EXPLORING THE SCOPE OF THE FREE MOVEMENT OF CAPITAL IN DIRECT TAXATION

Joanna Mitroyanni[1]

Introduction

The content of the Free Movement of Capital, being still under formation in the field of direct taxation, is expected to be defined more precisely in the years to come. At present, there is a series of recently decided and pending ECJ cases which may have a direct or indirect bearing on determining the scope of the right. The aim of this article is to give a statement of the current knowledge in relation to three aspects of the Free Movement of Capital, which are likely to have a significant impact on direct taxation in Europe if/when the ECJ pronounces its final views thereon: (i) the interrelation between the Free Movement of Capital and Freedom of Establishment; (ii) the possibility of declaring an MFN dimension of Art. 56 EC Treaty; and (iii) the conditions for extension of the Free Movement of Capital to third countries.

I An Overview of the Free Movement of Capital

By way of brief overview of the legislative framework, the Free Movement of Capital is regulated by Articles 56-60 EC Treaty and Directive 88/361. The current version of EC Treaty provisions on the Freedom of Capital is only a development of 1993, as those were inserted as part of the Treaty of Maastricht.

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1 MPhil/PhD Programme, Centre of Commercial Legal Studies, Queen Mary University of London. I wish to thank Prof Philip Baker for reviewing previous drafts of this article and for all his support.

Prior to that, Articles 67-73 EEC Treaty did not develop direct effect[2]. The EC Treaty provisions incorporate a very broad construction, which has not yet been considered systematically by the European Court of Justice (ECJ). A reason for this lies in the fact that cases referring to years before 1993 lack direct effect. Therefore, they could not be relied upon by taxpayers before the Court. In the same context, Directive 88/361 was enacted to implement ex-Art. 67 EEC Treaty, since no infringement claims could be brought before the ECJ on the sole basis of that Treaty provision.

Following replacement of Art. 67 et seq. by virtue of the Treaty of Maastricht, the direct applicability of Directive 88/361 was confirmed by the ECJ in *Bordessa*[3], a non-tax case. Further, in the field of tax, the Advocate General in *Baars*[4], noted that the earlier secondary legislation (Directive 88/361 shall be treated as part thereof) may continue to be looked at "*as a pointer to the scope of the fundamental freedom*". This is important as it allows the use of the so-called *Nomenclature,* annexed to Directive 88/361, as a non-exhaustive listing of transactions which fall within the scope of the Free Movement of Capital.

As to the wording of the EC Treaty articles, it should be noted that Art. 56(1) has been construed to be broader than a discrimination provision, as it extends prohibition to all restrictions on the free movement of capital. Namely, even non-discriminatory occurrences may be found in breach of the relevant provision as long as they pose an impediment to free movement. The purview of the above general prohibition is restricted by Art. 58(1)(a) EC Treaty, which, in connection with movements between Member States, allows retention of tax law provisions, existent at the end of 1993, which distinguish between taxpayers "*who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested*"[5]. The scope of Art. 58(1) EC Treaty, allowing differentiated treatment, nonetheless remains limited to cases which do not "*constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56*" (Art. 58(3) EC

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2 For details on the replacement of Articles 67-73 EEC in the context of the Treaty of Maastricht (in force on 1 Nov 1993) and the new numbering adopted by the Treaty of Amsterdam in 1997, see M Sedlaczek 'Capital and Payments: The Prohibition of Discrimination and Restrictions' [2000] European Taxation 14-15

3 *Criminal proceedings against Aldo Bordessa and Vicente Marí Mellado and Concepción Barbero Maestre* (Joint Cases C-358/93 and C-416/93) [1995] ECR I-0361 (*hereinafter Bordessa*)

4 *Baars v Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem* (Case C-251/98) [2000] ECR I-2787 (*hereinafter Baars*)

5 Declaration no. 7, Annex of the EC Treaty

Treaty). The meaning of this wording remained vague until it was clarified in *Lenz*[6] where the Court interpreted the provision as being a reiteration of the ECJ judgments in equal treatment cases. Namely, it seems as though the ECJ understood Art. 58(3) to be a provision that gives legislative form to the standard rulings of its case law in the field. The Court noted: "*the difference in treatment must concern situations which are not objectively comparable or be justified by overriding reasons in the general interest*"[7]. The approach taken in *Lenz* has been confirmed by the ECJ in its judgment in *Manninen*[8], issued two months later. Finally, a first (though incomplete) attempt to interpret Art. 58(1) in conjunction with (3) had been accomplished by the Advocate General in *Baars*[9] where the maintenance of coherence of the national tax system was mentioned as the only basis of permissible distinction leading to unequal treatment.

