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TAX OBSTACLES TO THE FREE MOVEMENT OF CAPITAL

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Capital movements were wholly liberalised throughout the Community by Council Directive 88/361/EEC of 24th June 1988[2] implementing what was then article 67 of the EC Treaty. Such liberalisation took effect on 1st July 1990 in the then twelve Member States subject to certain derogations for the Hellenic Republic, Ireland, Portugal and Spain all of which expired on 31st December 1992. By the time Austria, Finland and Sweden became Member States on 1st January 1995, the Treaty of Maastricht had replaced articles 67 and 106 EC with a new article 73B, so that Directive 88/361/EEC became obsolete, except for its classification of capital movements.[3] With the unconditional liberalisation of all capital movements, came potential scope of challenging any national measure which amounted to an obstacle to the free movement of capital.[4]

In the tax field, the Court of Justice considered this question explicitly in *Bachmann v Belgium*.[5] In that case the Court held that a Member State's legislation which made the deductibility of life assurance and similar premiums conditional on such amounts being paid to an entity in that Member State did not infringe the principle of the free movement of capital or current payments (contained in what were then articles 67 and 106 EC). The issue was raised again

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2 OJ L178, 8.7.88, p 5.

3 Which is still used, notably in application of the provisions on capital movements which can be found in the Europe Agreements between the Community and certain East European countries.

4 The fact that liberalisation under Article 67 EC was not unconditional prevented that article from having direct effect, but the Court has confirmed, in Case C-163/94, *Sans de Lera* 14th December 1995, that Article 73B(1) does have direct effect, and so by implication, does Article 73B(2). For a discussion of the earlier cases, see the note by Castillo de la Torre in (1995) 32 CML Rev, 1025, 1035.

5 Case C-204/90, [1992] ECR 1-276.

in *Svensson and Gustavsson v Ministère du Logement et de l'Urbanisme*,[6] when the Court held that the principle of the free movement of capital (article 67 EC) was infringed by national legislation which limited the grant of an interest subsidy on housing loans to cases where the loan was contracted with an authorised credit institution established on national territory.

In both cases the Court found that the national legislation in question created an obstacle to the freedom to provide services contrary to article 59 EC. In *Bachmann* the obstacle was justified on the grounds of cohesion of the national tax system, whereas in *Svensson* it was not, because there was no direct link between the grant of the interest rate subsidy and its financing by means of the taxation of the profits of the leading institutions.[7] The point that interests us here, however, is the relationship between the provisions of the EC Treaty on the free movement of capital and the other freedoms. Advocate General Mischo, in *Bachmann*, and Advocate General Elmer, in *Svensson*, were both of the opinion that the principle of the free movement of capital was not relevant in cases which were governed by article 59 EC, but the Court in *Svensson* apparently did not agree.

Given the absence of a definitive ruling on this issue, it is clearly prudent, when challenging discriminatory tax legislation, to plead infringement of the principle of the free movement of capital in addition to infringement of one of the other fundamental freedoms (free movement of workers, freedom of establishment and freedom to provide services). However, such an approach is not conducive to concise pleading as was illustrated, in the past, by the apparent overlap between obstacles to the freedom of establishment, which are prohibited by article 52 EC, and discrimination on the grounds of nationality, which is prohibited by article 6 EC (formerly article 7). The Court has now clarified that a claim of infringement of article 6 EC does not take one's case any further if one has already established an infringement of one of the basic freedoms (articles 30, 48, 52 or 59).[8] It is to be hoped that the Court will soon give similar guidance as to the interrelation of the provisions of article 73B (formerly articles 67 and 106) and articles 30, 48, 52 and 59, when applied to tax cases. The purpose of this brief article is to set out some indicators for the direction in which such clarification might go.

From a practical point of view, commercial operators may question the usefulness of clarifying matters of pleading when one can always raise all possible grounds initially and argue the matter in court. The answer is twofold. First, anything which enables lawyers to concentrate their efforts on the relevant rather than the

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6 Case C-484/93, [1995] ECR 1-3955.

7 Indeed, *Svensson* was not a tax case. For further discussion see Marc Dassesse. 'The Wielockx and Svensson Judgments', ECTJ, Vol 1, 1995/96, Issue 3, p 181.

