreement towards the approach taken by the ECJ in this field, especially in regard to the Court's reasoning about the interaction between the FMC and the other freedoms.

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3 The concept of "third country" is not as easy to define as it may seem, given that the borderline between the notion of "Member States" and other jurisdictions like the "overseas countries and territories" - to which Part IV of the TFEU and, previously, the ECT, apply - and the "other territories" like the Channel Islands is very tenuous, to the point that the former, are neither deemed as MS, nor as TCs and the "other territories" are still to be expressly fit into that category. For a detailed analysis on this subject, see P. Kavellars, *The Foreign Countries of the European Union*, EC Tax Review, Ed. Kluwer 2007/6, p. 268.

4 See, among others, Pasquale Pistone, *The Impact of European Law in the Relations with Third Countries in the Field of Direct Taxation*, Intertax 34, 2006, no. 5, p. 234., Dennis Weber, *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht: The ECJ gives the wrong answer about the applicability of the free movement of capital between the EC member states and non-member countries,* British Tax Review 6 (2007). Daniël Smit, *The relationship between the free movement of capital (…),* EC Tax Review 2007-6, p. 267, Daniël Smit and Ben J. Kiekebeld, *EC Free Movement of Capital, Corporate Income Taxation and Third Countries: Four Selected Issues*, Ed. Kluwer 2008, p. 43., Christiana Panayi, *The Fundamental Freedoms and Third Countries: Recent Perspectives*, *European Taxation* (November 2008), p. 571, and *Thin Cap GLO et al. – a Thinly Concealed Agenda?*, Intertax, Vol. 35, no. 5, 2007, p. 298., Martha O'Brien, *Taxation and the Third Country dimension of free movement of capital in EU Law: the ECJ's rulings and unresolved issues*, British Tax Review, 2008. Tatiana Falcao, *Third-Country Relations with the European Community: A Growing Snowball*, Intertax, Volume 37, Issue 5, Kluwer 2009, p.316., Georg Kofler, Axel Cordewener and Clemens Phillipp Schindler, *Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before ECJ, European Taxation*, March 2007, Renata Fontana, *Direct Investments and Third Countries: Things are Finally Moving… in the Wrong Direction*, European Taxation, October 2007, p. 431., Sigrid Hemels et al., *Freedom of Establishment or Free Movement of Capital: Is there an Order of Priority? Conflicting Visions of National Courts and the ECJ,* EC Tax Review, 2010/1, p. 19, Steven Den Boer, *Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?,* European Taxation 2010 (Vol, 50).

While we concede that the Court's proverbial laconism does not help much in removing some of the interrogations that are still making headlines over the subject, we are, nonetheless, convinced that it is following quite closely the *spirit* of the FMC in relation to TCs. As we see it, this apparently dominant trend for the overturn of some of the aspects of the Court's interpretation is, to some extent, unfair, and fails to reach what we believe to be the *rationale* followed by the ECJ in its decisions in MS/TC situations. The purpose of this work is then, from an overall review of the landmark cases that have defined the Courts' thinking in this domain and the positions took by some of the authors that have opined about it, to attempt at explaining why, in our opinion, the ECJ has, in general, decided in coherence with the Treaty's goals and principles. We intend, as well, to identify some of the issues relating to FMC for TCs which we believe may shed some additional light on the ECJ's line of thinking about the extra-EU reach of the FMC.

2. The *text* and the *context* of the FMC in relation to third countries

2.1. The history of FMC and of its extension to TCs

All restrictions on the movement of capital between Member States and between Member States and third countries are prohibited under article 63. Curiously, being the last freedom of movement rule to be introduced in the EC Treaty, the FMC it is by far the widest as far as its territorial scope of application is concerned.

Up until 1992, the FMC had not acquired, even within the EU, the *erga omnes* effect granted to the other freedoms of movement by a direct command inserted in the EC Treaty[5]. In fact, although foreseeing the progressive abolition of restrictions on movements of capital in the EEC, the Treaty of Rome did not require their immediate liberalization, but invested in the Council the power to issue Directives to fulfill that goal. In the use of that power, the Council issued Directive 88/361/EEC[6], which purpose was to suppress any restrictions on the movements of capital between MSs while submitting a catalogue of capital movements (Annex I) that would benefit from such suppression. The MSs had until July 1, 1990, to enact in their internal jurisdictions the necessary measures to give effect to the prescriptions of the Directive.