II Interrelation between the Free Movement of Capital and Freedom of Establishment

A joint consideration of Art. 43(2) and 58(2) EC Treaty points to a mutual restriction of the scope of each of the two freedoms by the other[10]. Put another way, to the extent that a national tax provision constitutes a legitimate restriction of any one of the two freedoms, it should not be struck down as an infringement of the other.

Nevertheless, the practice of the ECJ gives evidence of a different approach. More specifically, it seems that insofar as one of the freedoms is found to be infringed, the ECJ does not proceed with examining whether the breach extends to the other freedom as well. Such an approach runs contrary to the above joint consideration of the wording of Arts. 43(2) and 58(2) EC Treaty; the process observed does not leave room for the national provision to be possibly found compatible with a legitimate restriction of the other freedom (namely, the one not considered)[11]. The ECJ has so far given priority to examining the Freedom of Establishment.

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6 *Anneliese Lenz v Finanzlandesdirektion für Tirol* (Case C-315/02, 15 July 2004) (*hereinafter Lenz*)

7 *Lenz* at para 27

8 *Petri Mikael Manninen* (C-319/02, 7 September 2004) at para 29 (*hereinafter Manninen*)

9 Advocate General Opinion in *Baars* at para 58

10 K Stahl 'Free movement of capital between Member States and third countries' (2004) 13 EC Tax Review 47, 48 (*hereinafter* Stahl); M Peters 'Capital movements and taxation in the EC' (1998) 7 EC Tax Review 4, 6-7

11 Stahl at 49

In *Baars*, the Advocate General noted:

> "*48. … In the present case, therefore, the fact that the freedom of establishment is in point does not preclude the simultaneous application of the rules on capital movements*".

In the case of shareholdings, a distinction is normally drawn between shareholdings of a certain size which allow "*a decisive influence over the undertaking's decision-making*" and all other participations, which do not fulfil the above requirements of size and impact on the determination of the company's activities. Should the above additional requirements be met, the Advocate General expressly notes that "*such investment.....would be protected.....under two separate heads*"*;* namely, it should qualify for protection under both the Free Movement of Capital and Freedom of Establishment.

The examination for an infringement of the Free Movement of Capital is treated by the Advocate General as an alternative to be tried in the event that the more far-reaching requirements relating to the Freedom of Establishment cannot be established. One point can therefore be that priority should be given to the freedom that places the highest standards for application in the specific instance. It follows that if the case is one of shareholding and those highest standards are fulfilled, entitlement to protection under both freedoms (i.e. Establishment and Capital) should be acknowledged.

Another illustrative example of this is the ECJ decision delivered in *DeBaeck*[12]. A Belgian tax resident selling shares held in companies which were tax resident in Belgium was exempt from tax on the capital gain if the disposal was made to Belgian tax residents. Where shares were sold to foreign companies, capital gains tax became due.

The judgment quotes:

> "*25....the exercise.....of their right of establishment is liable to be restricted, provided that the shareholding transferred gives its holder definite influence over the company's decisions and allows him (Mr DeBaeck) to determine its (the company's) activities.[...]*
>
> *26. If that is not the case, the difference of treatment.....must be regarded as constituting a restriction on the freedom of movement of capital for the purposes of Article 56 EC.....*"

12 *Jean-Claude De Baeck v Belgische Staat* (Case C-268/03) (*hereinafter DeBaeck*)

In the same line as in *Baars* above, the ECJ, without expressly saying so, seems to be treating the Freedom of Establishment as a sub-category of the Free Movement of Capital in relation to shareholdings; more specifically, it considers that an investment in a company's shares/stock falls within the scope of the Freedom of Establishment if specific requirements attached to the holding which indicate a high participation percentage and influence over decision-making are fulfilled. In the event that those requirements are not met, investment rights, without a need to satisfy any further conditions, are still protected against obstacles to free movement under the Free Movement of Capital provisions, being wider in scope than the Freedom of Establishment. This points to the conclusion that as regards shareholdings, the Free Movement of Capital is broad enough to encompass both portfolio and direct investment in securities; it follows that in connection with substantial shareholdings in particular, the Freedom of Establishment ends up as a sub-category of the Free Movement of Capital.

The above demonstrated interrelation is not of a mere theoretical value. On the contrary, it is expected to have a significant bearing on the scope of application of the Freedom of Establishment in view of a possible extension of the Free Movement of Capital to third countries. To the extent that a certain transaction falls within the overlapping area of the two freedoms, it should typically be entitled to the more extensive scope of the Free Movement of Capital, irrespective of whether the ECJ has solved the issue on the basis of the Freedom of Establishment. The purview of the Free Movement of Capital is wider compared with that of the Freedom of Establishment; if, therefore, extension to third countries is acknowledged for capital cases, the same should be granted to establishment ones falling within the overlapping area. Considering that there are pending judgments, such as the one in *Marks & Spencer*[13], where questions of cross-border loss relief are in issue, the obligation of Member States to give loss relief for foreign subsidiary losses could be extended to companies of the group located in third countries. In such a case, since there is a substantial shareholding, the investment should be protected under both freedoms.

