CAPITAL FREEDOM AND THIRD COUNTRIES

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Introduction

Much debate has been recently raised as to the Court's attitude to extend the protection offered by the EC Treaty under the provisions of capital freedom also to third countries.

It can be observed at the outset, that this is not a "black-and-white" issue. This paper is an attempt to analyze the legal context of the free movement of capital in relation to third countries; in addition, it tries to provide some answers to this issue by means of recalling and analyzing the ECJ's jurisprudence and the way it has evolved during the past few years.

PART I: LEGAL FRAMEWORK

1. Brief description of the EC Treaty provisions governing the freedom of capital

The original provision of the Treaty regarding the freedom of capital, i.e. Article 67 of the EEC Treaty limited the obligation of capital liberalization during the transitional period to intra-Community relations and only to the extent that was necessary for the proper functioning of the common market, while at the same time it provided for numerous derogation clauses.

It was not until 1990 that the free movement of capital became a reality between persons resident in Member States as a result of Council Directive 88/361[2].The free

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2 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, Official Journal L 178, 08/07/1988 p. 5

movement of capital was significantly liberalized by the aforementioned directive, which is considered to have been a "crucial step" for the establishment of the internal market by 1992, to the extent that it provided for the total and unconditional free movement of capital within the Community[3].

Nowadays, Article 56 of the EC Treaty prohibits all restrictions related to the free movement of capital between Member States as well as between Member States and third countries.

However, this *erga omnes* principle is not an absolute one under the context of the EC Treaty. Although encompassing the idea of the economic as well as monetary Union, the principal rule of Article 56 is subjected to a series of restrictions set out in Articles 57-60 of the EC Treaty.

2. Purpose of capital liberalization towards third countries

The reasons why the Community decided to unilaterally open its capital markets towards third countries still remain controversial.

On the one hand, the liberalization of capital movements between Member States is totally justifiable on grounds of completion of the internal market and the fulfillment of the objectives of the EC Treaty.

On the other hand the EC Treaty does not provide for the unlimited extension of the benefits of the internal market and its fundamental freedoms also to third countries, thus it seems difficult to understand the reason why the Community has decided to adopt such a radical provision, which also liberalizes capital movements to and from third countries[4].

It has been argued that the lack of reciprocal provisions could distort the harmonious development of the internal financial market. Secondly a number of scholars conclude that in order to ensure reciprocity in the treatment of capital movements in and out of the EU it would be preferable that the liberalization occurred through agreements with third countries, rather than unilaterally[5].

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3 That Directive was withdrawn when the treaty of Maastricht entered into force, introducing Article 73B (now Article 56) of the EC Treaty, which provides for full capital movement liberalization, not only within the EC, but also in relation to third states.

4 S.Mohamed, *European Community Law on the Free movement of capital and the EMU*, at page 216, Kluwer Law International 1999.

5 S.Mohamed, *European Community Law on the Free movement of capital and the EMU*, Kluwer Law International 1999.

It should be borne in mind however that this *erga omnes* scope of the capital freedom was already present in the Fourth Directive, where it was stated that

> *"the Community shall endeavour to attain the highest possible degree of liberalization in respect of the movement of capital between its residents and those of third countries".*

In addition, the wording of the Treaty in Article 56 is very clear regarding the extension of capital freedom towards third countries as well as among Member States giving the impression that the freedom at issue applies in the same way when the third country element is involved. This seems to have been anticipated by the drafters of the Treaty in Articles 57-60, which explicitly provide for the restriction of the capital freedom in cases where a third country national is concerned[6].

Consequently it has been shown that by extending a fundamental freedom traditionally granted to the nationals of the Member States of the Community, towards third countries' nationals as well, the "architects" of the Treaty envisaged the enhancement of foreign trade and the international financial operations of the Community, as well as establishing an attractive regime for foreign investors to invest their capital in its "gulfs". In this way the foreign investment in Europe and also investments made in the Euro currency would increase, which would lead to a greater currency strengthening and development of the market. This goal could be achieved only through the conquest of new markets by means of integration and *erga omnes* liberalization.

Therefore the reciprocal and unilateral liberalization that has been suggested by some scholars can be contemplated as a means of superseding the European community's true goal of unlimited expansion and integration towards trade enhancement and capital flows and should be consequently rejected taking into consideration that if this were the approach of the Community, it would have been reluctant to expand one of its fundamental freedoms towards third countries in the first place.

