Free movement of capital, taxation and third countries:

The European Court of Justice and cross-border dividends

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Abstract

A unique aspect of free movement of capital, one of the fundamental freedoms guaranteed by the Treaty establishing the European Community, is that it applies not only within the European Union, but also to movements of capital between EU member states and non-EU (or third) countries. The legal and practical significance of this global extension of the EU legal regime is still unclear but recent and pending cases before the Court of Justice of the European Communities ("ECJ") are now beginning to define its principles and limits. The potential impact is most clearly discernible in the field of direct taxation, where numerous infringement actions by the Commission and requests for preliminary rulings in taxpayer initiated cases are now being litigated. This article examines the cases on dividend taxation in the Court's intra-EU case law, and seeks to assess how these issues will be resolved in the third country cases now reaching the ECJ.

I. INTRODUCTION

The implications of the guarantee of free movement of capital in Article 56(1) of the EC Treaty[1] for Member States' tax systems began to emerge only in the mid-1990s. The first decision of the ECJ on the taxation of cross border dividends and free movement of capital was decided by the ECJ only seven years ago, in 2000. There have now been a number of rulings on what constitutes, and what justifies, a restriction on free movement of capital as it applies to taxation of dividends. The "third country dimension" of free movement of capital in relation to direct taxation first came before the Court in two cases decided in 2006, and several more are pending. The broad question yet to be answered is whether there is any substance to the EC Treaty's guarantee of FMC between EU Member States and third countries. If the prohibition on restrictions on third country capital movements has a significant impact on EU Member States' tax systems, what are the implications for the international tax system generally? Will third countries respond

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[1] Treaty establishing the European Community, consolidated version, 24.12.2002 OJ 2002 C 325/33.

in kind, removing discriminatory measures and disincentives to cross-border investment in their tax treatment of dividends? Will the OECD adjust its Model Tax Convention? Although it is too early to predict answers to these questions, this article attempts to clarify the key issues and possible outcomes through an examination of the ECJ's case law on FMC and direct taxation, focusing specifically on how the Court has developed its jurisprudence on cross-border dividends.

A. Free movement of capital from 1958 to 1993

Although the 1957 Treaty of Rome included free movement of capital among the foundational provisions of the European Common Market, this freedom was expressed in more ambiguous terms than the other freedoms.[2] The EC Treaty guarantees of free movement of goods, services, workers, and enterprise (or right of establishment) were recognized as having direct effect at an early stage of the evolution of EU law. However, it was not until 1990, when the third Council directive on the subject, Directive 88/361,[3] became effective that capital movements were defined for the purposes of EU law, the Member States were legally required to eliminate barriers to free movement of capital, and individuals and companies could invoke the right to FMC to challenge national tax laws in the Member States' courts, with access to the preliminary ruling process of the ECJ.[4]

The key provisions of Directive 88/361, Articles 1 and 4, were absorbed into the EC Treaty by amendments agreed in the Treaty of Maastricht, with effect from January 1 1994. The new EC Treaty Articles 73b-d, which are the relevant provisions to the issues

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[2] Article 67 of the Treaty of Rome read as follows: 1. During the transitional period and to the extent necessary to ensure the proper functioning of the common market, Member States shall progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested.

[3] Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, O.J. 1988, L 178/5. Member States were required by Article 1 of the Directive "to abolish restrictions on movements of capital taking place between persons resident in Member States" by July 1, 1990. Article 4 of the Directive was similar in content to EC Treaty Art. 58.1b.

[4] In joined cases C-358/93 and 416/93 *Bordessa* [1995] ECR I-361, a non-tax case, Directive 88/361 was held to have direct effect.

discussed in this article, were renumbered, without other amendment, as Articles 56-58 by the Treaty of Amsterdam.

B. Articles 56-58: introduction to the basic provisions

Article 56(1) reads:
"Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited."[5]

The reference to third countries was added in the process of the transferring the substantive rules of Directive 88/361 into the EC Treaty as described above. In addition, the requirement that the capital move between residents (of Member States) was deleted, so that it is sufficient that the capital move between Member States, or between a Member State and a third country. Persons who are neither nationals nor residents of an EU Member State may thus invoke the FMC guarantee in EU Member State courts.[6]

The significance of the clear wording of Art. 56, guaranteeing the free movement of capital between EU Member States and third countries in the same sentence and apparently on an equal basis with intra-EU capital movements cannot be lightly dismissed, nor can it be taken as unconditionally extending every aspect of FMC as it applies in the EU's internal market to third countries.

It is common to attempt to illuminate the scope and interpretation of provisions of the EC Treaty by examining their object and purpose. In the case of the third country dimension of FMC, this is, unfortunately, not a fruitful exercise. The objective of extending FMC beyond the EU was, apparently, to establish the euro as an international reserve

[5] Article 56(2) prohibits restrictions on payments in the same mandatory language. The implications of the prohibition of restrictions on cross border payments are not relevant to the issues discussed in this article.
[6] *Sanz de Lera*, Joined cases C-163/94, C-165/94, C-250/94 [1995] ECR I-04821 (14 December 1995); C-452/01*Ospelt*, [2003] ECR I-9743 23 September 2003. (Grand Chamber)

currency.[7] Although there is no doubt that the establishment of the single currency and the European Central Bank were part of the background motivation, this explanation is ultimately unsatisfying, or at least, incomplete.[8] Encouraging the flow of capital denominated in euros between the EU and the rest of the world so as to promote the euro's status as a stable store of value for central banks cannot be a complete explanation for the text of Art. 56.1, as this goal could have been expressed in a separate provision encouraging Member States to remove barriers to FMC with third countries in step with and for the purpose of progressing towards EMU. The addition of the third country dimension on an equal footing with and in the same sentence as intra-EU FMC seems to have more textual significance than simply expressing a general goal of promotion of the global use of the euro in international trade and investment. It is therefore difficult to reconcile the clear words of Art. 56.1 with the reality that, within the EU, the Commission and ECJ have attributed a legal substance to FMC that has developed without reference to EMU.

There are not many clues to be found in the few expressions of opinion emanating from within the ECJ as to the purpose of Article 56. In her Opinion in *Fidium Finanz,*[9] Advocate General Stix-Hackl noted that one of the objectives of the liberalization of capital movements was to facilitate the flow of international financial services. The Opinion of Advocate General Geelhoed in *Ospelt*,[10] recently reiterated by him in *Test Claimants in the FII Group Litigation*[11] is that, while in principle restrictions on both intra-EU and third country movements of capital are prohibited by Art. 56(1), the analysis of whether a restriction was justified could differ. This flows, in the Advocate General's view, from the different context of intra-EU FMC as a "constituent element of

[7] See Patrick Plansky, Cross-Border Movement of Capital: The Free Movement of Capital and Third-Country Relations (2005), Master's thesis for the academic degree of mag.rer.soc.oec., Wirtschafts Universität Wien, at pp. 62-63, Ståhl, Free movement of capital between Member States and third countries, *EC Tax Review* 2004, p. 47 at p. 52 and references there cited.
[8] The entry into force of new EC Treaty Articles 73a-h on January 1, 1994 coincided with the commencement of the second stage of Economic and Monetary Union (EMU), the third stage of which was the adoption in 1999 of the euro as the common currency of 11 of the then 15 Member States
[9] Case C-452/04 Opinion of 16 March 2006 at para. 99; the ECJ's judgment was issued 3 October 2006 [2006] ECR I-0000 (Grand Chamber) but did not specifically address the underlying purpose of Art. 56.
[10] Note __ above.
[11]Opinion 6 April 2006, C-446/04, para. 121.

economic and monetary union" and "the complete unity in terms of movement of money and capital" that EMU implies. In its judgment in *Test Claimants in FII Group Litigation*[12] the Court did not specifically base the third country dimension of FMC in EMU, although it agreed with the Advocate General that the situation within the EU might not be comparable to circumstances applicable to movements of capital between the EU and third countries, so that what constitutes a restriction in a third country case may differ from what constitutes a restriction in intra-EU cases. The Court also agreed that the justifications for a restriction on third country capital movements might differ from intra-EU justifications. This may indicate that the Court intends to approach the third country dimension issues as they arise, and with specific reference to factual circumstances, rather than applying its purpose-oriented approach to interpretation of the EC Treaty when considering whether a measure is necessary for the achievement of the single market.

Another indication that the goal of establishing the euro as an international reserve currency is secondary in stature in comparison with the creation of a true single market in the EU is substantial derogation from Art. 56 permitted by Art. 57.1. As will be discussed below, Art. 57.1 generally allows Member States to retain their existing restrictions on direct investment, and particularly on investment amounting to the establishment of subsidiaries and branches, between the EU and third countries even though this is where one would anticipate the most extensive increase in international investment denominated in euros.

In summary, it seems reasonable to view the language of Art. 56 as extending FMC to third countries as fully as possible on the same basis as within the EU, but always subject to the limitations, in particular, of Article 57, as well as general principles of Community law, and any specific factual or legal conditions in a particular case.

C. Articles 57 and 58: Limitations on Article 56.1

[12] 12 December 2006 [2006] ECR I-0000 (Grand Chamber) at para. 170-171, hereafter "*FII Test Claimants*"

As noted above, Art. 57.1[13] is a standstill or "grandfather" clause permitting Member States (and the Community itself) to continue to apply to third countries restrictive measures in force at the end of 1993 in four broad categories: direct investment (including in real estate), establishment, provision of financial services and admission of securities to capital markets. The ECJ has held that new measures that do not change the substance of a pre-1994 measure, or that reduce or eliminate obstacles to FMC are also permitted to remain in force by virtue of Art. 57.1.[14] For Member States which acceded after December 31, 1993 the grandfathered laws are those which were in existence at the date of accession.[15]

There has not yet been an ECJ case considering whether a post-1993 Community measure is contrary to the Treaty guarantee of FMC with third countries, undoubtedly because the Community legislature has not adopted any measures dealing directly with FMC and third countries.[16]

Although this issue has not be addressed by the Court, it seems unlikely that a Community measure adopted post-1993 that has the effect of liberalizing capital movements within the EU can be said to be restrictive of third country FMC simply because it does not also liberalize capital movements with third countries to the same extent. The 2003 amendments to the Parent-Subsidiary Directive (described and discussed below) which require Member States to remove tax restrictions on cross-border

[13] The text of Art. 57.1 provides: "The provisions of Article 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 in real estate – establishment, the provision of financial services or the admission of securities to capital markets."