III Does the EC Treaty have a Most Favoured Nation Effect?

MFN has mainly been used in the area of international trade over the twentieth century and has been one of the key features of the Friendship, Commerce and Navigation (FCN) Treaties concluded by the United States of America with some of their trading partners; after World War II, the MFN clause was incorporated in the GATT to regulate market access in the trade in goods. Further, in the context

13 *Marks&Spencer plc v David Halsey (HM Inspector of Taxes) (UK)* (Case C-446/03) (*hereinafter M&S*)

of the World Trade Organisation, it has been extended to matters that relate to the cross-border supply of services (GATS).

The ECJ was faced with the challenge of applying MFN to direct taxes in the European Internal Market (EIM) in the late 1990s[14] for the first time. At the time, it refrained from taking a position, as the question on MFN was addressed to the Court in the form of a supplementary ground for Treaty infringement. It was the referral of the *'D'*[15] case in 2003 that made the prospect of giving an MFN dimension to the Free Movement of Capital, as applied to direct tax cases, a highly disputed subject for discussion. On 5 July 2005, the Court issued its ruling in *'D'* and departing from the Advocate General's Opinion (delivered on 26th October 2004), it unreservedly rejected the application of MFN; in practice, it left no room for future consideration of the issue.

The wording of the EC Treaty

> "*1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States.....shall be prohibited*" (Art. 56(1) of EC Treaty)

To establish infringement of an EC Treaty fundamental freedom provision, the ECJ has always drawn a comparison between the cross-border situation, claimed to be disadvantaged by the law of a Member State, and its domestic equivalent within the same Member State. Put another way, the standards under comparison have so far normally been a domestic situation, on the one hand, and a cross-border situation of features comparable to those of the domestic situation, on the other (i.e. national treatment).

By referring to "*restrictions on the movement of capital.....between Member States*", the wording of the Treaty does not seem to introduce an MFN element. The provision could still remain one that examines, from the perspective of either the origin or host state (depending on the facts), the treatment of movements of capital between the two States. The comparison can be drawn either between the tax liability of a non-resident investor and that of a resident investor (if the case is considered under the law of the host state) or two resident investors one of which invests in another Member State (if the case is considered under the law of the origin state). If the "*restriction*" of Art. 56(1) is understood to contain an MFN

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14 *Metallgesellschaft Limited, Hoechst AG and Hoechst UK Limited v Commissioners of Inland Revenue, H.M. Attorney General* (Cases C-397/98 and C-410/98) [2001] ECR I-4727

15 *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* (C-376/03) 5 July 2005 (*hereinafter 'D'*)

dimension, it is not enough that a host state entitles a non-resident to the benefits of a DTC (signed by the host state), which is a matter the ECJ has dealt with[16]; it is only the most favourable treatment provided in the host state's network of DTCs with other Member States that escapes infringement of Art. 56(1) EC Treaty.

The wording of Art. 56(1) EC Treaty, though not expressly providing for MFN in the prohibition of restrictions on the free movement of capital, could possibly not exclude it either. Namely, it could be asserted that a restriction "*on the movement of capital.....between Member States*" is suffered by an investor, resident in a certain Member State, if that investor is treated by another Member State, in its investment venture in the latter state, less advantageously than investors resident in a third Member State. This is an interpretation which does not depart from the wording of the Treaty; the movement of capital still occurs between the same two Member States (i.e. host and origin states) of the traditional comparison.

The MFN in the Case Law of the ECJ

A case which has extensively been associated with MFN by the literature is *Saint Gobain*[17]. The facts can be outlined as follows: a German-located Permanent Establishment (PE) of a French Head Office was found by the ECJ entitled to be granted a benefit in Germany equal to the benefits of the Germany-US DTC despite not being a resident of Germany. In the author's view, this case may have involved a third party application of the Germany-US DTC but should not be considered to be related to MFN. Drawing from the fact that DTCs are part of the legal order of their contracting parties, *Saint Gobain* could be seen as a development of *Avoir fiscal* and *Commerzbank*, bringing the issue of PE equal treatment to resident companies up to the level of DTCs[18]. *Saint Gobain* was quoted by the Court in *'D'*[19]. Propositions of relevance to *'D'* were however turned down, as the judgment explicitly points out that the two cases involve a different comparison.

