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EUCOTAX Series on European Taxation

KLUWER LAW INTERNATIONAL

The EU and Third Countries: Direct Taxation

Edited by Michael Lang and Pasquale Pistone

Wolters Kluwer
Law & Business

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VOLUME 17

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The EU and Third Countries

Direct Taxation

EDITORS

Michael Lang
Pasquale Pistone

Wolters Kluwer
Law & Business

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Preface

This book is the outcome of a conference on the tax issues of the relations between the European Union and third countries, held at the Vienna University of Economics and Business Administration on 13–15 October 2006, which proved how popular European tax law has become not only within the borders of the European Union, but also in the most different areas from the world.

We were honoured by the presence of colleagues representing almost forty countries in the world, most of which prepared written presentations and national reports. The final, revised and updated version of most of such documents has been included in this book. May we therefore take this opportunity to warmly thank all colleagues who have contributed to the conference and the publication of this book, Vanessa Metzler, Mario Tenore, Birgit Stürzlinger and the Institute for Austrian and International Tax Law of the Vienna University of Economics and Business Administration (in particular Brigitte Dudli and Necha Demirova), as well as Margaret Nettinga, who patiently revised and edited all the chapters contained in this volume.

The inspiration for this conference undoubtedly came from the EURYI-ESF research project (whose funds have been made available for the publication of this book), which started in October 2005 at the Vienna University of Economics and Business Administration and is due to be completed in September 2010. In our view this book should represent the true scientific input of the tax community to such research project, thus making it possible to explore new paths and to consolidate the ones that have already been discovered.

Most tax scholars have noticed that there is a growing number of direct tax cases before the European Court of Justice (and a corresponding reduction in the number of cases concerning VAT); few are perhaps aware that – according to the official statistics of the Court – taxation was the most important subject-matter in terms of cases decided by the European Court of Justice in 2006, representing some 13% of the overall number of cases decided in that year. We believe that this trend is not an occasional one and will continue for the years to come, especially insofar as the European Court of Justice remains the main engine of European integration. However, even more astonishingly among such direct tax cases there has been a dramatic increase in the questions involving third countries, which could perhaps be described as one of the most delicate issues that the European Court of Justice is currently asked to address.

After the conference was held, and before the publication of this book, the European Court of Justice has decided a few direct tax cases on third countries, such as *ACT Group Litigation*,[1] *Thin Cap Group Litigation*,[2] as well as *Lasertec*

[1] ECJ 12 December 2006, case C-374/04 *ACT Group Litigation Order*.
[2] ECJ 13 March 2007, case C-524/04 *Test Claimants in the Thin Cap Group Litigation*.

GmbH,[3] *Skatteverket vs. A & B*[4] and *Holböck*,[5] giving rise to an evolution of its case law, which makes the free movement of capital and payments in fact subject to a number of limits derived by the impossibility to apply other fundamental freedoms. On various aspects our readers may notice that the Court has decided to follow a direction that is not exactly matching the one that most reporters had envisaged. However, we have decided to refrain from changing the reports accordingly, since we believe that this book should let our readers have the technical arguments developed by our reporters regardless of whether they actually match with the path taken by the European Court of Justice. Accordingly, this book should not be implicitly regarded as a technical criticism to some recent positions of the European Court of Justice on direct tax cases involving third countries, but rather as a respectful alternative point of view, that aims at bridging possible technical difficulties in the near future.

The book has been structured in three parts with a view to reflecting the actual differences among the reports that are contained within it. Part one includes the general report, as well as some reports on specific issues that were discussed during the conference. Part two and three are instead respectively dedicated to the reports from EU and non-EU countries. Despite being drafted among a common pattern, such reports nevertheless still show some considerable differences as a consequence of taking into account the topic under the absolute primacy of European law, or from another perspective, which includes to a minor or major extent some binding effect based on European law, but mainly looks at the problem in terms of public international law. Perhaps, this book with a number of contributions from all over the world could be a first concrete sign to show that European tax law is not (or no longer) just a matter for the Member States of the European Union, but rather a bulk of legal principles and values that could perhaps one day contribute to achieving global justice. In other terms, a book of European International Tax Law, which is developing as the legal order including the rules of domestic law and tax treaties as applicable in the light of the principles of European law: a matter that we submit should also become relevant in third countries, at least to the extent that their relations with the European Union are concerned.

Finally, we wish to thank the European Commission and the Austrian Fund for Research (FWF) for making their funds available to the conference and the publication of this book.

Michael Lang *Pasquale Pistone*

[3] ECJ, order 10 May 2007, case C-492/04 *Lasertec Gesellschaft für Stanzformen mbH.*
[4] ECJ, order 10 May 2007, case C-102/05 *Skatteverket vs. A & B.*
[5] ECJ 24 May 2007, case C-157/05 *Winfried Holböck.*

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petence at external level insofar "where the conclusion of an agreement by the Member States is incompatible with the unity of the common market and the uniform application of Community law" or "where, given the nature of existing Community provisions, such as legislative measures containing clauses relating to the treatment of nationals of non-member countries or to the complete harmonization of a particular issue, any agreement in that area would necessarily affect the Community rules within the meaning of the AETR judgment".[175] In addition, it was clarified that even if an agreement contains a clause guaranteeing that the Community rules are not affected by the provisions of an agreement (a "disconnection clause") this does not ensure that those rules will not be encroached upon but "on the contrary, may provide an indication that those rules are affected".[176] Moreover, the Court added that "if an international agreement contains provisions which presume a harmonization of legislative or regulatory measures of the Member States in an area for which the Treaty excludes such harmonization, the Community does not have the necessary competence to conclude that agreement".[177]

7.2 The Community competence to conclude a tax treaty with a third state

As follows from the above paragraph, the Court believes that the Community has exclusive competence to conclude an international agreement if such an agreement is likely to affect EC law. This approach is founded on the necessity of ensuring the full effectiveness of EC law by precluding Member States from accepting obligations or granting rights that would be capable of producing substantial distortions for the functioning of the internal market.[178]

Advocate General Tizzano found in his Opinion to *Open skies* cases that in the case of exclusive competence to conclude international agreements Member States are not allowed to conclude either agreements that are consistent with EC law nor agreements reproducing it.[179] To support the latter assumption, the Advocate General put forward three arguments. First, even a verbatim reproduction of Community rules does not guarantee that they will be applied consistently with the original version. Second, it is not certain whether amendments to EC rules will be transposed promptly and accurately. Last but not least, a serious risk would be involved that such "reproduced" EC rules would be removed from the scrutiny of the ECJ.[180]

[175] ECJ 15 November 1994, Opinion 1/94 [1994] ECR I-5267, para. 122.
[176] ECJ 15 November 1994, Opinion 1/94 [1994] ECR I-5267, para. 130.
[177] ECJ 15 November 1994, Opinion 1/94 [1994] ECR I-5267, para. 132.
[178] ECJ 15 November 1994, Opinion 1/94 [1994] ECR I-5267, para. 128.
[179] Advocate General Tizzano's Opinion to Case C-466/98 Commission v. the UK, points 71–72.
[180] Ibid., point 72.

National Report Portugal

Ana Paula Dourado

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I. The direct impact of Art. 56 EC Treaty in relations with third states

1.1 The legal framework of Art. 56 EC Treaty

1.1.1 Introductory remarks

The rules on the free movement of capital in EC law and their impact on the income tax law of Member States have been a focus of interest for recent tax law literature, as the European Court of Justice (hereinafter also ECJ, or the Court) has considered a number of cases involving domestic income tax rules and capital movement between Member States incompatible with the EC law[1].

Expectation is now further directed at ECJ case law concerning the meaning and scope of the free movement of capital from a Member State to a third state and from a third state to a Member State. In fact, Art. 56 (1) of the EC Treaty still raises several questions, as it prohibits restrictions of capital movements not only between Member States, but also, unlike what happens in respect of the other fundamental freedoms, between Member States and third states.

Among other things, the question stands out whether a Member State has to eliminate every restriction and discrimination resulting from domestic taxation in the same way as it has to eliminate them in respect of movements to and from other Member States, despite the fact that the third state is not bound to EC law, and, therefore, not bound to a principle of reciprocity[2].

The question arises as a result of the wording of Art. 56 (1) of the EC Treaty, which does not differentiate Member States from third states. The inclusion of third states in the prohibition occurred through the Maastricht Treaty, but as the purpose aimed at by the extension is unclear, this leads to different interpretations of the scope of the prohibition. In any event, a transfer of capital, onerous or not, from one state to another and vice-versa, is to be analysed under Art. 56 (1) of the EC Treaty, which gives an idea of the extent of the problem.

---

1 Cf. ECJ 14 October 1999, C-437/97 *Sandoz*; ECJ 6 June 2000, C-35/98 *Verkooijen*; ECJ 26 September 2000, C-478/98 *Commission/Belgium*; ECJ 21 November 2002, C-436/00 *X and Y*; ECJ 11 December 2003, C-361/01 *Barbier*; ECJ 8 June 2004, C-268/03 *De Baeck*; ECJ 7 September 2004, C-319/02 *Manninen;* ECJ 15 July 2004, C-242/03 *Weidert/Paulus*; ECJ 15 July 2004, C-315/02 *Lenz*; ECJ 19 January 2006, C-265/04 *Bouanich*.

2 See, e.g., Vogel/Gutmann/Dourado, Tax Treaties between Member States and Third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC Law, *EC Tax Review* 2006, p. 83 ff.; Schön, Der Kapitalverkehr mit Drittstaaten und das internationale Steuerrecht, in Gocke/Gosch/Lang (eds.) *Körperschaftsteuer, Internationales Steuerrecht, Doppelbesteuerung, FS für Franz Wassermeyer zum 65. Geburtstag* (2005) pp. 489 ff.; Ståhl, Free movement of capital between Member States and Third Countries, *EC Tax Review* 2004, pp. 47 ff.

The *Van Hilten* case[3], as the first case judged by the ECJ that was related to the movement of capital between a Member State and a third state and to direct taxes may have brought some clarity to the meaning and scope of Art. 56 (1).

Let me recall that Mrs. van Hilten was a national of the Netherlands and a resident of that country until 1988. She then changed her residence to Belgium and in 1991 to Switzerland. Her estate was composed of immovable property situated in the Netherlands, Belgium and Switzerland and movable assets within the EC and in third states (cf. § 15 ECJ judgment).

According to the inheritance tax law of the Netherlands, and to a declaration which forms an integral part of the Convention between the Swiss Confederation and the Kingdom of the Netherlands for the avoidance of double taxation, a national who, having resided in the Netherlands, dies within 10 years after ceasing to reside in that Member State, is deemed to have been resident in the Netherlands at the time of the death. This was the case of Mrs. van Hilten, and it implied that the tax base covered the universal property inherited, as is the case with the property of residents who die.

The ECJ considered that the above-mentioned tax law did not restrict the free movement of capital and that the change of residence, considered *per se*, was not a movement of capital.

I may, at this point, extract one basic assertion and four other basic questions from the *Van Hil*ten case:

1. It confirms that tax obstacles (whatever they mean) in relation to third states are included in the prohibition of Art. 56 (1) of the EC Treaty;
2. It is doubtful that the ECJ has followed the meaning given – until now – to the free movement of capital between Member States in its analysis between Member States and third states;
3. Statement 2 also seems to be applicable to the meaning of tax obstacles to the free movement of capital;
4. The scope of prohibited restrictions to free movement of capital and admitted justifications is still questionable.