[14] C-302/97, *Konle* [1999] ECR I-3099 at para. 52; *FII Test Claimants* at paras. 190-192.

[15] Pending case C-157/05, *Holböck v. Finanzamt Salzburg-Land* raises this issue in a third country context (Switzerland). Pending case C-492/04 *Lasertec*, also a third country case, raises the technical issue of whether "existing law" means law that has been enacted by December 31, 1993, or law that is applicable by that date.

[16] One might, at the fringes, speculate that the European Community's accession to the GATS, which allows WTO members to maintain restrictions on market access in financial services (and thus restrictions on movements of capital in connection with financial services) could amount to a Community measure on free movement of capital, and indeed, a "step back".

dividends within the EU, would be seen as a restriction on capital movements between the EU and third countries if the opposite view were accepted.

Article 57.2 sets out the Council's power to legislate by qualified majority in the same broad categories of capital movements with respect to third countries, and requires unanimity where the measure "constitutes a step back" in liberalization of capital movements.[17] It is unlikely that any significant Council legislation affecting Member States' direct tax treatment of FMC will be adopted now that the EU has 27 Member States, as unanimity is required in this area.[18] EU positive harmonization of Member States' direct tax systems is currently proceeding through soft law channels, notably through proposals for home state taxation of small and medium sized enterprises operating in more than one Member State,[19] and a common consolidated corporate tax base for other enterprises.[20] A general strategy for "coordination" (as opposed to harmonization) of national direct tax systems was announced at the end of 2006.[21]

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[17] Art. 57.2 provides: "Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other Chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from third countries involving direct investment – including investment in real estate – establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph which constitute a step back in Community law as regards the liberalization of the movement of capital to or from third countries." There have been no measures adopted on the basis of this provision.

[18] EC Treaty Art. 94 and 95(2). Although the amendments to the "Merger Directive" adopted in February 2005 were proposed before the 2004 enlargement, they were adopted unanimously by all 25 Member States, and so can be seen as evidence that positive harmonization may still be possible, even in an EU of 27 or more Member States. The Merger Directive is Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States [1990] O.J.L. 225/1, amended by Council Directive 2005/19/EC of 17 February 2005, [2005] O.J. L 58/19 of 4 March 2005.

[19] COM (2005) 702 final, Brussels, 23.12.2005, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, "Tackling the corporation tax obstacles of small and medium-sized enterprises in the Internal Market – outline of a possible Home State Taxation pilot scheme".

[20] COM (2006) 157 final, Brussels, 5.4.2006, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, "Implementing the Community Lisbon Programme: Progress to date and next steps toward a Common Consolidated Corporate Tax Base (CCCTB)".

[21] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, "Coordinating Member States' direct tax systems in the Internal Market", COM (2006)823 final, Brussels 19.12.2006. Two additional Communications, on specific priority areas for tax system coordination, were released the same date.

Art. 58 applies to both intra-EU and third country capital movements. Art. 58.1 provides a list of justifications for restrictions[22] that, most significantly for the issues discussed in this article, expressly allows Member States to retain their tax laws which distinguish on the basis of residence or where capital is invested. It might have been anticipated that the international taxation norm[23] that forbids discrimination based on nationality, and generally allows discrimination based on residence, would be adopted in the EU legal analysis of permissible restrictions on cross-border capital movements. However, the ECJ has ruled that Art. 58 must, as an exception to a fundamental freedom, be strictly interpreted.[24] While acknowledging that in relation to direct taxation, residents and non-residents are not generally in comparable situations, the ECJ has required Member States, in order to justify a restrictive tax measure, to demonstrate that, in a given case and in relation to the effects of a particular tax measure, the situation of a non-resident is not objectively comparable to that of a resident.[25] The so-called "*Schumacker* principle" was applied in respect of distinctions based on where capital is invested in *Verkooijen*[26] and more clearly restated in subsequent cases. The ECJ has also allowed Member States to put forward "overriding reasons in the general interest", that is, other bases not expressly set out in the EC Treaty, to justify a direct tax restriction on FMC, but has not often accepted such justifications, and has added no new bases of justification in the context of

[22] Art.58.1 provides: "The provisions of Article 56 shall be without prejudice to the right of Member States: a. to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested; b. to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.
3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

[23] The OECD Model Convention on Income and Capital, Article 24 Non-Discrimination provides in paragraph 1: "Nationals of a Contracting State shall not be subject in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State *in the same circumstances, in particular with respect to residence*, are or may be subjected." This wording has been taken to permit Contracting States to discriminate on the basis of residence.

[24] *Eglise de Scientologie* Case C-54/99 [2000] ECR I-1335 14 March 2000 at para. 17, as to the justifications on grounds of public policy or security in 58.1b. This was confirmed to apply also in relation to 58.1a in Case C-315/02, *Lenz*, [2004] ECR I-7063, 15 July 2004 at para. 26.

[25] C-279/93 *Schumacker* [1995] ECR I-225, 14 February 1995.]

[26] Case C-35/98 [2000] ECR I-4071, 6 June 2000, at para. 43.

FMC. Thus Art. 58 has not in practice extended the justifications available to Member States in cases where direct taxation and FMC interface.

II. THE SCOPE AND APPLICATION OF ARTICLE 56

A. The definition of "movements of capital"

Although Directive 88/361 is no longer technically in force, it is settled law that the "nomenclature" in Annex I of the Directive, listing the transactions and activities which are to be regarded as movements of capital, is still the most important and authoritative reference.[27] The ECJ also frequently reiterates that the list in Annex I is non-exhaustive, signaling that it is willing to consider other transactions and activities as constituting movements of capital.

The intra-EU FMC cases not related to direct taxation can be placed (with a few exceptions) into two dominant categories: (a) challenges to laws requiring prior official authorization for certain transactions or activities such as the export of currency,[28] the purchase of land by non-residents or non-nationals[29] or investment in the host country generally;[30] and (b) "golden share" cases.[31] Outside of these two categories, there are cases in which national measures providing preferential treatment for interest or guarantee fees in respect of loans from lenders established in the particular Member State were successfully challenged.[32] A requirement that charges on land be denominated in

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[27] Case C-22/97 *Trummer and Mayer* [1999] ECR I-1661 paras. 20-21.
[28] *Bordessa*, note ___, *Sanz de Lera* note _____.
[29] These cases include *Ospelt* (note ___ above); *Konle* (note ___ above); *Reisch* Joined cases C-515/99, C-519-524/99 and C-526-40/49 March 5, 2002 [2002] ECR I-2157; *Albore* Case C-423/98 13 July 2000 [2000] ECR I-5965; *Burtscher* Case C-213/04 12 January 2005 [2005] ECR I-10309; *Salzmann* Case C-300/01 15 May 2003 [2003] ECR I-4899.
[30] *Eglise de Scientologie*, note ___ above.
[31] The golden share usually confers on the Member State government special powers of management or control over formerly State-owned or allegedly strategic companies or sectors, but this category also refers to cases where legislative measures restrict investment above a certain level in a company or sector.
[32] C-484/93 *Svensson and Gustavsson* [1995] FCR I-3955 14 November 1998 and EFTA Case E-1/00, *State Debt Management Agency v. Íslandsbankí-FBA*, 14 July 2000. The EFTA Court plays essentially the same role as the ECJ in enforcement of the fundamental freedoms throughout the European Economic Area. See the discussion below regarding the *Fokus Bank* case decided by the EFTA Court.

the national currency or gold to be registered (and thus enforceable) was also held to be a restriction of FMC.[33]

The interaction of FMC with Member States' direct taxation systems has already yielded more cases than all the non-tax cases combined. There are cases on interest taxation, capital gains, wealth and inheritance taxes and charitable donations and there are many more pending. The earliest cases were primarily concerned with differential taxation by a Member State of domestic and foreign dividends received by individuals. More recently, taxation by a source state of outbound dividends has been the subject of legal challenge.

B. The Parent-Subsidiary Directive

Dividends received by corporations have not been the subject of litigation to the same extent as those received by individuals, due to the adoption in 1990 of the Parent-Subsidiary Directive[34] harmonizing (to a degree) the taxation of dividends paid from a subsidiary company in one Member State to a parent company another Member State. In the original version in force from 1992 to 2004, a "parent" company had to hold at least 25% of the capital of a "subsidiary". The minimum level of ownership is reduced to 20% on January 1, 2005, to 15% as of January 1 2007, and will be further reduced to 10% as of January 1, 2009, by amendments adopted in 2003.

The Directive requires EU Member States to eliminate withholding taxes on outbound dividends paid to a parent company, so that economic double taxation of company profits of the subsidiary by the subsidiary's home state, and juridical double taxation of the dividends by the two states, are abolished. The Directive requires the parent company's state of residence to either refrain from taxing dividends received from subsidiaries (exemption method), or provide a tax credit which reduces the parent company's

[33] *Trummer and Mayer*, note ____.
[34] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, [1990] O.J. L. 225/6 (Parent-Subsidiary Directive), amended by Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, [2003] O.J. L. 007/41.

corporate tax liability by the subsidiary's corporate tax paid in its home state in respect of such dividends. From 2005, the Directive also requires Member States to provide a credit to the parent company for any lower tier subsidiary's corporate tax paid in another Member State. Economic double taxation of the subsidiary's corporate profits by the parent's home state is thus also eliminated.

Although in the form of an EC legislative act, the Directive operates multilaterally to prevent double taxation in the same manner as, though more fully than, the international tax system based on the network of bilateral double taxation conventions (or "tax treaties") concluded between Member States (and between many Member States and third countries). Each Member State, including those which joined the EU after adoption of the Directive, must bring its laws into conformity with its provisions, and taxpayers may directly enforce the Directive in the national courts of the Member States in any case where a Member State has failed to properly transpose the Directive's provisions into national law.