5 That conclusion can be clearly drawn from the early ECJ Case 203/80 (*Criminal proceedings against Guerrino Casati*).

6 Official Journal L 178, 08/07/1988 P. 0005 – 0018.

The aforesaid catalogue was quite extensive, comprising twelve[7] specific categories of capital movements object of liberalization and a residual category regarding *"other capital movements"*, that were not accessible to third countries, although the intention to provide such territorial extension was clearly affirmed therein (cfr. Article 7):

> *"The Member States shall endeavour to attain the same degree of liberalization as that which applies to operations with residents of other Member States, subject to the other provisions of this Directive*"

This meant that, as early as mid-1990, the FMC became enforceable, but only with the Treaty of Maastricht, in force from 1 January 2004, did it acquire the dignity of a treaty freedom, through the introduction of article 73b in the ECT. However, evidencing that the EU lawmaker had always intended to establish this freedom with a universal territorial scope, article 63 foresaw, from its inception, the same freedom for all movements, regardless of the jurisdiction involved. However, a grandfathering provision was introduced in article 64. This rule safeguarded restrictions "*which exist on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries involving direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets".*

It follows that, historically, the protection of TCs FMC rights has been walking hand in hand with the protection of EU-wide movements. That being said, it would certainly be difficult to understand if the ECJ took a different route from the one prescribed by primary EU law and began curbing a freedom on grounds of the geographical origin of the entities involved, where such origin has, since Maastricht, appeared to be of very small legal significance.

2.2. Early landmark cases on FMC

In order to comprehend the ECJ's perspective on the breadth and depth of the FMC laid down in article 63, one must first to look at the earlier decisions it has handed down regarding this matter, which, it must be said, have very often been overlooked. In *Bordessa and others*[8], judged in 1995, the Court pointed out that the liberalization

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7 Those categories being (i) direct investments, (ii) investments in real estate, (iii) operations in securities normally dealt in on the capital market, (iv) operations in units of collective investment undertakings, (v) operations in securities and other instruments normally dealt in on the money market, (vi) operations in current and deposit accounts with financial institutions, (vii) credits related to commercial transactions or to the provision of services in which a resident is participating, (viii) financial loans and credits, (ix) sureties, other guarantees and rights of pledge, (x) transfers in performance of insurance contracts, (xi) personal capital movements, (xii) physical import and export of financial assets,

8 Joined cases C-358/93 and C-416/93.

of the movement of capitals had really begun earlier than the introduction of article 63; the direct applicability of FMC within the EU (then EEC) had been achieved after the deadline for transposition of Directive 88/361/EEC by Member States and citizens could rely directly on it. This decision was also important in clarifying the Court's standpoint on the proportionality of restrictions imposed on movements of capital.

Another landmark non-tax case dealing with transfers of bank notes and coins was *Sanz de Lera*[9]. In its judgment on this case, the Court took the opportunity to clarify that article 63 and 64 were applicable without the need for prior implementation by the internal laws of Member States (*direct effect*). In addition, as one of the persons involved was a Turkish citizen flying to Turkey with Spanish currency, the ECJ had to rule on whether he was covered by the FMC. The Court held that he was, since no grandfathering provision for that kind of capital movement had been secured in the Treaty, and article 63 was equally applicable to him.

Three more cases deserve to be highlighted in the ECJ's early record on FMC. In *Trummer and Mayer*[10] the Court remarked that:

> "*However, inasmuch as Article 73b of the EC Treaty substantially reproduces the contents of Article 1 of Directive 88/361 (…) the 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 73b et seq.* (…)".

It then became clear that the ECJ would use Annex I of the cited Directive as the fundamental reference for the identification of the movements of capital enjoying freedom under the Treaty, despite its acknowledged non-exhaustive nature. The interaction between the FMC and other freedoms was addressed in *Luisi and Carbone*[11], where the ECJ held that any controls on the movement of capitals permitted under the provisions of the Treaty could not constitute a disguised means of restriction of another freedom, namely the FoS.

A final mention is due to the 1981 *Casati* judgment, not so much for its importance in defining the scope of FMC, but rather because it contains one of the fundamental ideas of the ECJ's line of reasoning about the interaction between the FMC and the other freedoms:

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9 Joined Cases C-163/94, 165/94, and 250/94.

10 Case C-222/97.

11 Joined cases 286/82 and 26/83, *Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro*, para.34.

> *"Thus the free movement of capital constitutes, alongside that of persons and services, one of the fundamental freedoms of the community. Furthermore , freedom to move certain types of capital is , in practice, a pre-condition for the effective exercise of other freedoms guaranteed by the treaty, in particular the right of establishment ."*

This idea, which is wisely reminded to us by Däniel Smit[12] but that appears to be neglected by some of the authors that have written about the subject, is probably one of the most important hermeneutical assumptions the ECJ has been relying on cases where FMC and other freedoms are involved. That is very clear from cases like *Lasertec*[13], where as we will see, the alleged prevalence given by the ECJ to the FoE has been harshly criticized[14].

2.3. Jurisprudence regarding FMC and direct taxes

The bulk of the criticism that has been directed at the ECJ originates mainly from the way the Court has been deciding on cases which potentially involve the FMC and the freedom to provide services or the freedom of establishment. A number of cases in this area are now available and they include some which involve MS/TC situations alongside MS/MS ones. We will present an overview of some of these cases, on their TC implications, namely *Orange European Smallcap*[15], *FII Group Litigation*[16], *Thin Cap Group Litigation*[17], *Lasertec*, *Holböck*[18], *KBC*[19] and *Fidium Finanz*[20], and, thus, place ourselves in the right angle to verify whether the ECJ has failed to develop a treaty-abiding and coherent jurisprudence to the detriment of TC's rights, as has been pointed out in the literature, or if, on the contrary, these rights are getting just the protection ensured by the TFEU.