8 See, for example, Case C-330/91, *Commerzbank*, 13th July 1993.

irrelevant makes for efficiency and effectiveness. Second, in cases where the question is refereed to the Court of Justice in Luxembourg for a ruling pursuant to article 177 EC, one is dealing with a jurisdiction which is under severe time pressures and an increasing case load,[9] so it naturally appreciates concision. Moreover, oral argument before the Court of Justice is limited to 30 minutes maximum, so counsel needs to be able to make the best use of the little time which is available.

Current Payments, Capital Movements and other Freedoms

As a preliminary point it will help to recall the important distinction made by the Court in *Luisi and Carbone*[10] between current payments and movements (or transfers) of capital. Taking into account the general scheme of the Treaty and articles 67 and 106, as they then were, the Court held that "current payments are transfers of foreign exchange which constitute the consideration within the context of an underlying transaction, whilst movements of capital are financial operations essentially concerned with the investment of funds in question rather than remuneration for a service". As far as current payments are concerned, it should be observed that any obstacle to the realisation of the underlying transaction will, indirectly, be an obstacle to the making of the current payment and vice versa. For this reason, prior to the Maastricht amendments, article 106 EC liberalised "any payments connected with the movement of goods, services and capital, and any transfers of capital and earnings, to the extent that the movement of goods, services, capital and persons [had] been liberalised ...".[11] This text showed that it was envisaged by the Treaty draftsmen that there could exist national measures which were to be categorised as obstacles to current payments, and not as obstacles to movement of goods etc (even though, indirectly, their effect was to obstruct the movement of goods etc). For example, a requirement that the prior exchange control authorisation be obtained for the making of a payment for the movement of goods would have amounted to an infringement of article 106 EC, and not to an infringement of article 30 EC.

Expanding on this preliminary remark, we can categorise all the possible cases involving the basic freedoms under the EC Treaty as follows:

(1) obstacles to the free movement of goods or the free provision of services (contrary to articles 30 and 59 EC);

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9 One may speculate whether the advent of Economical and Monetary Union will increase the number of cases, relatively few so far, involving capital movements.

10 Joined Cases 286/82 and 26/83 [1984] ECR 377.

11 Article 73B now says simply that "... all restrictions on payments between Member States ... shall be prohibited".

(2) obstacles to the payment for such goods or services (contrary to old article 106, now article 73B(2);

(3) obstacles to the free movement of persons, i.e., the free movement of workers or the freedom of establishment (contrary to articles 48 and 52 EC);

(4) obstacles to the transfer of capital and earnings connected with the exercise of the free movement of persons (contrary to old article 106 EC, now article 73B(1) and (2));

(5) obstacles to the transfer of monetary assets (contrary to old article 67 EC as implemented by Directive 88/361/EEC, now article 73B(1) EC).

It will be argued that the above classification is consistent not only with the relatively few references in the Treaty, but also with the Court's decisions in *Lambert*, *Bachmann*, *Veronica*, *Schindler* and *Bordessa*. Only the Court's judgment in *Svensson* stands out of line, possibly in company with some observations of Advocate General Mischo in *Factortame*.

The Plain Words of the Treaty

Articles 52 and 61(2) EC provide support for our thesis that obstacles to the making of current payments or the movement of capital are a separate category from obstacles to the exercise of the other freedoms.

Article 52 EC, second paragraph, provided, and still provides, that exercise of the freedom of establishment is "subject to the provisions of the Chapter relating to capital". Although this has never had any practical effect, because the Council adopted the necessary directives liberalising capital transfers connected with the exercise of the right of establishment, the text shows again that the Treaty draftsmen envisaged that there could be obstacles to a capital transfer which should be assessed separately from any obstacle to the exercise of the right of establishment.

Article 61(2) provides further support when it says that "the liberalisation of banking and insurance services connected with the movements of capital shall be effected in step with the progressive liberalisation of movements of capital". The liberalisation of capital movements was a matter to be decided at the appropriate time when the Member States felt that they were ready for such a step and was not subject to automatic entry into force at the end of a transitional period. Article 61(2) was necessary to show that, notwithstanding the freedom to provide services as from the end of the first transitional period, the regulation of controls on capital

movements was an autonomous category independent of the other freedoms under the Treaty.[12]