3. Capital movements under the context of the EC Treaty and the fourth Council directive

The new rules on capital movements enshrined in Articles 56-60 of the EC Treaty do not contain a clear definition on what constitutes "capital movement". Therefore we should seek another legal instrument besides the EC treaty that could provide some guidance for the comprehension of these terms.

6 Luis Eduardo Schoueri, "European *Erga Omnes* Liberalization on Capital and Payments in the EC Treaty", *Tax Notes International*, January 29 2007, vol. (45), number (4), at page 345.

First of all it should be noted that, nowhere in the EC Treaty is it stated explicitly that the preceding legal rules would be deprived of all their legal effect. It would therefore be consistent with the purpose and the objectives of the EC Treaty to treat the preceding statutes[7] as guidelines with which to interpret the new provisions on capital movement.

Secondly, another source that could provide useful guidance for the clarification of the term "capital" would be the judicial one. In the past, many cases were taken into consideration as elaborating on the nature of the transaction involved in a given factual situation[8].

In many recent cases the Court has pointed out that useful guidance on the definition of the concept "capital" can be derived from the Fourth Council Directive 88/361/EEC and its attached nomenclature[9]. "This nomenclature still has the same indicative value for the purposes of defining the notion of capital movements"[10]. Even though it is no longer valid since the replacement of the articles governing the capital freedom by the provisions of the EC Treaty, its legal status should nevertheless be preserved in the light of serving as a guideline for interpreting concepts that are not explicitly defined under the context of the EC Treaty.

Annex I of Directive 88/361 contains a comprehensive but non-exhaustive enumeration and classification of different types of capital movements. The significance of Annex I was confirmed by the Court for the first time in *Sanz de Lera*, both as regards the scope of the transactions covered by the free movement of capital as well as the directly applicable Article 56(1), and in many judgments ever since.

7 Articles 67 et seq. of the EEC Treaty, as amended by Articles 73(b) et seq. after the Maastricht Treaty.

8 The most relevant cases are *R v Thompson, Johnson and Woodiwiss* Case 7/78, 1978 ECR 2247, (1979) 1 CMLR47, *Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro* Joined cases 286/82 and 26/83, (1984) ECR 377, (1985) 3 CMLR 52 and *Ministere Public v Lambert* Case 308/86, (1988) ECR 4369, (1989) 3 CMLR 649.

9 See among others ECJ 19 January 2006, *Margaretha Bouanich v Skatteerket*, C-265/04, para 29, ECJ 5 July 2005, *D case*, C-376/03 ECR 2005 para. 24, case C 452/01 *Ospelt and Schlossle Weissenberg* [2003] ECR I-9743 para. 7, ECJ, 16 March 1999, *Trummer och Mayer*, C-222/97, 1999 ECR para. 20 et seq. as well as ECJ, 14 December 1995, joined cases C-163/94, C-165/94 and C-250/94, *criminal proceedings against Lucas Emilio Sanz de Lera and others*, ECR 1995, I 4821et seq., 4837 para.22 and 4839 para. 34.

10 ECJ 23 February 2006, *Van Hilten* case, C-513/03, para. 39, ECJ 5 July 2005, *D case*, C-376/03 ECR 2005 para. 24.

4. Free movement of capital in relation to other Treaty freedoms

4.1 In general

It is not always easy to clarify the issue which freedom is applicable in each specific transaction because there are certain overlaps on the one hand with establishment and on the other with services involving capital movements such as banking and insurance[11]. Consequently the wide definition of capital movements can lead to many transactions falling under more than one treaty freedom.

This appears to have been anticipated in the Treaty, namely in Article 43 para. 2, and in Article 58 para. 2 EC. From these provisions it appears that the "architects" of the treaty were aware of the fact that the same transaction can be governed by more than one fundamental freedom[12].

On the other hand, it seems that where the drafters of the Treaty considered it to be necessary, they stated explicitly that a specific activity would be governed by one freedom solely[13].

In cases where a crossover between capital and establishment takes place, the Court begins by examining the case with respect to the provisions of one of the two freedoms in random order, without showing preference for one specific freedom. However, if the national court has in the first place requested an examination against the freedom of establishment and in the second place against the free movement of capital[14], the ECJ responds in that order. If it comes to the conclusion that the relevant legislation is incompatible with the first examined treaty freedom it regularly states that it is thereby not necessary to also rule on the second treaty freedom[15].

