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Review of UK and EU balance of competences: response to the call for evidence on *Single Market: Financial Services and the Free Movement of Capital*

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Introductory remarks

This paper is submitted in response to the call for evidence on ***Single Market: Financial Services and the Free Movement of Capital***. It focuses on developments affecting the balance of competences between the United Kingdom and the European Union in the area of **capital movements**. It directly addresses **questions 10 and 11** of the call for evidence. Its substance draws on aspects of the author's published research on capital market liberalisation and EU free movement law. [1]

Question Responses

Q.10. *What has been the effect of restrictions on placed on Member States' ability to influence capital flows into and of their economy, for example to achieve national public policy or tax objectives?*

- The **Treaty provisions on capital** (Arts 63-66 TFEU) have impacted on Member State competence to regulate capital flows in two key areas: **taxation and corporate governance**. In both fields, the Court of Justice of the European Union (hereinafter: Court of Justice or Court) has set important limits on Member States' scope to act unilaterally in accordance with their own domestic political preferences. These limits have been set principally through the Court's interpretation of **Art 63(1) TFEU – the primary legal base in the area of capital movements**. That provision prohibits 'all restrictions on the free movement of capital between Member States and between Member States and third countries.' It entered into force on 1 November 1993 (Treaty of Maastricht) and remains **unchanged by the Lisbon Treaty**.

- The following paragraphs provide an overview of the legal framework governing capital movements both within and beyond the internal market in the key areas of **taxation** and **corporate governance**. The aim throughout is to relate developments in the legal framework to discussion of Member State competence to influence

[1] See, in particular, T. Horsley, 'Death, Taxes and (Targeted) ECJ Activism: The Free Movement of Capital in EU Law,' in A. Arnull and D. Chalmers (Eds.) *The Oxford Handbook of European Union Law* (OUP, forthcoming 2014) and T. Horsley, 'The Concept of an Obstacle to Intra-EU Capital Movement' in N. Nic Shuibhne and L. Gormley (Eds.), *From Single Market to Economic Union: Essays in Honour of John A. Usher* (Oxford: OUP, 2012).

capital movements as a means to achieve national public policy or tax objectives. The authorities cited in footnotes are illustrative examples of key principles.

Taxation Policy

- In the field of **taxation**, the Court of Justice's interpretation of Art 63(1) TFEU has developed into a ***de facto* prohibition of discrimination**.[2] This approach recognises, as a matter of principle, **the fundamental right of Member States to structure their own tax systems, whilst requiring them, at the same time, to accommodate the demands of cross-border movement**.[3] It is the least intrusive of the current approaches employed to manage the division of competence between the Member States and the Union in EU free movement law.

- The basic requirement imposed by Art 63(1) TFEU in the field of taxation is one of strict equal treatment – no more, no less. That provision **prohibits all national measures that introduce or maintain differences in treatment – at any stage of assessment[4] – based on nationality or (typically) place of residency of taxpayers**. The prohibition of differences in treatment based on either criterion is the hallmark of the non-discrimination principle in EU law.[5]

- The Court structures its discrimination test in the field of capital movements in accordance with **established principles of international tax law**. In summary, the Court draws a key distinction, as regards direct taxation, between the situations of resident and non-resident taxpayers in its assessment of differences in treatment under Art 63(1) TFEU. **On the one hand**, the situations of resident taxpayers are considered objectively comparable.[6] Differences in treatment between resident taxpayers are thus considered discriminatory and prohibited by Art 63(1) TFEU (subject, of course, to possible justification – discussed below). **On the other hand**, the Court of Justice accepts that, in matters of direct taxation, the situations of resident and non-resident taxpayers are not objective comparable *per se*.[7] Member States remain therefore free to treat both groups differently without infringing the Treaty capital provisions.

