Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with Lasertec, A and B and Holböck

1. Introduction

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dividends from a Swiss company under Austrian dividend taxation rules, which were held to infringe the free movement of capital in intra-Community settings in Lenz because only domestic-source dividends were taxed at a reduced rate.

In all three cases, the ECJ sustained the respective Member State’s legislation, but for differing reasons. In Lasertec and A and B, the ECJ found that the disputed legislation primarily concerned the freedom of establishment, whereas the restrictive effect on the free movement of capital was merely an unavoidable consequence of such restriction and that, therefore, the cases had to be decided under Art. 43 and Art. 48 of the EC Treaty only. As the scope of the latter does not, however, extend to third country situations, the taxpayers concerned were ultimately unprotected by EC law. In contrast, in Holböck, the ECJ appears to have agreed with the taxpayer that the Austrian legislation at issue, which covered portfolio as well as direct investments, was to be measured against both the freedom of establishment and the free movement of capital. Nevertheless, the ECJ found that the Austrian legislation, as an “old” restriction that had already existed on 31 December 1993, was in any event ultimately unprotected by EC law. In contrast, in third country situations, the taxpayers concerned were accepted that the free movement of capital, on the one hand, and the freedom to provide services or the freedom of establishment, on the other, could be applied simultaneously to one and the same cross-border activity. In fact, the ECJ’s approach appears to be like an extremely time-delayed reaction to a distinction developed by Advocate General Alber in Baars, who took the view that

whence, several suggestions have been made to delimitate the related proportionality standards. Nevertheless, some preliminary conclusions may be drawn from A and B, Lasertec, and Holböck regarding, first, the relationship between the free movement of capital and the other fundamental freedoms (see 2.) and, second, the interpretation of the grandfather clause in Art. 57(1) of the EC Treaty (see 3.).

2. The Relationship between Free Movement of Capital and Freedom of Establishment

For obvious reasons, relating primarily to non-reciprocity, several suggestions have been made to delimitate the direct applicability of Art. 56 of the EC Treaty in third country settings. Interestingly, the ECJ has chosen to limit the scope of Art. 56(1) of the EC Treaty by simply denying the application of the free movement of capital in situations “primarily” affecting another fundamental freedom, since, in these cases, restrictions of the free movement of capital are “an unavoidable consequence” of any restriction on the other fundamental freedom and “do not justify, in any event, an independent examination of that legislation” in the light of Art. 56. This approach is a somewhat surprising one, as it was widely

accepted that the free movement of capital, on the one hand, and the freedom to provide services or the freedom of establishment, on the other, could be applied simultaneously to one and the same cross-border activity. In fact, the ECJ’s approach appears to be like an extremely time-delayed reaction to a distinction developed by Advocate General Alber in Baars, who took the view that
Yet, whilst Baars concerned a cross-border situation between two Member States, so that, ultimately, at least one fundamental freedom applied (and it could even be argued whether or not, given the structural convergence of all freedoms, the discussion there was somewhat academic), in the present context, this approach matters. Specifically, it could be said that it results in the consequence that the scope of another, ‘primarily affected’ fundamental freedom that does not cover third country scenarios, for example the freedom of establishment, cannot be ‘extended’ beyond the Community’s border by invoking the free movement of capital. Only in situations in which the restriction of the free movement of capital is not an “unavoidable consequence” of the restriction of another fundamental freedom, the taxpayer can rely on Art. 56(1) of the EC Treaty.

This approach, however, requires the determination of the freedom that is ‘primarily’ affected and it is submitted that this may not be easy.23 If two freedoms are potentially at issue, the ECJ, in principle, intends to examine the disputed measure in relation to only one of those two freedoms if it appears, “in the circumstances of the case, that one of them is entirely secondary in relation to the other.”24 It is immediately clear that such an assessment based on ‘the circumstances of the case’ must not rely on the specific factual situation of the taxpayer,25 as this would deprive Art. 57(1) of the EC Treaty of any meaning. This provision grandfathers restrictions of the free movement of capital in third country settings with the meaning. This provision grandfathers restrictions of the freedom of establishment or the freedom to provide services in intra-EU settings.26 If, however, the primarily affected fundamental freedom were to be determined according to the specific situation of a taxpayer, for example by reference to the size of his shareholding, Art. 57(1) of the EC Treaty could never apply to direct investments.27 This approach must, therefore, be rejected.