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11 See for example the *Fidium Finanz* case C-452/04, where the first question referred to the ECJ concerned that matter, i.e. the national Court was seeking for a clarification on whether granting credit on a commercial basis constituted a provision of services and was covered by Article 49 EC et seq. and/or whether it fell within the scope of Article 56 EC et seq. governing the free movement of capital.

12 K.Stahl , "Free movement of capital between Member States and third countries", *EC Tax Review* 2004(2)

13 Article 51(2) of the EC Treaty distinguishes between banking and insurance services connected with movements of capital on the one hand and the free movement of capital on the other and provides that the free movement of he first must be achieved "in step with the liberalization of the movement of capital".

14 In the above mentioned cases, *Baars* and *X AB & Y AB*, the court examined the treaty freedoms with the order that it had been asked to do by the referring national courts.

15 As stated above, this happened in *Baars*, as well as *X AB & Y AB* cases.

Accordingly, it is clear that a provision is not applicable where it is found to be inconsistent with Community law. However, it is not sufficient to find that a tax rule does not conflict with a freedom established in the EC treaty in order to be applicable[16]. On the contrary in that case further examination must take place in order to ascertain the consistency of the relevant rule with the other freedoms as well[17].

4.2 Crossover with freedom of establishment

4.2.1 *Commission v Netherlands* (joined cases C-282/04 and C-283/04)

The Court's holding in the recent case, *Commission v Netherlands* ("golden shares")[18], with regard to the freedom of establishment is worth citing[19]: "*…in so far as the special shares at issue entail restrictions on freedom of establishment, such restrictions are a direct consequence of the obstacles to the free movement of capital considered above, to which they are inextricably linked. Consequently, since an infringement of Article 56 EC has been established, there is no need for a separate examination of the measures at issue in the light of the Treaty rules concerning freedom of establishment*"[20].

4.2.2 The *FII* Judgment

In *FII Group litigation*[21], where both freedom of establishment as well as freedom of capital were invoked, the Court tested the national provisions against both the free movement of establishment and the free movement of capital.

16 This is clearly the case in the *Commission v Belgium* Case C-503/99 2002 ECR I-4809.

17 This conclusion is supported by the *Commission v Belgium* Case C-503/99 2002 ECR I-4809, where the ECJ held that the examined provisions were consistent with the free movement of capital since they were justified on grounds of public security, and although it did not go on to examine their consistency with the freedom of establishment –as it had been asked to do, it stated out that the relevant rules would be consistent with the latter treaty freedom as well by virtue of the fact that they could also be justified on grounds of public security.

18 ECJ 28 September 2006, joined cases C-282/04 and C-283/04, *Commission of the European communities v Kingdom of Netherlands*

19 See paragraph 43 of the judgment.

20 The Court has come to this conclusion before, in ECJ 13 May 2003, *Commission of the European Communities v Kingdom of Spain*, para. 86.

21 ECJ 12 December 2006, *FII Group Litigation* Case C-446/04.

With respect to the lawfulness of the FID regime[22], the Court established the inconsistency of such a regime with the freedom of establishment. It held that the legislation at issue did not contravene Community law on the freedom of establishment nor on the capital freedom, whereas in the second sub-question it did not go on to establish its inconsistency with the free movement of capital as well, once it had found it to be incompatible with the freedom of establishment[23].

The Court pointed out that its answer to the issue was incomplete, hence no protection for companies established in non-member countries is available under the provisions on the freedom of establishment. Therefore the national legislation had to be examined under the light of the provisions on capital freedom with which it was held to be inconsistent. It is nevertheless worth mentioning that the Court stressed the fact that the situations involved are not always comparable when the third country element is present, and in addition that the basis on which difference in treatment can be justified is much wider in cases where a non-member country is concerned[24].

4.2.3 *Lasertec* case

Furthermore, in *Lasertec*[25] the Court once more clarified that third countries' nationals are entitled to the protection offered by the EC Treaty in so far as the exercise of their capital freedom is concerned. By contrast freedom of establishment does not extend to third countries; therefore they cannot rely on the provisions of the Treaty regarding freedom of establishment in order to be protected[26].