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12 Op cit.,p.5

13 Case C-492/04, Para.25

14 See below, page 12, footnote 3.

15 Case C-194/06.

16 Case C-446/04.

17 Case C-524/04.

18 Case C-157/05.

19 Case C-439/07.

20 Case C-452/04.

FMC and FoE cases where TCs are involved

The first of the above cases is *FII*. Regarding this case, it is especially relevant to see how the Court decided on the conformity with the FMC of the so-called FID (foreign income dividend) regime applicable to companies resident in the UK receiving dividends from foreign sources. Under this regime, UK companies could treat a dividend distribution to their shareholders as a FID whenever that distribution had been done on the basis of foreign dividends received by the distributing company. The outgoing dividend paid advance corporation tax (ACT) but entitled the distributor to a refund of that ACT, which could reach its total amount, to the extent that FID matched the value of the outgoing dividend. The problem was that an individual, receiving dividends from a company in these conditions, could not benefit from a credit, but was treated as receiving low-taxed income.

The TC issue was related with the circumstance that although the FID provisions were introduced in July 1994, that is, after the relevant grandfathering date of article 64 TFEU, the Treaty did not prevent the introduction of measures essentially identical to others enacted before 31 December 1993. But those restrictive measures had to relate to *direct investment* (cf. Annex I, Directive 88/361/EEC) to be safeguarded under article 64, and that lead the ECJ to declare that only insofar as holdings in a company were "*acquired with a view to the establishment or maintenance of lasting and direct economic links between the shareholder and that company"* and allow "*the shareholder to participate effectively in the management of that company or in its control"* would they qualify as direct investments, and, as a result, would the restrictive measure be lawful.

In *Thin Cap*, the question at issue regarded the compatibility with EU law of the UK thin capitalization regime in the aftermath of the Lankhorst/Hohorst judgment. That regime had undergone various modifications, and all of them were at stake, but in relation to third country lenders to UK companies, the first decisive question to be answered was whether the UK rule which first did not allow an interest deduction on borrowings from non-UK companies to UK-related companies to or did not allow it above a certain arm's length amount, fell under the scope of the FMC or the FoE. The Court, inspired by *Baars*[21], took a *teleological* approach to assess which freedom was at stake. It held that the application of the restrictive rules always required a certain level of control by the lender, as they targeted group relations, and therefore, concerned article 49 and not the FMC. The restriction was, in a formula repeated many times by the Court, an *"unavoidable consequence"* of the restriction

21 Case C-251/98. *Baars* was especially important because it established a criterion to distinguish the exercise of the FoE from the exercise of the FMC in relation to tax restrictions in shareholdings. For the Court, *"a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment"* (para.22).

on the FoE. The consequence, for cases where the lenders are non-member countries, would be that they could not rely on the FMC.

In *Lasertec* the ECJ reiterated its own reasoning with respect to restrictions on controlling shareholdings vs. portfolio shareholdings. The case dealt with a situation akin to that judged in *Thin Cap GLO*, but exclusively in a MS/TC scenario*:* it was necessary to ascertain if a Swiss company which owned 2/3 of the share capital of a German company and which had made a loan to the latter could be liable to the German thin cap rules. The ECJ, following in the footsteps of previous case-law, namely *Baars* and *Thin Cap GLO*, realized that the German thin cap regime was also dependent on the lender being able to exercise *definite influence* over the borrower, and so the freedom at stake was the FoE, again a possible curb on the FMC being an *unavoidable consequence* of the latter. So, the Court maintained that the *purpose* of the rule at issue was decisive and added that there is no fixed percentage above which FoE comes into play, as *definite influence* can be exercised through different shareholding percentages in different situations.

The case facts in *Holböck* also pointed to the existence of such *definite influence*, as Mr. Holböck, an Austrian resident, held 2/3 of the share capital of a Swiss company and the question referred for a preliminary ruling in this case concerned the tax treatment given to dividends arising from that shareholding in Austria. The Austrian law provided for different rates depending on whether the dividends were distributed by Austrian companies or foreign ones, but in this case the higher rate applied to all foreign-sourced dividends irrespective of the size of the shareholding. The importance of Holböck lies in the fact that, unlike in the preceding cases, the restrictive rule was not aimed at a controlling participation, its *purpose* being to encompass all foreign dividends[22]. This led the ECJ to uphold that both FMC and the FoE could be at stake. However, the standstill provision of article 57(1) could be applied in this case, for Mr. Holböck's investment was *direct* in the sense of Annex I of Directive 88/361/EEC, and the restrictive legislation had been in force before 31 December 1993. Had this not been the case, probably the Court would again, inspired by ACT IV GLO[23] uphold that the FoE would be at stake as the *case facts* showed the existence of *definite influence*.