The Parent-Subsidiary Directive did not completely eliminate the possibility of intercorporate dividend taxation being found contrary to FMC. A recent ECJ ruling[35] may have revealed gaps in the Directive which are incompatible with FMC, and the Court has also recently commented on Member States' obligations to conform with Community law even where the Directive is not applicable.[36]

C. Inbound Dividends

The *Verkooijen* case[37] can be seen as the beginning of the recent flood of cases on direct taxation and FMC, as it was the first direct tax ruling specifically and solely on this freedom, rather than as an alternative or secondary ground to services, workers or, most commonly, establishment. *Verkooijen* resolved a number of significant issues, but

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[35] *Denkavit Internationaal*, C-170/05, 14 December 2006.
[36] *FII Test Claimants*, note ____.
[37]C-35/98 cited at note ___. There were earlier direct tax cases in which FMC was raised as a basis of incompatibility, including *Bachmann* and *Svensson and Gustavsson*, *Safir* and *Baars*, but the judgments in these cases emphasize or are based on compatibility with other fundamental freedoms.

unfortunately the judgment is somewhat confusingly written. The facts predated the coming into force of the Treaty of Maastricht amendments to FMC, and the case therefore fell to be decided under old Art. 67 and Directive 88/361.

Mr. Verkooijen was a resident of the Netherlands, and received dividends on shares he held in Petrofina NV, the Belgian parent company of his employer, Fina Nederland BV. He was denied a tax exemption for the dividends he received on these shares in 1991. Dividends up to 1000 NLG per individual and 2000 NLG per married couple were exempt if received from a Netherlands company.

The first ruling of note (at paras. 27-30) was that the cross-border payment and receipt of dividends was governed by Directive 88/361. Although not expressly mentioned in the nomenclature of capital movements in Annex I of the Directive, the receipt of dividends "presupposes participation in new or existing undertakings" which does appear in the Annex. Further, since the company paying the dividends was resident in another Member State and its shares were quoted on the stock exchange, the receipt of the dividends could be linked to the "acquisition … of foreign securities dealt in on a stock exchange", and was thus "indissociable from a capital movement".

Looking at the legislative history of the Netherlands tax exemption for dividends received by individuals from Netherlands companies, the ECJ noted that the exemption was designed to promote investment in domestic companies (as well as to reduce the economic double taxation of company profits in the hands of the distributing company and again when received by an individual as a dividend). It had the dual restrictive effect of dissuading Netherlands residents from investing capital in companies resident in other Member States, and making it more difficult for companies resident in other Member States to raise capital in the Netherlands.

The principle position of the Netherlands government in defending its tax law was that the difference in treatment of Netherlands taxpayers' investments in shares of Netherlands companies and investments in foreign companies, was not a prohibited restriction (or discriminatory) because the situations were not comparable, applying the test in S*chumacker*.[38] The Court seemed to accept that the *Schumacker* principle can be applied when the distinction pertains to where capital is invested, but analyzed the justifications by reference to the case law on what constitutes "an overriding reason in the general interest", without making a clear finding as to whether the situations were in fact comparable.

The Court rejected the position (advanced by the UK government) that the measure could be justified by its objective of promoting the national economy, since "according to settled case-law" purely economic objectives cannot constitute justifications for restrictions of fundamental freedoms.[39] The Netherlands, supported by several other Member States, argued that the partial exemption for domestic dividends mitigated the double taxation resulting from the "classical" system[40] of dividend taxation in the Netherlands. Since only Netherlands companies were taxed on their profits in the Netherlands, only dividends paid by Netherlands companies suffer economic double taxation in the Netherlands. If the Netherlands exempted dividends from non-resident companies as well, it would be granting a complete exemption to the share of such companies' profits received by Netherlands residents, while Netherlands companies had already been taxed by the Netherlands on their profits.

The Court did not directly address the argument based on prevention of domestic economic double taxation. It rejected all the justifications put forward, referring expressly to a number of its previous rulings in the context of direct taxation and restrictions on services, establishment and workers that concerned the underlying policy motivations for not extending the partial exemption to inbound dividends. Loss of tax revenue (or erosion of the tax base) has never been accepted as a justification for a

[38] See discussion above, notes ___. [25,26, p.8]
[39] Para. 48.
[40] In a classical system company profits are fully taxed, and dividends received by individual shareholders are also fully included in income and taxed at the recipient's normal marginal rate. Most OECD countries use a form of credit or exemption system for dividends to mitigate or eliminate such economic double taxation.

measure that restricts a fundamental freedom[41] (and was accordingly rejected in *Verkooijen*). Similarly, a Member State may not impose heavier taxation on foreign source income on the grounds that such income benefits from tax advantages in the Member State of source which compensate for the heavier tax in the state of residence.[42] The "cohesion of the tax system" justification[43] was rejected since there was no direct link between the taxation of company profits in other Member States, and the tax relief granted (or denied) to an individual Netherlands resident receiving dividends from such companies. A direct link exists only where the tax measures involve a balancing of a tax advantage available to a taxpayer with a tax charge applicable to the same taxpayer.

Verkooijen made clear that domestic taxation of dividends received by individuals is in principle covered by FMC. It also confirmed that Art. 58 does not generally allow measures which discriminate or restrict FMC on the basis of residence or the place where one's capital is invested. *Verkooijen* has been followed in a number of cases challenging dividend taxation measures applicable to individual shareholders in Austria, Finland, Germany,[44] and the UK.

In *Lenz*,[45] national tax laws according to which Austria taxed incoming dividends received by an individual Austrian resident at the taxpayer's normal marginal tax rate up to a maximum of 50% were challenged. A fixed flat rate of 25% was applied to domestic dividends, and the taxpayer would then not include the dividends in computing her aggregate taxable income. The recipient could choose to include the dividends in

[41] Para. 59 Case C-264/96 *ICI v. Colmer* [1998] ECR I-4695 16 July 1998.
[42] Case C- 294/97 *Eurowings Luftverkehrs* [1999] ECR I-7467
[43] This justification was accepted in the early case of *Bachmann v. Belgium*, C-204/90 [1992] ECR I-249 (28 January 1992). A measure which allowed a tax deduction for contributions to a pension provider established in Belgium but not to pension providers not established in Belgium was necessary to preserve cohesion of the Belgian tax system, because the measure concerned one and the same taxpayer, and the tax relief for the pension contribution was directly linked to the taxation of the pension benefits receivable in the future. This justification is almost invariably raised, and almost as invariably rejected.
[44] Case C-292/04 *Meilicke*, March 6, 2007 (Grand Chamber). The German tax credit for domestic dividends held to be incompatible with Art. 56 in this case was similar to that in *Manninen*, discussed below.
[45] C-315/02, *Lenz*, [2004] ECR I-7063, 15 July 2004. In Case C-242/03 *Weidert-Paulus* (decided the same day as *Lenz*) [2004] ECR I –7379 the issue was similar to the inbound dividend cases. Luxembourg taxpayers were allowed a deduction for the acquisition price of Luxembourg company shares but not for shares of companies of other Member States. Not surprisingly, this also was incompatible with Art. 56.

income, but the dividends would then be subject to tax at one half the average rate applied to the taxpayer's aggregate income.

The Court had no difficulty in finding the Austrian dividend tax measures constituted a restriction on FMC. Restating its ruling in *Verkooijen* unequivocally, it held that Art. 58.1 was to be strictly construed. A difference in treatment had to be based on situations which were distinguishable on objective and relevant grounds, or which could be justified by overriding reasons in the general interest and were necessary and proportionate to the objective of the legislation (see para. 27).

The Court found that there was no objective difference between Austrian taxpayers receiving dividends from companies in other Member States and those who received dividends from Austrian companies. The profits of both Austrian and foreign companies were subject to corporation tax. The preservation of coherence of the Austrian tax system did not justify the different treatment, as there was no direct link between a tax advantage made available and a tax charge imposed with respect to one and the same taxpayer. An economic link between the corporate tax paid by an Austrian company and the tax advantage provided to Austrian shareholders of Austrian companies in respect of dividends (i.e. double economic taxation of company profits by Austria) did not meet the strict criteria necessary to invoke cohesion of the tax system as a justification. In any event, the Austrian tax advantage allowed to the individual was not dependent upon the Austrian company having actually paid corporate tax on the profits distributed as a dividend.

Manninen[46] concerned a third type of tax advantage available to Finnish taxpayers in respect of domestic, but not inbound dividends. A domestic dividend entitled the shareholder to a tax credit of 29/71 of the amount of the dividend, which fully offset the tax of 29% paid by the Finnish company on its profits. No such credit was available on dividends received by a Finnish taxpayer in respect of the underlying corporate tax paid by a foreign company although a tax credit offset the withholding tax levied by the

[46] C-319/02 *Manninen* [2004] ECR I-7477, 7 September 2004 (Grand Chamber).

company's home country (in Manninen's case, Sweden) on the dividend. Thus juridical double taxation of Mr. Manninen's dividend by Sweden and Finland was prevented, but not economic double taxation of the Swedish company's profits (by Sweden) and the shareholder's dividends (by Finland). In an even more conclusive judgment, the ECJ found that the Finnish tax measures were an unjustified restriction on FMC.

FII Test Claimants is the first inbound dividends case to apply FMC to third countries; it is also the most complicated and the longest direct tax judgment ever given by the ECJ.[47] The case concerned the advance corporation tax ("ACT") and franked investment income ("FII") dividend tax system utilized in the UK from 1973 (1994 in the case of the foreign investment dividend or "FID" system) to 1999. Although this system was particularly complex and idiosyncratic and is no longer in force, the judgment issued December 12, 2006 contains some very important rulings of principle in respect of FMC, inbound dividends, and third countries.

The *FII Test Claimants* case is essentially a class action (or "group litigation") suit in the UK national courts, with the ECJ having provided a response to a reference for a ruling on a preliminary question on a number of test cases selected from the larger group of claimants. It is the only inbound dividends case concerning dividends received by corporations so far, largely because ACT was excluded from the provisions the Parent-Subsidiary Directive, since it is not a withholding tax on dividends, but a method of imposing corporate profits tax.