More specifically, this case concerned a Swiss "substantial"[27] corporate shareholder in a German GmbH who had granted a loan to the German GmbH, which exceeded the German thin cap safe harbour rules. The Court decided that, as had been suggested by the European Commission and the French government, the German rules should come within the scope of freedom of establishment because they

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22 "That regime permits resident companies receiving foreign-sourced dividends to obtain a repayment of the amount of surplus ACT, that is to say, the amount of ACT which could not be offset against the amount due by way of corporation tax.", para. 144 of the *FII* judgement.

23 See paragraphs 138 and 139 of *FII* the judgement.

24 See paragraphs 170, 171 of the *FII* judgement.

25 ECJ 10 May 2007, *Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emmendingen,* case C-492/04.

26 See paragraph 28 of the *Lasertec* judgment.

27 As the Court noted in paragraph 23 of its order: *"Lasertec, the lending company holds two thirds of the nominal capital in the applicant, the borrowing company. Such a holding unquestionably confers on Lasertec a determinative influence on the applicant's decisions and activities".*

applied to shareholdings that gave the shareholder a definite influence on the decisions of the company and allowed that shareholder to determine its activities, regardless of the precise threshold of shareholding[28].

4.2.4 *Holböck* judgment

Furthermore, reference has been made to the European Court of Justice for a preliminary ruling on the difference in the tax treatment of dividends by the Austrian State, depending on whether such dividends derive from domestic shares or from shares in companies established in non-Member States.

In particular, in *Holböck*[29] the national court was asking for a ruling on the compatibility of Austrian legislation with the freedom of capital, where dividends from inland shares were taxed at a rate of half the average tax rate applicable to the aggregate income, whereas dividends from a public limited company established in Switzerland, in which the taxable person held two-thirds of the shares, were invariably taxed at the standard rate of income tax.

The French and Netherlands Governments argued that the Austrian legislation should be considered only in terms of the rules regarding freedom of establishment, and not of those regarding the free movement of capital. The Court however very interestingly held that, as that freedom does not extend to the establishment of a Member State national in a non-member country, Mr Holböck would not be protected under the provisions on freedom of establishment, therefore the only freedom which should be triggered was the capital freedom[30], with which the national legislation at issue was found to comply on grounds of justification provided by Article 57(1) EC.

4.3 Capital freedom and freedom to provide services – the *Fidium Finanz* case

The same conclusion seems to be valid when it concerns the relationship between the free movement of capital and the free movement of services.

As the Court points out explicitly in *Fidium Finanz*[31], where a national measure relates to the freedom to provide services and the free movement of capital at the same time, it is necessary to consider to what extent the exercise of those

28 Tom O'Shea, "Third Country Not Entitled to Freedom of Establishment Rights under EC Treaty, ECJ says", *Tax Analysts*, 25 May 2007.

29 ECJ 24 May 2007, *Winfried L. Holböck v Finanzamt Salzburg-Land* case C-157/05.

30 See paragraph 19 of the *Holböck* judgment.

31 *Fidium Finanz* Case, C-452/04

fundamental liberties is affected and whether, in the circumstances of case, one of those prevails over the other[32].

Accordingly, what has to be kept in mind is that there is no such thing as a hierarchy of rules among the treaty freedoms, something which if true, would be reflected in the case law of the ECJ.

PART II: PERMITTED RESTRICTIONS ON FREE MOVEMENT OF CAPITAL AND ACCEPTABLE GROUNDS OF JUSTIFICATION

1. In general

Articles 57-60 EC constitute derogations from Article 56 EC and must be taken into consideration in an attempt to limit the scope of the capital freedom as laid down in Article 56 EC.

In general, admissible restrictions can be distinguished according to who is authorized by the EC Treaty to apply them[33].

On the one hand, Member States can rely on these provisions in order to introduce or maintain restrictions either towards third countries exclusively or towards third countries and other Member States as well. Articles 57(1) and 58 EC put forward the grounds of justification of national measures which constitute derogations from the free movement of capital either on a Member State-Member State, or on a Member State-third country context.

On the other hand, amendments to the current capital movements' regime can occur only through Community action. By virtue of Articles 57(2), 59 and 60 EC the Community can introduce restrictive measures on the free movement of capital where third countries are involved because these are derogations allowed by the EC Treaty.

