European Union

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

Contents

1. Introduction

As Art. 56 of the EC Treaty on the free movement of capital through its wording also covers the movement of capital "between Member States and third countries", it is not surprising that taxpayers attempt to obtain relief from the discriminatory tax treatment of investments to or from third countries by invoking this provision. Accordingly, an increasing number of tax cases on this third country effect are being brought before the Member States' domestic courts, and a considerable number of cases have already been decided by the European Court of Justice (ECJ) or are now pending before the Court.[1] Many of these cases cut across the European Union's external border problems on which the ECJ has already ruled in an intra-Community context,[2] others come up for the first time, some of which cover both intra-Community and third country relationships,[3] whilst yet others relate specifically to third country situations.[4]

It is only very recently that the ECJ has started to chart the unknown waters of third country relationships in the direct tax area.[5] Three noteworthy decisions given in May 2007 have shed additional light on quite fundamental issues in this area. *Lasertec*[6] again dealt with the German thin capitalization rules (which had already been challenged in *Lankhorst-Hohorst*),[7] this time concerning their application to loans extended by a Swiss parent company to its German subsidiary. In contrast, the two other cases, *A and B* and *Holböck*, both related to outbound investments. In *A and B*,[8] the ECJ was faced with the question of whether or not circumstances in a Russian permanent establishment (PE) of a Swedish company must be taken into account in determining the dividend tax exemption on the shareholder level.[9] *Hol-*

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1. For a detailed analysis of the issues concerned, see A. Cordewener, G. Kofler and C. Ph. Schindler, "Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before the ECJ", 47 *European Taxation* 3 (2007), p. 107 et seq. and the references in the article.
2. See, with regard to the German thin capitalization rules, first, ECJ, 12 December 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* [2002] ECR I-11779, concerning the freedom of establishment between Germany and the Netherlands and, second, ECJ, Order, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, concerning the free movement of capital between Germany and Switzerland. The same is true for the former Austrian taxation of foreign dividends, on which the ECJ had already ruled for intra-Community situations in ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol* [2004] ECR I-7063, which was now at issue for dividends from Switzerland in ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported.
3. This, in particular, applies to a number of UK group litigation cases. See ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, not yet reported; ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported; ECJ, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, not yet reported; and ECJ, Pending Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*, Official Journal, 2005, C-182/27. For a "third country dimension", see ECJ, Advocate General Bot's Opinion, 3 July 2007, Case C-194/06, *Staatssecretaris van Financiën v. Orange European Smallcap Fund NV*, concerning withholding tax refunds for a Netherlands investment funds regarding dividends from other Member States and third countries. Compare also ECJ, Pending Case C-414/06, *Lidl Belgium GmbH & Co. KG (M + T) v. Finanzamt Heilbronn*, Official Journal, 2006, C-326/26 with ECJ, Pending Case C-415/06, *Stahlwerk Ergste Westig GmbH v. Finanzamt Düsseldorf-Mettmann*, Official Journal, 2006, C-326/26, both concerning the treaty "exemption" of foreign PE losses under German tax treaties, but the first covering a situation between Germany and Luxembourg and the second one between Germany and the United States.
4. ECJ, Order, 10 May 2007, Case C-102/05, *Skatteverket v. A and B*, not yet reported. See also ECJ, Pending Case C-101/05, *Skatteverket v. A*, Official Journal, 2005, C-106/19, concerning Swedish taxation of dividends paid by a company that is not established in a European Economic Area Member State or in a State with which Sweden has concluded a tax treaty that contains a provision on the exchange of information. The hearing in this case before the ECJ took place on 12 June 2007.
5. See ECJ, 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported. For first conclusions, see Cordewener, Kofler and Schindler, note 1, p. 109 et seq.
6. ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported. The request for a preliminary ruling was issued by *FG Baden-Württemberg*, 14 October 2004, 3 K 62/99, *Internationales Steuerrecht* (2005), p. 275. For further information on this case, see, for example, H. Rehm and J. Nagler, "Ist § 8a KStG a. F. weltweit nicht mehr anwendbar?", *Internationales Steuerrecht* (2005), p. 261 et seq. and A. Schnitger, "Die Kapitalverkehrsfreiheit im Verhältnis zu Drittstaaten – Vorabentscheidungsersuchen in den *Rs. van Hilten*, *Fidium Finanz AG* und *Lasertec*", *Internationales Steuerrecht* (2005), p. 502 et seq.
7. ECJ, 12 December 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* [2002] ECR I-11779 regarding the freedom of establishment between Germany and the Netherlands.
8. ECJ, Order, 10 May 2007, Case C-102/05, *Skatteverket v. A and B*, not yet reported.
9. For details on the rather peculiar Swedish legislation, see B. Wiman, "Pending Cases Filed by Austrian Courts: The *Skatteverket v. A*, *Skatteverket v. A and B*, and *Bouanich* Cases", in M. Lang, J. Schuch and C. Staringer (eds.), *ECJ – Recent Developments in Direct Taxation*, (Vienna: Linde, 2006), p. 302 et seq.