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16 *Saint-Gobain v Finanzamt Aachen-Innenstadt* (Case C-307/97) [1999] ECR I-6161 (*hereinafter Saint Gobain*)

17 AP Dourado 'From the *Saint-Gobain* to the *Metallgesellschaft* case: scope of non-discrimination of permanent establishments in the EC Treaty and the most-favoured-nation clause in EC Member States tax treaties' (2002) 11 EC Tax Review 147; HE Kostense 'The *Saint-Gobain* case and the application of tax treaties. Evolution or revolution?' (2000) 9 EC Tax Review 220

18 Kostense at 222

19 *'D'* Judgement at paras 56-57

An MFN question was brought before the ECJ for the first time as part of the preliminary question referred in the context of the *Hoechst/Metallgesellschaft* case. However, neither the Advocate General nor the Court took up the occasion to rule on the issue; once a breach of the Freedom of Establishment was established in answering the first question of the referral, both the Advocate General and the Court found it was redundant to deal with MFN.

Recently, MFN was brought back to the fore in *'D'*. The MFN question that arose in *'D'* concerned whether a German tax resident subject to Wealth Tax in the Netherlands for the 10% of his overall wealth owned there should be entitled to the same tax deduction as the tax residents of Belgium, who were granted the respective allowance under the Netherlands-Belgium DTC. The Advocate General in his Opinion adopted a stance in favour of granting MFN[20]. He suggested, though, that the issue is not solved in the context of this case (i.e. *'D'*)[21]. If that suggestion had been followed by the Court, the MFN question would have been left to be tackled in *Bujara*[22], another case pending before the ECJ. However, as mentioned above, the ECJ took steps to examine the question of MFN and finally, placed it out of the scope of the EC Treaty. More specifically, no breach of the Free Movement of Capital was established under the first question referred: the Court, in line with its established *Schumacker*[23] statement that "*the situations of residents and of non-residents are not, as a rule, comparable*", found that liability to wealth tax does not place residents and non-residents in similar/comparable situations[24]. Difference of treatment is therefore allowed. As a result, consideration was then given to the MFN question, which was addressed as a supplementary ground for infringement. The ruling delivered by the ECJ on the MFN question altogether rejects comparability of situation between Mr 'D', not being tax resident in the Netherlands, and that of another non-resident therein (i.e. a Belgian resident) who receives a special benefit under the Belgium-Netherlands DTC. It follows that the Court understands that the comparison should exclusively be drawn between the tax treatment of a domestic situation and an equivalent cross-border situation, which constitutes exercise of one or more EC fundamental freedoms. Non-residents are therefore not accepted to be comparable with each other.

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20 *'D'* A.G. Opinion at para 72 et seq.

21 *'D'* A.G. Opinion at para 106

22 *Bujara v Rijksbelastingsdienst (NL)* (C-8/04) OJ C 59 06.03.2004 p. 17 (*hereinafter Bujara*)

23 *Finanzamt Köln-Altstadt v Roland Schumacker* (Case C-279/93) [1995] ECR I-225 at para 31

24 *'D'* Judgement at para 37

To reject the application of MFN in *'D'*, the Court followed Public International Law principles and refused to give the Belgium-Netherlands DTC third-party application. More specifically, Belgian and German residents have been held to be in non-comparable situations from the Netherlands perspective; that implies a different treatment is permissible in connection with their liability to wealth tax in the Netherlands. However, no other reasoning is provided by the Court to justify the non-comparability, except for the affirmation that "*the fact that those reciprocal rights and obligations apply only to persons* ***resident*** *in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions*". Namely, at a first level of understanding, non-comparability arises from the fact that DTCs do not have third-party application. In the author's view, the above offers no proper explanation; the Court confirms a principle of International Law but one could argue that the stance taken is at odds with the established position that "*as far as the exercise of the power of taxation so allocated is concerned, the Member States ..... may not disregard Community rules*"[25]. Namely, Member States may have retained competence to "*determine the connecting factors for the purposes of allocating powers of taxation between themselves*"[26] but at the stage of "*exercise*", they should give priority to EC Law (a consequence of supremacy). In light of this, non-comparability could only be justifiable in this case to the extent that it were treated as part of the process of "*allocation of taxing powers*"*;* namely, the taxing Member State (i.e. the Netherlands) would be treated as having exercised its competence to allocate its taxing jurisdiction and decided to grant the specific benefit to Belgian residents. Considering that the situation in issue clearly deals with the "*exercise*" of allocated taxing powers, the only explanation for the above position of the ECJ is to treat the judgment as launching an extension of the concept of "*allocation*", which inevitably leads to an overlap between "*allocation*" and "*exercise*"[27]. The limits of the aforementioned concepts have often been challenged lately and debate on their interrelation has opened among scholars in the area. Notably, developments are expected in the near to mid-future in connection with clarifying the part that "*allocation*" and "*exercise*" should play in interpreting and applying DTCs. MFN, as adjusted to the test of discrimination/forbidden restriction for the purpose of meeting the needs of the internal market, could therefore contribute to the development of new concepts in EC Tax Law.