Without going into all the details of the ACT system, UK resident companies had to pay ACT when they distributed profits as dividends, but could set off the ACT against their corporate profits tax for the year of the distribution, or carry it forward or back to years when it had sufficient "mainstream" corporate tax liability to absorb the ACT. A UK resident company receiving dividends from another UK company was exempt from tax on such dividends. In addition, the recipient company was entitled to a tax credit of its

[47] Pasquale Pistone, "Expected and Unexpected Developments of European Integration in the field of Direct Taxation," 2007 *Intertax*, Vol. 35 Issue 2, pp. 1-5 (editorial).

share of the ACT paid by the distributing company on the dividends,[48] and when the recipient company subsequently paid a dividend, it could set off the ACT tax credit against ACT payable by it on the subsequent distribution. An individual UK resident shareholder receiving a dividend from a UK company was similarly entitled to a refundable tax credit against personal income tax in the amount of the fraction of ACT liability of the distributing company attributable to the dividend received.

UK companies receiving dividends from non-resident companies were not exempt from corporation tax on such dividends, and the dividends did not carry with them an ACT credit (since no ACT was paid in respect of such dividends) or qualify as FII. A tax credit was provided to offset withholding tax imposed by the distributing company's home state, either under UK domestic law or a relevant tax treaty. If the UK recipient controlled or held 10% or more of the voting rights in the foreign distributing company, tax credit relief extended to the underlying foreign corporation tax on the profits out of which the dividends were paid.

The test claimants, all UK resident members of the BAT (British American Tobacco) group of companies, challenged the different treatment of domestic and inbound dividends as incompatible with both freedom of establishment and FMC on various grounds. At least one of the test claimants received dividends from a subsidiary resident in a third country. The Court ruled that, since all the test cases involved situations where the foreign distributing company was controlled by the UK resident recipient company, these cases were governed by freedom of establishment. However, since the facts of all the cases in the class action were not disclosed to the ECJ in connection with the test reference, the Court ruled that in any case where the UK company did not control the foreign company, the case fell under Art. 56 (at para. 38). The Court essentially held that the principles of establishment and FMC could be applied on the same basis, depending on the degree of ownership of shares in the foreign company.

[48] The dividend and tax credit together constituted franked investment income or "FII".

The Court did not consider that the combination of an exemption system for domestic dividends and the use of an imputation or tax credit system with respect to foreign source dividends was necessarily contrary to Community law, and pointed out that the Parent-Subsidiary Directive left to Member States the choice between an exemption and a credit system for providing tax relief for inbound dividends, as does the OECD Model Treaty in Articles 23A and 23B. However, the Member States must comply with Community law on free movement when designing their systems for preventing economic double taxation (para. 42-49). This means, following *Lenz* and *Manninen*, that inbound dividends may not entail less favourable tax consequences than domestic dividends, and that in exercising their discretion under the Parent-Subsidiary Directive, Member States must comply with the requirements of freedom of establishment and free movement of capital. Accordingly, the tax credit provided to the UK company must be at least equal to the tax paid in the source State, up to the limit of the recipient's UK tax liability in respect of the dividends.

In the case of dividends received by a UK company from a foreign company of which the UK company held at least 10% of the voting rights, the UK government claimed that it would be only in extremely rare circumstances that the foreign source dividends would bear a higher tax burden than domestic dividends, as the tax credit system compensated for both foreign withholding tax and foreign underlying corporate tax. The ECJ referred the actual determination of whether the tax imposed on inbound and domestic dividends were equivalent back to the national court.

In cases where the UK company held less than 10% of the voting rights, the tax credit compensated only for the withholding tax imposed by the source country, and not for the underlying corporate tax paid by the foreign company in its home state. This eliminates juridical double taxation of the dividends, but not economic double taxation of the corporate profits, so that foreign dividends were taxed more heavily overall than domestic dividends. The Court found that this difference in treatment discouraged UK companies from investing in companies in other Member States and the latter companies from raising capital in the UK, and thus constituted a restriction on FMC.

The UK government sought to justify the difference in treatment by citing the practical difficulties in determining the underlying corporate tax paid by a corporation in which the UK company holds less than 10% for purposes of calculating a compensating tax credit. It noted that the 10% threshold was more generous than the level prescribed by the OECD Model Convention and the Parent-Subsidiary Directive, at least in its original version (and equal to the final level in the Directive of 10%, effective as of 2009). The court responded that where a Member State exempted domestic dividends received by UK resident companies so as to ensure that profits were taxed only once, and where the Parent-Subsidiary Directive did not apply, a Member State could not subject foreign dividends to taxation without providing relief for double economic taxation of the underlying profits. A Member State had discretion in how to ensure it met these requirements, and could not set up practical difficulties to justify a system that infringed a fundamental freedom.

The next issue was whether the cash flow disadvantage imposed on UK companies, which, having received dividends from foreign companies (on which no ACT had been paid), then paid dividends to their own resident shareholders, compared to UK companies who received only domestic dividends and thus could set off ACT paid by the first distributing (UK) company on such dividends in calculating their own ACT liability, when they subsequently made a distribution. UK companies making subsequent distributions after having received dividends from foreign companies had to pay the full amount of ACT in respect of such subsequent distribution at the time of the distribution, and claim a refund of the excess ACT at the time of filing their corporation tax return. (This is because ACT is really just an advance payment of corporate tax.) The Court had earlier held in the *Metallgesellschaft et al.* case[49] that this cash flow disadvantage amounts to a restriction on establishment. It amounts to a restriction on FMC in cases where the shareholding does not amount to control.

[49] Joined Cases C-397/98 and 410/98 [2001] ECR I-1727.

The subsequent issues concerned the compatibility with Art. 56 of the FID regime introduced as of July 1 1994. The FID regime was intended to mitigate the problem faced by UK companies receiving large dividends from foreign companies, that it became difficult to utilize excess ACT against mainstream corporate tax when dividends were in turn paid to their own shareholders. The FID regime allowed a UK company to elect to treat a dividend paid to its own shareholders as a “foreign income dividend”. ACT was payable on FIDs, but if the FID could be matched to foreign profits (received from foreign subsidiaries) a refund of the surplus ACT would be paid at the time mainstream corporate tax of the UK distributing company became payable.

Again, the cash flow disadvantage to the UK company paying a FID of having to wait between 8 ½ and 17 ½ months for a refund of ACT on the dividend (i.e. from the time the dividend was paid and ACT was due, to the time the corporation tax return was filed) in comparison with UK companies not having to pay ACT at all when paying dividends which were not composed of previously received inbound dividends, amounted to less favourable treatment. Further, an individual shareholder of the UK company paying the FID would not receive a refundable tax credit in respect of the FID as would a UK shareholder receiving an ordinary dividend, and would instead receive different, but less advantageous, tax relief. Both of these disadvantages were held to be restrictions on freedom of establishment, or FMC, depending on whether the UK company controlled the foreign distributing company. The fact that the FID treatment was optional did not change the conclusion that it was incompatible with the Treaty (para. 161).

The Court next considered the legality of the FID regime where the inbound dividends came from third countries. It held that compatibility with Art. 56 was to be assessed on the same basis as within the EU: if the difference in treatment of domestic and inbound dividends has the effect of discouraging UK companies from investing in companies in third countries, and the latter from raising capital in the UK, it will amount to a restriction of FMC. To justify the measure it must be shown that the situation of UK companies receiving domestic dividends is not objectively comparable to UK companies receiving dividends from third countries, or that the measure is necessary and proportional to an overriding general interest.

The UK government claimed that it could be more difficult to determine the tax paid by third country companies than it was with respect to companies resident in the EU. The Court agreed that due to the degree of legal integration within the Community, and especially the Directive on Mutual Assistance in Tax Matters,[50] the circumstances concerning taxation of cross-border capital flows within the EU might not be comparable to the situation with respect to a non-EU country. At least in the abstract, the Court agreed with the Advocate General that there may be other justifications for restrictions of FMC in the third country context which are not acceptable within the EU. However, the only justification put forward by the UK government was the greater difficulty of determining how much tax was paid by the foreign company in its home state, and this only to justify the time lag between the time when ACT had to be accounted for in respect of foreign dividends, and when it was refunded. The Court applied a proportionality type of approach to find that legislation which refuses completely to take into account foreign corporate tax paid abroad in determining the amount of ACT due at the time a dividend is paid, while automatically deducting ACT, which is the UK equivalent tax on underlying profits of a UK resident company, cannot be justified. The final tax liability on the UK company paying domestic dividends to another UK company is not determined at the time the recipient receives the ACT credit which is automatically deducted when it in turn pays a dividend, so the argument that it is too difficult to provide any relief in respect of the underlying foreign tax on the profits out of which inbound dividends are paid is not tenable (paras. 156 and 172).

The final issue of relevance here was the effect of Art. 57. The basic ACT system had been in place since 1973, but the FID rules dated from after December 31, 1993. In this context, the Court stated that the term “direct investment” in Art. 57 had to be interpreted

[50] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15

in accordance with Directive 88/361[51] and that the concept of direct investments concerns “investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity” (para.181). As regards the holding of shares, direct investment means that the shareholder must have the ability to participate effectively in the management of that company or in its control. It must be noted that this is less than “definite influence over the company’s decisions” allowing the shareholder “ to determine the company’s activities” and operations, which is the test for when a shareholding amounts to the exercise of the right of establishment. Article 57 grandfathers restrictive measures only inasmuch as they apply to direct investments (including investment which amounts to establishment) between EU Member States and third countries (para. 185-187) Thus it seems that to the extent the tax restrictions on FMC apply to dividends related to holdings of shares below the direct investment level (i.e. “portfolio” shareholdings), Art. 57 is inapplicable so these measures are incompatible with Art. 56 (unless justified).

The ECJ held that the fact that the FID system was optional did not necessarily prevent it being a new restriction. The actual determination of whether Art. 57 applied was referred back to the national court for resolution in accordance with the principle that post-1993 measures that do not impose new restrictions or which reduce or eliminate obstacles to FMC fall within Art. 57 and may be retained.[52] It appears that the FID system in fact reduced the inequality of treatment of inbound dividends in relation to domestic dividends, so that it is possible that Art. 57 will apply, at least in respect of dividends received on shares in third country companies which amount to direct investment [196].