böck[10] concerned dividends from a Swiss company under Austrian dividend taxation rules, which were held to infringe the free movement of capital in intra-Community settings in *Lenz*[11] because only domestic-source dividends were taxed at a reduced rate.[12]

In all three cases, the ECJ sustained the respective Member State's legislation, but for differing reasons. In *Lasertec* and *A and B*, the ECJ found that the disputed legislation primarily concerned the freedom of establishment, whereas the restrictive effect on the free movement of capital was merely an unavoidable consequence of such restriction and that, therefore, the cases had to be decided under Art. 43 and Art. 48 of the EC Treaty only. As the scope of the latter does not, however, extend to third country situations, the taxpayers concerned were ultimately unprotected by EC law. In contrast, in *Holböck*, the ECJ appears to have agreed with the taxpayer that the Austrian legislation at issue, which covered portfolio as well as direct investments, was to be measured against both the freedom of establishment and the free movement of capital. Nevertheless, the ECJ found that the Austrian legislation, as an "old" restriction that had already existed on 31 December 1993, was in any event grandfathered by Art. 57(1) of the EC Treaty, so that the taxpayer was protected by Art. 56(1), but could not invoke that protection effectively.[13]

Whilst the ECJ obviously accepted the view that taxpayers may, in principle, directly rely on Art. 56 of the EC Treaty in third country situations when the application of this freedom is neither pre-empted by another freedom nor the resulting restriction is grandfathered by Art. 57(1),[14] the Court missed the opportunity to follow the path set in *Test Caimants in the FII Group Litigation*,[15] and, hence to explore and delimitate the meaning of Art. 56 in third country relationships by defining the standard of comparability, the acceptable justifications and the related proportionality standards.[16] Nevertheless, some preliminary conclusions may be drawn from *A and* B, *Lasertec*, and *Holböck* regarding, first, the relationship between the free movement of capital and the other fundamental freedoms (see 2.) and, second, the interpretation of the grandfather clause in Art. 57(1) of the EC Treaty (see 3.).

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

For obvious reasons, relating primarily to non-reciprocity, several suggestions have been made to delimitate the direct applicability of Art. 56 of the EC Treaty in third country settings.[17] Interestingly, the ECJ has chosen to limit the scope of Art. 56(1) of the EC Treaty by simply denying the application of the free movement of capital in situations "primarily" affecting another fundamental freedom, since, in these cases, restrictions of the free movement of capital are "an unavoidable consequence" of any restriction on the other fundamental freedom and "do not justify, in any event, an independent examination of that legislation" in the light of Art. 56.[18] This approach is a somewhat surprising one, as it was widely accepted that the free movement of capital, on the one hand, and the freedom to provide services[19] or the freedom of establishment, on the other, could be applied simultaneously to one and the same cross-border activity.[20] In fact, the ECJ's approach appears to be like an extremely time-delayed reaction to a distinction developed by Advocate General Alber in *Baars*, who took the view that

> where the free movement of capital is directly restricted such that only an indirect obstacle to establishment is created, only the rules on capital movements apply, ... [while] ... where the right of establishment is directly restricted such that the ensuing obstacle to establishment leads indirectly to a reduction of capital flows between Member States, only the rules on the right of establishment apply.[21]

10. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported. For a detailed analysis, see W. Haslehner, "Gelöste und offene Fragen zur Anwendbarkeit der Kapitalverkehrsfreiheit im Verhältnis zu Drittstaaten", *taxlex* (2007) (in print). The request for a preliminary ruling was issued by *Verwaltungsgerichtshof*, 28 January 2005, 2004/15/010. For details of this case, see D. Hohenwarter, "Vorlagebeschluss des VwGH zur Kapitalverkehrsfreiheit im Verhältnis zu Drittstaaten", *Steuer und Wirtschaft International* (2005), p. 225 et seq. and C. Staringer, "Pending Cases Filed by Austrian Courts: The *Holböck* Case", in Lang, Schuch and Staringer, note 9, p. 9 et seq.

11. ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol* [2004] ECR I-7063.

12. For detailed analysis and the changes made to Austrian tax law, see G. Kofler, "Austria", in C. Brokelind (ed.), *Towards a Homogeneous EC Direct Tax Law: An Assessment of the Member States' Responses to the ECJ's Case Law* (Amsterdam: IBFD, 2007), p. 84 et seq.

13. Two procedural points should be noted. First, it is astonishing that neither the Austrian local tax authority nor the Federal Ministry of Finance took part in the proceedings before the ECJ. Second, Mr Holböck obviously was in an unfortunate (timing) position, as the Federal Ministry of Finance had extended the effects of *Lenz* to third country situations insofar as the respective cases could be reopened under Austrian procedural law. For this, see D. Aigner and G. Kofler, "Austria Clarifies Third-Country Impact of ECJ's *Lenz* Decision", 36 *Tax Notes International* (1 November 2004), p. 477 et seq.

14. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Paras. 24 and 30 et seq. See also ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Paras. 169 et seq. and 174 et seq.

15. ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 170 and 171.

16. For a recent discussion of the approaches in legal writing, see Cordewener, Kofler and Schindler, note 1, p. 114 et seq.

17. Id., p. 110 et seq.

18. This line of reasoning had already carefully been prepared (although in a mere "EU situation") by ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-7995, Para. 33. For further references, see note 30. For the reverse situation, in which the freedom of capital was primarily concerned in a non-tax case, see, for example, ECJ, 28 September 2006, Joined Cases C-282/04 and C-283/04, *Commission of the European Communities v. Kingdom of the Netherlands* [2006] ECR I-9141 ("golden shares"). See also T. O'Shea, "Third Country Denied Freedom of Establishment Rights in *Lasertec*", 46 *Tax Notes International* (4 June 2007), p. 992.

19. Art. 49 EC Treaty.

20. See W. Schön, "Der Kapitalverkehr mit Drittstaaten und das internationale Steuerrecht", in R. Gocke, D. Gosch and M. Lang (eds.), *Körperschaftsteuer – Internationales Steuerrecht – Doppelbesteuerung. Festschrift für F. Wassermeyer* (Munich: C.H. Beck, 2005), p. 499 et seq. The same view was obviously taken by the German Federal Tax Court when deciding a case concerning the participation of a German resident in a South African company. See *Bundesfinanzhof*, 9 August 2006, I R 95/05, *Betriebs-Berater* (2006), p. 2565 et seq. The German Federal Ministry of Finance has ordered the German tax authorities not to apply this ruling to other cases. See *Bundesfinanzministerium*, 21 March 2007, IV B7 – G 1421/0, *Internationales Steuerrecht* (2007), p. 340 and the comments by H. Rehm and J. Nagler, *Internationales Steuerrecht* (2007), p. 320 et seq.

21. ECJ, Advocate General Alber's Opinion, 14 October 1999, Case C-251/98, *C. Baars v. Inspecteur der Belastingen/Ondernemingen Gorinchem* [2000] ECR-2787, Para. 26.

Yet, whilst *Baars* concerned a cross-border situation between two Member States, so that, ultimately, at least one fundamental freedom applied (and it could even be argued whether or not, given the structural convergence of all freedoms,[22] the discussion there was somewhat academic), in the present context, this approach matters. Specifically, it could be said that it results in the consequence that the scope of another, "primarily affected" fundamental freedom that does not cover third country scenarios, for example the freedom of establishment,[23] cannot be "extended" beyond the Community's border by invoking the free movement of capital. Only in situations in which the restriction of the free movement of capital is not an "unavoidable consequence" of the restriction of another fundamental freedom, the taxpayer can rely on Art. 56(1) of the EC Treaty.[24]