Another landmark case in this area is *Orange European Smallcap*, where the Court was asked to judge, in relation to TCs, whether article 56 (article 63 TFEU) should be applied uniformly irrespective of the movements of capital taking place within

22 In the Court's own words: *"Unlike the situations in Cadbury Schweppes and Cadbury Schweppes Overseas (paragraphs 31 and 32) and Test Claimants in the Thin Cap Group Litigation (paragraphs 28 to 33), the Austrian legislation in the present case 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"* (para.23).

23 C-374/04, *Test Claimants in class IV of the ACT Group Litigation v Commissioners of Inland Revenue.,* paras. 38 and 39.

the EU or between TCs and the EU, and also if *"a Member State's (The Netherlands) reduction of the concession provided for fiscal investment enterprises established in that Member State with regard to taxation at source of a dividend received from a third country on the basis of the interest in that enterprise of shareholders who are not resident or are not established in the Member State concerned constitutes a restriction on the free movement of capital."*[24]

This an interesting case in the perspective of third countries because it only deals with the FMC and not with the FoE, which apparently would never be an issue here, since it involved investments in funds in respect of which no *definite influence* and *control* seemed exercisable by investors. The ECJ really stood by the TC's position declaring that the above restriction was incompatible with the FMC and rejected the arguments of the Dutch Government that the situation of residents in TCs was not comparable to that of residents in The Netherlands, and that such circumstance excluded, under article 65 (1) (a) the illegality of the difference of treatment. The Court also emphasized that *loss of tax revenue* could never be a justification in this TC scenario insofar as the restriction affected also investors of Member States. Finally, this case was also remarkable in the way the Court bluntly reminded that "*when the principle of free movement of capital was extended, pursuant to Article 56(1) EC, to movements 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 for those relating to relations with third countries."*[25]

In *KBC*, the ECJ, asked if the Belgian internal method of elimination of economic double taxation on dividend distributions was unlawfully discriminatory in regard to dividends from third countries as it did not allow the carry forward of credits for those dividends[26], responded that:

- National legislation which is applied irrespective of the extent of a holding "*may fall within the purview both of article 43 EC (…) and article 56 EC*";[27]
- *Definite influence* leads to the application of the FoE, but this freedom will only apply if the *purpose* of the legal provision in question or the *facts of the case* point to that *definite influence;*
- In a Member State/TC scenario a restriction on FMC may be justified by reasons other than those acceptable when only Member States are involved.

24 Cfr., para.103.

25 Cfr., para.87.

26 Cfr., para.24.

27 Cfr., para.69.

FMC, FoS and TCs – Fidium Finanz

The factual background in *Fidium Finanz* involved a Swiss finance company which had been denied the right to grant loans to customers in Germany through the internet, as it lacked a domestic authorization for that purpose. The reference for a preliminary ruling was made on the grounds of a possible breach of article 63, as the authorization was only required to entities carrying on activities “in the national territory” and not “towards the national territory” as was the case of *Fidium Finanz*. It revolved around the problem of determining whether the commercial granting of credit was primarily a financial movement protected by article 64, or a provision of services under article 56.

Although acknowledging that the granting of consumer credit was beyond doubt a capital movement as per the nomenclature laid down in Directive 88/361/EEC, the ECJ held that such activity entailed a provision of services, both under settled case-law and community secondary legislation[28]. The consequent overlap of the two freedoms had to be solved, according to the Court, by identifying the *prevailing* freedom. For the judges, it was unequivocal that the granting of commercial credit in the conditions observed in Fidium’s case was a provision of services, as the purpose of the potentially restrictive rules was to ensure that the services providers enjoyed certain *qualities* which gave assurance that they would properly conduct the granting of credit. Those rules did not target the subsequent signing of the contract and transfer of the loan amounts[29], but rather posed a restriction to the performance of services which could not be removed on the basis of the FMC by a non-EU domiciled company like Fidium Finanz. The circumstance that this restriction might have harmed the financial movements between the two countries involved was again seen as an *unavoidable consequence* of a restriction on a freedom not accessible to the Swiss company.

3. Is the criticism trend right or is there coherence overall (albeit with some shortcomings)?

3.1. Special guidelines for application of the FMC towards TCs?

Being a non-reciprocal freedom of movement, the FMC may create some rights for non-EU residents, as regards direct taxes, which may not be available to nationals of the Union. This may well impact the national revenues and even allow illegitimate tax avoidance which is the States’ prerogative to avoid. Thus, it is fair to ask whether the FMC towards TCs deserves such a broad application as is being upheld

28 Cfr., para.39.

29 Cfr., para.45.

by the ECJ for the same freedom in MS/MS situations[30].