These four statements, which in fact do not help us much in understanding the meaning and scope of the free movement of capital, may show that the ECJ was careful and did not want to explain what a tax obstacle or tax restriction was for the purposes of free movement of capital between a Member State and a third state, nor whether and to what extent the meaning and scope of free movement of capital between a Member State and a third state are different from the meaning and scope of free movement of capital between Member States.

The interpretation of the decision and of the conclusions of the Advocate General will probably lead to controversial results. Perhaps the *Van Hilten* case raises more questions than certainties. Thus, there were considerable expectations re-

[3] See ECJ 23 February 2006, C-513/03 *Van Hilten*.

garding the ECJ judgments on the pending cases *Group Litigation Orders*[4] (*Test Claimants in Class IV of the ACT Group Litigation* and *Test Claimants in the FII Group Litigation* are now decided), *A*[5], and *A and B*[6], *Holböck*[7], and also *Lasertec*[8].

Notwithstanding this, I will take the *Van Hilten* case into account to try to arrive at a meaning of movement of capital, its respective scope and also the meaning of restriction to that freedom in the EC Treaty. The *Fidium Finanz* case[9] and the above mentioned *Test Claimants in Class IV* and *Test Claimants in the FII Group Litigation* will also guide me in this task. Whereas in the *Fidium Finanz* case, the ECJ analyses the overlapping of free movement of capital and free movement of services regarding the right to grant credit on a commercial basis, by a company established in Switzerland to customers resident in Germany, in the Test Claimants cases the ECJ analyses a possible overlapping of free movement of capital and freedom of establishment, concerning tax treatment given to payment of dividends.

The conclusions I will reach at this stage will be the point of departure of the issues analysed in the rest of the report. I will only consider third states that have not concluded any agreement on free movement of production factors with the EC and its Member States, unless I make an express reference to this latter category of third states.

1.1.2 Meaning and scope of free movement of capital in the EC Treaty within the EC and in the relations with third states

1.1.2.1 Meaning of free movement of capital in the EC Treaty: preliminary remarks

The EC Treaty contains no definition of capital and the Directive regarding the free movement of capital (Directive 88/361/EEC Directive) has opted to enumerate and classify different types of capital, instead of giving a condensed definition.

Following the guidance provided by Directive 88/361/EEC, the ECJ and the literature basically agreed on the definition. In general terms, any right concerning assets is capital for the purposes of the EC Treaty, and movement of capital is

[4] C-524/04 Test *Claimants in the Thin Capitalization Group Litigation*; C-201/05 *Test Claimants in the CFC and Dividend Group Litigation*; ECJ 12. December 2006, C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*; ECJ 12. December 2006, C-446/04 *Test Claimants in the FII Group Litigation*.

[5] C-101/05.

[6] C-102/05.

[7] C-157/05.

[8] C-492/04.

[9] C-452/04, 3 October 2006.

the transfer of rights concerning assets[10, 11]. Moreover, the protection of the free movement of capital covers any legal transaction that is necessary to attain the transfer of assets[12].

In fact, it also results from the examples given in the Directive 88/361/EEC that "movement of capital" is to be interpreted in a very broad sense, covering portfolio investments across states and different types of direct investment and establishment, including transfers related to insurance contracts, establishment of branches and subsidiaries[13]. This broad definition of capital raises the issue of the effective scope of the free movement of capital, as it frequently overlaps with other freedoms.

Contrary to what happens in relation to the other freedoms dealt with in the EC Treaty, this protection is, according to the wording of Art. 56 (1) of the Treaty, independent of the category of the persons involved (nationals or non-nationals of a Member State) and of the state of location of the capital.

The *Sanz de Lera* case[14], concerning national conditions for the export of money, seems to confirm that the approach to the examination on free movement of capital to and from third states must be identical to the one involving movements of capital between Member States. In fact, reference is made to the reasoning in the *Bordessa* case and no argument is added because of the fact that a third state is involved. Thus, the wording of Art. 56 (1), as well as the arguments used in the *Sanz de Lera* decision, indicates that free movement of capital between a Member State and a third state is to be examined on the same ground as capital movements between Member States.

[10] Cf. Joined cases C-358/93 and C-416/93 *Bordessa Case* [1995] ECR I-361; C-222/97 *Trummer och Mayer Case,* [1999] ECR I-1661;

[11] See, e.g., Gorjão-Henriques, *Direito Comunitário,* 3rd. ed. (2005) 463 ff; Dourado, Free movement of capital and capital income taxation within the EU, *EC Tax Review* 1994, 179; Peters, Capital movements and taxation in the EC, *EC Tax Review 1998,* 5; Ståhl, *EC Tax Review* 2004, 48; Weber, *Tax avoidance and the EC Treaty freedoms, A Study of the limitations under European Law to the prevention of tax avoidance* (2002) 70 ff.; Schön, Europäische Kapitalverkehrsfreiheit und nationales Steuerrecht, in Schön (ed.) *Gedächtnisschrift für Brigitte Knobbe-Keuk* (1997) 747; Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) p. 498; Von Wilmowsky, Freiheit des Kapital- und Zahlungsverkehrs, *Europäische Grundrechte und Grundfreiheiten,* 2nd edition (2005) 343. Wilmowsky makes reference to the "establishment of rights and transfer of rights" (343); Glaesner, in Schwarze (ed.) *EU Kommentar* (2000) 803; Kiemel, in Von der Groeben/Schwarze (eds.) *Kommentar zum Vertrag über die Europäische Union und zur Gründung der EG,* 6th edition (2003) Art. 56 m.no. 1.

[12] Von Wilmowsky, Freiheit des Kapital- und Zahlungsverkehrs, 344.

[13] Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) p. 492; Ståhl, *EC Tax Review* 2004, 48.

[14] As the first case involving movements of capital with third states: Joined cases C-163/94, C-165/94 and C-250/94.

Despite the *Sanz de Lera* case, it is doubtful whether the definition of capital is as broad as mentioned, where third states are involved. For example, when a movement of capital takes place between a Member State and a third state, it is legitimate to ask whether the definition includes any cross-border transfer of capital that is associated with the exercise of another fundamental freedom.

As the freedom of establishment and the free movement of services are restricted to EC nationals (and not to the EC territory, as the *Saint-Gobain* decision[15] clarified), they may then act as restrictions to the meaning and scope of the free movement of capital[16]. Otherwise, third states would benefit from the other fundamental freedoms in the EC Treaty[17].

This is a difficult issue to solve, as the problem of concurrence of provisions applicable to the fundamental freedoms is not clearly solved in the Treaty. In the event the free movement of capital overlaps either with the right of establishment (see the *Test Claimants in Class IV* and *Test Claimants in the FII Group Litigation* cases), or with the free movement of services (see the *Fidium Finanz* case), or even with the free movement of workers (as happened in the *Van Hilten* case), the Treaty does not expressly give preference to any of the freedoms.

However, both in the *Van Hilten* and the *Fidium Finanz* cases, the free movement of workers and the free movement of services provisions excluded application of the free movement of capital provisions, and therefore restricted the meaning (and scope) of free movement of capital.

Again in The *Test Claimants in Class IV* and *Test Claimants in the FII Group Litigation* cases, the freedom of establishment seems to exclude application of the free movement of capital provisions when overlapping situations occur, but the criteria used were not exactly the same. Whereas in the *Test Claimants in Class IV* case, the ECJ position is not clear, as a situation where the holder has "definite influence over the company's decisions [allowing] it to determine the company's activities" may seem to to fall within the scope of both Articles 43 and 56 (paras. 39 and 38), in the *Test Claimants in the FII Group Litigation* case, the holding of at least 10% of the voting rights was the criterion chosen for the situation to exclusively fall within the scope of the freedom of establishment (paras. 81, 95, 118).

The *Test Claimants in Class IV* case is not particularly helpful in solving the issue of overlapping freedoms, as the ECJ did not consider the referred rules incompatible with the EC Treaty. But the *Test Claimants in the FII Group Litigation* case deserves to be mentioned, because, if paras. 165–173 are interpreted according to the previous paragraphs of the decision (in a systematic way), I come to the

[15] ECJ 21 September 1999, C-307/97 *Saint-Gobain.*

[16] In a similar sense, but defending a "spatial restriction", Ohler, *Europaïsche Kapital- und Zahlungsfreiheit, Kommentar zu den Artikeln 56 bis 60 EGV* (2002) Art. 56, m.no. 214 ff. See, in a critical perspective, Ståhl, *EC Tax Review* 2004, 52.

[17] Ståhl, *EC Tax Review* 2004, 50.

conclusion that, when a third state is involved, the situation is only covered by Article 56 if the holding does not reach 10% of the voting rights.

Moreover, if I extend the reasoning of the *Saint-Gobain* or the *Vestergaard* decisions[18] to the free movement of services and the free movement of capital, these would imply the right of the EC nationals to provide and receive services and to provide and receive capital, as long as two Member States are involved. The pattern of comparability regarding the free movement of capital would then still require a comparison between EC nationals in the same or comparable situation.

1.1.2.2 Meaning of free movement of payments in the EC Treaty

Art. 56 (2) of the EC Treaty makes reference to the free movement of payments. Unlike the free movement of capital, the free movement of payments implies a cross-border transfer of capital destined to pay for a specific transaction[19]. The scope of the free movement of payments comprises every cross-border payment, independent of the underlying transaction being protected as a fundamental freedom of the EC Treaty: for example, if the amount owed for delivery in Portugal of merchandise is to be deposited in an account in Macau, the payment is protected by the EC Treaty, even though there is no free trade agreement between the EC and Macau (or China).

On the other hand, some restrictions applicable to the free movement of capital are not applicable to the free movement of payments. In fact, the latter may not be restricted, whenever it is associated with transactions protected under other fundamental freedoms.

1.1.2.3 The impact of the standstill clause of Art. 57 (1) of the EC Treaty on the free movement of capital

One of the restrictions applicable to the free movement of capital, but not to the free movement of payments, is the standstill clause in Art. 57 (1) of the EC Treaty. According to it, "[t]he provisions of Art. 56 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment – including real estate – establishment, the provision of financial services or the admission of securities to capital markets".

As the ECJ has clarified, Art. 57 (1) also safeguards amendments introduced after 31 December 1993 to domestic provisions which existed on that date, as long as some conditions are met: the amendments may not introduce substantial changes to the previous regime (to the main aspects of the regime) but may reduce or eliminate restrictions. Provisions introducing fundamental changes to the existing regime as well as new procedures are not admitted after 31 December 1993[20]. Besides, the safeguard clause only respects the above-mentioned areas (direct investment, establishment, the provision of financial services or the admission of securities to capital markets) and therefore, portfolio investment is considered to be excluded[21]. As I will discuss below, the scope of the standstill clause has been used by some authors as an argument to restrict the scope of the free movement of capital between a Member State and a third state.

It is not yet clear what the meaning of "existing" restrictions on 31 December 1993 is, namely, whether it suffices that they have been passed by parliament or whether they have been in force in that date. Hence, there are considerable expectations concerning the ECJ decision on the *Lasertec* case. The Portuguese version of the Treaty seems to have chosen the right interpretation, as it makes reference to restrictions which are *in force* on 31 December 1993.

1.1.2.4 The impact of Arts. 43 (2), 51 (2) and 58 (2) on the free movement of capital

Art. 43 (2) and Art. 51 (2) of the EC Treaty make the exercise of the freedom of establishment and of the free movement of services dependent on the implementation of the free movement of capital and therefore have had some impact on the scope of the right of establishment and free movement of services. However, on the one hand, these provisions are now obsolete, since the free movement of capital has been implemented, and, on the other hand, they do not provide with an answer regarding a preference rule, in the event one transaction is simultaneously covered by the free movement of capital rules and by another free movement regime.