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25 *Saint Gobain* at 57

26 *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin* (Case C-336/96) [1998] All ER (EC) 826, [1998] 3 CMLR 607 at para 24; *Saint Gobain* at 56

27 *'D'* A.G. Opinion at 101: the A.G. seems to place the issue within the scope of the concept of *"exercise"* rather than *"allocation"*.

The way that the MFN query was set out by the referring court clearly showed that a ruling on MFN was requested only if a breach of the EC Treaty were not established on the basis of the traditional test of unequal treatment of foreign (i.e. German) tax residents as compared to domestic (i.e. Dutch) tax residents. The above indicates that an MFN approach to the free movement of capital would function as a stricter version of the test of discriminatory/unequal treatment. More specifically, the comparison in the context of an MFN approach would continue to involve the tax system of one state[28] (namely, either the host or origin state) but it is moved up to the level of the provisions of that state's DTCs; namely, a precise arrangement of its DTC with another Member State is compared with the most favourable version of the specific arrangement in its entire network of DTCs. An outcome of this is that the MFN considerations under the EC Treaty should normally arise in connection with issues appearing in DTCs, which points to a smaller range of tax-related issues, compared with the broadness of tax-relevant themes that may otherwise be brought before the ECJ. Further, albeit that MFN involves a comparison which always brings in a third state, it remains a consideration of treatment of two situations within the context of the law of one state; the difference from the traditional comparison is that the situations under examination are both of a cross-border nature[29]; still, in line with the traditional test, it should be evidenced that the situations under comparison bear enough similarity to be juxtaposed.

The Advocate General has pointed out that the application of an MFN clause may be necessary "*for the establishment of the single market*"[30]. However, "*...the principle of non-discrimination on grounds of nationality, as a rule safeguarding freedoms of movement, does not require that a citizen of one Member State should receive the best possible treatment in the other...*". It is true that MFN develops an understanding of the internal market which seems closer to a 'Single Market' objective; MFN places an obligation on each Member State to apply to nationals of other Member States the most favourable treatment across its DTC network with EC Member States and possibly, third countries[31]. This leads to a situation in which each taxing Member State shall apply, vis-à-vis the other Member States,

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28 This is why recognition of MFN does not imply that the Court has departed from its judgment in *Gilly*. In *Gilly,* a disparity between the French and German tax systems led to a tax higher burden, as the tax paid at source could not be fully relieved under the credit method applied by the state of residence due to the lower domestic tax rate of the latter. No discrimination/restriction arising from the law of one Member State was therefore in issue.

29 R van der Linde 'Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the *D* case' (2004) 13 EC Tax Review 10, 11

30 *'D'* A.G. Opinion at para 96

31 For analysis on the 'third countries' dimension, see below in this work under section 3.

only one provision of its EC DTC network. That provision is inevitably the most favourable one; otherwise, the requirements of the 'equal treatment test' would not be properly fulfilled. However, since applying the best possible treatment is not a Treaty objective as such, it is necessary that each time, it is made sure that MFN should rectify a Treaty obstacle. Therefore, in a case like *'D'*, the aim should be to establish that a restriction on the Free Movement of Capital into the Netherlands occurs against German nationals as compared with Belgian nationals due to the special benefit granted to the latter under the Netherlands-Belgium DTC.

Implications of applying MFN

It is doubtful whether the EIM, at its current stage of development, could accommodate an MFN aspect of the fundamental freedoms. The implications to arise from the application of MFN could cause serious irregularities in the use of international tax concepts in the internal market and the relations between Member States and third countries. The EIM in the area of direct taxes is still composed of 25 sovereign states and as a result, international tax concepts still dominate their intra- and extra-EC fiscal relations.

In the event that MFN had been found applicable, its impact on DTCs between Member States would have been radical. The Court repeats in a standard way in its judgments that Member States have retained the competence to determine the connectors which allocate taxing powers between themselves but should exercise any such power consistently with Community Law. However, an interpretation of Art. 56(1) in light of MFN could reach a point of eliminating such competence otherwise enjoyed by the Member States. More specifically, serious irregularities that affect the reciprocity principle of DTCs would be generated in those cases that the taxing power is shared between the source and residence states. In cases of dividend, interest and royalty payments, the state of source would be required to extend the lowest withholding tax rate appearing in its DTC network with other Member States[32] to all its DTC partners across the internal market (and possibly third states![33]). In parallel, when the source state takes the position of residence state, the amount of relief it should give shall depend on the tax withheld at source (on the basis of the MFN principle). The residence state could, as a result, be found in a situation in which the relief for taxes withheld at source would correspond to a much higher amount than the taxes collected through withholding. The lower the withholding taxes a state has accepted to impose through its DTC network, the more likely that the state be affected by the above. Arguments relating to disturbing the balance of DTCs could therefore be raised.