It could be against this background that the ECJ considers the “the purpose of the legislation concerned.”28 Accordingly, if the national legislation at issue applies only to situations that are (also) covered by, for example, the substantive scope of the freedom of establishment or the freedom to provide services, the taxpayer cannot rely on the free movement of capital. If, in contrast, the national legislation also applies to situations not (primarily) covered by any other freedom, Art. 56(1) of the EC Treaty may be invoked, irrespective of the specific factual situation of the taxpayer.29 This delimitation is especially important in cases concerning cross-border equity investments. In such cases, according to settled case law, Art. 43 and Art. 48 of the EC Treaty are at issue if a shareholding enables the holder to have a definite influence on a company’s decisions and to determine its activities,30 whilst other shareholdings, especially portfolio holdings, are protected by Art. 56.31 The application of Art. 56 of the EC Treaty in a third country situation, therefore, depends on whether or not the legislation at issue is ‘intended to apply only to those shareholdings which enable the holder to have a definite influence on a company’s decisions and to determine its activities’.

25. In fact, it may even be impossible, as can be derived from the explanations given by ECJ Advocate General Alber’s Opinion, 14 October 1999, Case C-25/98, C. Baars v. Inspecteur der Belastingen/Onderzemingen Gorinchem [2000] ECR I-2787, Paras. 27 and 30 concerning his own distinction, i.e. “The above principles fail to categorise cases in which a national measure both directly hampers capital flows and directly affects the right of establishment... There is therefore a third rule governing the relationship between the two freedoms: Where there is a direct intervention affecting both the free movement of capital and those of the right of establishment, both fundamental freedoms apply, and the national rule must satisfy the requirements of both”. For third country relations, this can only mean that Art. 56(1) of the EC Treaty applies, as Art. 43 lacks the necessary erga omnes effect.
27. See note 32.
29. For this apparent paradox, see Cordewener, Kofler and Schindler, note 31, p. 112 et seq. For an attempt to introduce a differentiated interpretation of Art. 56 of the EC Treaty on the one hand, and Art. 57(1) on the other, see ECJ Advocate General Geelhoed’s Opinion, 6 April 2006, Case C-446/04, Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, not yet reported, Para. 119.
31. ECJ, 12 December 2006, Case C-374/04, Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue, not yet reported, Paras. 37 and 38, ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, not yet reported, Par. 36; ECJ, 24 May 2007, Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue, not yet reported, Par. 26-34, ECJ, 10 May 2007, Case C-492/04, Laseret Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen, not yet reported, Par. 19; and ECJ, 24 May 2007, Case C-157/05, Winfried L. Holböck v. Finanzamt Salzburg-Land, not yet reported, Para. 22.
32. See for this approach already Cordewener, Kofler and Schindler, note 1, p. 111 et seq. For an attempt to introduce a differentiated interpretation of Art. 56 of the EC Treaty in the field of direct taxation, see, for example, ECJ, 15 July 2004, Case C-315/02, Amellenc Lenz v. Finanzamtsdirektion für Tirol [2004] ECR I-7063 and ECJ, 7 September 2004, Case C-319/02, Petri Manninen [2004] ECR I-7477.
33. ECJ, 24 May 2007, Case C-157/05, Winfried L. Holböck v. Finanzamt Salzburg-Land, not yet reported, Para. 23.
this is not the case, the legislation may simultaneously “fall within the scope of both Article 43 EC on freedom of establishment and Article 56 EC on free movement of capital”. 36

It goes without saying that this approach shifts the focus to the question of how to determine the existence of a definite influence over a company. Whilst the precise threshold is subject to dispute,37 the ECJ has found such influence to exist in (direct) holdings of 100%, 38 75%, 39 66.66% 40 and 50%, 41 whilst 10% 42 usually does not suffice. In Lasertec, however, the ECJ now suggests that such an influence can be inferred from a holding of 25%, 43 and it accepts that even a lesser holding may suffice once the 25% threshold is met if holdings of related shareholders are also taken into account or, irrespective of the actual stake, control is factually exercised. 44

From this perspective, it appears to be consistent that the ECJ, in Cadbury Schweppes, 45 Test Claimants in the Thin Cap Group Litigation 46 and Lasertec 47 rejected the application of the free movement of capital in cases involving controlled foreign company (CFC) rules or thin capitalization rules, which, to be triggered, require a control threshold to be reached, whilst the Court implicitly accepted its application in Test Claimants in the FII Group Litigation 48 and Holbbie, 49 in which the respective national legislation on taxation of inbound dividends applied to portfolio holdings in third country companies. It is along these lines that the ECJ in A and B 50 rejected applying Art. 56(1) of the EC Treaty to a situation involving a third country branch, as the creation of that branch, which indirectly affected Swedish taxation of dividends, was clearly and primarily covered by Art. 43 and 48 of the EC Treaty, even though its creation arguably also falls within the substantive scope of Art. 56(1). 31