Art. 39, regarding the free movement of workers, allows for restrictions to the exercise of that right, on the grounds of public policy, public security or public health[22], but there is no reference to the free movement of capital.

Art. 58 (2) allows the application of domestic or EC restrictions compatible with the right of establishment, for specific domestic or EC reasons. As Art. 58 (2) justifies restrictions to fundamental freedoms, its purpose is different from the purpose followed by the above-mentioned Art. 43 (2) and Art. 51 of the EC Treaty. We will consider the impact of Art. 58 (2) as a possible justification for restrictions in the relations with third states, in point iii) below.

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[18] ECJ 28 October 1999, C-55/98 *Bent Vestergaard.*

[19] C-286/28 and C-26/83 *Luisi and Carbone* [1984] ECR, 377; Bouanich Case, cit., § 26. See Kiemel, in Kommentar ..., cit., § 5 of commentaries to Art. 56.

[20] Opinion of Advocate General Geelhoed, 10.4.2003, C-452/01; *Ospelt Case*, 452/01, para. 52; C-302/97 *Konle Case* [1999] ECR 3099, para. 52 ff.; *Test Claimants in the FII Group Litigation Case*, paras. 192–196.

[21] Kessler/Eicker/Obser, Die Schweiz und das Europäische Steuerrecht – Der Einfluss des Europäischen Gemeinschaftsrechts auf das Recht der direkten Steuern im Verhältnis zu Drittstaaten am Beispiel der Schweiz, *IStR* 2005, 664–665; Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 493–495.

[22] Let us recall that Arts. 46 para. 1 and 55 allow restrictions on the same grounds to the right of establishment and free movement of services, respectively.

The majority of the literature has argued that any overlapping of regimes, concerning free movement of production factors implies the application of all provisions involved, as their object of protection is different. Moreover, The ECJ has been progressively pursuing this interpretation[23]. However, in the *Van Hilten,* the *Fidium Finanz* and the Test Claimants in the FII Group Litigation cases, the ECJ seems to have applied a different interpretation because the movement of factors involved third states.

In the *Van Hilten* case, although in para. 40, the ECJ recalls that inheritances appear under heading XI of Annex I to Directive 88/361, entitled 'Personal capital movements', in para. 49, the ECJ holds that "it must be observed that the mere transfer of residence from one State to another does not come within Article 73b of the Treaty" [currently, Art. 56]. "As the Advocate General pointed out in point 58 of his Opinion, such a transfer of residence does not involve, in itself, financial transactions or transfers of property and does not partake of other characteristics of a capital movement as they appear from Annex I to Directive 88/361".

And yet, in the *Van Hilten* case, in the absence of the above-mentioned tax rule that introduced a legal fiction (the fiction that Mrs. van Hilten was a resident in the Netherlands, for tax purposes, at the time she died), the transfer of residence would mean that the estate (i.e. capital) of Mrs. van Hilten situated outside the territory of the Netherlands would be subject to the tax regime applicable to non-residents and not to the tax regime applicable to residents – i.e., the estate located outside the Netherlands, would not be taxed by that country and might be subject to a more favourable tax regime.

Protection under Art. 56 (1) of EC Treaty may be invoked when there is a cross-border transfer of capital. Identification of a cross-border transaction varies according to the underlying legal transaction and may occur either because the asset (and the right on the asset) changes its location, or because the owner of the capital changes his place of residence. Examples of the first case are credits, which are located in the state of residence of the debtor: if the debtor changes his residence to another state, the credit also moves to the other state; shares, which are located in the state of establishment of the company, and accordingly move if the company changes its place of establishment; and mortgage, which moves with the property secured. Examples of the second situation are any transfers of property where either recipient or the owner of the property (or both) have changed their residence and are residents of different states[24].

Thus, the transfer of residence of the owner of assets means, in the *Van Hilten* case and for tax purposes, a movement of capital in the broader sense of the EC

[23] See, Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 498 ff.; and among other cases, ECJ 28 April 1998, C-118/96 *Safir*; ECJ 18 November 1999, C-200/98 *X AB and Y AB*; ECJ 13 April 2000, C-251/98 *Baars*; ECJ 4 June2002, C-367/98 *Commission/Portugal*.

[24] Von Wilmowsky, Freiheit des Kapital- und Zahlungsverkehrs, 346–347.

law, as the capital would be out of the reach of the Netherlands tax law, in the absence of the legal fiction. In other words, the transfer of residence of Mrs. van Hilten was a condition for a cross-border transfer of capital, for tax regime purposes, were the estate to be treated in the same way as the estate of other non-residents with a comparable tax base. I may therefore question whether a restrictive meaning of capital was adopted in the *Van Hilten* case.

But if that was the case, neither the Advocate General nor the Court mentioned it. And in particular, they did not at any point justify their interpretation by the fact that the underlying situation involved a Member State and a third state.

Just as happened in the *Sanz de Lera* case, where the reasoning in the *Bordessa* case was referred to unconditionally, in the *Van Hilten* case reference is made to the previous jurisprudence of the ECJ, namely to the *Barbier* case[25]. In the *Barbier* case, the Court concluded that EC law precludes domestic legislation according to which, the fact that the deceased was under an unconditional obligation to transfer the legal title of immovable property, situated in that Member State, to another person, who had financial ownership of that property, could only be taken into account if, at the time of the death, the deceased resided in that Member State; on the contrary, it could not be taken into account, if the deceased resided in another Member State. In the *Van Hilten* case, the ECJ cites para. 58 of the *Barbier* decision, in order to confirm that an inheritance is a movement of capital within the meaning of (ex) Art. 73-b of the Treaty, "except in cases where its constituent elements are confined within a single Member State".

The ECJ did not quote para. 58 completely, however. It is interesting for our aims, to recall it: "investments in property such as those made within the Netherlands territory by Mr. Barbier, acting from Belgium, clearly constitute movements of capital within the meaning of Art. 1 (1) of Directive 88/361, as does the transfer of immovable property by its sole owner to a private company in which he holds all the shares, as well as the inheritance of that property".

The issue under judgment in the *Van Hilten* case was not really different from the one in the *Barbier* case. In the *Barbier* case, non-residents (nationals or not) were being discriminated. In the *Van Hilten* case, one category of non-residents was discriminated (nationals who exited the Netherlands and died within ten years). The relevant difference between both cases was that in the *Van Hilten* case, third states were involved, but the Court did not mention that fact.

Finally, the *Fidium Finanz* case seems to confirm the path followed in *Van Hilten*, as the ECJ gave preference to the free movement of services, disregarding the free movement of capital: "it is apparent that, in the circumstances of the main case, the predominant consideration is freedom to provide services rather than the free movement of capital. Since the rules in dispute impede access to the German financial market for companies established in non-member countries, they affect primarily the freedom to provide services" (para. 49 of the decision).

[25] ECJ 11 December 2003, C-364/01 *Barbier*.

1.1.2.5 Scope of free movement of capital in the EC Treaty

In spite of some guidance given by the *Van Hilten* and the *Fidium Finanz* cases, it is not yet clear what the scope of the free movement of capital is when a cross-border transaction occurs between a Member State and a third state, whether the exceptions to it, where third states are involved, are to be interpreted in broader terms than the exceptions to the free movement, in the event of only Member States being involved, and whether the justifications until now accepted by the ECJ for restricting the free movement are to be interpreted in the same way, i.e., with the same scope[26]. The *Test Claimants in the FII Group Litigation* case may bring some additional orientation to some of these aspects, as I will mention below.

Opinions regarding the scope of the free movement of capital may range from those considering it the "most advanced Community freedom"[27], as allegedly very few exceptions were allowed to it, and because it has an *erga omnes* scope[28], and those considering that the scope of the free movement between Member States and third states is limited to the freedom of transfer of EC capital in order to achieve the internal market[29]. Others consider that its scope is quite narrow, taking into account the criterion of comparability in the relations with third states, and the possible justifications to restrictions [30].

Some aspects were quite defined until the *Van Hilten* and *Fidium Finanz* decisions, but previous analysis was normally based on cross-border transactions between Member States.

It was quite clear both from the broad definition of capital movement and ECJ case law that one single transaction may be covered by several freedoms, and therefore, the provisions regarding the free movement of capital may be applied together with the provisions regarding other freedoms[31].

The opposite consequence to the just-mentioned simultaneous application of provisions regarding the free movement of capital and the other freedoms, is also true: in transactions between Member States, the application of the free movement of capital provisions does not preclude the application of provisions regarding the other freedoms, or vice-versa, but this also means that it is sufficient that a domestic provision is incompatible with only one of the freedoms, for its application to

[26] In the Verkooijen case, Advocate General La Pergola (24.6.1999) defended that exceptions were only compatible with the Treaty if proportionate and suitable to achieve the purpose they pursue.

[27] Pistone, *The Impact of Community Law in tax treaties: issues and solutions* (2002) 37.

[28] Again, Pistone, *The Impact of Community Law in tax treaties: issues and solutions,* 37.

[29] See, in particular, Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 502 ff.

[30] See, e.g. Schnitger, Die Kapitalverkehrsfreiheit im Verhältnis zu Drittstaaten, *IStR* 2005, 493 ff.

[31] See Von Wilmowsky, Freiheit des Kapital- und Zahlungsverkehrs, 345-346. And in the opposite sense, regarding free movement of capital and freedom of establishment, the *Test Claimants in the FII Group Litigation* case.

be forbidden[32]. The *Safir* case, *Ambry* and *Svenson* cases[33] are examples of this reasoning, although in the previous *Bachmann* case[34], the ECJ has interpreted the free movement of capital as a residual freedom (subsidiary to the other freedoms).

What is more, as I have already mentioned, the *Van Hilten* and the *Fidium Finanz* cases (seem to) introduce a different interpretation of the connection between the free movement of capital and other free movements. Let me recall that in the *Van Hilten* case, the ECJ considered that the transfer of residence abroad could not be characterized as free movement of capital, but exclusively as a free movement of persons.

However, without the transfer of residence no cross-border inheritance tax law issue would occur, in the sense that the Netherlands would not tax the assets situated outside its territory. Discouraging the exit of nationals resident in the Netherlands is, for the purposes of inheritance tax law in the Netherlands, discouraging the exit of capital.

As the Court put it in the *Barbier* case, "The rights conferred by that directive [88/361] are not subject to the existence of other cross-border elements. The mere fact that the result of a national provision is to restrict movements of capital by an investor who is a national of a Member State on the basis of his place of residence is sufficient for Art. 1 (1) of Directive 88/361 to apply" (para. 59). Para. 49 of the *Fidium Finanz* case contradicts this doctrine.

Although a preference rule was expressly followed in the *Fidium Finanz* case (paras. 34, 39 ff., in particular para. 49), the ECJ does not always follow such a rule in testing compatibility of domestic tax rules with the different Treaty freedoms. For example, in a situation covered by the free movement of capital and by the right of establishment, the order of examination of compatibility followed by the ECJ has been haphazard and the underlying criterion is hard to determine[35]. On the other hand, when the ECJ reaches the conclusion that a domestic provision is incompatible with one of the fundamental freedoms, it often states that it is not necessary to examine the compatibility of the domestic provision with the other freedom[36].

1.1.3 Some conclusions

It follows from the previous paragraphs that the wording of Art. 56 (1) of the Treaty does not help us to differentiate the concept of movement of capital and its scope, on the basis of the quality of the states involved in the cross-border transfer. Directive 88/361/EEC does not give a different concept either, on the basis of

[32] Ståhl, *EC Tax Review* 2004, 49.