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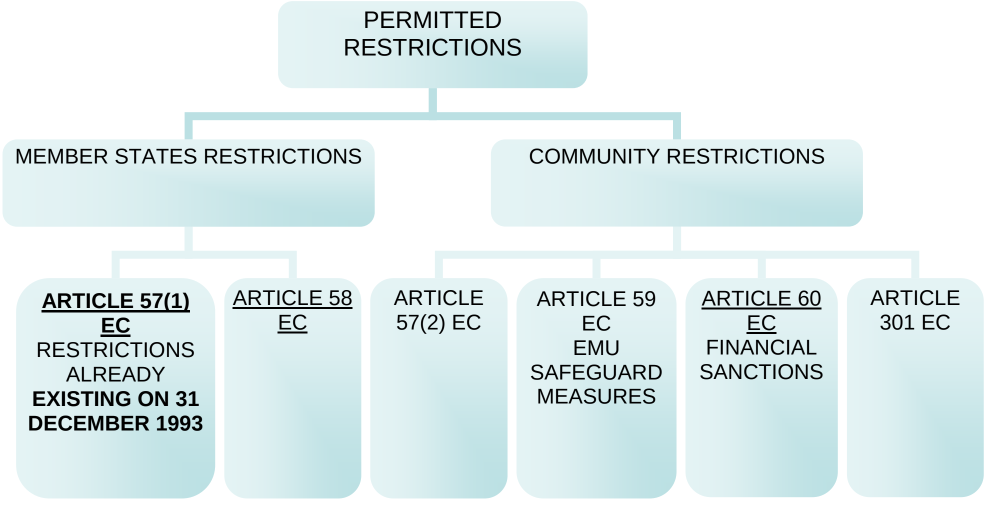
32 *Fidium Finanz* Case C-452/04, paras. 32 et seq.

33 Jean Pierre Raes, 2003, "Restrictions on foreign ownership: European Community and International framework" [online], available at: ec.europa.eu/economy_finance/events/2003/workshop/raes.pdf



2. Member States Restrictions on Capital Movements to and fro from Third Countries

2.1 Scope of Article 57(1) EC

The Court has tried to interpret the measures provided for by Article 57 of the EC Treaty, as well as the capital classifications entailed therein for the first time in *Sanz de Lera*.

The Court in this case has established the direct effect of Article 56 of the Treaty[34], while at the same time it has ascertained that the provisions of Article 57(1) can be relied upon for restrictions on the freedom of capital to be permitted, only to the extent that such restrictions fall indeed under the scope of the provision at issue both as regards the category of capital they concern and the date when they were in force.

With regard to the question of the exact time by which the relevant restrictive measures must be in force in order to be permitted, the recent *FII* case is the most relevant.

In *FII*, the Court held that a national measure adopted after a date laid down in Article 57(1) of the Treaty is not *ipso iure* excluded from the derogation provided therein. If the new provision is identical to the old one, or if it is considered to be an amendment of minor importance, then it will be covered by the derogation of Article

34 See *criminal proceedings against Lucas Emilio Sanz de Lera and others* judgment, ECR 1995, I 4821et seq., paragraph 41.

57(1). By contrast, legislation deviating from the preceding law cannot be regarded as legislation existing at the date set down by the Community measure in question[35].

Furthermore, in *Holböck*[36] the Court held that the national measures at issue constituted a restriction on capital freedom, which was justifiable on the grounds of justification put forward by Article 57(1).

In particular, according to Austrian legislation dividends from domestic shares were taxed more favourably than dividends deriving from a company established in a third country, i.e. in Switzerland, in which the taxable person held two-thirds of the shares.

The Court held that such a restriction on capital movements, comes within the scope of Article 57(1) EC; by virtue of this Article, a Member State may, in its relations with non-member countries, apply restrictions on capital movements, even though they contravene the principle of the free movement of capital laid down under Article 56 EC, if those restrictions already existed on 31 December 1993. As a result, following the same line of reasoning as in the *FII* judgment[37], it was held that the Austrian Legislation did comply with Community law.

2.2 Grounds of justification provided by Article 58 EC

Article 58 EC provides the basis for national legislators to deviate from the principle that all restrictions are prohibited[38]. Under certain grounds of justification, provided that the national measures do not result in "arbitrary discrimination" or "disguised restriction", Member States are permitted to adopt measures that would be considered to be inconsistent with Community law at first sight.

Moreover, national legislation, that is deemed to constitute an obstacle to the free movement of capital, may nevertheless be acceptable if it can be justified by overriding requirements of public interest, such as the protection of the cohesion of the tax system, the prevention of tax evasion and the effectiveness of fiscal supervision[39].