Following *FII Test Claimants*, it is now clearly established that if a taxpayer can show that the effect of the national tax law is to tax foreign dividends more heavily than

[51] Flynn locates the origin of the phrase in connection with free movement of capital further back in time to Annex II of the First Directive for the implementation of Art. 67, JOCE 1960 P43/921 Series II Chapter 1959-1962, p. 49 English special addition. See Flynn, note ___ above, at footnote 5 on p. 776.
[52] Following Case C- 302/97 *Konle*, note ___ at para 52.

domestic dividends, even if it results in only a cash flow disadvantage and not a heavier tax burden at the end of the day, Art. 56 will be infringed.

There is one exceptional recent case on inbound dividends which must not be ignored. In *Kerckhaert and Morres v. Belgium*[53], the Court held that Belgium's schedular system, subjecting both domestic and foreign dividends received by individuals to a tax of 25% without taking into account corporate profits or withholding tax imposed in the Member State of residence of the distributing company, did not infringe Art. 56. The taxpayers were Belgian residents who had received dividends from a French company. They were entitled to the French 50% imputation tax credit (or *avoir fiscal*) so that the total French and Belgian tax on the French dividends was less than was payable on Belgian dividends. The French tax credit more than offset the effect of the French withholding tax of 15% which was applied to the combined dividend and the tax credit. Thus Belgium did not tax French dividends more heavily than Belgian dividends, as both were subject to the same 25% Belgian tax, and although Belgium did not provide a tax credit for French withholding tax, the French *avoir fiscal* completely offset the effect of French withholding tax, so that no actual tax disadvantage was suffered by the taxpayers. In this sense *Kerckhaert-Morres* is clearly distinguishable from the trilogy of leading cases, *Verkooijen, Lenz* and *Manninen* where there was heavier taxation by the taxpayer's home country of foreign source dividends.

The Court could have limited its response to the reference question to a ruling that, in the circumstances, there was no actual discrimination or restriction. However, it chose to consider the argument that the Belgian system was discriminatory in that it taxed dividends received from another Member State the same as Belgian dividends, when dividends received from France were subject to French withholding tax as well as Belgian income tax. In order to avoid the discriminatory treatment claimed the taxpayers, Belgium ought to provide a tax credit to compensate for the French withholding tax.

[53] C-513/04 14 November 2006 [2006] ECR I-0000, (Grand Chamber).

This argument would be quite appealing if the Member State in which the company paying the dividends was resident provided no tax credit to non-residents, and simply applied a 15% withholding tax on dividends paid to non-residents. This is the normal treatment of cross-border dividends under tax treaties based on the OECD Model, and is normally combined with the grant of a tax credit (or an exemption) by the recipient's state of residence to mitigate or eliminate the juridical double taxation of the taxpayer on the dividend by both States. The unusual feature in the Belgian system was that no tax credit was provided by Belgium for the French withholding tax, possibly because of the availability of the French tax credit. The Belgium-France tax treaty provided for Belgium to provide such a tax credit, but Belgium had amended its tax law to remove the tax credit entitlement.

The Court ruled that Belgium's refusal to grant a tax credit was not discriminatory, and more significantly, not within the purview of Community law. It resulted from the discretion exercised by Belgium in the parallel operation of two separate national tax systems, not from discrimination against inbound dividends *within* the Belgian tax system. The Court stated that Community law did not require Member States to eliminate juridical double taxation, an area of competence left to the Member States under Art. 293.[54] The Commission does not accept this aspect of the judgment in *Kerckhaert-Morres*, and has already commenced a new challenge to Belgium's dividend taxation system, now that France has eliminated its *avoir fiscal*.[55]

Many Member States have now revised their laws on taxation of inbound dividends received by individuals to bring them into conformity with the EC Treaty. Several Member States amended their tax laws either in anticipation of the *Verkooijen* ruling or soon thereafter.[56] The Commission issued a Communication[57] in late 2003 addressing

[54] Art. 293 provides so far as relevant: Member States shall so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: (…) – the abolition of double taxation within the Community.
[55] Commission Press Release IP/07/67, 22 January 2007.
[56] These include Germany, France, UK (1999), Netherlands. See Richard J.Vann, General Report, 88A Cahiers de droit fiscal international (2003) and Ilhi, Malmer, Schonewille and Tuominen EU Report in IFA *Cahiers de Droit Fiscal International* 2003; and the discussion of "The Demise of Imputation" in Michael J. Graetz and Alvin C. Warren Jr., (2006) 115 Yale Law Journal 1186 at pp. 1208-1212.

the issue of dividend taxation of individuals, the first example of Commission guidance to Member States on the significance of decisions of the ECJ in tax matters.

Notwithstanding the Communication, there are still some national inbound dividend tax measures that are currently the subject of litigation. In addition to the new infringement action against Belgium mentioned above, the Commission has commenced an infringement process against Greece[58] and a reference for a preliminary ruling is pending regarding differences in Dutch tax relief granted in respect of dividends received by certain collective investment funds from Dutch and foreign companies.[59] The latter case and another pending case, *Holböck v. Finanzamt Salzburg-Land,* [60] discussed below, involve dividends received from third countries.

D. Outbound dividends

The compatibility with Art. 56 of various national tax rules with respect to outbound dividends, whether received by individuals or corporations, is much less clear than is the case with inbound dividends. Where the inbound dividends cases are concerned with different treatment based on where capital is invested, different treatment of outbound dividends is a question of different treatment based on residence of the recipient.

As outlined earlier, the Parent-Subsidiary Directive has eliminated withholding taxes where the recipient company holds at least 15% of the capital of the distributing company, so that the issue does not now arise in respect of dividends flowing within corporate groups. The Commission took the position in its 2003 Communication that a Member State could not exempt domestic dividends yet continue to levy a withholding

[57] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, “Dividend taxation of individuals in the Internal Market”, COM(2003) 810 final, Brussels, 19.12.2003.
[58] IP/06/1410 17 October 2006 Direct Taxation: Commission requests Greece to end discriminatory treatment of dividends received from foreign companies. Greece provides a tax exemption for dividends received by individuals from Greek companies, but not from foreign companies.
[59] Pending case C-194/06 *Orange European Smallcap Fund NV* OJ C 178 29.07.2006 p. 15.
[60] Pending Case C-157/05, note ___.

tax on outbound dividends.[61] In its view, a comparison of the total tax burden on domestic dividends with the effect of the withholding tax on outbound dividends is necessary to determine whether the system is compatible with FMC.

The first case on outbound dividends and FMC came from the EFTA Court in late 2004.[62] Fokus Bank, resident in Norway, withheld tax of 15% on dividends paid to two of its shareholders, companies resident in Germany and the UK. Since the Parent-Subsidiary Directive applies within the EEA, these companies' shareholding in the capital of Fokus Bank would have been below the 25% level at which the Directive prohibited withholding tax at the time. A Norwegian resident shareholder was not subject to the 15% withholding tax, and received a full imputation tax credit effectively exempting the dividend from Norwegian tax by treating a portion of the underlying corporate tax paid by Fokus Bank on its profits as having been paid by the Norwegian shareholder (similar to the tax credit in *Manninen*).

Fokus Bank challenged the Norwegian withholding tax as incompatible with Art. 40 of the EEA Agreement,[63] which is the functional equivalent of Art. 56 except that it does not extend to countries not party to the EEA Agreement. The Norwegian court referred the interpretation of Art. 40 to the EFTA court.

Following the ECJ's ruling in *Ospelt*,[64] the EFTA Court held that the rules governing free movement of capital in the EEA Agreement are essentially identical in substance to those in the EC Treaty and therefore should be interpreted and applied in the same way as Art. 56 as between EEA countries. The EFTA Court accordingly treated the distribution and receipt of dividends as movements of capital, following *Verkooijen*. The different

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[61] Section 3.3.1, p. 17, note ___.
[62] Case E-1/04 *Fokus Bank ASA v. Norwegian State*, 23 November 2004 available online at http://www.eftacourt.lu/default.asp?layout=article&id=251 .
[63] Art. 40 EEA provides, so far as relevant here: "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 the nationality or on the place of residence of the parties or on the place where such capital is invested." The EEA comprises the EU Member States plus Norway, Iceland and Liechtenstein.
[64] Note ___.

treatment by Norway of domestic and outbound dividends could deter non-residents from investing in Norwegian companies, and make it more difficult for such companies to raise capital outside Norway, and so in principle were incompatible with EEA Art. 40.

As to justification, the same approach as under the EC Treaty was applied: Although tax laws may validly distinguish between taxpayers who are not in a comparable situation with regard to their residence, a difference in treatment is only compatible with Art. 40 if the situations of resident and non-resident are not objectively comparable, or is justified by reasons of overriding public interest. The difference in treatment must be proportional to the objective.

The EFTA Court found that the fact that Norwegian residents are subject to Norwegian tax on all their income, while non-residents are subject to Norwegian tax only on income from Norwegian sources did not prevent their situations being objectively comparable in respect of the taxation of dividends (residents of other countries are also taxed on their worldwide income). The Court rejected the argument that outbound dividends are different from inbound, and relied on *Lenz* and *Manninen*. Since Norwegian taxpayers were protected from economic double taxation by Norwegian law, residents of other EEA countries had to be equally protected, so that denying them the imputation tax credit infringed Art. 40.

Norway sought to justify the different treatment as necessary to preserve the cohesion of the *international* tax system. It argued that if the source country is required to provide the same tax credit for non-residents as it does for resident shareholders, the effect is to eliminate the ability of the source state to tax the profits of resident companies distributed to non-residents. This is inconsistent with the allocation of taxing jurisdiction accepted in international tax law, in accordance with which the source country may tax such distributions, and it is for the shareholder's home country to offset the double taxation by means of a tax credit or exemption. The EFTA court held, however, that this would give precedence to the terms of bilateral tax treaties (which allocate taxing jurisdiction in this way) over the EEA agreement's guarantee of FMC.