In our opinion, nothing in the legislative and historical context of the introduction of this freedom can lead us to believe that TCs suffer a *capitis diminutio* in this respect. As noted by authors like Cordewener, Köfler and Schindler[31], the question of the *direct application* of the FMC towards TCs has been raised before, but really with no grounds on which to justify an effective different treatment in relation to purely EU movements[32]. This is so because, in the first place, the provision establishing the FMC does not draw any distinction based on territoriality, despite the inclusion in the Treaty of a grandfathering provision specifically for third countries[33] which was completely justifiable since the movement of liberalization within the EU had begun four years earlier. Second, none of the article 65 clauses excluding the illegality of some restrictions to the freedom of movement of capital applies differently to movements with third countries.

This point has not generated much discussion given that the ECJ has always held, from *Sanz de Lera*, that the wording of article 63 points inevitably to the application, in the same way and to both intra-EU and extra-EU operations, of the freedom provided for therein[34]. Therefore, although some talk has been spent on a possible reduction of the material scope of the application of article 63 TFEU to MS/TC situations[35], we believe that the present controversy surrounding this matter derives much more from differences of interpretation than from differences on the *scope of application* of the FMC. Indeed, we are convinced that the ECJ has not been formulating innovative *guidelines* on the scope of application of the FMC vis-à-vis the other freedoms, aiming to reduce that scope; it has merely been sustaining a consistent purposive interpretation, in accordance with the general principles of interpretation laid down in article 31 of the Vienna Convention on the Law of Treaties (VCLT), on the way those freedoms concretely interact.

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30 Examples of judgments that were seen as broad interpretations of the FMC are, for instance Case C-315/02 *Lenz* and Case C-319/02 *Manninen*.

31 Op cit., p.110.

32 Craig and De Búrca seem to suggest otherwise, but apparently not to the point of denying the *erga omnes* effect of this freedom (cfr. *EU Law, Text, Cases and Materials*, Oxford University Press, 4th Edition 2008, p. 725).

33 See article 64 (1) (2) TFEU.

34 See, *inter alia*, Case C-101/05 *Skatteverket v. A*, para.31 *et seq.*

35 See Cordewener et al, op cit. p. 112. These authors refer to a reduction of the scope of application of the FMC as a result of the ECJ's position in applying exclusively the other two freedoms whenever the former coincides, in a given situation, with one of the latter.

3.2. *The interaction between the FMC and the Freedoms of Establishment and Services and the problem of* exclusivity *or* predominance

In our view, the best way to discern between the freedoms at issue is to go *back to basics*, ie., to understand the potential economic impact of each of the freedoms and the way that economic impact has molded their integration into the Treaty.

FoE is the "*right to take up and pursue activities as self-employed persons and to set up and manage undertakings (...), subject to the provisions of the Chapter relating to capital*". This right includes a number of positive features and also a very important *negative* one: the right of a non-national to resist the application national measures which may compromise the *free establishment*[36]. Economically speaking, it can be said that the FoE comprises the possibility to *actively* participate in an MS' economy, mainly through a fixed installation and a direct management of the activity carried on from there. A country awarding this freedom is renouncing to restrain a business which may *actively* change its economy. No such right is given to TCs in the Treaty.

FMC, in its turn, refers to movements of capital of all sorts, from deposits to insurances[37], meaning, in a TC context, that no TC national (or resident) may be impeded to place his capitals in the EU and also that no EU national (or resident) may be refrained from moving capitals outside of the EU. The intersection between the FMC and the FoE may be seen in other capital movements, but it is in the field of *direct investments* that the borderline between capital and investment seems to appear less clear. Anyway, if the FoE is to have a meaning of itself, FMC in situations of *direct investment* must relate to the *financial and monetary* side of it, ie., to everything related with the placement of capital required, vg., for the maintenance of the *lasting economic links*[38], as typically occurs, for instance, with the acquisition of a majority stake in a company. The FMC does not mean that the activity itself cannot be restricted *ab initio* or after it has been taken up, if the legal conditions for it cease to be observed. The same could be said about the relationship between the FMC and the performance of services. The FoS is an *end* in itself, insofar as it concerns the actual possibility to perform a service (vg., providing legal services) whereas the capital required for it is a *means* which may, nonetheless, be of vital importance to that *end*.

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36 See Wyatt and Dashwood, in *European Union Law*, Thomson/Sweet & Maxwell, 5th Edition, London 2006, p. 754.

37 See below, p. 4.

38 See Directive 88/361, Annex I (2) (3) (4). For instance, the FMC does not allow the practice of an insurance activity, it enables the "*transfer of capital in performance of insurance contracts*" (see below p. 4).