This approach, however, requires the determination of the freedom that is "primarily" affected and it is submitted that this may not be easy.[25] If two freedoms are potentially at issue, the ECJ, in principle, intends to examine the disputed measure in relation to only one of those two freedoms if it appears, "in the circumstances of the case, that one of them is entirely secondary in relation to the other".[26] It is immediately clear that such an assessment based on "the circumstances of the case" must not rely on the specific *factual* situation of the taxpayer,[27] as this would deprive Art. 57(1) of the EC Treaty of any meaning. This provision grandfathers restrictions of the free movement of capital in third country settings with regard to certain investments, which, almost automatically, coincide with activities that would be protected by either the freedom of establishment or the freedom to provide services in intra-EU settings.[28] If, however, the primarily affected fundamental freedom were to be determined according to the specific situation of a taxpayer, for example by reference to the size of his shareholding, Art. 57(1) of the EC Treaty could never apply to direct investments.[29] This approach must, therefore, be rejected.

It could be against this background that the ECJ considers the "the purpose of the legislation concerned".[30] Accordingly, if the national legislation at issue applies only to situations that are (also) covered by, for example, the substantive scope of the freedom of establishment or the freedom to provide services, the taxpayer cannot rely on the free movement of capital. If, in contrast, the national legislation also applies to situations not (primarily) covered by any other freedom, Art. 56(1) of the EC Treaty may be invoked,[31] irrespective of the specific *factual* situation of the taxpayer.[32] This delimitation is especially important in cases concerning cross-border equity investments. In such cases, according to settled case law, Art. 43 and Art. 48 of the EC Treaty are at issue if a shareholding enables the holder to have a definite influence on a company's decisions and to determine its activities,[33] whilst other shareholdings, especially portfolio holdings, are protected by Art. 56.[34] The application of Art. 56 of the EC Treaty in a third country situation, therefore, depends on whether or not the legislation at issue is "intended to apply only to those shareholdings which enable the holder to have a definite influence on a company's decisions and to determine its activities".[35] If

22. Compare A. Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht* (Cologne: Otto Schmidt, 2002), pp. 103 et seq., 200 et seq. and 249 et seq. with further references.

23. See, in respect of inbound investments, ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 27 and, in respect of outbound investments, ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Paras. 26-29.

24. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 24.

25. In fact, it may even be impossible, as can be derived from the explanations given by ECJ, Advocate General Alber's Opinion, 14 October 1999, Case C-251/98, *C. Baars v. Inspecteur der Belastingen/Ondernemingen Gorinchem* [2000] ECR-2787, Paras. 27 and 30 concerning his own distinction, i.e. "The above principles fail to categorise cases in which a national measure both directly hampers capital flows and directly affects the right of establishment … There is therefore a third rule governing the relationship between the two freedoms: Where there is a direct intervention affecting both the free movement of capital and those of the right of establishment, both fundamental freedoms apply, and the national rule must satisfy the requirements of both". For third country relations, this can only mean that Art. 56(1) of the EC Treaty applies, as Art. 43 lacks the necessary erga omnes effect.

26. See, with further references, ECJ, 3 October 2006, Case C-452/04, *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht* [2006] ECR I-9521, Para. 34.

27. See note 32.

28. For a recent and detailed analysis, see D. Smit, "Capital movements and third countries: the significance of the standstill-clause ex-Article 57(1) of the EC Treaty in the field of direct taxation", *EC Tax Review* (2006), p. 203 et seq.

29. For this apparent paradox, see Cordewener, Kofler and Schindler, note 1, p. 112 et seq. For an attempt to introduce a differentiated interpretation of Art. 56 of the EC Treaty, on the one hand, and Art. 57(1), on the other, see ECJ, Advocate General Geelhoed's Opinion, 6 April 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 119.

30. See ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-7995, Paras. 31-33; ECJ, 3 October 2006, Case C-452/04, *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht* [2006] ECR I-9521, Paras. 34 and 44-49; ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Paras. 37 and 38; ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 36; ECJ, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue,* not yet reported, Paras. 26-34; ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 19; and ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 22.

31. See for this approach already Cordewener, Kofler and Schindler, note 1, p. 114.

32. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 31 ("... although a Member State national who holds two thirds of the share capital of a company established in a non-member country …"). It is, however, striking that in *Lasertec*, the ECJ refers *also* to the factual circumstance that the lending company had a holding that conferred a definite influence. See ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 23. See also the critical remarks by Haslehner, note 10.