Norway also argued that the Court should take into account the tax credits available to non-resident shareholders in their home country either by reason of a bilateral tax treaty or under the home country's domestic law in determining whether outbound dividends were in fact subject to a greater tax burden than Norwegian domestic dividends. In response, the Court held that the availability of a Norwegian imputation credit for both resident and non-resident shareholders on the same basis as required by Art. 40 could not be made dependent on whether a tax advantage was provided in the non-resident's home state. Norway could not rely on the tax rules prevailing in other EEA countries to make good its discrimination against non-Norwegian shareholders.

It should be noted that the tax credits (potentially) available to the non-resident dividend recipients under the Norway-Germany and Norway-UK tax treaties would not compensate for the underlying Norwegian corporation tax paid by Fokus Bank on its profits (for which the Norwegian imputation credit available to Norwegian residents did compensate). There was no finding by the court, and it was unclear in the report for the hearing, whether either Germany or the UK provided a tax credit for underlying Norwegian corporate tax paid by Fokus Bank.

Fokus Bank was a significant new application of FMC. Norway amended its tax legislation in anticipation of the decision to conform with the EEA Agreement. The correctness of some aspects of the ruling is, however, in doubt as three rulings of the ECJ in 2006 on outbound dividends have taken a different view as to the applicability of the inbound dividends cases, and the relevance of bilateral tax treaty provisions to the issue of whether a measure actually results in less favourable treatment of outbound dividends.

The next case on FMC and outbound dividends, *Bouanich*,[65] concerned the Swedish tax provisions applicable on the repurchase by a Swedish company of its shares, and so is perhaps not strictly speaking an outbound dividends case. A Swedish resident was subject to tax of 30% of the capital gain realized on the repurchase of the shares.

[65] C-265/04 [2006] ECR I-923 19 January 2006.

However, the gross proceeds of the repurchased shares were treated as a dividend when paid to a non-resident, on which in principle the non-resident was liable to Swedish withholding tax of 30%. Ms. Bouanich, as a resident of France, was entitled to the benefit of the Sweden-France tax treaty, which reduced the rate of tax payable on the dividend to 15%, and allowed the deduction of the nominal value (which is often if not usually much lower than the acquisition cost) of the shares in calculating the amount of the dividend.[66]

The Court found that the Swedish tax law constituted a restriction on FMC and could not be justified, and indeed the Swedish government conceded the incompatibility between the Swedish law and Community law and stated its intention to amend the Swedish rule. The ability of Swedish residents to deduct the acquisition cost of the shares in computing the capital gain, while non-residents were taxed on the gross repurchase price, was clearly different treatment. The Court found that the acquisition cost of the shares was so directly linked to the payment of the share repurchase price that residents and non-residents were in an objectively comparable situation in this regard, so that there was no basis on which to justify the different treatment.

The second question was whether the Sweden-France tax treaty fixing the maximum Swedish tax rate on the dividend received by French residents at 15%, should be taken into account in determining whether there was a restriction on FMC. Contrary to the position taken by the Commission, the Court held that the Swedish law derived from the tax treaty and the tax treaty thus formed part of the legal framework to the case, and had to be taken into account in determining the correct interpretation of Community law. However, it was for the Swedish court to apply Swedish law, including the tax treaty, to the particular case and assess whether a non-resident shareholder in a given case was subject to less favourable treatment than resident shareholders.

[66] Ms. Bouanich took the position that only France had the right to tax the transaction, as a capital gain: para. 45. The ECJ did not deal with this argument.

The significance of *Bouanich* is the Court's willingness to assess the existence of a restriction based on the actual effects of a relevant tax treaty. This is a clear divergence from *Fokus Bank*, though in the latter case the issue was whether the source state, Norway, could invoke the tax treaty's effect in the state of residence, while in *Bouanich* it was whether the source state could invoke the tax treaty's effect on the tax levied by the source state.

The ECJ (Grand Chamber) issued its ruling in *Test Claimants in Class IV of the ACT Group Litigation* ("*ACT IV*"),[67] on December 12, 2006, the same day it released its ruling in *FII Test Claimants*. *ACT IV* also concerned the compatibility of certain aspects of the UK's former ACT system with freedom of establishment and capital were considered, but in *ACT IV* it was the alleged differential treatment of outbound dividends that was at issue.

Neither resident nor non-resident corporations receiving dividends from UK resident companies were subject to UK tax (whether corporate income tax or withholding tax) on the dividends. As outlined earlier, resident companies had to pay ACT when they distributed profits as dividends, whether to UK shareholders or to foreign shareholders, but could set the ACT paid in respect of the distribution against their corporate profits tax liability for the year, or carry it forward or back to years when it had sufficient corporate tax liability to absorb the ACT.

The claimants alleged that the failure by the UK to grant a tax credit to non-resident companies for the ACT paid by the UK resident distributing company was incompatible with FMC, since resident companies were entitled to a tax credit. However, the Court accepted that resident and non-resident companies receiving dividends from resident companies were not necessarily in comparable positions, as the non-resident company is not liable to UK corporate tax, or to ACT when it distributes its profits to its shareholders. The source state (UK) is not in a position to mitigate double economic taxation of profits in the form of dividends received by the non-resident shareholder, as

[67] Case C-374/04, [2006] ECR I-0000.

granting the same ACT credit would mean giving up its right to tax corporate profits generated on its territory in accordance with international tax norms. The state of residence of the dividend recipient has the obligation to ensure that double economic taxation is mitigated (assuming it does the same for domestic dividends).

ACT IV takes a very different approach from *Fokus Bank*.[68] At para. 59 the Court clearly states that the Member State of source is not required to provide a mitigating tax credit to non-resident dividend recipients to offset the underlying corporate tax paid by the distributing corporation just because it provides such a credit to resident dividend recipients. This, the Court says, would oblige the Member State of source "to abandon its right to tax a profit generated through economic activity on its territory", precisely the position unsuccessfully taken by Norway in *Fokus Bank* . It also recalls the mirror-image position, also unsuccessful, taken by the Netherlands government in *Verkooijen*, that it was entitled to tax corporate profits generated in other Member States when received in the form of dividends by Netherlands residents. The result is clearly different depending on whether it is the state of source or the state of residence which invokes its jurisdiction to tax the corporate profits.

The distinction between *Fokus Bank* and *ACT IV* which may allow the two cases to stand together (but for the ruling on the relevance of the tax treaty's provisions) is that in *ACT IV* there was no withholding tax imposed by the UK on the dividends paid to non-residents so that there was no economic double taxation of non-resident shareholders by the UK. (In cases where the relevant tax treaty allowed withholding tax, there was an offsetting entitlement to an ACT credit.) In *Fokus Bank*, Norway claimed a 15% withholding tax from the recipient shareholder (effectively imposing economic double taxation on Fokus Bank's profits in its hands and in the hands of its non-resident

[68] The Advocate General (Geelhoed) in *ACT IV* expressly stated that the EFTA had erred in *Fokus Bank* in footnote 83 of the Opinion, 23 February 2006 based on his reasoning at paras. 69-71. He forcefully stated that the source state is only responsible to equalize taxation of domestic and outbound dividends to the extent it applies its tax jurisdiction to the dividend in the hands of the recipient – i.e. only in respect of the 15% withholding tax in *Fokus Bank*. It may achieve equality of taxation through the effects of a tax treaty, but it is no defence for the source state to say that the residence state failed to live up to its tax treaty obligations. The Court generally followed the AG's recommendations in its responses to the reference questions, but did not refer to *Fokus Bank* or expressly adopt the AG's reasoning.

shareholders), but did not allow an offsetting credit as it did for resident shareholders. It may be that had Norway not imposed the withholding tax (so that the situation would parallel the UK situation in *ACT IV*), or the EFTA Court had allowed the tax credits available in the home States to be taken into account, there would have been no unequal treatment by Norway of resident and non-resident shareholders.

The last case to be discussed here, *Denkavit Internationaal*,[69] was based on freedom of establishment. However, because the facts in *Denkavit* pre-date the Parent-Subsidiary Directive, and so concern the legality of the taxation of dividends by Member States in the absence of EU harmonization measures, it may turn out to be more significant in the context of FMC.[70]

Denkavit Internationaal BV, a Dutch parent company, held, directly or indirectly all the shares of its two French subsidiaries. The French Code Général des Impôts imposed a 25% withholding tax on dividends paid by French companies to non-resident shareholders. The withholding tax rate was reduced to 5% under the France-Netherlands tax treaty where the recipient Netherlands company held at least 25% of the capital of the French company. No withholding tax was imposed on dividends paid to French residents, or permanent establishments (PEs) in France of foreign companies, so such residents and PEs of foreign companies were effectively exempt on dividends received from French companies.

Despite a provision of the France-Netherlands tax treaty under which the Netherlands was to provide a tax credit for the French withholding tax against the recipient's Netherlands tax liability, the Netherlands instead provided an exemption for the dividends. In the result, the French dividends paid to the Netherlands parent company bore more French tax, and more tax overall, due entirely to the uncredited withholding tax, than dividends paid to French residents or permanent establishments in France of foreign corporations.

[69] C-170/05 14 December 2006 (First Chamber).
[70] Jerome Delauriere, "Does *Denkavit* signal the end of withholding tax?", 45 Tax Notes Int'l 303 (January 29, 2007)]

The Court found that French resident parent companies were treated differently from non-resident parent companies in that residents were almost entirely exempt of tax on dividends while non-resident parent companies were subject to the 5% withholding tax. There was no relevant objective difference in the situations that would make the different treatment non-discriminatory, since it was based solely on the location of the parent's registered office. Relying on *ACT IV*, the Court said that once a Member State imposes a tax on both resident and non-resident shareholders in respect of dividends received from a resident company, the situation of the non-resident shareholders becomes comparable to the situation of resident shareholders. The exemption for resident parent companies was designed to eliminate economic double taxation; since France had chosen to relieve its resident companies' profits of a series of tax charges (i.e. economic double taxation), it must extend that relief to non-residents to the extent to which such double taxation results from exercise of its tax jurisdiction.