Rules of Conflicts

This said, one should also verify whether the conflict rules foreseen in articles 49, *in fine*, and in article 65(2), state an order of preference of one of the freedoms at issue, whenever there is a potential dual freedom protection. As regards the first provision, although we do not share the position of the Commission[39] that this conflict rule is redundant beyond the scope of the provision of article 64(1), as it may also be relevant where non-discriminatory capital movement restrictions are justified under article 65 (1) (a), we consider, as Smit[40], that no prescription to limit the extension of the FMC may derive therefrom. As to article 65 (2), it appears clear that its aim is to elucidate that the application of the lawful restrictions to the FoE in cases where the FMC could also apply cannot be put at stake by the latter freedom, and it impacts MS/MS situations as well as MS/TC ones. For example, an UK individual, other than a lawyer, cannot rely on the FMC to acquire a majority stake of a Spanish Law firm if there is an internal restriction thereon. The aforesaid provision does not imply, as defended by Smit[41], that a TC person may be entitled to an *establishment*, (only thinkable under the *direct investment* provisions), article 56 (2) being only a way to ensure that TCs are under the same restrictions that impend upon intra-EU establishments.

In conclusion, it could be said that none of the conflict rules establishes a rule of prevalence. It is manifest, from the case-law, that the decision on which freedom to apply should be based on a *teleological* interpretation of the restrictive domestic law[42], and not on an *a priori* definition of the scopes of application; thus the scarce references to the conflict rules by the ECJ.

Interpretation criteria. Purposive approach with exclusivity or parallel application?

A different question is to assess whether the pendulum of the ECJ's decisions on TC's has been purposefully swinging to the FoE and the FoS' side, through a biased undervaluation of the FMC. On this matter, we tend to agree that the conflict at issue has much to do with *causality*, ie., with defining a criterion to determine if there is a *"sufficient link between the contested measure"* and the FMC[43]. In our opinion,

39 Cfr. Daniël Smit, *EC Free Movement of Capital, Corporate Income Taxation and Third Countries* (…), p. 14

40 Op cit., p. 14.

41 Op cit., p. 16.

42 As noted by Tom o'Shea, *Third Country Denied Freedom of Establishment Rights in Lasertec*, Tax Notes International, June 4 2007, p. 990. From the same author and also about this subject, *Holbock: Austrian Dividend Tax Rules found compatible with the EC Treaty*, Tax Notes International, 11 June 2007, 1131-1134.

43 Smit, op. Cit., p. 37

what the Court is doing is precisely that: it is trying to look at the scope and purpose of the restrictive national rule and identifying its links with the freedoms which may be at issue. The fact that it has done so less by focusing on the FMC than by defining the scope of application of the other two freedoms, may be due more to a methodology of analysis than to a pre-existing rule of priority. For the Court, it is certainly easier, in most cases, to set the freedoms apart by circumscribing the nucleus of the FoE and the FoS, and avoid further investigation, whenever it is concluded that the restriction is closely linked with one of those freedoms. This is clear from the Court's *dictum* in *A*[44].

In Smit's detailed study about the subject, this author identifies two trends in respect of the concurrence of the two freedoms. A first trend sustains that the FMC, whenever the cross-border movement is of a *passive* nature – that nature being determined by the *purpose* of the rule - the FMC is exclusively applicable. Otherwise, the other freedoms apply[45]. This approach, that we could well label *purposive with exclusivity*, has not gained much support and is not in line with the consolidated views of the ECJ about the subject, clearly expressed, *inter alia*, in *KBC*[46], *Thin Cap Glo*[47] and *Burda*[48]. In fact, it is settled case-law and doctrine[49] that the FMC and the other two freedoms may be applied simultaneously.

The predominance rule and the purposive interpretation

The main source of criticism of the ECJ's judgments in this domain has been the application of a rule of *predominance* of one of the freedoms, by virtue of a previous analysis of the *purpose* of the provision, that is to say, by assessing whether the restriction targets a form of exercise of a freedom or the other, or of both. As a matter of fact, one can identify two lines of cases where this criterion has had full applicability and has been decisive for their outcome. A first line comprises cases like *Thin Cap GLO* and *Lasertec* where the concept of *definite influence* through a direct or indirect shareholding of a company, developed in *Baars*, was the decisive criterion for the Court's inclination to state that the freedom at stake was the FoE.
About this, many authors have expressed their strong reservations. For Cordewener et al., the primacy of this *definite influence* criterion over a further examination of the restrictive rule leads to the dispensability of article 64(1) in regard to *direct investments,* as those investments prior to 1994 would always fall under the scope of

44 Cfr. Para.22.

45 Op.cit., p.27.

46 Cfr. Para. 69.

47 Cfr. Para.36.

48 Case C284/06, para.71.

49 Smit, op cit. p.41., and Cordewener et al., op cit., p.112.

the FoE, and thus, would never be available to TCs[50]. These authors also raise the question of the legitimacy of the protection of third country investments being inversely proportional to the size of such investments. Other authors, like Renata Fontana[51] are even more assertive, considering that the Court has taken a step too far by determining an "automatic" exclusion of the FMC whenever *definite influence* comes into play, but base their assertions on a need to adopt a *systematic* interpretation of the provisions the freedoms articles which they really do not clarify. Finally, literates like Christiana Panayi are more radical, implying that the Court may have an agenda to subordinate the FMC to the other freedoms as a way to curb TCs rights Court when they say it is *"reluctant to apply the FMC if there is an overlap with another freedom"* [52].