Analysis of the Cases

In the first of the above list of cases,[13] a Mr Lambert was accused of breaching Luxembourg exchange control regulations by accepting payments for cattle in foreign currency, and converting the foreign currency on the Luxembourg financial market at the free rate of exchange, rather than on the regulated market which was obligatory for all commercial transactions. Since the financial franc was weaker than the regulated franc, Mr Lambert obtained more francs for his foreign currency than the law allowed. Mr Lambert's defence was that the Luxembourg rules amounted to an infringement of articles 7 and 106 of the Treaty (as they were). He also argued that the effect of the Luxembourg exchange control rules was to put him at a competitive disadvantage vis-à-vis traders in other Member States, and also impliedly amounted to an obstacle to the free movement of goods. Advocate General Sir Gordon Slynn (as he then was) rejected Mr Lambert's argument about the free movement of goods in the following terms: "As *Casati*[14] shows, Member States are not required by Community law to tolerate current payments in cash if cash payments are not necessary to achieve the liberalisation of the movement of goods, particularly if cash is not the normal commercial method of payment. Nor can it be said that a 'free' exchange market is a necessary corollary or precondition of a free market in goods." The Court did not even address the question of article 30. It disposed of the matter simply by stating that: "... rules which require exporters to have foreign currency payments in respect of their sales paid through a bank and to exchange such currency on the regulated foreign exchange market and which, as a result, prohibit them from taking payments in banknotes are not a barrier to the liberalisation of payments connected with the movement of goods which is incompatible with article 106 EC." It can be seen that the reasoning of the Court in *Lambert* presupposed that any restriction on the payment for imported goods was a matter to be dealt with under article 106 EC and not under article 30 EC.

In the next case, *Factortame*,[15] Advocate General Mischo was faced with the general question as to whether UK law on the registration of fishing vessels was contrary to Community law generally. For this reason he considered not only

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12 For an illustration, see Case 267/86, *Van Eycke v ASPA* [1988] ECR 4769.

13 Case 308/86, *Ministère public v R Lambert*, [1988] ECR 4369.

14 Case 203/80 [1981] ECR 2595.

15 Case C-221/89, *The Queen v Sec of State for Transport, ex parte Factortame*, [1991] ECR 1-3905.

article 52, but also article 67 EC. He observed that "a requirement for registration that the owners, operators, shareholders and directors, as the case may be, must be domiciled in the Member State, and, in the case of a company, that it must have its principal place of business there is incompatible with article 52." In the next sentence he added quite simply: "It is also incompatible with the First Directive as amended by Directive 86/566/EEC of 17th November 1986 (OJ L332/22)."[16] The Court, for its part, found that there was an infringement of the freedom of establishment and did not address the question of capital movements. The question arises whether the Advocate-General was saying that there was an infringement of article 67 EC simply because there was an infringement of article 52 on the freedom of establishment. It is submitted that this is not what the Advocate General was saying. He was making a general statement about how UK rules in question were incompatible with Community law, and so had to consider the possibility that (1) the Spanish investors were exercising their rights of establishment, because they intended to manage the companies in question within the meaning of the second paragraph of Article 52 EC; or (2) were simply making a portfolio investment. The UK domicile requirements, etc., amounted to an infringement of article 52 EC in respect of the first category of investor, and an infringement of article 67 EC in respect of the second. The two categories are mutually exclusive.

The third case is *Bachmann* which we have already mentioned. In this case the Commission had argued that the provisions of Belgian law constituted discrimination based on the place where the capital was invested. Advocate General Mischo observed that Mr Bachmann had given no indication of having experienced the slightest difficulty in effecting the transfers of capital corresponding to the payment of his insurance premiums, and the Commission had not cited any such difficulties in the case of other persons. The Advocate General deduced that the reasoning of the Commission and of Mr Bachmann was simply that, if the tax deductibility of premiums had not been limited, more people would have concluded insurance contracts with companies in other Member States and the flow of capital out of Belgium into other Member States would have been greater. The Advocate General considered this too tenuous and indirect a link between the contested provision and the movement of capital. The Court stated categorically that "article 67 does not prohibit restrictions which do not relate to the movement of capital but which result indirectly from restrictions on other fundamental freedoms ..." On the facts, the Court observed that "provisions such as those at issue before the national court preclude neither the payment of insurance contributions to insurers established in another Member State nor their payment in the currency of the Member State in which the insurer is established."[17] In this

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16 At paragraph 53.