- The CJEU adopts a **functional approach** to categorisation of resident and non-resident taxpayers. In several instances, the Court has concluded that the situations

[2] This follows the Court's approach to the scrutiny of Member State tax measures across the Treaty free movement provisions on workers, establishment, and services (Arts 45, 48 and 56 TFEU).
[3] E.g. Case C−374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I−11673 at para. 36.
[4] E.g. Case C-35/11 *Test Claimants in the FII Group Litigation*, Judgment of the Court (Grand Chamber) of 13 November 2012 at para. 52 (differences in treatment re. imputation methods).
[5] Art 18 TFEU.
[6] Case C-35/98 *Verkooijen* [2000] ECR I-4071.
[7] Case C-169/03 *Wallentin* [2004] ECR I−6443 at para. 15.

of resident and non-resident taxpayers were *de facto* comparable with respect to specific issues (principally: the deduction of business expenses).[8] Differences in treatment between the two groups were, as a result, considered to restrict intra-EU capital movements contrary to Art 63(1) TFEU. **The functional approach to the definition of resident and non-resident taxpayers has important implications for the Member States.** Member States cannot hide behind the labels 'resident' and 'non-resident' taxpayers in circumstances where the two categories of taxpayer are, despite their differing status, in fact objectively comparable.

- **Art 63(1) TFEU does not prohibit double taxation**. Subject only to the discrimination test outlined in the preceding paragraphs, **Member States are broadly free under EU law to model their tax systems as they see most appropriate**. There is no obligation, for instance, on Member States to offset taxes paid by resident taxpayers in another Member State on income received abroad.[9] **The restrictive effect of double taxation** (for mobile taxpayers/cross-border investors) **is considered a consequence of the parallel exercise of two sets of non-discriminatory Member State tax systems**.[10] As the Court of Justice has repeatedly noted, double taxation is a matter for the Member States to regulate amongst themselves; for example, by means of international conventions.[11] To this end, **Art 293 EC** required Member States, so far as possible, to enter into negotiations with each other with a view to abolishing double taxation within the (then) Community. However, that provision was **repealed by the Treaty of Lisbon**.

- It is worth noting that, at odds with the substance of its own case law, the Court of Justice **rarely uses the language of discrimination**. It prefers instead to interpret Art 63(1) TFEU more broadly as a prohibition on national tax measures that are **'liable to deter or dissuade'** cross-border investment.[12] This is more than just an academic or semantic point. On a literal reading, the latter interpretation has the **potential greatly to extend the scope of the Court's competence to scrutinise national tax measures against Art 63(1) TFEU**. However, the Court's use of the broader language of 'deterrent' and/or 'dissuasive' effects on the free movement of capital **should not alarm the Member States**. Presently, the Court's taxation jurisprudence is, in practice, firmly orientated on the narrower, discrimination-based approach outlined

[8] E.g. Case C-450/09 *Ulrich Schröder v Finanzamt Hameln* [2011] ECR I-2497 and Case C-250/08 *Commission v. Belgium*, Judgment of the Court (First Chamber) of 1 December 2011 (not yet reported).
[9] E.g. Case C-513/04 *Kerckhaert and Morres* [2006] ECR I-10967 at paras 19 and 20.
[10] E.g Case C-157/10 *Banco Bilbao Vizcaya Argentaria SA*, Judgment of the Court (First Chamber) of 8 December 2011 (not yet reported) at para. 38.
[11] E.g. Case C-540/07 *Commission v. Italy* [2009] ECR I-10983 at para. 31.
[12] E.g. Case C-35/98 *Verkooijen*, cited above at note 6 at paras 35 and 35.

above. Only exceptionally has the Court concluded that genuinely non-discriminatory national tax rules infringe Art 63(1) TFEU.[13]

- The discrimination-based review of Member State tax provisions follows **Art 65 TFEU(1)(a)**. That key provision permits Member States '**to distinguish between taxpayers who are not in the same situations with regard to their place of residence or with regard to the place where their capital is invested**' when applying national tax measures. The Member States introduced that provision into the Treaty framework in an effort to delineate the Court's competence to review national tax measures as restrictions to the free movement of capital. In practice, the provision **codified rather than amended** the Court's taxation case law, which was already so limited. Attempts by Member States to construe Art 65(1)(a) TFEU more broadly (i.e. beyond the terms of the discrimination approach) have been firmly rejected by the Court.[14]