The effect of the France-Netherlands tax treaty providing for a compensating tax credit was then addressed. Since the tax treaty formed part of the applicable law, the Court took its provisions into account, following *Bouanich* and *ACT IV*. However, since the credit was only available to the extent of the Netherlands tax paid on the dividends, and the dividends were exempt under Dutch domestic law, the credit did not in fact reduce the total tax payable by the Netherlands parent company to the same level as the (usually nil) tax payable by a French parent company.

France argued that it was for the Netherlands, as the State of residence of the parent company, to ensure that there was no (economic) double taxation. The Court referred back to its first direct taxation decision[71] for support for the proposition that France as the source State could not rely on a bilateral convention to avoid its obligations under the EC Treaty. This is remarkably similar to the statement in *Fokus Bank*, and seems to suggest that the tax treaty is not to be taken into account in assessing the impact of the French

[71] Case 270/83 *Commission v. France* para 26. This case stands for the proposition that a Member State whose domestic legislation is incompatible with a fundamental freedom cannot rely on a tax treaty to justify it. The tax treaty may not override the supremacy of EU law.

dividend tax regime. However, it is clear from the judgment that it is the actual effect of Dutch law, including the tax treaty, on the tax burden borne by the outbound dividends that is relevant. If the tax treaty does not in fact mitigate the double taxation by the source country, then the source country still bears the obligation of ensuring that there is no disadvantageous treatment of outbound dividends by comparison with domestic dividends.

The *Denkavit* situation appears to have arisen anew with respect to Netherlands dividend withholding tax rules, which have been referred to the ECJ in *Amurta S.G.P.S.*[72] The issue is whether the exemption from dividend withholding tax available only to shareholders liable to corporate tax in the Netherlands or to permanent establishments of foreign corporations to which the shareholding is effectively connected is a restriction on FMC, since foreign corporations are not entitled to the exemption. The Commission has recently referred Belgium, Spain, Italy, the Netherlands, Portugal and Latvia[73] to the ECJ alleging that their outbound dividend tax laws infringe both FMC and freedom of establishment, relying on the *Denkavit* judgment.

The outbound dividends cases, few and recent as they are, together result in a coherent, if incomplete, jurisprudence similar to the inbound dividends cases. One looks first to the source country's tax system, and whether it treats domestic and outbound dividends the same. If yes, there is no restriction: *ACT IV*. If there is a difference in treatment, one considers the relevant tax treaty to the extent it limits the source country's jurisdiction to tax the outbound dividend: *Bouanich*. The issue of whether the tax treaty in fact equalizes the source State tax burden on domestic and outbound dividends will normally be referred back to the national court for determination.

If an applicable tax treaty requires the home State of the recipient of the dividends to compensate for withholding tax imposed by the source State, (the element of economic double taxation of corporate profits/dividends by the source State), and the home State in

[72] Pending case C-379/05.
[73] Commission Press Release IP/07/66 22 January 2007. The infringement action against Luxembourg was not referred to the ECJ as the country changed its law in response to the Commission's reasoned opinion.

fact does so, it is likely, based on *Denkavit* that the Court would find that the withholding tax imposed by the source State is not a restriction.

Denkavit follows *Fokus Bank* (and is consistent with *ACT IV*) to the extent it holds that a source State tax system that imposes economic double taxation on “outbound” corporate profits in the form of a dividend withholding tax, but mitigates it in respect of domestic corporate profits distributed to domestic shareholders, is incompatible with Art. 56. In both cases the system fully prevented economic double taxation in respect of corporate profits within the domestic sphere by providing a credit to the dividend recipient to offset the corporate tax. Accordingly, corporate profits were taxed once only by the source State, but outbound dividends were taxed twice by the source State.

III. The Third Country Dimension of FMC

The significance of the interpretation and application to be given to the third country dimension of FMC is obvious in respect of both inbound and outbound dividends. Although many EU Member States have revised their tax regimes for taxing inbound dividends since 1993 to remove any discrimination regardless of where the distributing company is resident, there are undoubtedly some situations where the amendments have been made only in respect of EEA source dividends. EU resident investors in Canadian companies whose ownership of shares does not amount to control may be able to assert claims based on the principles in *Manninen* and *FII Test Claimants* that dividends received from a Canadian company must receive the same advantageous treatment as domestic dividends. If the EU Member State provides a an exemption, special rate or imputation credit to the dividend recipient in respect of domestic and EU/EEA dividends profits, it would have to provide the same relief in respect of Canadian source dividends.

The same is true in the case of outbound dividends. By way of example, a Canadian company holding less than a controlling stake in a company resident in an EU Member State will be subject to withholding tax of 5% to 15% imposed by the source State on the dividends under most of Canada's tax treaties with EU Member States.[74] Canada will exempt the dividends from Canadian taxation if it is derived from active business activity by the distributing company in the source country, so that there will be no Canadian tax against which to credit the withholding tax. If the source country exempts domestic dividends, the conditions for *Denkavit* to apply are present, and the Canadian company can presumably recover the withholding tax by action in the national court of the source State.

There are three main issues in respect of the application of Articles 56-58 to third country movements of capital. The first is the problem of overlapping freedoms. If two or more fundamental freedoms are restricted by an EU Member State's tax measure, one of which is FMC, in what circumstances will the Court base its ruling on FMC and not the other freedom? The second issue is the scope and application of Art. 57, the grandfather or standstill provision. The third is the issue of justifications for restrictions, whether as expressly recognized in Article 58 or under the doctrine of overriding reasons in the general interest, and more particularly, whether the justifications available in respect of third country capital movements are more extensive than in intra-EU situations.

A. Overlap with other fundamental freedoms

One issue that has not been definitively resolved arises where a given national law is capable of infringing more than one fundamental freedom. There are many situations in which a measure impacts both capital and services, or capital and establishment, and even, such as the case of taxation of pension contributions and benefits, all four: workers, establishment, services and capital.[75] Since the legal principles governing the fundamental freedoms have by and large converged, both as to what constitutes a restriction and what justifications are accepted, the practical outcome for the taxpayer (or

[74] Canada does not have a tax treaty with Greece, so that the withholding rate is 25% on dividends paid by Canadian companies to Greek recipients.
[75] In the recent case on Denmark's pension taxation rules, the Commission put forward free movement of workers, services, capital and the right of establishment and the Art. 18 right of EU citizens to move and reside freely throughout the EU: *Commission v. Denmark* C-150/04 30 January 2007 (Grand Chamber). The Court ruled that it was not necessary to consider FMC since the Danish tax measures were incompatible with all the other Treaty freedoms which were put forward.

the Member State or Commission) is not usually a function of which freedom was relied on, at least in intra-EU cases.

Since FMC is the only fundamental freedom that extends beyond the EU to third countries, it is critical that the alleged restriction fall under Art. 56 in order for the taxpayer to have a basis on which to challenge a tax measure's compatibility with the EC Treaty. Although there are many judgments and opinions on the criteria for determining which fundamental freedom is to be applied, there is a degree of uncertainty still prevailing on this issue generally. In respect of FMC and dividends, the actual test claimants in *FII Test Claimants* reference were UK parent companies which held directly or indirectly 100% of the capital of subsidiaries in other EU Member States, EEA countries and third countries. The Court at paragraph 37[76] stated that freedom of establishment would apply wherever the recipient company exercised definite influence over the decisions and activities of the distributing company. Since the wider group of claimants could include UK companies which did not control the foreign distributing company, the Court considered that Art. 56 would apply in those situations (paragraph 38). The implication of these statements is that FMC will only apply where the relationship does not amount to actual control of one company by the other (or by an individual),[77] so that FMC will not be available in third country situations where there is control, because these fall under freedom of establishment, which does not apply outside the EU/EEA.

The pending *Holböck*[78] case is a challenge to Austria's inbound dividend rules by an Austrian resident who held two-thirds of the capital of a Swiss company. It will directly raise the issue of whether Art. 56 can be relied on in a third country situation when freedom of establishment would apply to an intra-EU situation. The argument would be that the list of capital movements in Directive 88/361 include direct investments amounting to establishment (and the grandfathering of measures pertaining to such direct

[76] The court cited Baars, Cadbury Schweppes and X and Y.[review bases of these decisions]
[77] In Case C-251/98 [2000] ECR I-2787, *Baars*, the Netherlands resident individual taxpayer held all of the shares of an Irish company, and this was considered to be a matter for freedom of establishment, and it was "not necessary" to apply free movement of capital.
[78] See note [15].

investments in Art. 57 reinforces the point.) It would, therefore, be an unwarranted restriction of the application of Art. 56 to third countries to exclude capital movements that are not protected by freedom of establishment. Further, it might be argued that it undermines the purpose of supporting Art. 56 of supporting the single currency and liberating capital flows globally to the furthest extent possible.

This issue was recently addressed in the context of the overlap of services and capital in *Fidium Finanz.*[79] This case was not a tax case; it concerned German legislation that required financial services providers to obtain official authorization to offer financial services to German residents unless they were established in an EU or EEA Member State. *Fidium* was a Swiss enterprise offering short term consumer loans via internet to German residents. It was not required by Switzerland to obtain any authorization to operate because it did not offer financial services in Switzerland. It challenged the German law on the basis that it was a restriction on FMC with a third country.

The Court found that while the German measure concerned both services and capital, the substance of the restriction was the freedom to provide services without being established in Germany, a Treaty freedom which does not extend to third countries. The measure was primarily and directly a restriction on access to the financial services market, and the obstacle to FMC was merely an inevitable and indirect consequence of the restriction on services. Thus it was "not necessary" to consider the application of Art. 56. The Court cited its decision in *Cadbury-Schweppes*,[80] a direct tax case where the allegedly restrictive tax measures only applied as between UK resident companies and controlled subsidiaries, that is, in respect of establishment though both establishment and capital were relied on.