[33] Case C-410/96 [1998] ECR I-3955; C-484/93 [1995] ECR I-249.

[34] Case C-204/90, 28.1.1992.

[35] See Ståhl, *EC Tax Review* 2004, 48–49.

[36] See Ståhl, *EC Tax Review* 2004, 48–49. In a different sense, see the *Test Claimants in the FII Group Litigation* case.

the states involved in the cross-border transfers: transfers between Member States vs. transfers between a Member State and a third state.

It also follows from the *Van Hilten* and the *Fidium Finanz* cases that as the free movement of persons and the free movement of services are not extended to nationals of third states, free movement of capital involving third states can be limited to movements that do not imply other fundamental freedoms. Art. 57 (1) has also been interpreted in this sense[37].

However, this path is not a satisfactory means of differentiating a legitimate restrictive tax measure from an illegitimate one when an inbound dividend (or capital), whose beneficial owner is an EC national, is considered. And the ECJ did not follow that path in the *Test Claimants in the FII Group Litigation* case (see again paras. 165–173), which confirms that tax treatment of inbound dividends, whose beneficial owner is an EC national, falls under Article 56, even when those dividends are paid by a company of a third state. For example, from the perspective of a domestic tax policy or of a double tax treaty policy, it would make no sense to give a tax credit for double taxation of dividends to an EC national, resident in a Member State, when he holds a portfolio investment in a company resident in a third state, and to refuse that credit when he holds a direct investment[38]. But it is legitimate to consider that, contrary to its wording, Art. 56 (1) of the EC Treaty most probably does not intend to treat capital movements between Member States and capital movements between a Member State and third states in the same way, namely when the beneficial owner of the income is a third state national.

Several reasons that seem to justify the different aims underlying the meaning and scope of the free movement of capital between Member States and a Member State and third states have been mentioned in the literature.

In a summarized form, I will recall some of these arguments. Basically, free movement of capital has to be interpreted systematically along with the other rules of the Treaty. Among other regimes in the Treaty, that are relevant for a restrictive interpretation of the meaning of the free movement of capital to and from third states, because they are connected with the regime and implementation of this freedom, the following ones stand out: the Economic and Monetary Union and its implementation justify a total liberalization of capital movements within the EC but not in relation to third states; the harmonization of direct tax regimes is a result of negotiations between Member States, and is not extended to third states; the Economic and Social Cohesion objectives and policies are exclusive to the EC Member States. In this context, the free movement of capital may not be disassociated from the constitution of an Internal Market with a common financial and monetary policy. And since third states, as a rule, are not bound to EC law, prohibiting Member States from applying any restriction to the free movement of capital involving a third state, would lead to an extremely awkward and unbalanced result. A complete liberalization of free movement of capital from and to the EC territory in relations with third states is therefore not congruent with a teleological interpretation of the free movement of capital.

[37] Ohler, *Europaïsche Kapital- und Zahlungsfreiheit*, Art. 57 m.no. 3.

[38] In this sense, but without distinguishing between inbound and outbound dividends, Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 502.

Furthermore, let me also recall that in the *D* Case[39], the ECJ has implicitly recognized the impossibility of inter-state (international) neutral taxation *lato sensu* in the EC (in the absence of tax harmonization). And the recognition that EC law does not prohibit different tax treatment of non-residents confirmed that EC law does not require capital import neutrality in the EC[40].

Finally, in the *Test Claimants in the FII Group Litigation* case, the ECJ admitted that "because of the degree of legal integration that exists between Member States of the Union, in particular by reason of the presence of Community legislation which seeks to ensure cooperation between national tax authorities, such as Council Directive 77/799/EEC ..., the taxation by a Member State having cross-border aspects which take place within the Community is not always comparable to that of economic activities involving relations between Member States and non-member countries".

From the preceding, I do not distill very broad results about the meaning and scope of capital for the purposes of Arts. 56 to 58 of the Treaty, where third states are involved. Let me recall that at this stage, I am neither taking into account the EEAA nor the (special) Agreements with Switzerland and other third states.

I may then suggest, at this point, the following conclusions:

1. The aim of the free movement of capital between a Member State and a third state in the EC Treaty is not clear.
2. The meaning of the free movement of capital may be more restrictive if the cross-border transactions involve a Member State and a third state, than if the cross-border transactions involve two Member States.
3. Conclusion 2 is particularly valid in respect of evaluating domestic (and EC) tax rules.
4. The meaning and scope of the free movement of capital involving third states may be restricted if transactions are primarily covered by another fundamental freedom, but this is not a satisfactory path to differentiate restrictive tax rules compatible with the Treaty from restrictive tax rules incompatible with the Treaty when the issue regards inbound income whose beneficial owner is an EC national.
5. From the free movement of capital between a Member State and a third state it does not follow that a transaction to or from a third state that would only be covered by the free movement of capital rules of the EC Treaty, would be unconditionally protected against domestic tax restrictions, namely if the beneficial owner is a third state national.

[39] C-376/03, 5 July 2005. See also, Test Claimants in Class IV, paras. 84 ff.

[40] Vogel/Gutmann/Dourado, Tax Treaties, 89.

6. The relation between the free movement of capital and other fundamental freedoms in the Treaty, any overlapping problems, and the inclusion of third states in the free movement of capital, make the definition and scope of the free movement of capital more interrelated than that following from the analysis of other fundamental freedoms within the EC Treaty.

1.2 The comparability in the relations with third states

1.2.1 The Van Hilten case: adding some arguments to the discussion

In the *Van Hilten* case, the whole reasoning of the Advocate General and the Court does not differentiate between an intra-EC movement of capital and a similar movement involving a Member State and a third state. As I mentioned before, comparison is made with the *Barbier* case, and I can find no reference suggesting that the *Van Hilten* case should be dealt with differently, because third states are involved in the underlying transactions.

Let me add some arguments to the discussion based on the Opinion of the Advocate General and the reasoning of the ECJ in the *Van Hilten* case. According to the Advocate General, "capital movements are financial operations which aim essentially at placing and investing the amount in question. Thus, they are financial operations and differentiate themselves from current payments because they are related to the constitution of property. I may therefore deduct that free movement of capital in the EC law aims at permitting the EC exiting persons to benefit from the most favourable conditions that may be given to them within the EC and in the third states in order to invest and place their capital" (para. 49).

Let me break down the elements of the cited statement.

In the first place, the assertion itself aims at clarifying the purpose of the free movement of capital in Art. 56 (1) of the EC Treaty: "free movement in the EC Law aims at ...".

Secondly, the aim pursued by Art. 56 (1) concerns EC nationals who are exiting the EC and investing and placing their capital in Member States and in third states. This implies non-discrimination of an EC national, independent of the state of investment or placement of their capital.

However, as the Advocate General makes reference to an aim and not to a prohibition of tax obstacles, it is not clear whether Art. 56 has a broad or a limited direct effect. I would say that Art. 56 goes beyond the elimination of technical restrictions to the transfer of EC capital[41]. It certainly does not mean that there should be an equal treatment of EC and foreign capital in cross-border transactions (in the broader meaning of capital, as mentioned above)[42].

[41] In the sense proposed by Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 506.

[42] As Schön also defends in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 506.

Thirdly, point 49 of the Advocate General's Opinion indicates that, as a rule, restrictions on cross-border investment and placement of capital are not compatible with EC law, even if the capital flows from the EC to third states.

Two arguments used in the case limit the scope of the above-mentioned point 49 of the Advocate General's Opinion. One is connected with tax evasion, which was mentioned by the Advocate General and the Court, to justify the domestic tax legislation under analysis, no reference being made to the principle of proportionality. In fact, contrary to settled case law on the subject[43], no observation is added to the effect that application of any anti-abuse legislation should be proportional to the aims pursued by that legislation.

I cannot find any express reference either to the relevance of the legal regime applied by the third state, i.e. to the cohesion argument as it has been constructed recently: "the concept of cohesion generally means no more than avoiding double taxation or ensuring that income is actually taxed, but only once (the principle of only-once taxation)" (point 20 of the Opinion of the Advocate General Kokott in the *Manninen* case[44]). The other argument, related to the first one, is the "search for inspiration" in the OECD Model Convention and its Commentaries.

Whereas in the *Gilly* case, Commentaries to the OECD Model Convention were invoked because the compatibility of a rule in the double taxation convention between France and Germany with the EC Treaty was being tested (paras. 31 ff. of the decision), in the *Van Hilten* case, the ECJ interpreted the domestic legislation and its compatibility with the EC Treaty in the light of the OECD Model Convention Commentaries (although the declaration which forms part of the double taxation convention between the Netherlands and Switzerland contained the same rule).

It is true that the ECJ recalled that "it follows from the case law that the measures prohibited by Article 73-B, 1, of the Treaty, as being restrictions on the movement of capital, include those which are likely to discourage non-residents from making investments in a Member State or to discourage that Member State residents to do so in other States or, in the case of inheritances, those whose effect is to reduce the value of the inheritance of a resident of a State other than the Member State in which the assets concerned are situated and which taxes the inheritance of those assets" (para. 44).

But in paras. 45 and 46, the ECJ considered that the domestic legislation, providing that the estate of a national of a Member State who dies within 10 years of ceasing to reside in that Member State is to be taxed as if he still were a resident, did not constitute a restriction on the movement of capital, because it cannot

[43] Among others, *Gebhard Case* C-55/94; *Parodi*, Case C-222/95, para. 31; *Commission/Belgium*, Case C-478/98, para. 45; *X and Y II*, Case C-436/00, paras. 42, 43, 60 ff.; *Centros*, Case C-212/97; *Lasteyrie du Saillant*, Case C-9/02, para. 51 ff.; *Cadbury-Schweppes*, Case C-196/04, Opinion of the Advocate General, points 85 ff.; cf. Dennis Weber, *Tax avoidance*, 209 ff.

[44] ECJ 7 September 2004, C-319/02 *Manninen*.

constitute a restriction on the movement of capital of nationals of the other Member States. Whereas the language used in para. 44 opened the door to movements to and from third states, in paras. 45 and 46 reference is only made to nationals of Member States.

Finally, it is worth mentioning that underlying the above-mentioned two arguments was the assumption that the domestic legislation contained legitimate rules concerning the allocation of taxation rights (differences in treatment between residents who are nationals of the Member State concerned) (see para. 47 of the ECJ decision).

I wonder what would have been the judgment if the exit tax had been directed at residents leaving the country, independent of their citizenship. Had that been the case, the inheritance tax rules in the Netherlands would most probably be judged incompatible with the non-discrimination principles in the Treaty, if the cross-border transactions only involved Member States.

1.2.2 Protection of third states nationals and Economic Double Taxation

However, if citizens of a Member State are protected by the fundamental freedom on capital movement, the issue is whether a national and resident of a third state is never protected by the free movement of capital.

In a triangular situation relatively different from the one examined in the *Saint-Gobain* case, involving a non-EC national whose capital has a relevant connection with an EC Member State, there are good reasons to argue that restrictions on free movement from a Member State to a third state are covered by Art. 56. This is the case of a company resident in a third state **R** with a portfolio investment in a company resident in a Member State **S** effectively connected to a permanent establishment in another Member State **PE**[45]. The double taxation convention between R and S is applicable, but double taxation may occur in the EC territory, if PE does not give a credit regarding the dividends paid in S.