- **It is difficult for Member States to justify (discriminatory) national tax measures caught by the prohibition in Art 63(1) TFEU**. With respect to restrictions on capital movements within the internal market, the Treaty includes only one express derogating provision. **Art 65(1)(b) TFEU** permits Member States:

> '*to take all requisite measure to prevent infringements of national law and regulations, in particular in the field of taxation and the prudent supervision of financial institutions, or to lay down procedures for the declaration of capital movements for the purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security*.'

- **The Court of Justice interprets the scope of Art 65(1)(b) restrictively**. In particular, it emphasises that national measures safeguarded by that provision must not constitute 'arbitrary discrimination' or 'disguised restrictions on the free movement of capital.'[15] Further, the Court has also made it clear to the Member States that they may not maintain restrictions on intra-EU capital movements based on 'a general presumption of tax evasion or tax fraud.'[16]

- **Directive 2011/16 EU**[17] on administrative cooperation in the field of taxation is often cited by the Court to support its decision to *reject* Member State attempts to invoke

[13] E.g. Case C-439/97 *Sandoz GmbH* [1999] ECR I-7041.
[14] E.g. Case C-35/98 *Verkooijen*, cited above at note 6.
[15] Art 65(3) TFEU.
[16] E.g. Case C-478/98 *Commission v. Belgium (Eurobonds)* [2000] ECR I-7587 at para.
[17] [2011] OJ L 64/1. This Directive replaces Directive 77/779/EC.

Art 65(1)(b) TFEU in order to justify discriminatory tax measures.[18] That instrument **establishes an EU-wide system of mutual cooperation between Member State tax authorities with a view to ensuring the efficient functioning of national tax regimes and combating tax evasion and fraud**. The existence of that Directive has **greatly curtailed the scope for Member States to appeal to the justification grounds listed in Art 65(1)(b) TFEU**. Its express aim is to manage legitimate Member State concerns regarding, for example, potential tax evasion through the establishment of a detailed EU system of mandatory administrative cooperation in the field of taxation.

- **On the other hand**, the possibility exists for Member States to justify discriminatory tax measures (and restrictions on capital movements generally) in order to achieve **non-discriminatory proportionate overriding public interest objectives**.[19] In the area of taxation, accepted justifications include, inter alia, 'securing the cohesion of the tax system'[20] and 'effective fiscal supervision.'[21] The former ground is particularly narrowly construed. It applies only to justify national tax restrictions where Member States are able to show a 'direct link' between a particular tax advantage and an offsetting tax payment.[22] Of course, following established principles of EU free movement law, **obstacles to the free movement of capital may not be justified on purely economic grounds** (e.g. a reduction in tax revenue).[23]

Taxation and External Capital Movements

- **Uniquely** amongst the Treaty free movement provisions, **Art 63(1) TFEU** on capital **extends *beyond* the territorial confines of the EU internal market**. That provision also applies to national measures that restrict capital movements between Member States and third countries. To date, the case law on the external dimension of capital is focussed squarely on the review of taxation measures.[24] In this field, the Court of Justice has, to a greater extent, **directly transposed its case law on internal market restrictions to the global context**.[25] Its approach to the scrutiny of Member State tax measures in connection with capital movements between Member States and third countries is informed by the discrimination test outlined in the preceding section (see 'taxation' above).