The *Fidium Finanz* ruling would seem to exclude the application of Art. 56 even where no other Treaty freedom applies, and not only where two or more could apply (since only FMC applies in third country cases), but one is more directly applicable. The logic of

[79] C-452/04 3 October 2006 [2006] ECR I-0000. (Grand Chamber)
[80] Case C-196/04 12 September 2006, [2006] ECR I-0000.

denying recourse to Art. 56 by third country claimants on the basis that the circumstances are more directly concerned with a freedom to which they have no access is somewhat questionable. In her Opinion in the case, the Advocate General carefully examined the regulatory situation in Switzerland and the ability of the German authorities to ensure appropriate supervision of lenders' activities involving German borrowers and to obtain necessary information from Swiss authorities regarding Fidium Finanz. She concluded that in all the circumstances the requirement of official authorization was justified and proportional. This approach seems more reasonable and logical, particularly where the issue, as in the direct tax cases, is not purely a restriction on access to markets in the EU, but differential tax treatment of capital flows.

Investment amounting to establishment is expressly included in the list of capital movements in Directive 88/361, and to simply hold that it is "not necessary" to consider FMC in a third country case where the capital movement takes the form of direct investment amounting to establishment would be a very sharp curtailing of the third country dimension. Furthermore, the specific permission provided to Member States in Art. 57.1 to maintain in force measures which restrict direct investment which amounts to establishment in respect of third countries would be meaningless if Art. 56 was never to apply where the investment in connection with which the movement of capital occurred amounted to establishment. One could argue that it is only where the restrictive measure has to do directly and primarily with the exercise of the right of establishment, and a movement of capital is only indirectly and unavoidably connected with that exercise, that recourse to Art. 56 should be excluded in third country cases. This would be consistent with the services-capital ruling in *Fidium Finanz.* Such an approach would arguably not preclude application of Art. 56 in dividend taxation cases, even where the recipient company controlled the distributing company, if it can be asserted that the taxation of dividends is not a question of market access, but discriminatory treatment of capital movements, and the level of share ownership or control is not directly at issue. This would mean that the freedom that is most directly and primarily affected is capital, not establishment.

The Court has now taken a similar stance to its ruling in *Fidium Finance* in a direct tax case, though not with respect to dividends. In its judgment in *Test Claimants in the Thin Cap Group Litigation*[81] the Court excluded examination of compatibility of a measure with Art. 56 where the scope of the impugned tax measure is restricted to groups of companies, in third country cases as well as where the taxpayer also relies on freedom of establishment. This case concerned the UK tax treatment of interest paid by a UK company to its parent company or a lender within the related company group, whether in an EU Member State or a third country, and clearly excluded the application of Art. 56 where the parent company was resident in a third country, on the basis that freedom of establishment was primarily and directly concerned. The likelihood that the Court will treat dividends differently seems small, unless the Court can be persuaded that dividends pertain most directly to capital movements, regardless of the level of ownership of shares in the distributing company.

B. Article 57

As noted above, the actual determination in a reference for a preliminary ruling of whether a post-1993 national measure is grandfathered by Art. 57.1 is usually referred back to the national court for determination in accordance with the responses given by the ECJ to the referred questions. The UK High Court's conclusions on whether the FID provisions of 1994 are grandfathered by Art. 57.1 will be very illuminating.

If it now seems that the Court will conclude that dividends paid by controlled subsidiary to parent company are not governed by Art. 56 but by the right of establishment, it is clear that dividends paid and received in respect of portfolio investments in shares cannot be grandfathered by Art. 57.1. Between direct investment amounting to establishment and portfolio investment likes the middle ground of direct investment.

[81] Case C-524/04, March 13, 2007 (Grand Chamber).

The Court drew a line between portfolio and direct investment in *Commission v. The Netherlands*.[82] Direct investment was defined as the "form of participation in an undertaking through the holding of shares which confers the possibility of effectively participating in its management and control", while portfolio investment refers to "the acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking." The side of this line on which any particular investment falls will undoubtedly be the subject of future references.

As Member States have adjusted their dividend taxation measures in the wake, or in anticipation of challenges, a useful exercise will be to analyze which ones have changed their rules to eliminate incompatibility with Art. 56 in third country cases as well as in respect of other EU and EEA Member States. There are undoubtedly some Member States that have not removed tax restrictions on dividends. Although taxation rules pertaining to dividends flowing only from portfolio investments are clearly both governed by Art. 56 and not subject to grandfathering under Art. 57, the level of EU-third country portfolio investment, the dividends flowing from such investments, and the amount of tax revenue which could be subject to challenge are obviously significant. The impact of Art. 56 will therefore undoubtedly be of some consequence in the international tax and investment world. At the very least, the EU cases on dividend taxation must raise the possibility of new norms being adopted internationally, whether within the OECD or in bilateral relations with major trade and investment partners of individual EU countries. It would certainly be in the interests of EU Member States to seek to achieve reciprocity bilaterally or globally than to find themselves constrained to offer more favourable tax treatment to investors and investment in third countries unilaterally.

C. Justifications

[82] Joined cases C-282/04 and C-283/04, 28 September 2006, [2006] ECR I-0000, at para.19. See also the definition accepted in *FII Test Claimants* at para. 181, quoted at page ___ above.

FII Test Claimants indicates that the Court accepts that the same fundamental principles apply in third country situations as in intra-EU situations when determining whether a measure amounts to a restriction on FMC (paras. 164-168), although the issue of whether situations are objectively comparable when third country capital movements are concerned may involved different considerations. In particular, the existence of harmonizing measures such as the Parent-Subsidiary Directive may lead to the conclusion that two situations of taxpayers or investments within the EU are objectively comparable, while two situations, one within the EU and one in a third country, are not comparable. In the usual reasoning sequence of the analysis, this would mean that no restriction will be found to exist.

It is equally clear from paragraph 171 of *FII Test Claimants* that the Court is open to new justifications being put forward by Member States when the restriction affects third country capital movements. The justifications that have been accepted in intra-EU cases will undoubtedly be available to Member States defending tax measures from third country challenges. These include measures that ensure the effectiveness of fiscal supervision,[83] that are designed to maintain a Member State's fiscal coherence,[84] reflect the principle of territoriality including the preservation of a balanced allocation of taxing power between Member States[85] (and presumably between a Member State and a third country), or are necessary to prevent tax evasion or avoidance.[86] The measure must also meet the standard of proportionality – that it be appropriate to achieve its purpose, and restrict no more than necessary the exercise of a fundamental freedom.

The justifications of ensuring the effectiveness of fiscal supervision and prevention of tax evasion and avoidance will likely be relied on most often in third country cases. The ECJ often rejects the former justification by referring to the extensive provisions for exchange of direct tax information between Member States in the Mutual Assistance Directive.[87] It

[83] This was accepted in Case 120/78, *Cassis de Dijon* [1979] ECR 649 as one of the original "mandatory requirements" at para. 8.
[84] *Bachmann*, note ___.
[85]Case C-446/03 *Marks & Spencer*, [2005] ECR I-I0837 13 December 2005.
[86] *Lankhorst-Hohorst* [2002] ECR I-11779.
[87] Note _____ above.

seems to take the position that the existence of this directive is sufficient to overcome all compliance information difficulties among Member States. For third States, there is no equivalent multilateral instrument, although there are other mechanisms for sharing of tax information, including the Convention on Mutual Administrative Assistance in Tax Matters, sponsored by the Council of Europe and the OECD. Belgium, Denmark, Finland, the Netherlands, Poland and Sweden have signed this Convention, as well as a number of non-EU Member States including Canada. Some tax treaties between EU Member States and third countries also contain broad provisions for exchange of tax information, and even mutual assistance in tax collection. However, the Mutual Assistance Directive is much more far-reaching and as a "domestic" EU measure, may carry more weight because it has direct effect and the Court is the ultimate interpreter of it. It can therefore be anticipated that the existence of the Mutual Assistance Directive may be cited by the Court as a distinction between intra-EU and third state circumstances which can support a Member State's more stringent requirements for disclosure and proof of facts and even differential tax treatment, when this would not constitute a justification for a similar restriction on capital movements between EU Member States.

Membership in the OECD, and its Code of Liberalisation of Capital Movements[88] may also prove relevant in determining whether a restriction is justified in respect of a particular third country. Clearly, the potential for tax evasion and the impossibility of obtaining disclosure of financial information from a particular third country will affect the ECJ's view of the proportionality of a given measure.

It is possible that the Court will take inspiration from other jurisprudence developed by it which allows different interpretations in different contexts. For example, the well-established case law of the ECJ on the lack of direct effect of WTO Agreements within the EU is an example of the Court citing lack of reciprocity as a basis for giving different legal effect to different types of provision within the EU legal order.[89]

[88] OECD Directorate for Financial and Enterprise Affairs, (Paris: OECD, 2006).
[89] ECJ 23 November 1999, C-149/96, *Portugal v. Council* [1999] ECR I-8395, and among others, ECJ 1 March 2005, C-377/02 *Léon van Parys NV v. Belgian Intervention and Refund Board (BIRB)*[2003] ECR I-10497 and ECJ 30 September 2003, C-93/02 P *Biret International v Council* [2003] ECR I-10497.

Quite specifically, the ECJ may allow the justification, always unsuccessful in intra-EU case, of preventing erosion of the national tax base or diminution of government revenues. In *FII Test Claimants*, this argument, made in the abstract, was dismissed by Advocate General Geelhoed, but not rejected as untenable in all circumstances. The high degree of economic integration among EU Member States, and the quasi-federal character of its common budget and structural funds re-distribution program could support a different level of protection for Member State tax bases in relation to third countries' tax equality claims.

IV. Conclusions

The third country dimension of FMC is still unknown territory, with only limited indications from the Advocates General and the ECJ of how this emerging issue will evolve in the EU legal order. While many of the non-tax types of restriction may easily apply in the case of third countries (one can imagine a golden share challenge from a third country company that would like to make a substantial investment in an EU privatized former public monopoly) the tax cases raise more subtle issues of what constitutes discrimination, or restriction, in the context of an existing set of international tax norms observed by most EU Member States and their largest trading partners within the OECD. The dividend taxation cases are the most evolved of the direct tax – FMC cases, and so perhaps are the best indication of the ECJ's likely approach as it takes on the role of the first international tax court. The next year or two will likely be decisive in this evolution from a jurisprudential perspective, but the policy adaptations will continue for some time after the case law lays down the most significant strokes of clarity.