The arguments put forward are not convincing.

Let us look first at the level of *substance*. It is undisputed that the dividing line between an investment of a *passive* nature and an *active* investment where the investor is not only placing capital but is deciding how that capital should be invested, is the exercise of *control* or *direct influence*. This last decision is clearly linked with an *establishment* in general, and with the setting up of a *subsidiary*, in particular (article 49). For both the host and the origin states the exercise of the right of establishment normally has an economic impact which largely exceeds that of the mere placement of capital needed for that establishment. Moreover, due to such impact and to the use non-nationals or non-residents may make of the *establishment*, the need to restrict its effects by those states may be felt more acutely. The same can be said about the rendering of regulated services like banking, health, legal, security and others.

The restrictive rules at issue in *Lasertec* and *Thin Cap GLO* (both host state cases) were precisely aimed at restraining the (tax) effects that the exercise of *definite influence* conferred to the controlling shareholders (the shaping of the level of debt of the subsidiaries) and, thus, were directly aimed at the exercise of establishment in a certain way. The *capital* factor was, indeed, secondary, and an evidence of that was that the application of the restrictive rule was dependent on a debt-to-equity ratio rather than on the amount of the loan. It is therefore, perfectly understandable that where the *size* of the shareholding confers *definite influence* and the contested rules are aimed at restraining its effects, the applicable *freedom* is the FoE, which is not available to TCs.

The same can be said about *Fidium Finanz,* which involved the rendering of banking services. The background facts are a clear evidence of the *substantive* need to give

50 Op. Cit., p. 113.

51 Op. Cit. p. 434.

52 Op. Cit. p. 573.

predominance to the FoS in that situation: the regulation of the granting of commercial loans is notoriously more linked with the *services* side of that activity than with the placement of capital[53]. To illustrate this, we can say that the main difference between a purchase of 100 million euros of bonds and the granting of 100 million euros in consumer credit in Germany is that the last activity is clearly a service, although both entail movements of capital. That is why, in substance, the concepts of "*prevailing freedom*[54]" and "*unavoidable consequence*" are only there to express a hierarchy on the applicability of freedoms which derive, in the above cases, from the *purpose* of the rule, and its importance should not go beyond that of consistently describing the reasoning of the Court. They do not express a pre-existing preference for one of the freedoms.

In this context, the judgments of the Court really prove its consistency with the *purpose-of-the-rule* approach. As accurately noted by Tom O'Shea[55], in *Lankhorst-Hohorst*[56] , the question referred to the ECJ dealt with thin cap rules as in *Thin Cap GLO*, but in a strictly MS/MS scenario, and the ECJ decided, as in the latter case, that the freedom at stake was the FoE. In that case, if it had decided to apply, in parallel or in exclusivity, the FMC, the restriction would, most probably, also be found illegal. This, then, prompts the question: is it coherent to decide differently, and concede rights to TCs against settled principles held by the ECJ in a MS/MS context?

An additional proof of the Court's consistency in this field is a mirror-case to Lasertec: *Comission V. Netherlands (Golden Share)*[57]. In this case, although it had been questioned by the Commission whether the Dutch State's *golden share* was an obstacle to the acquisition of a position of control by a non-resident, the Court held that the breach of the right of establishment thereof was a *"direct consequence of the obstacles to the FMC"*.

As much as we agree with the *purpose-of-the-rule* approach taken by the Court, we cannot say the same in relation to the alternative *factual* approach it has been developing in cases like *Holböck*, *KBC* and, more recently, in *SGI*[58]. When a restrictive rule, like the denial of the tax advantage to foreign dividends in *Holböck*, is not designed to restrict a form or a manifestation of the FoE but a movement of

53 Cfr. *Fidium Finanz*, para. 4. This paragraph really defines the services character of the activity at stake.

54 Or "center of gravity" or "predominant feature" as recalled by Smit, op. cit., p.35.

55 Op cit., p. 990 (3/4).

56 Case C-324/00.

57 Cases C-282/04 and C-283/04.

58 Case C-311/08, para.35.

capital (like dividend distributions), then it must be considered that it *primarily* affects the FMC. In this event, the *purpose* of the rule is to restrict a certain movement of capital, whatever the degree of control an investor has vis-à-vis the investment, as is the case in *Holböck*. What we do not understand in the ECJ's reasoning in *Holböck* (though we agree with the final solution based on 64(1)) is why the FMC was not seen as being the primarily affected freedom, since the ECJ admitted it had been restricted. If it turns out that, in a similar case, the discriminated against or restricted shareholding grants *definite influence* to its owner, a possible factual restriction on the FoE should be considered an *unavoidable consequence* of the restriction on the FMC. That would be no more than a consistent application of the *Golden Shares* jurisprudence. Otherwise, to keep on sustaining said approach, may be tantamount to depriving the *purpose-of-the-rule* methodology of any useful meaning, as the facts of the case will, eventually, dictate its outcome[59].