17 At paragraph 32.

way the Court made it clear that the rules on the free movement of capital are only applicable to restrictions which attach to the making of the monetary transfer itself.

In *Veronica*,[18] the Dutch Media Authorities considered that Veronica, an authorised broadcasting organisation, had infringed Dutch law by setting up a commercial radio transmitter in Luxembourg designed to broadcast into the Netherlands. In an earlier case[19] the Court had already decided that the Dutch Media Authorities were entitled to safeguard the audiovisual sector by limiting the activities of its broadcasting organisations. Consequently there was no infringement of either the freedom of establishment (article 52 EC) or the free movement of capital (article 67 EC) contrary to Veronica's arguments. The Court did not address the relationship between articles 52 and 67, but Advocate General Tesauro did. Although he was also of the opinion that there was no infringement of articles 52 and 67, he considered, in the alternative, the question whether, if there was an infringement, it could be justified. His reasoning is based on the hypothesis that the exercise of the freedom of establishment necessarily involves a movement of capital and any justification for the restriction on the freedom of establishment would also amount to a justification for the corresponding obstacle to the movement of capital. For this purpose, the Advocate General was obliged to make an amalgam of articles 52 and 67 which might be interpreted as meaning that an infringement of the one article would necessarily amount to an infringement of the other. Nevertheless, he repeated with approval the words of the Court in *Bachmann*: "Article 67 does not prohibit restrictions which do not relate to the movement of capital but which result indirectly from restrictions on other fundamental freedoms", and so must be taken to endorse that principle also.

Schindler[20] is hardly a case on capital movements. The Court was faced with categorising lotteries with respect to the freedoms contained in the Treaty. It decided that the persons who run lotteries are providing services, and it went out of its way to say that lotteries are not governed by the provisions of the Treaty on the free movement of goods, the freedom of establishment or the movement of capital. The case offers only mild empirical support for our argument that obstacles to capital movements and obstacles to the freedom to provide services are mutually exclusive categories.

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18 Case C-148/91, *Vereniging Veronica v Commissariaat voor de Media* [1993] ECR 1-487.

19 Case C-288/89, *Collective Antennevoorziening Gouda* [1991] ECR 1-4007.

20 Case C-275/92, *HM Customs and Excise v Gerhart Schindler and Joerg Schindler* [1994] ECR 1-1039.

In *Bordessa*[21] the Court observed that "the physical transfer of assets falls not under articles 30 and 59 but under article 67 and the directive implementing that provision. Even if it were established that such a transfer constituted a payment connected with trade in goods or services, the transaction would be governed not by articles 30 and 59 but by article 106 of the EEC Treaty."[22] This statement is again clear authority for the proposition that obstacles to the payment or capital transfer must be assessed as a separate category from obstacles to the exercise of one of the fundamental freedoms under articles 30, 52 or 59 EC.

Then came *Svensson* referred to above. Advocate General Elmer observed that a national rule which restricts the grant of state interest subsidies on housing loans to cases where the lending bank is established in the Member State in question does not in itself imply that cross-frontier transactions arising out of the loan contract are prevented or made more difficult. He repeated the observations of the Court in *Bachmann* that "article 67 does not prohibit restrictions which do not relate to the movement of capital but which result indirectly from restrictions on other fundamental freedoms".[23] However, he was not categoric in stating that article 67 could not apply; he merely said that it was "less relevant" to discuss the question in relation to article 67 rather than article 59. The Court apparently thought that it was relevant. It held that the national measure in question infringed both articles 59 and 67. The Court's reasoning appears to be based on an amalgam of the two articles. After deciding that it had to determine whether the Luxembourg regulations amounted to an obstacle to the free movement of capital (at paragraph 8), the Court limited its reasoning in paragraph 9 to the provision of services, before concluding in paragraph 19 that the regulations infringed both articles 59 and 67.

It is difficult to rationalise the Court's decision in *Svensson*. Consider the following two hypothetical variants of the case. Take, first of all, the same facts, but let us assume, in addition, that Mr Svensson had to obtain Luxembourg authorisation to import capital from abroad. Here there would be two obstacles: an obstacle to the movement of capital, by virtue of the requirement of the authorisation, and an obstacle to the provision of banking services, by virtue of the rules about interest subsidies. As a second variant, suppose Mr Svensson had private capital invested in Sweden and also in Luxembourg, and so had the possibility of moving capital from one or other source in order to invest in a house without having recourse to the services of a bank. If, through fiscal or other regulations, Luxembourg law made it less attractive for Mr Svensson to move the

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21 Case 358/93, [1995] ECR 1-3955. Case 163/94 *Sanz de Lera* 14th December 1995 is not relevant to our discussion because it involved transfers of banknotes to a non-EC country.