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32 Possibly also third states; see below in this work, under Section IV.

33 ibid

Another result of applying MFN to the provision on the Free Movement of Capital would relate to shifting the understanding of MFN, so far being attached to market access, into a concept that would also comprise the tax treatment of foreign investment within the market of the host state (namely, after the access process has been completed). However, this post-access aspect would be even less likely to be subject to MFN, as it should normally be linked to 'national treatment', which limits the comparison between domestic and foreign situations. For example, under Art III paras (1) and (2) of GATT 1947, national treatment shall be understood as being limited to a prohibition of differentiated treatment between imported and domestic products; no MFN concept is incorporated therein. Further, in Art. I para 1 of GATT 1947, MFN deals with market access transactions only. Considering the facts in *'D'*, it becomes obvious that the tax measure in issue, falling within the scope of Wealth Tax, did not involve market access but was instead a provision of post-access treatment. If therefore MFN were to apply to Art. 56 EC Treaty, Member States would not be allowed to differentiate in their post-market access tax treatment between foreigners, which would constitute a departure from the traditional MFN concept. It seems that granting *'D'* with MFN treatment would possibly have led to the creation of a new concept. This could perhaps be considered as too radical an intervention into the current content of MFN, which has been formed over the years.

IV Freedom of Capital and Third Countries

An area in which the scope of the Free Movement of Capital has not yet been clarified by the ECJ relates to movements of capital between Member States and third countries. As regards non-tax cases that involve cross-border movements of capital, it is settled case law of the ECJ[34] that Member States are bound, vis-à-vis third countries, to ensure that their national laws place no impediments to the fundamental right of Art. 56(1). More specifically, having acknowledged the direct effect of the Nomenclature of Directive 88/461/EEC in *Bordessa*, which was a non-tax case of capital movements between Member States, the ECJ went on to extend such treatment to third countries in *Sanz de Lera*. The Court decided the case on the same grounds as *Bordessa* and in that way, established a precedent of non-differentiated treatment between capital movements that take place within the EIM and those that are directed to, or originate from, third countries.

34 *Bordessa*, see footnote 2; *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu* (Joint Cases C-163/94, C-165/94 and C-250/94) [1995] ECR I-4821

The Approach in the Area of Taxes

(i) The EC Treaty

The situation seems however to be a lot more complicated with respect to a possible extension of the Free Movement of Capital to third countries in the area of taxation. It is clear that the wording of Art. 56 does not distinguish between fiscal restrictions and impediments arising from other disciplines. Instead, it takes an all-inclusive approach quoting "*all restrictions on the movement of capital...*". Therefore, a literal interpretation of the provision points to no differentiation in treatment between tax measures that affect movements of capital within the EIM, on the one hand, and movements to and from third countries, on the other.

A consideration of the far-reaching implications of such an interpretative approach, however, casts doubt on whether a purposive interpretation, namely one that reflects the objectives of the EIM, would necessarily lead to the same conclusion[35]. The provisions which regulate the internal market are in most cases of an intra-EC scope; namely, they limit themselves to transactions that take place between parties from two Member States. Further, from a Public International Law perspective, entitlement to undertake rights and obligations under the Treaties should, in principle, rest with Member States only, as they are the only signatory parties to the Treaties. As regards the interrelation between the EIM and the rest of the world, Art. 307 of the EC Treaty quotes that any pre-accession agreements between Member States and third countries shall, in principle, remain unaffected by the provisions of the EC Treaty. It is only in connection with areas of incompatibility with the EC Treaty that an obligation is placed on Member States to proceed with eliminating the incompatible aspects. The above thoughts point to the following conclusion: *the EC Treaty seems to deal with third countries only to the extent necessary for the realisation of the European Internal Market*. This implies that restrictions on the Free Movement of Capital between Member States and third countries shall be prohibited only to the extent they undermine the objective of the EIM. Such a conclusion would not allow, as such, an extension to third countries of the provisions on the EIM, irrespective of whether those confer rights or impose obligations. Considering that, a literal interpretation of Art. 56, extending unilaterally a considerable part of the EIM rights to third countries[36] would depart from the objective of the Treaty provisions which deal with the creation of the EIM. Such an approach would go further than ensuring the realisation of the EIM among the signatories of the Treaties; it would end up granting third countries more favourable treatment than the Member States

35 Stahl at 49 et seq.

36 See also on the interrelation between the Free Movement of Capital and Freedom of Establishment, earlier in this work under Section II.

themselves, as the latter do not only benefit from rights but also incur obligations in the context of the EIM.