Economic double taxation within the EC is contrary to the aims of the fundamental freedoms, namely to capital export neutrality, and may serve as guidance for judgments on compatibility of domestic tax measures with the above-mentioned freedoms[46]. Capital export neutrality implies that (EC) exporting companies pay nearly the same amount of tax, whether their income has an EC or third-state source, and as long as they are taxed only once in the EC territory[47].

But economic double taxation has only been considered contrary to the fundamental freedoms when it is discriminatory with regard to EC nationals[48]. In the example, however, the PE is not an EC national and it is therefore difficult to justify its protection under EC law.

Another example concerns anti-abuse clauses in triangular situations.

In the case of a company resident in a Member State R with a portfolio investment in a company resident in a third state TS effectively connected to a permanent establishment in another Member State PE, an anti-abuse clause, applied by Member State R (a CFC clause, for example), would cause double economic taxation within the EC territory and might therefore be incompatible with the EC Treaty.

LOB clauses also seem to be incompatible with the free movement of capital if they lead to economic double taxation within the EC. In sections II and VII below, I will return to this point.

1.2.3 Some additional conclusions

Taking into account the present stage of the discussion in the literature and existing ECJ case law, I may now add the following conclusions to the previous ones:

1. The aim of the free movement of capital between a Member State and a third state is partially clear: the free movement of capital in EC law aims at permitting EC persons to benefit from the most favourable conditions that may be given to them within the EC and in the third states in order to invest and place their capital.
2. The personal scope of the EC rules on the free movement of capital is also partially clear: EC nationals benefit from the EC provisions on the free movement of capital, whether they invest in a Member State or in other states, but the scope of the free movement is not yet defined.
3. It is not possible to conclude, at this stage of the discussion and existing jurisprudence, that cross-border transfers of capital are protected independently of the persons involved.
4. In the absence of harmonized regimes of taxation, domestic legislation may choose its rules regarding allocation of powers, namely to differentiate among their own nationals who have transferred their residence, because this does not constitute a restriction on the movement of capital of nationals of the other Member States.
5. Prevention of tax evasion justifies the fact that non-harmonized domestic tax legislation restricts the exit of nationals resident in the Member State (and therefore discriminates against nationals who are not in the same situation in respect of their place of residence) in order to prevent evasion of tax on cross-border capital. Prevention of tax evasion is a legitimate aim to justify restrictive measures and comply with Art. 58 1 a) and b) (ex- 73-D).
6. The principle of proportionality is either non-applicable to the restrictions on the movement of capital between a Member State and a third state or has a very narrow scope or at least a narrower scope than in cases involving Member States.

[45] See again, giving this triangular example, Pistone, The Impact of European Law on the relations with Third Countries in the field of direct taxation, *Intertax* 2006, 235.

[46] See again point 20 of the Opinion of Advocate General Kokott in the *Manninen* case.

[47] Vogel/Gutmann/Dourado, Tax treaties, 92.

[48] Cf., confirming this case law, points 58, 65 and 69 of the Opinion of the Advocate General in *Test Claimants in Class IV of the ACT Group Litigation* (Case C-374/04, 23.2.2006).

7. Economic double taxation of EC nationals within the EC may be a guideline to test whether domestic tax rules are incompatible with the EC Treaty, as long as they are discriminatory.

1.3 Possible justifications in relations with third states

1.3.1 Art. 58 (1) a) and b) and protection against tax evasion and/or tax avoidance

According to Art. 58 (1) a) and b), application of the regime on free movement of capital does not hinder Member States – either from applying the relevant provisions of their tax law distinguishing between taxpayers who are not in the same situation regarding their place of residence or the place where their capital is invested (a); or from taking all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation ... or to take measures which are justified on the grounds of public policy or public security (b). Letter a) and the first part of letter b) contain rules that cannot be found elsewhere in the Treaty, but, as is known, the ECJ's interpretation of these provisions has been quite restrictive (see, however, para. 170 of the ECJ *Test Claimants in the FII Group Litigation* decision).

As a matter of fact, application of the cited rules has been only admitted if a general EC interest is followed and the principle of proportionality is observed[49]. Special relevance has been given by the Court to para. 3, according to which, measures and procedures permitted in para. 1 may not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Art. 56. In practice, Art. 58 (1) a) and b) has not been interpreted differently from the other provisions in the Treaty regarding the fundamental freedoms[50].

Paras. 49 and 50 of the *Marks & Spencer* decision might have brought changes to this line of interpretation, though, or at least to the narrow interpretation of the principle of proportionality, as the Court recognizes that the possibility of transferring losses incurred by a non-resident company to a resident company – a right recognized for a group of companies resident in the Member State – entails the risk of tax avoidance. Moreover, in the *Van Hilten* case, the ECJ accepted in very broad terms that the legislation under analysis "is justified by the concern to prevent a form of tax evasion, whereby a national of a State, in contemplation of his death, transfers his residence to another State where the tax is lower" (para. 48). Finally, in *the Test Claimants in the FII Group Litigation* case, the ECJ admitted

[49] See footnote 42 above.

[50] See e.g., Opinion of the Advocate General in *Baars*, Case C-251/98, point 58; *X and Y*, Case C-436/00, point 72; Opinion of the Advocate General in Weidert/Paulus, Case C-242/03; and Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 514.

not only that taxation by a Member State having cross-border aspects which take place within the Community is not always comparable to that of economic activities involving relations between Member States and non-member countries (para. 170, already mentioned above), but also that a Member State may be able to demonstrate that a restriction on capital movements to or from third states "is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States" (para. 171).

1.3.2 Art. 58 (2) of the EC Treaty

Art. 58 (2) of the EC Treaty also seems to have an impact on the scope of the free movement of capital. By indicating that the chapter on the free movement of capital does not hinder the possibility of the application of restrictions concerning the right of establishment, which are compatible with the Treaty, Art. 58 (2) allows the application of domestic or EC restrictions compatible with the right of establishment, for specific domestic or EC reasons. It is often argued that this regime may be extended to restrictions concerning the free movement of services[51].

Presumably, any specific aims pursued by the domestic legislator (or the EC) restricting one fundamental freedom exceptionally admitted by the EC Treaty are not hindered by an overlapping with another fundamental freedom[52]. Thus, the same reasoning is valid in respect of a legitimate restriction applied to the free movement of capital. As Wolfgang Schön has put it, a person may neither invoke the freedom of establishment nor the free movement of services, as long as specific aims of protection of the rules concerning movement of capital justify domestic restrictions[53].

As mentioned above, Art. 58 (2) justifies restrictions on fundamental freedoms and therefore its purpose is different from the purpose followed by the above-mentioned Art. 43 (2) and Art. 51 of the EC Treaty. However, as nationals of third states may not invoke the right to other freedoms, Art. 58 (2) is limited in scope to cross-border transfers involving nationals of a Member State.

1.3.3 Protection of state revenue

In several decisions the ECJ has clarified that the loss of tax revenue is not an acceptable justification for restricting a fundamental freedom. Otherwise, it would allow the protection of national economic agents (as it is directly aimed at protecting those agents), and restrict the function of the internal market[54].

Taking into account our previous conclusions regarding the purpose of the free movement of capital between Member States and third states, it seems that, when-

[51] Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 500.

[52] Idem, 500.

[53] Idem, 501.

[54] See, e.g., Vanistendael, Cohesion: the phoenix rises from his ashes, *EC Tax Review* 2005, 212 ff.

ever the argument of the loss of tax revenue does not damage the achievement of tax neutrality within the EC, tax rules on capital movements between a Member State and a third state, may be restrictive. They should not, however, discriminate among nationals of a Member State.

I still wonder whether it is suitable or necessary to invoke the loss of tax revenue as a justification for a restrictive tax measure on a transaction between a Member State and a third state. In most cases, the scope of the free movement of capital as applicable to movements between a Member State and a third state will be sufficient to judge a tax rule compatible with the EC Treaty, as happened in the *Van Hilten* case.

1.3.4 Effective fiscal controls, cohesion and proportionality

Member States have argued that some discriminatory tax rules aim at preventing tax evasion or tax avoidance, because effective fiscal controls cannot be exercised in respect of non-residents. Nevertheless, settled case law points out that Member States have available instruments of enhanced cooperation under Council Directive 77/799/EEC of 19 December 1977, as amended, concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation. Supposedly, that instrument of administrative cooperation provides for ways of obtaining information comparable to those existing between tax authorities at the national level[55].

Mutual assistance between tax administrations (namely, exchange of information and assistance in the collection of taxes) is at present a major aim of the OECD, in view of the increasing internationalization of economic relations. Art. 26 of the OECD Model Convention has been redrafted in order to expand its scope, taking into account the Model Agreement on Exchange of Information on Tax Matters and the report "Improving Access to Bank Information for Tax Purposes". Furthermore, Art. 27 provides for assistance in the collection of taxes, but it is up to the contracting states to include such a provision in their bilateral treaties as well as the extent of the assistance.

I may then ask whether any restrictive measures imposed on cross-border transfers of capital between a Member State and a third state, justified by the fact that, otherwise, the Member State might lose tax revenue, and that it has no information on the tax situation in the third state, is compatible with the EC Treaty, taking into account the above-mentioned Arts. 26 and 27 of the OECD Model Convention.

I wonder, for example, whether a CFC rule applicable by a Member State to capital with source in a third state, which does not fulfil the conditions required by the ECJ in the *Cadbury-Schweppes* decision[56], would be compatible with the EC

[55] Point 81 of the Opinion; *Schumacker* case, § 45. See also, ECJ 15 May 1997, C-250/95 *Futura Case* paras. 65 ff.

[56] ECJ 12 September 2006, C-196/04.

Treaty, and whether the ECJ might consider that the states involved should, instead of applying a CFC rule, ask for information under Art. 26 or for assistance in collection under Art. 27. Or whether the granting to a shareholder, who is generally liable to tax in his Member State of residence, of a corporate tax credit in respect of dividends paid by a domestic share company or a share company registered in another Member State, but the refusal of such tax credit in respect of dividends paid by a share company registered in a third state, would be justified for effective fiscal control reasons or rather by the cohesion argument[57].

It seems reasonable to at least argue that the concrete provisions regarding exchange of information and, possibly, assistance in collection, in the double tax treaty applicable in the states involved should be compared to the EC Directive on mutual assistance (see again, paras. 170 and 171 of the *Test Claimants in the FII Group Litigation* case). The argument of effective fiscal controls must undoubtedly be relevant in respect of tax havens[58] and any state that does not exchange information or does not provide administrative assistance.

But if, as happened in the *Van Hilten* case, regarding certain underlying transactions and corresponding income, the Commentaries to the OECD Model convention recommend inclusion of anti-abuse provisions in bilateral tax treaties or in domestic rules applicable to cross-border transactions – such as CFC clauses, or an "exit tax" such as the one applicable to Mrs. van Hilten – it would not be correct to ignore these recommendations included in the Commentaries, and only invoke Arts. 26 and 27 of the Model Convention.

The cohesion principle may also have an important role to play if the meaning given to it recently by the ECJ, and introduced by Advocate General Kokott, is adopted. In other words, if the correct testing of the compatibility of a domestic rule with the Treaty requires a complete analysis of the tax regime applicable in the source and in the residence state to one or two related taxpayers, the cohesion argument may be invoked by a Member State[59]. This is especially true in respect of tax havens and third states that do not provide any or even regular assistance under Arts. 26 and 27 of the OECD Model Convention.

The principle of proportionality, as a general principle aimed at controlling any restrictive measures applicable by a public entity, must be always observed, although its concrete meaning and scope are shaped according to the underlying legal and factual circumstances. Thus, taking into account that Art. 56 (1) of the EC Treaty provides for free movement of capital between Member States and third states, any restriction to this free movement – as defined, and taking into account its scope – must observe the principle of proportionality.