The determination of the applicable fundamental freedom based on the analysis of the scope of the contested national legislation largely reduces the possibility to apply Art. 56(1) of the EC Treaty to direct investments to and from third countries. With regard to investments in foreign companies, the investor can invoke the free movement of capital only when the national legislation at issue applies in a “neutral” way to all types of holdings, even if his individual shareholding confers a definite influence on a company’s decisions. 52 In this case, the complementary protection under the free movement of capital becomes exclusive in third country situations if a specific economic activity would, in substance, also be covered by the freedom of establishment, which, however, cannot be applied in the specific case for territorial reasons. 53 The approach taken by the ECJ towards direct investments is prima facie consistent with Art. 57(1) of the EC Treaty, as it leaves this provision (some) scope of application in the area of substantial shareholdings. 54 It is, however, astonishing that the ECJ creates a framework of protection that is inversely proportional to the size of such an investment, 55 which implies that Member States can adjust their tax laws to explicitly target direct investments in third countries without interfering with Art. 56(1) of the EC Treaty. Given the historically greater importance attributed by EC law 56 to direct investments as opposed to portfolio investments, this appears to be, at least, counterintuitive. 57

36. Id. Para. 24.
37. For a discussion of the different approaches, see, for example, J. Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht (Cologne: Otto Schmidt, 2005), p. 205 et seq.
39. ECJ, 12 December 2006, Case C-374/04, Test Claimants in Class IV of the ACF Group Litigation v Commissioners of Inland Revenue, not yet reported, and ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, not yet reported, Para. 37.
40. ECJ, 13 March 2007, Case C-524/04, Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, not yet reported, Para. 32.
41. ECJ, 10 May 2007, Case C-492/04, Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen, not yet reported, Para. 23 and ECJ, 24 May 2007, Case C-157/05, Winfried L. Holbbie v. Finanzamt Salzburg-Land, not yet reported, Para. 24 et seq. in conjunction with Para. 9.
42. ECJ, 12 September 2006, Case C-196/04, Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue [2006] ECR I-7995, Para. 32 in conjunction with Para. 6.
43. ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, not yet reported, Para. 38 et seq.
44. ECJ, 13 March 2007, Case C-524/04, Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, not yet reported, Para. 32.
45. ECJ, 10 May 2007, Case C-492/04, Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen, not yet reported, Para. 24 et seq. in conjunction with Para. 9.
46. ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, not yet reported, Para. 24 et seq.
47. ECJ, 10 May 2007, Case C-492/04, Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen, not yet reported, Para. 23.
48. ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, not yet reported.
50. ECJ, 10 May 2007, Case C-102/05, Skatteverket v. A and B, not yet reported.
52. ECJ, 24 May 2007, Case C-157/05, Winfried L. Holbbie v. Finanzamt Salzburg-Land, not yet reported, Para. 31. Compare also the developments in Austrian court practice. Whilst the Tax Court (Unabhängiger Finanzsenat) of Linz, 13 January 2005, RV/0279-L/04, extended the ECJ’s holding in the Lenz case to portfolio dividends from, inter alia, Switzerland and the United States (for a comprehensive analysis thereof, see G. Kofler and G. Toüßl, “Austria’s Differential Treatment of Domestic and Foreign Intercompany Dividends Infringes the EU’s Free Movement of Capital”, 45 European Taxation 6 (2005), p. 232 et seq), the Tax Court (Unabhängiger Finanzsenat) of Vienna, 8 May 2007, RV/0003-W/03 recently extended it to dividends derived from a 60% shareholding in a Czech company. Accordingly, even before the ECJ decided on Holbbie, the Tax Court of Vienna had already ruled similarly.
53. For detailed discussion of the various opinions in legal doctrine on this issue, see Cordewener, Kofler and Schindler, note 1, p. 111 et seq.
54. See 3. It remains, however, to be seen how the ECJ will deal with issues constituting ’establishment’ or the ’provision of financial services’ within the meaning of Art. 57(1) of the EC Treaty, as restrictions of such activities may arguably (always) be covered by Art. 43 or Art. 49 and, therefore, deprive Art. 57(1) of any meaning in these areas. See already ECJ, 3 October 2006, Case C-452/04, Fidium Finanz AG v. Landesanstalt für Finanzdienstleistungsaufsicht [2006] ECR I-9521, Paras. 34 and 44 concerning financial services, and the respective considerations in ECJ, Advocate General Strickland’s Opinion, 16 March 2006, Para. 74.
57. Nevertheless, this approach implies, for example, that Art. 56(1) of the EC Treaty cannot be invoked in respect to loss utilization of foreign PE’s. For a
3. The Meaning and Effect of the Grandfather Clause in Art. 57(1) of the EC Treaty

Once it has been established that the application of Art. 56(1) of the EC Treaty is not pre-empted by another fundamental freedom and that the taxpayer is, therefore, ‘justified in invoking the prohibition of restrictions on the movement of capital between Member States and non-member countries set out in Article 56(1) EC’ to challenge the application of national tax legislation, the grandfather clause in Art. 57(1) may, nevertheless, safeguard the national measure to the benefit of the Member State, even though it contravenes the principle of the free movement of capital. According to this provision, Art. 56 of the EC Treaty is ‘without prejudice to the application to non-member countries of any restrictions which existed on 31 December 1993’ under national or EC law that were adopted in respect of the movement of capital to or from non-member countries involving, inter alia, ‘direct investments’. Holböck touches on some specific issues relating to the interpretation of Art. 57(1) of the EC Treaty that are briefly summarized as follows:

- First, the clause ‘without prejudice to the application to non-member countries does not limit the scope of Art. 57(1) of the EC Treaty to restrictions in respect of investments from third countries into the Community. Rather, this provision may grandfather restrictive measures on both inbound and outbound investments.