(ii) The ECJ Case Law

Recently published literature[37] contains an interesting argument in favour of not extending the free movement of capital provisions to third countries under the same conditions as those applying to transactions between Member States. The argument has been drawn from the Opinion[38] delivered by the ECJ on the European Economic Area (EEA) Agreement. The Court clarified that, irrespective of its identical wording to the EC Treaty in certain provisions, the EEA Agreement cannot be interpreted under the same terms as the EC Treaty in view of the different objectives shared by the two legislative instruments. Stahl's argument starts from the acknowledgement that the EEA Agreement should be given a different purposive interpretation from the EC Treaty due to the fact that the former does not envisage the same degree of integration as the latter. It follows that third countries, being in an even looser connection with the EC than the EEA countries, should be treated accordingly. As Stahl herself mentions, however, the main problem with the above comparison is that the provision which relates to third countries is part of the EC Treaty itself and is therefore bound by the principles of interpretation applicable thereto. Still, though, a solution to this could be suggested if the opinion expressed under (i) above were considered: namely that the EC Treaty deals with third countries only to the extent necessary for the implementation of the EIM. In that context, it could therefore be asserted that provisions on third countries, incorporated into the EC Treaty, should not in principle be interpreted according to the EIM objective of close integration. Only where they cope with issues relating to the creation and operation of the EIM should teleological interpretation come into play under the same terms as those which apply to intra-EC movements. For instance, if the extension of a freedom merely involves conferring a benefit to a third country without (direct) impact on the EIM, then different interpretative rules should be given consideration.

The ECJ has so far not given its views on the free movement of capital and third countries. However, in two recently decided cases, it has briefly referred to the issue for the first time. The reference was made for the purpose of pointing out that, in the cases in issue, the Court was to limit its examination to the movements

37 Stahl at 51-52

38 ECJ Opinion 1/91 of 14 December 1991 on the Draft Agreement for the Creation of a European Economic Area (EEA) between the Community and the Countries of the European Free Trade Association (EFTA).

of capital between Member States only. In *Lenz*[39], the Court expressly limits the scope of its ruling to movements of capital between Member States. Such an approach could perhaps imply that a different treatment would probably be afforded to movements of capital to and from third countries. Further, in *Manninen*[40], the Court follows the same practice as in *Lenz* and makes clear that its ruling is limited to an intra-EC situation. What is more, the Advocate General made a step further in *Manninen* and explicitly set forth that Art. 56 EC Treaty does not place a requirement to treat situations that involve third countries under the same terms as movements of capital between Member States. Still, though, the Advocate General avoids tackling the issue of deciding "*to what extent the principles developed.....can be transposed to cases involving third countries*"[41].

Crucial input on the issue has been expected to come out in the context of the *van Hilten*[42] case, in which the Advocate General's Opinion was delivered on 30 June 2005. The question posed is whether the Netherlands provision which subjects the estate of Dutch nationals, resident outside the Netherlands for less than 10 years, to inheritance tax under the same terms as Dutch tax residents is in breach of the Free Movement of Capital. Considering that the deceased person (i.e. Ms van Hilten) was resident in a third country (i.e. Switzerland) at the time of her death, the case has been understood as one that shall clarify whether the Free Movement of Capital should be extended to third countries. The Opinion of the Advocate General, however, does not provide a generally applicable answer in connection with extending the Free Movement of Capital to third countries. More specifically, the Opinion contains a narrow construction of the respective Nomenclature article, annexed to Directive 88/361/EEC, which refers to inheritance. It is clarified that a change of country of residence, not being accompanied by any change of location of property, does not qualify as a movement of capital[43]. The ambit of Chapter XI of the Annex was limited to transfers of ownership of property[44]. The Advocate General held that an actual movement is required, so that the Nomenclature can be applicable; this narrows down the scope of the provision to transfers of the assets of an estate to the heirs[45]. Therefore, inheritance transfers, as they stand in the

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39 *Lenz* at para 17

40 *Manninen:* Judgement at para 51 and Advocate General Opinion at para 79

41 Advocate General Opinion in *Manninen* at para 79

42 *van Hilten v Rijksbelastingdienst (NL)* (Case C-513/03) OJ C 85 03.04.2004 p.12 Advocate General's Opinion issued on 30 June 2005 (*hereinafter van Hilten*)