[18] E.g. Case C-493/09 *Commission v. Portugal* [2011] ECR I-9247 at para. 49.
[19] E.g. Case C-36/98 *Commission v. Portugal* [2002] ECR I-4731 at para. 38.
[20] E.g. Case C-250/08 *Commission v. Belgium*, cited above at note 8 at paras 70-75.
[21] E.g. Case C-101/05 *Skatteverket v A* [2007] ECR I-11531.
[22] E.g. Case C-250/08 *Commission v. Belgium*, cited above at note 8.
[23] E.g. Case C-20/09 *Commission v. Portugal* [2011] ECR I-2637 at para. 65.
[24] This contribution does not consider the legal framework authorising Union action to restrict capital movements on counter-terrorism grounds (Art 75 TFEU).
[25] E.g. Case C-101/05 *Skatteverket v A*, cited above at note 21 at para. 42.

- **However, the regulation of external capital movements at Union level has, in practice, had less impact on Member State autonomy**. This is due principally to the Court's **more generous approach to the justification of national measures** that are caught by the prohibition in Art 63(1) TFEU. The Court is alert to the very different legal and political dynamics governing capital movements between Member States and third countries. In particular, it has acknowledged the limitations of the current framework for mutual cooperation between national tax administrations in **Directive 2011/77 EU**. As an instrument of EU law, **that Directive imposes legal obligations *only* on Member States and not third countries**.[26] In light of this, the Court has indicated that Member States may seek to justify restrictive tax measures affecting external capital movements on grounds that would *not* constitute valid justifications in the internal market context.[27]

- The **Treaty framework also provides additional safeguards** for the benefit of the Member States in connection with the external application of Art 63(1) TFEU. **First**, the Treaty permits Member States to maintain certain restrictive measures regulating, inter alia, direct investment or the provisions of financial services, with third countries that existed on or before 31 December 1993.[28] **Secondly**, the Treaty permits Member States to *introduce* new restrictions on capital movements between Member States and third countries. **Art 64(3) TFEU empowers the Council to 'adopt measure which constitute a step backwards in Union law as regards the liberalisation of the movement capital to or from third countries.'** The use of that provision is governed by the special legislative procedure. As such, the Council must act unanimously and after consulting the European Parliament. Finally, **Art 66 TFEU** provides a legal base to address specific concerns linked to the free movement of capital with third countries and affecting the operation of economic and monetary union.

- The **Lisbon Treaty** introduced a **new emergency brake mechanism** to supplement the existing legal framework granting Member States a degree of political control over the external dimension of capital movements. **Art 65(4) TFEU** empowers the Commission and/or the Council to adopt a decision that a restrictive national tax measure adopted by a Member State concerning one or more third countries is considered compatible with Union law. That provision is specifically targeted at the Court of Justice. **It is designed to 'claw back' from the Court the final say over the legality under EU law of national tax rules in the global capital movement context.**

[26] E.g. Case C-72/09 *Établissements Rimbaud SA* [2010] ECR I-10659 at paras 40-41.
[27] E.g. Joined Cases C-436/08 and C-437/08 *Haribo Lakritzen Hans Riegel BetriebsgmbH* [2011] ECR I-305 at para. 120.
[28] Art 64(1) TFEU.

- Art 65(4) TFEU is a unique provision and a **powerful tool to safeguard Member State interests in the field of taxation**. To activate Art 65(4) TFEU, the Council must act unanimously and within three months following on application by a Member State. In order to overturn a decision by the Court of Justice declaring a Member State tax provision restrictive externally, the Council must demonstrate that the measure concerned is **justified by 'one of the objectives of the Union and [is] compatible with the proper functioning of the internal market.'** The provision has not yet been invoked.

Corporate Governance

- The **Treaty provisions on capital movements** have also affected Member State competence in the regulatory (i.e. non-fiscal) sphere. **The term 'capital movement' for the purposes of Art 63(1) TFEU is broadly interpreted**, covering a range of economic transactions.[29] These include, inter alia, the acquisition of property; inheritance transfers; personal loans; in addition to the more obvious categories of direct and portfolio investment. **The breadth of the capital movement definition has opened up a wide range of Member State regulation to potential scrutiny against Art 63(1) TFEU**.