33. For this test of application of the freedom of establishment, see, for example, ECJ, 13 April 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787, Paras. 21 and 22; ECJ, 21 November 2002, Case C-436/00, *X, Y v. Riksskatteverket* [2002] ECR I-10829, Paras. 37 and 66-68; ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, [2006] ECR I-7995, Para. 31; ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 39; and ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 58.

34. See, for example. ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol* [2004] ECR I-7063 and ECJ, 7 September 2004, Case C-319/02, *Petri Manninen* [2004] ECR I-7477.

35. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 23.

this is not the case, the legislation may simultaneously "fall within the scope of both Article 43 EC on freedom of establishment and Article 56 EC on free movement of capital".[36]

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

From this perspective, it appears to be consistent that the ECJ, in *Cadbury Schweppes*,[45] *Test Claimants in the Thin Cap Group Litigation*[46] and *Lasertec*[47] rejected the application of the free movement of capital in cases involving controlled foreign company (CFC) rules or thin capitalization rules, which, to be triggered, require a control threshold to be reached, whilst the Court implicitly accepted its application in *Test Claimants in the FII Group Litigation*[48] and *Holböck*,[49] in which the respective national legislation on taxation of inbound dividends applied to portfolio holdings in third country companies. It is along these lines that the ECJ in *A and B*[50] rejected applying Art. 56(1) of the EC Treaty to a situation involving a third country branch, as the creation of that branch, which indirectly affected Swedish taxation of dividends, was clearly and primarily covered by Art. 43 and 48 of the EC Treaty, even though its creation arguably also falls within the substantive scope of Art. 56(1).[51]

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

36. Id., Para. 24.
37. For a discussion of the different approaches, see, for example, J. Schönfeld, *Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht* (Cologne: Otto Schmidt, 2005), p. 205 et seq.
38. See, for example, ECJ, 13 April 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787, Para. 20 et seq; ECJ, 7 September 2006, Case C-470/04, *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo* [2006] ECR I-7409, Para. 24 et seq; ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, not yet reported; and ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 37.
39. ECJ, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue,* not yet reported, Para. 32.
40. ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 23 and ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 24 et seq. in conjunction with Para. 9.
41. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-7995, Para. 32 in conjunction with Para. 6.
42. ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 58 et seq.
43. ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 21.
44. Id., Para. 22 in conjunction with Para. 4.
45. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-7995, Para. 32.
46. ECJ, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 34.
47. ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, not yet reported, Para. 25.
48. ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported.
49. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Paras. 23 and 24.
50. ECJ, Order, 10 May 2007, Case C-102/05, *Skatteverket v. A and B*, not yet reported.
51. See Heading I.1 of the nomenclature of the capital movements set out in Annex I to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, Official Journal, 1988, L 178/5.
52. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 31. Compare also the developments in Austrian court practice. Whilst the Tax Court (*Unabhängiger Finanzsenat*) of Linz, 13 January 2005, RV/0279-L/04, extended the ECJ's holding in the *Lenz* case to portfolio dividends from, inter alia, Switzerland and the United States (for a comprehensive analysis, see G. Kofler and G. Toifl, "Austria's Differential Treatment of Domestic and Foreign Intercompany Dividends Infringes the EU's Free Movement of Capital", 45 *European Taxation* 6 (2005), p. 232 et seq), the Tax Court (*Unabhängiger Finanzsenat*) of Vienna, 8 May 2007, RV/0003-W/03 recently extended it to dividends derived from a 60% shareholding in a Czech company. Accordingly, even before the ECJ decided on *Holböck*, the Tax Court of Vienna had already ruled similarly.
53. For detailed discussion of the various opinions in legal doctrine on this issue, see Cordewener, Kofler and Schindler, note 1, p. 111 et seq.
54. See 3. It remains, however, to be seen how the ECJ will deal with issues constituting "establishment" or "the provision of financial services" within the meaning of Art. 57(1) of the EC Treaty, as restrictions of such activities may arguably (always) be covered by Art. 43 or Art. 49 and, therefore, deprive Art. 57(1) of any meaning in these areas. See already ECJ, 3 October 2006, Case C-452/04, *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht* [2006] ECR I-9521, Paras. 34 and 44-49 concerning financial services, and the respective considerations in ECJ, Advocate General Stix-Hackl's Opinion, 16 March 2006, Para. 74.
55. For such a critical position, see, for example, Schön, note 20, p. 501 et seq. and H. Rehm and J. Nagler, "Verbietet die Kapitalverkehrsfreiheit nach 1993 eingeführte Ausländerungleichbehandlung?", *Internationales Steuerrecht* (2006), p. 861.
56. See, for example, Heading I of the nomenclature of the capital movements set out in Annex I to Council Directive 88/361/EEC, note 51.
57. Nevertheless, this approach implies, for example, that Art. 56(1) of the EC Treaty cannot be invoked in respect to loss utilization of foreign PEs. For a