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35 See paragraph 196 of the *FII* judgment.

36 ECJ 24 May 2007, *Winfried L. Holböck v Finanzamt Salzburg-Land* case C-157/05.

37 See paragraph 41 of the *Holböck judgment.*

38 ECJ 19 January 2006, *Margaretha Bouanich v Skatteverket*, C-265/04, at paragraph 30 the Court states that: "*Article 56 EC prohibits all restrictions on the movement of capital between Member States, subject to the grounds of justification set out in Article 58.*"

39 See ECJ 13 October 1999, Case C-439/97, *Sandoz GmbH v Finanzlandesdirektion fur Wien, Niederosterreich und Burgenland*, ECJ 26 September 2000, case C-478/98, *Commission of the European Communities v Kingdom of Belgium, and* ECJ 15 July 2004, case C-242/03, *Ministre des Finances v Jean-Claude Weidert et Elisabeth Paulus*

In addition, such national legislation must meet the four conditions of the proportionality test of the *Gebhard formula* in order to be justified[40].

It should be borne in mind at the outset, that ECJ jurisprudence indicates that the Court sets very high standards both as regards the objective of the national measures at issue and their proportionality, in order to consider them to be consistent with Community Law. Derogating from the prohibition of all restrictions on the free movement of capital, Article 58(1) and (2) must be interpreted strictly[41]. The provisions at issue must be construed as containing an exhaustive enumeration of the grounds that a deviation from the principle enshrined in Article 56 may be relied upon.

In addition, it should be noted that Article 58(1) of the Treaty must be read together with Article 58(3); hence the latter limits the extent to which derogations from the principle of capital freedom by virtue of Article 58(1) are permitted.

In particular, in *Lenz*[42], the Court pointed out the need to distinguish between unequal treatment permitted under Article 58(1)(a) and arbitrary discrimination prohibited under Article 58(3) EC[43]. The difference in treatment must concern situations which are not objectively comparable, or must be justified by overriding reasons in the general interest. In addition, the national measures must not go beyond what is necessary to attain the objective pursued[44].

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40 As stated in paragraph 37 of the case C-55/94 *Gebhard*, known as the Gebhard test: *"It follows however from the Court's case law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfill four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and must not go beyond what is necessary in order to attain it".*

41 ECJ 14 March 2000, *Association Eglise de Scientologie de Paris et. Scientology International Reserves Trust v The Prime Minister*, case C-54/99, at paragraph 17, ECJ 7 September 2004, case Petri Manninen, C-319/02 at paragraph. 28.

42 ECJ 15 July 2004, *Anneliese Lenz v Finanzlandesdirektion fur Tirol*, case C-315/02, paragraph 27.

43 Before *Lenz*, the Court had already held in *Verkooien* (C-35/98), that "*Article 73d(3) of the Treaty states specifically that the national provisions referred to by Article 73d(1)(a) are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments, as defined in Article 73b*" (Paragraph 44). However, in this judgment the Court did not go so far as to establish the distinction which must be made between unequal treatment which is permitted under Article 58(1) and arbitrary discrimination, which is prohibited by Article 58(3).

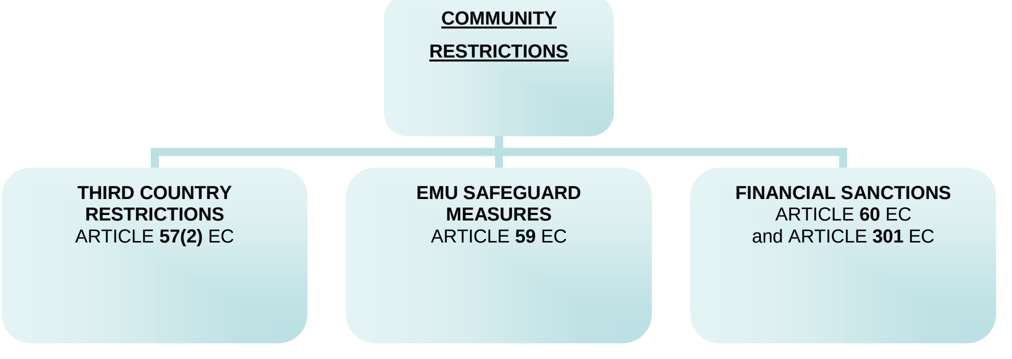
44 The same reasoning was adopted in ECJ 7 September 2004, *Petri Mikael Manninen*, case C-319/02 and in ECJ 19 January 2006, *Margaretha Bouanich v Skatteerket*, C-265/04.