- **In the regulatory context, the Court of Justice has extended the scope of its capital case law *beyond* the discrimination model applied in the taxation field**. This has more considerable implications for Member State autonomy. Moving beyond the discrimination model – based on equal treatment – enables litigants (including the Commission under Art 258 TFEU[30]) to scrutinise the existence of Member State regulation *per se*. **Under this 'restrictions' approach, Member States may be called to justify national measures that merely 'dissuade,' 'deter' or 'render less attractive' capital movements.** In such cases, the justification framework discussed above applies *mutatis mutandis*.

- The impact on Member State autonomy in the regulatory context is most apparent in the area of **corporate governance**. In particular, **the Court has condemned so-called 'golden shares' as restrictions on intra-EU capital movements**.[31] Golden shares are special categories of shareholding created by Member States – typically in previously nationalised undertakings – in deviation from ordinary rules of national company law. The creation of such shares is designed to enable the Member State

[29] The CJEU continues to follow the definitions formulated by the Member States in Annex I of Directive 88/361 EC [1988] OJ L 178/1 (now repealed).
[30] Art 258 TFEU empowers the Commission to initiate infringement actions against Member States for alleged breaches of EU law.
[31] E.g. Case C-98/01 *Commission v. United Kingdom (Golden Shares)* [2003] ECR I-4641.

concerned to retain a degree of control over the ownership and management of privatised undertakings (disproportionate to the value of the special 'golden share').

- The Court of Justice has established a clear principle that **any deviation from the ordinary framework of company law that is linked to the exercise of Member State authority constitutes a restriction to the free movement of capital**. This prohibition extends to capture genuinely non-discriminatory golden shares. On the Court's view, the very existence of such shares is liable to deter investment in the undertakings concerned and, further, reduce the value of shareholdings.[32] Attempts – including by the United Kingdom Government – to argue that non-discriminatory golden share provisions should escape scrutiny at Union level have fallen on deaf ears.[33] On the one hand, **the Court recognises that the Treaty does not compel Member States to privatise nationalised undertakings.** On the other hand, it takes the view that, where a Member State does decide to privatise a public undertaking, that State may not create and use special categories of shares to exercise control over its continued ownership and management.

- **Member States may, of course, seek to justify golden shares**. It is open to them to demonstrate that the restrictive effect of their special shareholdings is necessary in order to secure a non-discriminatory proportionate overriding public interest objective. **Member States rarely succeed in their efforts to persuade the Court that a suitable proportionate public interest objective exists to justify the creation and maintenance of golden shares**. The Court has acknowledged a range of overriding public interest requirements – including, inter alia, the need to guarantee services of general interest[34] or the protection of workers and minority shareholders.[35] In the final analysis, however, it frequently concludes that the retention of golden shares goes beyond what is necessary to achieve these public interest objectives. **Justifications thus fail on proportionality grounds.**

- However, on occasion, Member States have managed to square particular national policy objectives with the Treaty framework. These cases concern golden shares held by Member States in certain strategic undertakings, such as energy companies. **The Court has accepted that certain circumstances may justify the retention by Member States of a degree of influence in undertakings that are active in fields involving the provision of services in the public interest, such as the supply of energy.**[36] However, in order to comply with Art 63(1) TFEU, Member States must comply with a good governance test. **Golden shares are only justified where they**

[32] E.g. Case C-171/08 *Commission v. Portugal (Golden Shares)* [2010] ECR I-6817 at paras 60 and 61.
[33] E.g. Case C-98/01 *Commission v. United Kingdom (Golden Shares)*, cited at note 31 above.
[34] E.g. Joined Cases C-282/04 and C-283/04 *Commission v. Netherlands* [2006] ECR I-9141 at para. 19.
[35] E.g. Case C-112/05 *Commission v. Germany (Volkswagen*) [2007] ECR I-8995.
[36] E.g. Case C503/99 *Commission v. Belgium (Golden Shares)* [2002] ECR I-4809.

empower Member States to oppose corporate resolutions *ex post* and on very specific non-economic grounds, which must be clearly defined in advance. Finally, the exercise of golden shares must be subject to strict procedural safeguards and, ultimately, judicial review.