- Second, Art. 57(1) of the EC Treaty may also safeguard general provisions, such as the Austrian rules on dividend taxation, in respect of their application to third countries. It is, therefore, not restricted to provisions specifically focused on capital movements to and from third countries.

- Third, in interpreting the categories of investments covered by Art. 57(1) of the EC Treaty, recoupment may be made to concepts defined in the nomenclature of the capital movements set out in Annex I to Council Directive 88/361/EEC. Against this background a ‘direct investment’ within the meaning of Art. 57(1) of the EC Treaty exists if the shares held enable the shareholder either pursuant to the provisions of the national laws relating to companies limited by shares or in some other way, to participate effectively in the management of that company or in its control.

- Fourth, Art. 57(1) of the EC Treaty is not to be interpreted narrowly as only grandfathering direct restrictions of certain investments, but, rather, extends to restrictions concerning payments flowing from such an investment, like dividends.

- Fifth, restrictions are deemed to have ‘existed’ on 31 December 1993, even if the restrictive measure has subsequently been amended, but only if it is, in substance, identical to the previous legislation or limited to reducing or eliminating an obstacle in the earlier legislation.

- Sixth, and lastly, the date stated in Art. 57(1) of the EC Treaty (‘31 December 1993’) is, in principle, relevant irrespective of the date of accession of the respective Member State. This can clearly be inferred from Holböck, as the ECJ did not attribute any relevance to the fact that Austria acceded on 1 January 1995. This conclusion is also supported by the recent amendment of Art. 57(1) of the EC Treaty, which added that “[i]n respect of restrictions existing under national law in Bulgaria, Estonia and Hungary, the relevant date shall be 31 December 1999” which, e contrario, strongly implies that the year-end of 1993 is indeed decisive for the other Member States that acceded after that date.

Finally, it should be noted that the ECJ’s approach to the relationship between the fundamental freedoms left another interesting, though rather rare, issue presented

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by Lasertec undecided. The German rules at issue were adopted on 13 September 1993 and entered into force on 18 September 1993, but did not apply before 1 January 1994. Lasertec would, therefore, have raised the question of whether or not such rules could be regarded as restrictions, “which existed on 31 December 1993”.

There is, however, broad consent in legal writing that, for Art. 57(1) of the EC Treaty to apply, the relevant national legislation had to be applicable on “31 December 1993”, as only “restrictions” are grandfathered and these may only result from rules already applying on this date, irrespective of their date of enactment.73

4. Conclusions

A and B, Holböck and Lasertec do not constitute a deathblow for the free movement of capital in third country relationships. However, these cases demonstrate that two important hurdles must be cleared before the prohibition of restrictions of cross-border capital movements in Art. 56(1) of the EC Treaty effectively applies to situations between Member States and third countries. Specifically, neither must Art. 56(1) of the EC Treaty be pre-empted by another freedom nor must the restriction be grandfathered by Art. 57(1).74 If these hurdles are cleared, taxpayers may, in principle, rely on Art. 56 of the EC Treaty in third country situations to counter tax restrictions in respect of inbound as well as outbound investments.75

The Member States may, in turn, still invoke Art. 58 of the EC Treaty to defend their measures, and the ECJ has already implied that, in third country relationships, neither the standards for comparability nor for justification and the related proportionality test must necessarily coincide with the standards usually applied by the Court to intra-Community situations.76 Accordingly, it will be for future case law to explore and delimitate the scope of the free movement of capital in third country scenarios. In this respect, the increasing number of pending cases77 should give the ECJ sufficient opportunity to establish reliable guidance for national courts and taxpayers.

74. ECJ, 24 May 2007, Case C-157/05, Winfried L. Holböck v. Finanzamt Salzburg-Land, not yet reported, Paras. 24 and 30 et seq. See also ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, not yet reported, Paras. 169 et seq. and 174 et seq.
75. For a comprehensive discussion, see Cordewener, Kofler and Schindler, note 1, p. 107 et seq.
76. ECJ, 12 December 2006, Case C-446/04, Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, not yet reported, Paras. 170 and 171. See also Cordewener, Kofler and Schindler, note 1, p. 114 et seq.
77. See notes 2 to 4.