[57] This was one of the questions under analysis in the *Manninen* case (C-319/02). See also, para. 171 of the *Test Claimants in the FII Group Litigation* case.

[58] Schön, in Gocke/Gosch/Lang (eds.) *FS für Franz Wassermeyer* (2005) 517–518.

[59] See, Vanistendael, *EC Tax Review* 2005, 217 ff.

In the *Van Hilten* case, application of domestic tax law to nationals who died within 10 years after ceasing to reside in the Netherlands was implicitly held to be proportional to its aim. On the contrary, a rule that would always treat nationals as residents would not observe the principle of proportionality[60]. The category of third states (EEA Member State, tax haven, state providing regular assistance under Arts. 26 and 27 OECD Model Convention) should also be considered for evaluating whether the principle of proportionality is observed.

II. The indirect impact of the fundamental freedoms in relations with third states

2.1 "Passive" aspects of fundamental freedoms: Protecting third states' resident/nationals

Paras. 18 and 19 of the Vestergaard decision, read as follows:

Para. 18: "... it is important to point out that in order for services such as those in question in the main proceedings, namely the organisation of professional training courses, to fall within the scope of Article 59 of the Treaty [61] it is sufficient for them *to be provided to nationals of a Member State on the territory of another Member State, irrespective of the place of establishment of the provider or recipient of the services.*"

Para. 19: "Article 59 of the Treaty applies not only where a person providing a service and the recipient are established in different Member States, but also *whenever a provider of services offers those services in a Member State other* than the one in which he is established ... wherever the recipients of those services may be established ...".

The addressees of the free movement of services, according to the passage cited, corresponding to para. 18, are nationals of Member States.

A cross-border situation occurs when a service (as the object of a fundamental freedom) is provided to a *national of a* Member State on the *territory of another* Member State. The same criteria are applicable to the freedom of establishment. Whereas in the *Bent Vestergaard* case, the Member State of nationality adopted tax discriminatory rules concerning the deductibility of expenses incurred in another

[60] And in the *Test Claimants in the FII Group Litigation* case, the ECJ did not accept the justification of the United Kingdom Government: the Government justified the payment of advance corporation tax by companies receiving foreign-sourced dividends, on grounds of the difficulties arising from the verification of the tax paid abroad, only in order to explain the period of time between the time when ACT was accounted for and the time when it was repaid. It seems that the principle of proportionality underlies the ECJ evaluation of the measure.

[61] [at present, Article 49].

Member State, in the *Saint-Gobain* case, the secondary establishment of an EC national in another Member State was negatively affected by tax measures applicable to income sourced in a third state[62]. Or, in other words, by tax measures *applicable by a Member State* (the State of the secondary establishment) *to a national of another Member State* and *by the third state to income sourced* in the third state.

In both cases, the discriminatory measures affected an EC national[63], however. It was sufficient that two Member States were involved.

What is more, if the *place of establishment of the provider or recipient of the services* is irrelevant, this means that a situation in which a permanent establishment located in a third state of a company registered in a Member State, paying interest income to an individual citizen of another Member State, even if that person resides in a third state, seems to be covered by the Treaty.

What seems to result from the *Saint-Gobain* and the *Vestergaard* decisions and para. 49 of the Opinion of the Advocate General in the *Van Hilten* case is that the free movement of capital implies the right of EC nationals to place and invest capital in a third state where the capital has a relevant connection with another EC State, e.g., if the beneficiary of the income is a national of another Member State.

At this stage of the discussion, it still has to be explained how far the right of EC nationals to place and invest capital in a third state (*tout court,* as in the abovementioned para. 49 of the Opinion of the Advocate General in the *Van Hilten* case), goes.

2.2 "Acknowledging" the right of a third state to discriminate against residents of EC Member States

2.2.1 Art. 307 of the EC Treaty

Third states have the right to discriminate against nationals and/or residents of EC Member States, as, in principle, third states are not bound to EC law. However, it is more rigorous to make reference to categories of third states, taking into account their relations with the EC Member States. In this report, reference is made to the EEA Agreement (Agreement on the European Economic Area) and to the Agreements concluded between Switzerland and the EC Member States. Both the EEA Member States and Switzerland must take account, to a certain extent, of the ECJ case law and interpretation of EC law (or of "concepts of EC Law" – cf. Art. 16 para. 2 of the Agreement on the Free Movement of Persons between the EC and its Member States, of the one part and Switzerland, of the other).

On the other hand, it is clear that an EC Member State is prohibited from concluding treaties with third states that violate a fundamental freedom in the EC

[62] As Pistone recalls, *Intertax* 2006, 235.

[63] See also *Test Claimants in the FII Group Litigation.*

Treaty. Art. 307 of the EC Treaty requires Member States to eliminate incompatibilities with EC law arising from treaties concluded before the entry into force of the EC Treaty or to terminate these treaties[64].

In the *Open Skies* cases[65], benefits (such as free access of routes and granting of traffic rights) were accorded to companies resident in the EC Member States that were renegotiating the bilateral free aviation agreements with the US, and to US-based companies. The restriction of benefits to the companies resident in the contracting states violated, according to the ECJ, the fundamental freedoms of nationals of the other Member States.

Although all the rights and obligations within the *Open Skies* Agreements implied reciprocity and favourable treatment, the nature of those treaties is nevertheless different from the nature of bilateral tax treaties, because they did not imply a sharing of sovereign powers. In tax treaties, a rule "cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance" (para. 62 of the ECJ decision on the *D* case). In the *Test Claimants in Class IV* case, the ECJ applied this reasoning (and quoted this sentence) to LOB clauses (para. 89) and considered that these clauses are not incompatible with Articles 43 and 56 of the EC Treaty.

Contrary not only to the doctrine in the *Open skies* cases, but also to the doctrine in the *Test Claimants in Class IV* case, I think that anti-abuse clauses, like LOB clauses, in tax treaties concluded between a Member State and a third state may be incompatible – but are not necessarily incompatible – with the EC Treaty: their compatibility with the fundamental freedoms in the EC Treaty requires a casuistic analysis[66].

Furthermore, in the process of negotiating a tax treaty with a third state an EC Member State is neither obliged to require that all EC residents are entitled to the treaty's benefits, nor may it demand from a third state that a uniform set of LOB clauses be included in all bilateral tax treaties with Member States.

Some guidelines on the compatibility of LOB clauses with EC law can be established.

LOB clauses are connected to the entitlement or non-entitlement of a taxpayer to a tax treaty, which is a question prior to the allocation of taxation between the contracting states. LOB clauses still fall under the competence of the contracting states.

LOB clauses only seem to be clearly incompatible with the Treaty, in the event that they are part of a tax treaty concluded between two Member States and are discriminatory (non-entitlement of permanent establishments, different treatment of a non-resident individual in comparison with a resident individual) or lead to economic double taxation within the EC.

64 Vogel/Gutmann/Dourado, Tax Treaties, 83.
65 See ECJ 5 November 2002, Cases C-466/98 and 467/98.
66 Vogel/Gutmann/Dourado, Tax Treaties, 92 ff.

Let us imagine the case of a company resident in Member State 1 (MS1) with a subsidiary in a third state (TS), whose assets are effectively connected to a PE in Member State 2 (MS2). If MS1 adopts the exemption method and MS2 does not tax, application of an LOB (included in the tax treaty between MS1 and TS) by the TS does not imply violation of EC preference (Art. 10 of the EC Treaty) by MS1. MS1 does not avoid economic double taxation of EC shareholders, but MS1 and MS2 do not tax and therefore capital export neutrality is not violated.

2.3 Protecting income sourced in third states

Domestic tax legislation still distinguishes between permanent establishments and resident companies whether these are parent companies or subsidiaries. One example regards taxation of dividends received by a PE of a company resident in a third state and the holding in respect of which the dividends are paid is effectively connected with the PE.

The *Saint-Gobain* judgment has been partially implemented in the Portuguese tax legislation, following the Parent-Subsidiary Directive, as amended. A PE, located within the Portuguese territory, of a company resident in another Member State is entitled to a tax credit, under the same conditions as a parent company, regarding dividends distributed by companies resident in another Member State.

If the source state of the dividends is a Member State, withholding tax reductions occur under the Parent-Subsidiary Directive and not automatically from a bilateral tax treaty, unless PEs were granted a (at least partial) treaty entitlement to benefits.

Taking into account the stage of EC and international tax law, it seems that a Member State may not yet require from a third state the granting of a treaty entitlement to a (or any) PE, situated in that first state, of companies resident in another EC Member State. A partial treaty entitlement of PEs, as has been suggested by the OECD, could be discussed. However, according to the *D* case, the fundamental freedoms do not preclude that reciprocal rights and obligations in a bilateral tax treaty apply only to persons resident in one of the two contracting states (para. 61 of the *D* case)[67].

Combining the doctrine of the *Saint-Gobain*, *D*, *Van Hilten*, *Fidium Finanz*, and *Manninen* cases regarding the meaning of cohesion, I come to the conclusion that taxation of income with sources in a Member State and effectively connected to a PE located in another Member State of a company resident in a third state is not subject to Art. 56 of the EC Treaty.

2.4 Tax treaty provisions with third states as a benchmark

In the *D* case, the ECJ accepted that, under the Netherlands-Belgium tax treaty, Belgian residents are granted a more favourable treatment than that applicable to German residents under the Netherlands-Germany tax treaty. According to para. 61 of the decision, the fact that "those reciprocal rights and obligations ap-

67 Vogel/Gutmann/Dourado, Tax Treaties, 84 ff.

ply only to persons resident in one of the two Contracting States is an inherent consequence of bilateral double taxation conventions".

Thus, the ECJ considered it legally irrelevant to compare the situation of two non-residents belonging to different countries, because bilateral tax treaties differ from one another and a specific article "cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance" (para. 62).

This reasoning is also applicable to a tax treaty concluded between a Member State and a third state: if non-discrimination and free movement within the EC do not require equal treatment of all nationals or residents within the EC (within the internal market), there is no rationale to require equal treatment by a Member State of EC nationals or residents in a Member State and national or residents in a third state[68].

III. Fundamental Freedoms in relation to EEA States under the EEA Agreement

3.1 Specific features of the EEA Agreement

I have already mentioned that the EEA Agreement (EEAA) creates a special category of third states. Let me recall that the contracting parties to the EEAA are the European Community and its Member States, on the one side, and the Republic of Iceland, the Principality of Liechtenstein and the Kingdom of Norway, on the other. Among other goals, it has the "objective of establishing a dynamic and homogenous European Economic Area, based on common rules and equal conditions of competition and providing for the adequate means of enforcement including at the judicial level, and achieved on the basis of equality and reciprocity and of an overall balance of benefits, rights and obligations for the Contracting Parties" (Preamble of the Agreement); and the EEAA is "determined to provide the fullest possible realization of the free movement of goods, persons, services and capital within the European Economic Area ..." (Preamble of the Agreement).

The fact that some freedoms have a different wording under the EEAA than that of the EC Treaty is not necessarily relevant. The wording is the point of departure and the limit of interpretation in law, but interpretation is aimed at the teleology of a legal provision or a set of connected legal provisions.

An Opinion by the ECJ on a draft to the EEAA[69] seems to be out-of-date. In that opinion, the ECJ considered that the purpose of the EEAA is to achieve free

[68] Vogel/Gutmann/Dourado, Tax Treaties, 89.