Consequently, it is evident that in the post-*Lenz* era, the derogation in Article 58(1)(a) is itself limited by Article 58(3) EC, which provides that national provisions referred to in Article 58(1) must not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital. In that respect, these provisions must be read together so as to restrict the grounds on which a national measure, which constitutes a restriction on the free movement of capital, may be justified. This narrows considerably the derogation contained in Article 58(1) EC.

3. Community action for the restriction of capital freedom towards third countries - Articles 57(2), 59, 60 EC

3.1 In general

The capital freedom in relation to third countries can be limited on the basis of derogations provided by Articles 57(2), 59 and 60 of the EC Treaty as well, whereas in cases where the third country element is not involved only recourse to the derogatory provisions of Articles 57 and 58 can be made.



3.1 Article 57(2) EC

Article 57(2) pursues a twofold objective; on the one hand it provides for the further liberalization of the capital freedom towards third countries, whereas on the other hand it states that the freedom of capital can be restricted consistently with Community Law under certain conditions when a third country is concerned.

3.2 Article 59 EC

Article 59 incorporates the temporary EMU[45] safeguard measures that the Council can take in exceptional circumstances and under certain conditions.
More specifically, by virtue of Article 59, the Council, acting by a qualified majority, may take safeguard measures with regard to third countries, provided that they are strictly necessary, in cases where movements of capital to or from third countries cause or threaten to cause serious difficulties for the operation of the Economic and Monetary Union.

3.3 Articles 60 and 301 EC

Article 60 EC empowers the Council to take urgent measures on the movement of capital with respect to third countries, in case action by the Community is considered to be necessary in the context of the Common Foreign and Security Policy of the European Union envisaged in Article 301 EC.

It is evident that Article 60 EC must be construed in conjunction with Article 301 EC, which provides for the circumstances under which the former provision can be triggered[46].

Accordingly, where a common position or a joint action is adopted according to the provisions of the Treaty of the European Union relating to the common and foreign security policy and provide for an action by the Community to interrupt or to reduce in part or completely, economic relations with one or more third countries, the Council is authorized to take the necessary urgent measures, namely financial sanctions[47], acting by qualified majority and on a proposal from the Commission.

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45 The abbreviation EMU stands for "European Monetary Union".

46 The most relevant cases in this area are CFI 21 September 2005, case T-306/01, *Ahmed Ali Yusuf and Al Barakaat International Foundation v Council of the European Union, Commission of the European Communities,* CFI 21 September 2005, case T-315/01, *Yassin Abdullah Kadi v Council of the European Union, Commission of the European Communities,* and CFI 12 July 2006, case T-253/02, *Chafiq Ayadi v The Council of the European Union.*

47 "These restrictions may cover by definition all types of capital movements and payments. In practice they usually materialise in the shape of freezing of bank accounts and other financial assets of specific natural or legal persons or a ban on foreign direct investments in the country involved". Jean Pierre Raes, 2003, "Restrictions on foreign ownership: European Community and International framework" [online], available at:
ec.europa.eu/economy_finance/events/2003/workshop/raes.pdf

However, although it is in principle the third country element that generates recourse to the provisions of Articles 60 and 301 EC, it is the case law of the Court of First Instance that indicates that this is not always the case[48].

4. Recent developments in ECJ case law - the *Thin Cap Group Litigation*[49]

In the *Thin Cap* case, the UK anti-avoidance rules concerning "thin capitalization" were targeted[50].

By its questions, the national court essentially asked whether Community Law precludes national legislation of a Member State whereby the ability of a resident Company to deduct for tax purposes, interest paid on loan finance is restricted, where the loan at issue is granted by a company other than a parent company, resident in the first Member State[51].

Accordingly, the combinations which had to be examined by the Court were the following: 1) EU Resident Parent as well as EU Resident Lender, 2) EU Resident Lender only, 3) EU Resident Parent but Non-EU Resident Lender and 4) Non-EU Resident Parent and Non-EU Resident Lender.