3. The Meaning and Effect of the Grandfather Clause in Art. 57(1) of the EC Treaty

Once it has been established that the application of Art. 56(1) of the EC Treaty is not pre-empted by another fundamental freedom[58] and that the taxpayer is, therefore, "justified in invoking the prohibition of restrictions on the movement of capital between Member States and non-member countries set out in Article 56(1) EC" to challenge the application of national tax legislation,[59] the grandfather clause in Art. 57(1) may, nevertheless, safeguard the national measure to the benefit of the Member State, even though it contravenes the principle of the free movement of capital.[60] According to this provision, Art. 56 of the EC Treaty is "without prejudice to the application to non-member countries" of any restrictions "which existed on 31 December 1993" under national or EC law that were adopted in respect of the movement of capital to or from non-member countries involving, *inter alia*, "direct investments". *Holböck* touches on some specific issues relating to the interpretation of Art. 57(1) of the EC Treaty that are briefly summarized as follows:[61]

- First, the clause "without prejudice to the application to non-member countries" does not limit the scope of Art. 57(1) of the EC Treaty to restrictions in respect of investments *from* third countries into the Community. Rather, this provision may grandfather restrictive measures on both inbound and outbound investments.[62]
- Second, Art. 57(1) of the EC Treaty may also safeguard general provisions, such as the Austrian rules on dividend taxation, in respect of their application to third countries.[63] It is, therefore, not restricted to provisions specifically focused on capital movements to and from third countries.[64]
- Third, in interpreting the categories of investments covered by Art. 57(1) of the EC Treaty, recourse may be made to concepts defined in the nomenclature of the capital movements set out in Annex I to Council Directive 88/361/EEC.[65] Against this background a "direct investment" within the meaning of Art. 57(1) of the EC Treaty exists if the shares held enable the shareholder

  > either pursuant to the provisions of the national laws relating to companies limited by shares or in some other way, to participate effectively in the management of that company or in its control.[66]

- Fourth, Art. 57(1) of the EC Treaty is not to be interpreted narrowly as only grandfathering *direct* restrictions of certain investments, but, rather, extends to restrictions concerning payments flowing from such an investment, like dividends.[67]
- Fifth, restrictions are deemed to have "existed" on 31 December 1993, even if the restrictive measure has subsequently been amended, but only if it is, in substance, identical to the previous legislation or limited to reducing or eliminating an obstacle in the earlier legislation.[68]
- Sixth, and lastly, the date stated in Art. 57(1) of the EC Treaty ("31 December 1993") is, in principle, relevant irrespective of the date of accession of the respective Member State.[69] This can clearly be inferred from *Holböck*, as the ECJ did not attribute any relevance to the fact that Austria acceded on 1 January 1995.[70] This conclusion is also supported by the recent amendment of Art. 57(1) of the EC Treaty, which added that "[in] respect of restrictions existing under national law in Bulgaria, Estonia and Hungary, the relevant date shall be 31 December 1999",[71] which, e contrario, strongly implies that the year-end of 1993 is indeed decisive for the other Member States that acceded after that date.

Finally, it should be noted that the ECJ's approach to the relationship between the fundamental freedoms[72] left another interesting, though rather rare, issue presented

different position, see *Bundesfinanzhof*, 22 August 2006, R 116/04, *Bundessteuerblatt,* Part II (2006), p. 864 et seq., currently before the ECJ as ECJ, Pending Case C-415/06, *Stahlwerk Ergste Westig GmbH v. Finanzamt Düsseldorf-Mettmann*, Official Journal, 2006, C-326/26. For a first discussion of the request, see M. Schwenke, "Anmerkungen zum Vorlagebeschluss des BFH an den EuGH vom 22. August 2006 – I R 116/04", *Internationales Steuerrecht* (2006), p. 818 et seq. and, for a possibly different view of the applicability of Art. 56(1) of the EC Treaty in cases involving PEs, see T. O'Shea, "*Holböck*: Austrian Dividend Tax Rules Found Compatible With the EC Treaty", 46 *Tax Notes International* (11 June 2007), p. 1134.