[69] Opinion 1/91 of 14 December 1991 on the draft agreement between the Community and the countries of the European Free Trade Association, relating to the creation of the European Economic Area (ECR 1991, I-361).

trade and competition, while the EC Treaty aims at establishing an internal market and an economic and monetary union. The ECJ considered that these different aims could not guarantee an identical interpretation of provisions with the same wording in both treaties.

The objective behind the liberalization of freedoms of production factors in the EEA was emphasized in the *Ospelt* case[70]. In para. 29, the ECJ pointed out that "one of the principal aims of the EEAA is to provide for the fullest possible realisation of the free movement of goods, persons, services and capital within the whole European Economic Area, so that the internal market established within the European Union is extended to the EFTA States". The objective of creating a homogenous Economic Area (Art. 1 para. 1 of the EEAA), has consistently guided the jurisprudence of both the EFTA Court and the ECJ.

According to Art. 6 in the EEAA, "provisions in the EEAA identical to the corresponding provisions in the EC Treaty, shall be interpreted in accordance with the relevant decisions from the ECJ as announced until the day of the signing of the agreement". As a matter of fact, the EFTA Court has been taking into account the jurisprudence of the ECJ concerning the interpretation of the fundamental freedoms beyond that deadline, as the *Fokus Bank* case[71] exemplifies. Homogeneity of the EFTA Court and ECJ decisions is assured by the EEA Joint Committee that keeps under constant review the development of the case law of the ECJ and the EFTA Court.

The *Fokus Bank* case is also to be taken into account by the ECJ in similar cases occurring between Member States, as the literature commenting on the case has already observed[72]. Art. 31 (3) of the Vienna Convention of the Law of Treaties can support the relevance of the EFTA Court cases for such ECJ judgments.

If the previous paragraphs contain a *right answer* to the meaning of the fundamental freedoms in relation to the EEA States, they also entail that the meaning and scope of free movement of factors between EEA States is not different from the meaning and scope of free movement of factors between Member States.

3.2 The comparability in relations with EEA States and possible justifications

In intra-EC situations the ECJ normally compares domestic situations with cross-border situations, with a view to ascertaining whether there is a breach of EC law.

[70] Case C-542/01.

[71] EFTA Court 23 November 2004, Case E-1/04.

[72] Larking, Fokus Bank: the end of withholding tax as we know it?, *EC Tax Review* 2005, 76–77; Cordewener, Europaïsche Vorgaben für die Verfahrensrechte von Steuerausländern – Formellrechtliche Implikationen der 'Fokus Bank' – Entscheidung des EFTA-Gerichtshofs – Teil I, *IStR* 2006, 113 ff.; Teil II, *IStR* 2006, 158 ff.

The comparability in the relations with EEA States follows the same pattern used by the EFTA Court in the *Fokus Bank* case: in this case, and to put it simply, the EFTA Court analysed whether Art. 40 of the EEAA precludes legislation whereby shareholders residing in Norway are granted a tax credit on dividends paid by a Norwegian company, whereas shareholders residing outside Norway are not granted such a credit. According to Art. 40 of the EEAA Agreement, "Within the framework of the provisions of this Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to persons resident in EC Member States or EFTA States and no discrimination based on nationality or on the place of residence of the parties or on the place where such capital is invested". A subsidiary question was whether it made any difference if the shareholder's state of residence was obliged to grant a tax credit for withholding tax under its treaty with Norway.

In order to judge the case, the EFTA Court took into consideration the case law of the ECJ concerning Art. 56 and analysed whether the domestic law restricted the free movement of capital, namely whether it had adverse effects on the profits of non-resident shareholders, eventually discouraging non-residents from investing in Norwegian companies[73].

Like the ECJ case law, the EFTA Court considered that a difference in treatment could only be compatible with the EEAA, if the situations were not objectively comparable. According to the EFTA Court, residents and non-residents were in comparable situations, as both of them could suffer economic double taxation in respect of the dividends – even though residents were taxed on their global income, whereas non-residents were only taxed in respect of Norwegian-sourced income. The question of comparability of the legal situation applied to the taxpayers was raised by the Norwegian Government (according to which the total amount of tax paid by the non-residents on the dividends – in the source and in the residence state should be considered), but not accepted by the Court.

To support its view, the Court cited the *Lenz* and the *Manninen* cases, although these cases related to tax treatment of inbound dividends (whereas in the *Fokus Bank* the case concerned outbound dividends). In the *Fokus Bank* case, the issue of comparability was explored thoroughly in the perspective of the taxation in the source state of non-resident's direct investment income – which had not happened before in the ECJ case law[74]. But this was not an obstacle to the EFTA Court in following the pattern of comparability that may be found in the ECJ case law.

Thus, it seems that in respect of principles in the EEAA, similar to the ones in the EC Treaty, the comparability in the relations with the EEA is to be determined according to the same criteria as the ones guiding the relations within the EC.

The same reasoning applies to possible justifications to restrictive or discriminatory measures in relations with EEA States, as the *Fokus Bank* case also illustrates. Quoting the *Manninen* case, the EFTA Court considered that a difference in treatment can only be regarded as compatible with Art. 40 of the EEAA where the situations are not objectively comparable, or where it is justified by reasons of overriding public interest. Besides, the difference in treatment, if justified, may not exceed what is necessary in order to attain the objective of the legislation. The justification of the domestic legislation under analysis, on the basis of its cohesion, was rejected by the Court.

The formal presentation of the EFTA decisions and methodology followed in the analysis of the cases also shows us the similarities with the ECJ judgments.

[73] Larking, *EC Tax Review* 2005, 69 ff.
[74] See Larking, *EC Tax Review* 2005, 72.

IV. Agreements between Switzerland and the European Union

As Pasquale Pistone has pointed out, "the impact of European law on the relations with Switzerland provides for a fairly complex pattern. Seen from the Swiss perspective, it becomes even more complex"[75].

In the next paragraphs, some preliminary thoughts are devoted to the Agreement on the Free Movement of Persons (OJ 30.4.2002, L 114/6) and to the Agreement on the Taxation of Savings (OJ 29.12.2004, L 385/30) and their impact on direct taxes. The issue certainly deserves a more in-depth analysis in the future.

4.1 Scope of the Agreements and their impact on direct taxes

4.1.1 The Agreement on the Free Movement of Persons

The objectives of the Agreement on the Free Movement of Persons (hereinafter: Agreement) are not yet clear. Some of its provisions seem to be applicable to direct taxes, but their interpretation raises many questions, which have not yet been dealt with by case law.

Among the relevant provisions, I may find non-discrimination clauses protecting nationals of either contracting party resident in another contracting party (Art. 2 of the Agreement and Arts. 9, 15, 17, 18, 25 in Annex I) and a provision referring to interpretation of the Agreement on the basis of the relevant case law of the ECJ (Art. 16 (2)). Prior to the date of the signature of the Agreement (21.6.1999), insofar as application of the Agreement involves concepts of Community law, account must be taken of that relevant case law. Case law after that date must be brought to Switzerland's attention, and a Joint Committee will determine the relevance of that case law to ensure that the Agreement works properly.

This set of provisions is coherent and interpretation of the Agreement may in the future lead to similar results as the ones achieved in the application of the

[75] Pistone, *Intertax* 2006, 241.

EEAA by the EFTA Court. However, we should not forget that the competence of the Joint Committee in the Agreement is not identical to the competence of a Court. Besides, it is not clear whether the power of the Joint Committee in "determining the relevance of the case law of the ECJ after 21.6.1999" (Art. 16 (2)) has a different nature from the "recommendations issued for the management and proper application of the Agreement" (Art. 14).

A major factor of uncertainty regarding the scope of the Agreement in respect of direct taxes lies in Art. 21[76]. Art. 21 makes reference to tax treaties. Its interpretation and realtionship with Art. 16 para. 2 and the other rules concerning the free movement of persons and non-discrimination are fundamental for deciding whether the Agreement (namely, the above-mentioned articles on non-discrimination) effectively applies to direct taxes.

According to Art. 21 (1), the provisions of the bilateral tax treaties between Switzerland and the Member States of the EC are unaffected by the ones in the Agreement. And, in particular, they may not affect the definition in the tax treaties of frontier workers. Para. 2 of the same article safeguards the distinction of taxpayers, whose situations are not comparable, especially as regards their place of residence.

One issue lies in the meaning of "unaffected". One possibility is to interpret it in the sense that the exercise of a right to tax according to a bilateral tax treaty may totally disregard the Agreement. This interpretation goes in the opposite direction of the one given by the ECJ to the EC Treaty in the *Saint-Gobain* case (para. 58) and confirmed by the EFTA Court in the *Fokus Bank* case, regarding the EEAA. Another question concerns para. 2 of Art. 21, namely, whether residents and non-residents may be in a comparable situation. In addition, both issues have to be analysed in the light of Art. 16 (2) – i.e., whether the doctrine in the *Saint-Gobain* decision applies to interpretation of Art. 21 (1); and whether the doctrine in *Gerritse*[77], *Lasteyrie du Saillant* and *D* is to be applicable to interpretation of Art. 21 (2).

A systematic interpretation of the Agreement leads us to the basic conclusion that the objective of free movement of persons and the prohibition of discrimination will not be attained if direct taxes are discriminatory or act as restrictions to that movement. But Art. 21 seems to indicate that non-discrimination in the relations between the contracting parties does not go so far as non-discrimination between Member States of the EC. The role that the Joint Committee will effectively exercise in "determining the relevance of the case law of the ECJ after 21.6.1999" (Art. 16 (2)), will be a key to the present questions.

As a point of departure, I would say that the meaning of free movement of persons between the contracting parties in the Agreement may probably not reach the

[76] See again, Pistone, *Intertax* 2006, 241.
[77] C-234/01, 12 June 2003.

same degree of intensity as its meaning within the EC Treaty: it is a quantitative distinction and not a qualitative one. Whether this will occur through a more restrictive meaning of free movement of persons or through a broader acceptance of justifications to discriminatory or restrictive tax measures is still to be seen.

4.1.2 The Savings Agreement

In the Savings Agreement there is no Joint Committee to recommend or impose interpretation of its provisions, but a reference to the interpretation of the Savings Agreement is found in its Memorandum of Understanding: the contracting parties declare that they will apply the agreed measures in good faith and that they will not act unilaterally in order to damage the Agreement (4. Declaration of intentions).

From this reference, it is possible to draw the following guidelines: To fulfil its objectives, the Savings Agreement is not only to be interpreted in accordance with the Vienna Convention of the Law of Treaties, but also according to the EC Directives referred to in the Savings Agreement; and the name of the Savings Agreement is an important element in this respect: it is an Agreement between the European Community and the Confederation of Switzerland providing for measures equivalent to those laid down in the Council Directive 2003/48/EC on Savings Income in the form of interest.

Moreover, according to Art. 31 of the Vienna Convention, a treaty is to be interpreted in good faith, according to the common meaning of the words in the treaty, in its context, taking into account the object and the purpose. The EC Savings Directive is part of the context of the Agreement and therefore a main element in its interpretation. Besides, the purpose of the Agreement is clear: basically, its purpose is to achieve taxation of savings interest by the adoption of equivalent measures in the contracting parties. Art. 32 of the Vienna Convention makes reference to the complementary elements of interpretation, namely to the circumstances in which the treaty was concluded. The circumstances play an important role in this case, and do not leave room for many doubts. Let me recall that the entry into force of Council Directive 2003/48/EC, under the agreement reached in Santa Maria da Feira on June 19–20, 2000 (under the Portuguese EC presidency), was dependent on the conclusion of agreements with some third states, including Switzerland. If these third states – which did not tax savings interest of non-residents and did not provide any administrative assistance to other states – did not provide for measures equivalent to those laid down in the Directive, the interest on savings would very easily exit the EC territory and move in the direction of these third states.