First of all, in so far as the national court was asking for a ruling on the incompatibility of the legislation at issue with the freedom of establishment and the freedom to provide services as well as with the freedom of capital, the Court had to determine which freedom of movement should apply.

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48 In the CFI 21 September 2005, case T-306/01, *Ahmed ali Yusuf and Al Barakaat International Foundation v Council of the European Union, Commission of the European Communities* at paragraphs 112-116, the Court of First Instance held that financial sanctions pursuant to Article 60 and 301 could not be confined solely to nationals of third countries; on the contrary, the CFI held that the financial sanctions at issue were not contrary to Community Law, although they affected nationals of Member States as well, to the extent that the objective pursued was the effectiveness in the context of the free movement of capital.

49 ECJ 13 March 2007, case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue.*

50 Thin capitalization consists in financing a company by way of loan in preference to equity capital, in order to benefit from a more advantageous tax treatment. Pursuant to the UK thin capitalization rules, which were in force in various forms until 2004, where a company repaid loan interest, such payments were deductible from taxable profits, whereas distributions of profits were subject to advance corporation tax. The deductibility of interest paid by UK subsidiaries to non-resident companies could be restricted in certain circumstances. However those restrictions did not apply to companies which paid interest to another resident company.

51 By contrast, the interest deduction would not be prohibited if the loan had been granted by a parent company also resident in that Member State. See paragraph 23 of the *Thin Cap* judgment.

In accordance with settled case-law[52], national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, which give them definite influence on the company's decisions and allow them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment[53].

Consequently, the Court concluded that the national legislation at issue, which prohibited the deduction of interest paid by a resident company on loans granted either by a parent company which is resident in another Member State or by a company which is resident in another Member State and is controlled by such parent company, without imposing that restriction on a resident company which has been granted a loan by a company which is also resident in that Member State, is precluded by Community Law concerning the freedom of establishment.

However, such legislation can be justified if two conditions were met. On the one hand, those rules must allow the companies concerned to produce evidence as to the commercial reasons for entering into the transaction in question. On the other hand, the re-characterization of interest paid as a distributed profit must be limited to the proportion of the interest which exceeds what would have been paid on an arm's length basis.

As regards the situation where a loan has been granted to a resident Company by another Company which is resident in another Member State or in a non-member country, but which has no controlling shareholding in the first company, and where each of those companies is controlled by a common parent company, which is, for its part, resident in a non-Member State, the Court held that no Community freedom -neither freedom of establishment nor capital freedom-could apply.

In particular, the Court held that the capital freedom was not applicable, given that the Third Country resident Parent Company had a controlling shareholding in either the lending or the borrowing company. In such case, the *Baars* test would be met in a Member State-Third Country context. However the freedom of establishment does not extend to third countries, therefore no protection can be offered under the EC Treaty context.

PART III: CONCLUSION

It appears from the above analysis that the primary issue which should be addressed both by scholars and the European Court of Justice is the scope of Article 56 of the

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52 ECJ 13 April 2000, case C-251/98, *C. Baars v Inspecteur der Belastindienst Particulieren/ Ondernemingen Gorinchem,* para. 22

53 See paragraph 27 of the *Thin Cap* judgment.

EC Treaty on capital freedom in relation to third countries; as the answer to the question whether the freedom provided by this Article applies in the same way where a third country national is concerned, still remains controversial and generates different opinions.

Article 56 incorporates the "minimum" that has been agreed between the Member States at a time when the Community was free to rule otherwise. Its wording is very clear as to what the drafters of the Treaty have envisaged in embodying it therein.

By virtue of Article 220 EC the role of the Court is to *"ensure that in the interpretation and application of this Treaty the law is observed"*. In other words, the Court does not rule; it merely applies the rule of Law provided by the EC Treaty judging on the basis of the true facts that are put forward in each specific situation.

On these grounds, the Court is bound by the Treaty to apply either freedom of establishment or freedom of capital depending on the genuine facts that it has to decide upon.

So far, it has shown that it is consistent in applying freedom of establishment whenever it diagnoses the element of "definite influence" to exist.

However, it has not been reluctant to apply capital freedom in the cases that it has considered that this was the only freedom which should have come into play[54].

54 See chronologically *Sanz de Lera* (ECR 1995, I 4821et seq.), *Commission. v Netherlands* (joined cases C-282/04 and C-283/04), *FII* (Case C-446/04) and *Holböck* (C-157/05) judgments.