43 *van Hilten* A.G. Opinion at para 57

44 *van Hilten* A.G. Opinion at para 53

45 *van Hilten* A.G. Opinion at para 59

wording of the Nomenclature, cover the distribution of an estate among the heirs but not the act of coming into the estate at the point in which the deceased person passes away. Further, the Advocate General found that (where there is a movement of capital) there is no "*restriction*": the Dutch provision under scrutiny does not treat Dutch nationals that move abroad in such a way that they end up in a less attractive position than nationals who stayed home. In this regard, it is mentioned that an ordinary credit is granted for inheritance taxes paid abroad. Where the taxes paid abroad have been higher than the overall tax liability due in the Netherlands, the disadvantage is taken to be an outcome of the disparities between the two tax systems due to lack of harmonisation. The Advocate General draws no distinction between cases in which an EU national moves his/her residence to another Member State and cases in which residence is shifted to a third country[46]. As long as an actual transfer of capital can be established, the treatment of both instances seems to remain the same. In this case, no infringement of the Free Movement of Capital was sustained and therefore, the reasoning did not reach the point of considering the third country involvement. In light of this, the Opinion of the Advocate General in *van Hilten* does not seem to provide a clear answer in relation to the scope of Art. 56 EC Treaty vis-à-vis third countries.

Should the ECJ establish that capital transfers to and from non-Member States are entitled to the benefits of the Free Movement of Capital, the implications would be on a large scale. Only by indication, it could be mentioned that the principle of *Verkooijen* could lead to an obligation to give a full foreign tax credit in the context of an imputation system for dividends paid from third country companies. Further, situations that fall within the scope of both the Freedom of Establishment and Free Movement of Capital could now be viewed as being extended to third countries[47] through the latter. Cases of Thin Capitalisation[48] or intra-group transfers of losses, provided the ECJ allows group loss relief in *Marks & Spencer*, would probably also be applied to group companies resident outside the EIM. In this regard, the impact would also be likely to affect legislative measures at European level. For instance, a comprehensive system for taxing multinational groups within the EC, as roughly envisaged by the European Commission in the context of a Common Consolidated Tax Base (CCTB), would risk being found incompatible with the EC Treaty, since it would most probably leave non-EC group members out of the Formulary Apportionment.

46 *van Hilten* A.G. Opinion at para 74

47 See earlier in this work under section 1.

48 O Thömmes and S Mueller 'ECJ to Decide on Protection of Non-EU Companies against Discrimination' (2004) 32 Intertax 448

V Conclusion

The clarification of the scope of the Free Movement of Capital by the ECJ may bring forward significant developments in the field of direct taxation, depending on the stance to be adopted (by the ECJ) in the aspects of the freedom analysed above. Before the judgment of the ECJ in *'D'* was issued, the impact was expected to focus on the interrelation between EC law and the Member States' DTC network. Following the ruling in *'D'*, it seems that a major issue, such as the MFN, will no more give rise to complexity. DTC-related themes remain high up on the Agenda; however, after *'D'*, they are not specifically linked to the Free Movement of Capital. Further, it can be asserted that the risk of a breakdown feared to be caused in the internal and, probably, also external network of DTCs concluded by EC Member States has now been eliminated. A possible extension of the Free Movement of Capital to third countries calls for a uniform EC-wide arrangement of the DTC provisions touched upon (for instance, Arts. 10, 11, 12 of the OECD Model). The current framework, which features DTCs broadly structured on the OECD Model but with substantial differences the one from the other, is likely to cause complexity and could render the system impossible to operate. Proposals in that area have been put forward[49] but the debate is still at an early stage and no official position has yet been made known by the European Commission.

The decision delivered by the ECJ in *'D'* seems to incorporate a comprehensive approach to the issue of MFN and it seems that little room is left to adopt a different stance in the near or long-term future (i.e. *Bujara*[50], a case on MFN which has not yet been heard by the ECJ). Regarding the application of the Free Movement of Capital to flows to and from third countries, the Advocate General's Opinion in *van Hilten* was recently issued. The Advocate General did not proceed to expressly set forth his views on the extension of the Free Movement of Capital to third countries, as the case was decided a step earlier, namely by asserting that the referred question entailed no actual capital movement and that no infringement of Art. 56 EC Treaty could be established. In that way, a narrow construction of the ambit of the Free Movement of Capital clause has been put forward. In light of this, the potential of extending the Free Movement of Capital to third countries remains an open theme.

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49 check the following URL under 'Consequences for the tax treaty policies of EU Member States' for material relating to this topic: http://europa.eu.int/comm/taxation_customs/taxation/company_tax/conferences_events/article_1266_en.htm

50 *Bujara*