22 At paragraphs 13 and 14.

23 At paragraph 9.

capital from Sweden than from Luxembourg, there would have been a restriction only on the free movement of capital. The difference between this latter hypothesis and the actual case is the fact that the source of the capital was a bank loan and so involved the provision of services by the bank. Is this a reason for saying, as the writer argues, that article 59 applied in *Svensson* but, contrary to the Court's finding not article 67 (now article 73B)? The lack of reasoning of the Court on this point does not enable us to find a satisfactory answer.

The foregoing discussion shows a possible weakness in the writer's argument when it comes to cases involving banking services provided by a credit institution and which involve a capital movement. Nevertheless, in the interests of simplicity and concise pleading, it would be preferable to rule that the existence of an infringement to a credit institution's freedom to provide services do not, *ipso facto*, involve an infringement of the right to make the corresponding capital transfer, and that, in future, cases like *Svensson* be determined as involving only an infringement of article 59 EC.

Tax Measures which Infringe Article 73B EC

One may well wonder what sort of tax measure could amount to an obstacle to the free movement of capital without amounting to an obstacle to the exercise of one of the fundamental freedoms. A good example is that of a private portfolio investor who buys securities issued by a company in another Member States. The taxation of the dividends or interest paid to him will be determined by that Member State rules for withholding tax and granting tax credits in respect of dividend and interest income paid to non-residents. *Prima facie* there is an obstacle which affects not the exercise of the freedom of movement of goods, services or persons, but simply to the making of the investment, i.e., the movement of capital. The EC Treaty, as amended by the Masastricht Treaty,[24] recognises this when it establishes a derogation allowing Member States to apply the relevant provisions of their tax law which distinguish between tax payers who are not in the same situation with regard to the place of their residence or with regard to the place where their capital is invested. The writer adopts the reasoning of Mr Paul Farmer, that this exception may be interpreted as allowing Member States to continue with withholding taxes and imputation systems, etc, provided they do not discriminate unjustifiably, but it does not put the clock back on the Court's case-law on discrimination in cases such as *Commerzbank*, *Halliburton*, etc.[25]

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[24] Article 73D as inserted by article G.15 of the Treaty of Maastricht.

[25] Paul Farmer, 'EC Law and Direct Taxation - Some Thoughts on Recent Issues', ECTJ, Vol 1, 1995/96, Issue 2, p 91 at p 98.

While the existence of the exception established by article 73D EC supports our argument, it also appears to leave scant opportunity for challenging a tax measure simply on the ground that it infringes the rules on the freedom to make current payments or capital transfers. A theoretical example might be where a stamp duty or tax which was chargeable on transfers of securities investments to non-residents but not on transfers to residents. The transfer of the securities would not necessarily involve the exercise of the right of establishment (if the securities were held merely for investment purposes) and would not discriminate vis-à-vis the nationality of any intermediary providing services in relation to such investment. Such a duty or tax would amount to pure discrimination against capital movements made to other Member States. Arguably the exemption in article 73D EC would not apply because the tax would not be a direct tax charged on a "taxpayer" in the sense of that article, but an indirect tax levied on the securities transaction.[26]

Conclusion

In conclusion - and limiting our observations to the tax field - where it is alleged that a national tax measure should be declared illegal because it infringes the freedom of movement of goods or of workers, the freedom of establishment or the freedom to provide services, it should not be necessary to allege that the same fact constitute an infringement to the free movement of capital (or of current payments). It would be pertinent to invoke the latter provisions if the alleged obstacle made it more difficult, or less attractive, to make the relevant current payment or capital movement *qua* monetary transfer. However, in the latter respect, the exception provided by article 73D EC would appear to exonerate the more obvious targets for attack, namely those arising out of withholding and imputation systems.

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[26] A Commission proposal (OJ C133, 14.6.76) and an amended proposal (OJ C115, 30.4.87) to harmonise such taxes were withdrawn.