- **It is not yet clear whether Art 63(1) TFEU could be used to review special shares created for the benefit of, or acquired by, private investors**. If confirmed, this would indeed mark a significant expansion in the scope of the Treaty rules on capital movement with considerable potential implications for Member State autonomy. A whole new range of non-discriminatory provisions of Member State company law would be opened up for potential scrutiny at Union level against Art 63(1) TFEU. However, **Member States should not be too concerned at this prospect.** The case law and underlying rationale of the Treaty freedoms indicates that such a development is highly unlikely. The golden shares jurisprudence, in common with the Treaty freedoms generally, is principally focussed on scrutinising the exercise of public power in deviation from ordinary company law.[37] Private conduct is assessed against the Treaty rules on anti-competitive conduct (Arts 101 and 102 TFEU).

Q.11. *What may be the impact of future challenges and opportunities for the UK, for example, related to non-membership of the euro area or development of the banking union?*

Future Challenges

- Looking ahead, **two key issues** are likely to emerge in the free movement of capital. **First**, Member States should anticipate rapid growth in the external dimension of the freedom. **Secondly**, and of particular relevance to the United Kingdom, there is the possibility of market fragmentation as a consequence of non-participation in future euro-area and/or banking union initiatives. Both issues present distinct challenges and opportunities for the United Kingdom as well as for the Union in general.

External Capital Movements

- The regulation of capital movements between Member States and third countries is still in its infancy. Presently, there are only a handful of judicial decisions in this area. A number of these also address restrictions between Member States and EEA states. **Global cross-border investment is liable to continue to increase in the coming years, giving rise to fresh challenges to Member State measures**. Most of these challenges will concern national tax measures.

[37] See especially, Case C-171/08 *Commission v. Portugal (Golden Shares,)* cited at note 32 above at para. 55.

- As discussed above (Q.10), **the current approach at Union level indicates a degree of sensitivity to Member State concerns regarding the scrutiny of national tax measures against the Treaty rules on capital movement in the external context**. The Court of Justice has acknowledged, for instance, that the absence of a system of mutual cooperation between Member State and third country administrations justifies a different and more generous approach to the justification of tax measures as restrictions on the free movement capital. **This reading of Art 63(1) TFEU will likely continue in the absence of specific and legally binding instruments between Member States and non-member countries on tax cooperation**.

- Moreover, it is also important to recall that **Member States retain a unique degree of political influence over taxation policy as regards external capital movements**. In particular, the introduction of the 'claw back' provision (Art 65(4) TEFU) by the Lisbon Treaty provides a mechanism for Member States to manage the pace and depth of developments in this area. On one view, the introduction into the Treaty framework has already sent a sufficiently clear signal to the Court of Justice to tread carefully when defining the outer limits of its case law in this specific area. **In any case, should the Member States consider the Court to have overstepped the mark, they may overturn its judgments by unanimous decision in the Council**. Rarely do Member States enjoy such competence to 'revisit' what they considered to be politically unfavourable decisions of the Court of Justice.

Non-participation in future initiatives

- The second issue – non-participation in future initiatives – arguably poses greater challenges for both the United Kingdom and the Union. **The introduction of a separate legal framework within or outside of the current Treaty structure for Eurozone countries brings with it the risk of fragmenting the internal market**. This risk is, of course, not specific to the field of capital movements. **Any system of enhanced cooperation may lead to the creation of obstacles to trade within the internal market**.

- **Fragmentation would undermine, for both the United Kingdom and Union more generally, the economic benefits associated with liberalised capital markets**. Investors and undertakings may be confronted with new obstacles to the movement of capital, with an overall detrimental impact on growth. This would mark **a clear step backwards in terms of the establishment of a functioning internal market for capital** – an area in which considerable progress has been made in recent years.

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