Justifications

With respect to justifications, we disagree with some of the doctrine that has shown inclination to accept the *loss of tax revenue* as possible justification for a restrictive measure on the FMC as regards TCs[60].

It is a known fact that the objectives underlying the FMC towards TCs do not stem from the common EU aspiration of implementing the *internal market*, but from the goal to "*ensure the credibility of the single Community currency on world financial markets and maintaining financial centres with a world-wide dimension within the*

59 The ECJ's decision in Case C-182/08 *Glaxo Wellcome*, appears also to be in contradiction with the previous judgments in *KBC* and *Hölbock*, as far the criterion to ascertain the *primarily affected freedom* is concerned; it must be noted, though, that the background to the first case includes any non-resident entities – although, from a *principled* and *coherent* standpoint, that circumstance should be irrelevant. The referring court had asked the ECJ to declare whether Germany was infringing articles 49 or 63 when it excluded, from the corporate tax computation, the reduction of the value of shares as a result of a dividend distribution, in those situations where the acquirer buys those shares from a shareholder who is not entitled to a deduction (credit) to that tax (typically non-residents), whereas, in case the shares are from a taxpayer who is entitled to that credit (resident entities), such reduction in value is taken into account. In ascertaining the prevailing freedom, the Court stuck to the *purpose-of–the-rule* methodology, stating that "*the application of that legislation does not depend on the size of the holdings acquired from the non-resident shareholder (…)*" (para. 49) and "*even if that legislation has restrictive effects on the freedom of establishment, they are an unavoidable consequence of a restriction on the freedom of movement of capital*", and was silent in respect to the fact pattern of the case. However, the above contradiction may be merely apparent, as perhaps the Court was – one can only guess - totally in line with the preceding Advocate General Bot's Opinion in relation to the case facts and their connection with the FMC (cfr. Para. 88), but decided to not go beyond the teleological examination for the sake of briefness.

60 Cordewener et al., op. Cit. p. 116.

Member States"[61]. From here and from the aforesaid unilateral character of the FMC, it cannot, nonetheless, be concluded that the room for justifications is *per se* wider, in relation to TCs[62]; more room for justifications may be accepted in MSs and TCs are not in the same legal context[63]. That is the case, for instance, of the need for an effective fiscal supervision, which may be attained more easily within the Union through instruments like the Mutual Assistance Directive[64].

Conversely, the acceptance of the *loss of the tax revenue* as a single justification corresponds, in practice, to depriving the FMC towards TCs of its useful effect as regards direct taxes. In fact, justifying the imposition of tax barriers to avoid any loss of tax revenue, in a non-abusive context, and when the balanced exercise of taxing powers is not threatened, would allow MSs to impose a higher tax base on inbound or outbound movements with TCs without having to take account of the overall restrictive effect of a potential accumulation with the taxes imposed by the TCs involved, even when those taxes have been properly allocated.

4. Anticipating some challenges ahead

It is almost certain that more questions like those we have been focusing on will keep on being referred to the ECJ and that more light will be shed on issues like *justifications* and *proportionality* in TC scenarios.

However, other types of challenges may come up where different freedoms intersect at different levels and the ECJ may find it difficult to decide which freedom(s) should prevail. Take, for instance, a merger operation between two EU companies owned by EU majority shareholders and also by EU and non-EU minority shareholders. The merged companies would be exercising their rights of establishment and the operation could be tax neutral under the Mergers Directive[65]. Under that regime, EU shareholders may also get a deferral of the tax on any capital gains arising from the operation. It is clear from the preamble of this Directive that its main aim is to facilitate cross-border reorganizations in the EU, and so it seems primarily oriented at the protection of the FoE. Nevertheless, it should be noted that the capital invested in the company by the shareholders is also protected due to the referred deferral of capital gains and so, it can also be claimed that there is an element of FMC protection here. In the event one or more of the minority shareholders are TC residents, taxable on their merger capital gains in one of the

61 Cfr. *Skatteverket v. A*, para.31 et seq.

62 *Idem, ibidem.*

63 *Idem,* para.32.

64 Council Directive 77/799/EEC of 19 December 1977.

65 Directive 434/90/EEC.

countries involved, will they be able to successfully invoke the FMC, or is the FoE the prevailing freedom even from those shareholders standpoint?

The exact same question could also arise in a transfer of corporate residence scenario where the MS of the migrating company levies exit taxes also at the level of the shareholders of that company[66]. Could TC shareholders claim FMC rights or is the restriction on their movements of capital an unavoidable consequence of the right to move its primary establishment by their participated EU company? Do the FoE rights claimable by the migrating company have the effect of removing the aforesaid FMC ones? These are only two examples of the challenges the ECJ may be facing very soon in this area.

66 The TC question seems not to have been formulated by the Commission in the October 2009 referral to the ECJ of Portugal and Spain over their restrictive exit tax provisions for companies.