As a reward for the introduction of the above-mentioned equivalent measures, Switzerland benefits from the regime of exemption in the source state of dividends paid by a subsidiary to a parent company resident in another contracting party, and from the regime of exemption in the source state of interest and royalties payments between associated enterprises resident in different contracting states.

In conclusion, the interpretation of central concepts like "interest payment", "paying agent", "beneficial owner", has to be conducted according to their meaning in the directive, unless the Savings Agreement establishes special rules.

V. The impact of Secondary EC Law on the relations with third states

The analysis of the impact of EC law in the relations with third states also implies the analysis of the impact of secondary EC law in the same relations.

If I consider the Portuguese tax legislation implementing the EC directives harmonizing income tax, namely the Parent-Subsidiary Directive and the Interest and Royalties Directive, I easily come to the conclusion that relations with third states are not taken into account. Implementation of the Directives in domestic law is normally conducted by, the delegates who represented the state in the technical groups of the Council for the drafting of the Directives. It is not to be expected that implementation of the Directives goes beyond the consensus reached at the EC level.

In the next paragraphs, I will consider a few hypothetical examples to illustrate these introductory remarks.

5.1 Parent company in a third state with a PE in an EC Member State

Let me consider a parent company, resident in a third state with a PE in an EC Member State, receiving income from an EC subsidiary, resident in another State than the PE State. The income is effectively connected to the PE.

1. If the PE is located in the Portuguese territory, and receives dividends from the subsidiary resident in another Member State, effectively connected to the PE, the treatment under the Parent-Subsidiary Directive will not be applicable, as the parent company would have to be resident in another Member State (Art. 46 para. 6 Corporate Income Tax Code, hereinafter, CITC).

   On the other hand, the regime of the Interest and Royalties Directive is only applicable to interest and royalty income with a source in the Portuguese territory:

   (i) when the beneficiary is a company resident in another Member State or a PE situated in another Member State of a company resident in a Member State,

   (ii) and when income is paid by a company resident in the Portuguese territory, or by a PE, situated in the Portuguese territory, of a company resident in another Member State (Art. 80, para. 2 g), CITC).

Interest or royalty income paid by PEs situated in the Portuguese territory of companies resident in a third state is therefore not covered by the Interest and Royalties Directive, as transposed by the Portuguese CITC.

Besides, application of the Interest and Royalties Directive is denied if the beneficiary mentioned in (i) is controlled by a company resident in a third state, unless the taxpayer proves that the chain of shareholdings is not aimed at benefiting of the reduction of the withholding rate (Art. 80, para. 3, CITC).

2. If the subsidiary is resident in Portugal, and pays dividends to the parent company resident in a third state that are effectively connected to the PE Member State, the regime of the Parent-Subsidiary Directive will not be applicable. Exemption of distributed profits would only be applicable if the parent company of the PE were resident in a Member State, had a participation of at least 20% in the subsidiary, for an uninterrupted period of two years, and the conditions of Art. 2 of the Parent-Subsidiary Directive were fulfilled (Art. 14 paras. 3 ff. of the CITC).

   The regime of the Interest and Royalties Directive is not applicable to interest and royalty income with source in the Portuguese territory, when the beneficiary is a PE situated in another Member State of a company resident in a third state.

   As I discussed earlier, possible breaches of Arts. 43 and 56 of the EC Treaty may happen if economic double taxation occurs within the EC territory.

5.2 Parent company in an EC Member State with a PE in a third State

1. Let me next consider a parent company, resident in an EC Member State, receiving income from a subsidiary that is resident in another Member State that is effectively connected to a PE located in a third state.

   In this case, if the parent company is a resident in the Portuguese territory, the domestic legislation does not provide double taxation relief for taxes paid in the state where the PE is located.

2. If the subsidiary is resident in Portugal and pays interest or royalty income to a parent company resident in another Member State, the tax treatment as applicable under the Interest and Royalties Directive is not extended to the PE located in a third state.

5.3 Subsidiary in a third state with a PE in an EC Member State

Let me now consider the case of a parent company, resident in an EC Member State, receiving income from a subsidiary resident in a third state with a PE in an EC Member State.

1. If the parent company is a company resident in Portugal, the domestic legislation does not extend the tax treatment as applicable under the Parent-Subsidiary Directive to subsidiaries resident in a third state (cf. Art. 46 paras. 1, 5 and 6). This is also true for any portion of income attributable to the PE.
2. If the PE is located in Portugal, the regime of the Interest and Royalties Directive does not seem to apply as it is a PE from a company resident in a third state. However, the domestic law does not make an express reference to the case where the parent company is a resident in a Member State, and the answer to this situation is not clear.

5.4 Subsidiary in an EC Member State with a PE in a third state

If a parent company, resident in an EC Member State, receives income from a subsidiary resident in Portugal with a PE in a third state, the Interest and Royalties Directive would not apply if the beneficial owner were the PE in the third state.

5.5 Subsidiary in an EC Member State with a sub-subsidiary in a third state

If we imagine the case where a parent company, resident in Portugal, receives income from a subsidiary resident in another EC Member State that fully controls a sub-subsidiary in a third state, a foreign tax credit granted to the dividends received by the Portuguese parent company does not take into account any taxes paid in the third state by the sub-subsidiary (Art. 46, para. 10, *in fine,* CITC).

5.6 Parent company resident in an EC Member State controlled by a company resident in a third state

Another example concerns a parent company resident in an EC Member State, receiving income from a subsidiary resident in another EC Member State. The parent company is, however, fully controlled by shareholders resident in a third state.

1. In case the parent company is resident in Portugal, the domestic legislation only denies application of the Parent-Subsidiary Directive to distributed profits not subject to effective taxation or with origin in income that does not qualify for the Directive (Art. 46 (10) CITC). The case of the parent company fully controlled by shareholders resident in a third state is not foreseen in the domestic legislation, and therefore, the Directive seems to apply to the dividends received by the subsidiary resident in the Member State. The Directive is not extended though to the dividends paid by the parent company to the shareholder resident in the third state.
2. If the subsidiary is resident in Portugal, the tax treatment foreseen in the Parent-Subsidiary Directive is applicable (Art. 14 para. 3 CITC). No LOB clause

was introduced for the case where the parent company in another Member State is totally controlled by another company in a third state.

However, the Interest and Royalties Directive will not apply if the beneficial owner is the shareholder company in the third state (Art. 80, para. 2 g) of the CITC).

VI. Art. 307 EC Treaty

As mentioned above, EC Member States are prohibited from concluding treaties with third states, which violate the fundamental freedoms in the EC Treaty. Such a prohibition indirectly results from Art. 307 of the EC Treaty. This rule requires Member States to eliminate incompatibilities with EC law arising from treaties concluded before the entry into force of the EC Treaty, or after it, but before a Member State adheres to the EC, or even to terminate those treaties[78]. Adding clauses to those treaties, or replacing existing clauses contained in the original treaties signed before 1 January 1958 or the date of accession, does not make them compatible with Art. 307. The fact that a clause is introduced in a tax treaty before being declared incompatible with the EC Treaty by the ECJ implies, likewise, that it has to be removed from the treaty.

However, a Member State that limits the scope of a bilateral tax treaty with a third state to nationals and/or residents of either contracting state, precluding it to persons who are controlled by residents and or nationals of other states, does not necessarily infringe Art. 307 of the EC Treaty.

The compatibility of an LOB clause with the EC Treaty requires that the Member State may not apply it to EC nationals/residents, and if application of the LOB by the third state does not cause economic double taxation, the LOB seems compatible with EC law. Application of the economic double taxation criterion implies a judgment on the proportionality of the measure.

Let us imagine again, R, resident in Member State MS1, with a subsidiary resident in third state TS, whose assets are effectively connect to a PE of R, situated in Member State MS2. If royalties or interest is paid by TS to MS2, and if MS2 does not tax it and MS1 exempts the income, application of an LOB by TS does not cause economic double taxation. Therefore, I am of the opinion that application of the LOB clause does not violate EC law.

Another path would be to consider LOB clauses incompatible with the Treaty – as a rule –, but justifiable as an anti-abuse measure according to the criteria so far accepted by the ECJ[79, 80].

[78] See Lehner, in Vogel/Lehner, *DBA Doppelbesteuerungsabkommen, Kommentar,* 4th edition (2004) §§ 258–262, 194–195.

[79] See the Advocate General's Opinion in *Cadbury-Schweppes*, C-196/04.

[80] As suggested by Eric Kemmeren during the Conference in Vienna on EU and Third States: Direct Taxation (11–12 October 2006), taking into account the following example. R, resi-

However, as mentioned above, in the *Test Claimants in Class IV* case, the ECJ considered that Articles 43 and 56 of the EC Treaty do not preclude LOB clauses in bilateral tax treaties, without requiring any distinctive criteria[81].

VII. The treaty-making power of the European Union in relations with third states

As I have argued before, EC Member States are not prohibited from including in their tax treaties with third states rules that differ from treaties they have concluded with other third states, or which differ from those which other Member States have included in their treaties with third states, or which give a more favourable treatment than the one resulting from treaties concluded with other Member States. Besides, Member States are neither prohibited to include in their tax treaties with third states LOB clauses nor to apply, in some cases, CFC clauses to resident companies (cf. the ECJ's *Cadbury-Schweppes* decision)[82].

Differences in the rules of bilateral tax treaties result both from the fact that domestic tax law and private law are hardly harmonized in the EC and from the nature of bilateral tax treaties, which are negotiated on a case-by-case basis.

Thus, the conclusion of tax treaties with third states at the Community level is not really an issue of powers – either Art. 293 or the doctrine of implied powers or both could serve as legal basis for the exercise of such competence[83]. The issue is that at this stage of direct tax harmonization, what seems feasible is a framework treaty covering some indisputable principles.

dent in State MS 1 holds subsidiary Sub in MS 2, which subsequently holds sub-subsidiary SubSub in TS. SubSub pays a royalty to Sub. The LOB provision under DTC TS – MS 2 will disallow treaty benefits to Sub in respect of the royalties received from SubSub, because the shareholders of Sub are not residents of MS 2, but of MS 1. TS will levy a withholding tax based on its domestic law, of let us assume 30%, instead of the treaty rate of 0% (exclusive taxation in residence state MS 2). If we assume that the royalty payment is 100, TS will levy an amount of 30. According to Kemmeren, the shareholder test based on residence is inconsistent with the ECJ's case law – e.g. ECJ 05-03-1996, case C-48/93 (Factortame II). If Sub carries out a genuine economic activity and the intangible concerned is used for pursuing that economic activity, Sub should be entitled to treaty benefits. However, TS cannot be obliged to grant them. Therefore MS 2 should provide a solution, because that Member State allowed a LOB provision which is inconsistent with Article 43 EC (hindrance of establishing a subsidiary by R in MS 2 compared to establishing a subsidiary in MS 2 by a company resident in MS 2). A possible solution would be that MS 2 is obliged to credit fully the 30 withholding tax levied by TS. In this way, both the DTC between TS and MS 2 and the EC Treaty are satisfied.

81 See again, paras. 88, 89, ff., of the case.

82 Vogel/Gutmann/Dourado, Tax treaties, 83–86.

83 See ECJ 31 March 1971, Case 22/70 AETR; and Vogel/Gutmann/Dourado, Tax treaties, 89–90.

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