58. See 2.

59. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 31.

60. Id., Para. 39.

61. For extensive analysis, see Smit, note 28, p. 203 et seq.

62. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 36.

63. Id., Para. 32, and explicitly Para. 36 ("... in their application to capital movements to or from non-member countries ..."). See also on this effect ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 174 et seq.

64. See for such interpretation Smit, note 28, p. 210 et seq. and references. See also, for example, C. Peters and J. Gooijer, "The Free Movement of Capital and Third Countries: Some Observations", 45 *European Taxation* 11 (2005), p. 478 et seq., who discuss the different views taken by Netherlands courts in this respect.

65. For a detailed analysis, see Smit, note 28, p. 205 et seq.

66. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 35. See also ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 182.

67. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 36. See also ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 183. For a discussion of the contrary position, see ECJ, Advocate General Geelhoed's Opinion, 6 April 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Para. 116.

68. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 41. See already ECJ, 1 June 1999, Case C-302/97, *Klaus Konle v. Republik Österreich* [1999] ECR I-3099, Paras. 52 and 53 and ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Paras. 191 and 192.

69. In this sense already, see W. Kessler, K. Eicker and R. Obser, "Die Schweiz und das Europäische Steuerrecht – Der Einfluss des Europäischen Gemeinschaftsrechts auf das Recht der direkten Steuern im Verhältnis zu Drittstaaten am Beispiel der Schweiz", *Internationales Steuerrecht* (2005), p. 665, note 90 and Cordewener, Kofler and Schindler, note 1, p. 117 et seq. For a different position, see Staringer, note 10, p. 25.

70. See, for example, ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Para. 43. See also M. Stefaner, "ECJ Finds Austria's Treatment of Dividends in Line With EC Treaty", 46 *Tax Notes International* (4 June 2007), p. 1001.

71. See Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the treaties on which the European Union is founded, Official Journal, 2006, L 157/203, at 209. Prior to this amendment, Annex IV of the 2003 Act of Accession (Official Journal, 2003, L 236/33, 797) set out a specific provision for Estonia to apply Art. 58(1) lit. a of the EC Treaty to provisions that existed on 31 December 1999 and affect capital movements between the Member States.

72. See 2.

by *Lasertec* undecided. The German rules at issue were adopted on 13 September 1993 and entered into force on 18 September 1993, but did not apply before 1 January 1994. *Lasertec* would, therefore, have raised the question of whether or not such rules could be regarded as restrictions, "which existed on 31 December 1993". There is, however, broad consent in legal writing that, for Art. 57(1) of the EC Treaty to apply, the relevant national legislation had to be applicable on "31 December 1993", as only "restrictions" are grandfathered and these may only result from rules already applying on this date, irrespective of their date of enactment.[73]

4. Conclusions

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

The Member States may, in turn, still invoke Art. 58 of the EC Treaty to defend their measures, and the ECJ has already implied that, in third country relationships, neither the standards for comparability nor for justification and the related proportionality test must necessarily coincide with the standards usually applied by the Court to intra-Community situations.[76] Accordingly, it will be for future case law to explore and delimitate the scope of the free movement of capital in third country scenarios. In this respect, the increasing number of pending cases[77] should give the ECJ sufficient opportunity to establish reliable guidance for national courts and taxpayers.

73. See A. Schnitger, "Mögliche Wirkungsgrenzen der Grundfreiheiten des EC-Vertrages am Beispiel des § 8 KStG", *Internationales Steuerrecht* (2004), p. 636.
74. ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*, not yet reported, Paras. 24 and 30 et seq. See also ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Paras. 169 et seq. and 174 et seq.
75. For a comprehensive discussion, see Cordewener, Kofler and Schindler, note 1, p. 107 et seq.
76. ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, not yet reported, Paras. 170 and 171. See also Cordewener, Kofler and Schindler, note 1, p. 114 et seq.
77. See notes 2 to 4.