HM Treasury's Call for Evidence on the Single Market: Financial Services and the Free Movement of Capital

Impact of the free movement of capital on Member States' policies in the area of direct taxation in non-EU relationships

By Daniël S. Smit[1]

1. Introduction

1.1 This paper addresses the question: what is the impact of the free movement of capital under Article 63 TFEU, as interpreted by the Court of Justice of the European Union (CJ), on Member States' policies in the area of direct taxation.[2] The focus will be on the relations between Member States and non-EU Member States ("third countries").

1.2 In the landmark case *avoir fiscal* issued by the CJ in 1986, it was confirmed that direct tax measures that distinguish between income from transnational investment and income from comparable domestic investment can be scrutinized under the freedom of establishment. In this case, the CJ ruled that by not granting a French tax credit to French branches of companies resident in another Member State on the same terms as those applying to companies resident in France, the freedom of establishment was infringed.

1.3 In another landmark case *Verkooijen* issued by the CJ in 2000, it was confirmed that direct tax measures that distinguish between income from transnational investment and income from comparable domestic investment can be scrutinized under the free movement of capital.

1.4 In the meantime, a large body of CJ case law has emerged. From this case law it follows that distinctions made in Member States' direct tax systems on the basis of the place of residence, as may be made *inter alia* in the case of thin capitalization rules[3] or withholding taxes[4] and distinctions on the basis of the place where the capital is invested, as may be made *inter alia* in the context of CFC legislation[5], intra-group loss compensation[6] and relief of double taxation[7]

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2 The term "direct taxation" refers to taxes on income and capital and any identical or substantially similar taxes. Notable examples of *in*direct taxes are VAT and estate duties.

3 ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst* [2002] ECR I-11779; ECJ 13 March 2007, C-524/07, *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107.

4 ECJ 14 December 2006, C-170/05, *Denkavit Internationaal and Denkavit France* [2006] ECR I-11949.

5 ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995.

6 ECJ 13 December 2005, C-446/04, *Marks & Spencer* [2005] ECR I-10837.

7 ECJ 7 September 2004, C-319/02, *Manninen* [2004] ECR I-7477.

may be in breach of the freedom of establishment and/or the free movement of capital. The non-discrimination tests applied by the CJ under each of the respective Treaty provisions appear to have converged almost completely.[8]

1.5 In brief, one can infer from the above case law that, within the Union, income from transnational investment may not be taxed less favourably than income derived from a comparable domestic investment, unless a valid justification exists.[9] Not only individuals and small investors are protected against discrimination under the Treaty freedoms, but also companies and large investors. Within the Union, the CJ's case law in the field of direct taxation has had a significant impact on the Member States' tax policies in the area of direct taxation. The core question is whether the same conclusion applies in the relations between Member States and third countries. This question is dealt with below.

2. Background of the liberalization erga omnes under Article 63 TFEU

2.1 Article 63(1) TFEU explicitly provides that all restrictions on the movement of capital between Member States and between Member States and third countries are prohibited.

This unilateral liberalization *erga omnes* is exceptional, although not unique, in international investment law. A similar liberal approach towards third countries is found *inter alia* in the Framework Agreement on the ASEAN Investment Area[10], the MERCOSUR Protocol on the Promotion and Protection of Investments from Countries not Members of MERCOSUR, which is entirely dedicated to third-party investment[11] and some earlier African EIIAs, such as the Community Investment Code of the Economic Community of the Great Lakes countries.[12] Other

8 For a clear example: ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] I-11753.

9 The implications of the above case law on Member States' direct tax systems within the Union have been described and evaluated extensively in the scholarly literature. See, *inter alia*, F. Vanistendael (ed.), *EU Freedoms and Taxation* (Amsterdam: IBFD Publications, 2006); D.M. Weber, *Tax Avoidance and the EC Treaty Freedoms* (The Hague: Kluwer Law International, 2005); S. van Thiel, *Free movement of persons and income tax law: the European Court in search of principles* (Amsterdam: IBFD Publications, 2002); M. Lang, J. Schuch & C. Staringer (eds), *Tax Treaty Law and EC Law* (Vienna: Linde Verlag, 2007).

10 This agreement imposes an obligation to the parties to extend the full right of establishment and national treatment to investments from third countries by 2020 (*i.e.* ten years after the same rights must be granted to the members of ASEAN).

11 This Protocol grants substantial protection standards for investments from countries outside MERCOSUR after these investments have been made in accordance with the national laws of the MERCOSUR member countries, including investor-state settlement of disputes. The Protocol does not, however, grant entry and establishment rights to investments from third countries, which are enjoyed by investments from MERCOSUR countries.

12 This Code grants specific rights to investors of third states. In particular, they grant the same legal protection as that granted to enterprises with capital within the Economic Community, including protection with respect to intellectual property rights. Moreover, such investors are not to be subject to discrimination under the law. However, third-party investors have to meet

instruments, such as the OECD Code of Liberalisation of Capital Movements, do not contain a legal obligation but a best-endeavour commitment regarding residents from countries that are members of the IMF.[13] In practice, however, the extension of liberalization measures on an *erga omnes* basis has been the predominant policy of OECD countries. Lastly, a similar best-endeavour commitment imposed on the Member States was found in Article 7 of the former Directive 88/361/EEC. Under this provision, Member States were to endeavour to attain in their treatment of transfers in respect of movements of capital to or from third countries the same degree of liberalization as that which applies to operations with residents of other Member States.

2.2 Although a certain degree of liberalization *erga omnes* had already been achieved between Member States and third countries, such liberalization was often subject to further conditions, such as reciprocity requirements. The implementation of the *erga omnes* principle in Article 63(1) TFEU was therefore a controversial point during the Maastricht Treaty negotiations.[14] The French proposed only full freedom of capital movements between EU residents. The most fervent proponents of the *erga omnes* principle, on the other hand, were the Germans and the Dutch, who feared that the threat of exchange restrictions vis-à-vis third countries would increase the uncertainties in the financial markets. The British, while taking a liberal line, were concerned about the link between full capital liberalization and the freedom to establish in the Community. They wished to maintain the right to demand reciprocity, especially in the sphere of financial services. It was not until the final stage of negotiations (under the Netherlands Presidency) that it was agreed to include the *erga omnes* principle in the Treaty, although subject to a number of derogations.[15]

In the scholarly literature, a number of underlying reasons for the extension of the free movement of capital towards third countries have been identified.[16] Ohler observes that the aim of the unilateral liberalization vis-à-vis third countries was to increase confidence in the European capital market and to make the European currency more attractive. Haferkamp also points to the wish to strengthen the Union's position as an international financial centre. Bakker mentions the fact that a number of Member States already offered such freedom *erga omnes*. If other Member States were to continue their restrictions vis-à-vis third countries, these restrictions could be easily circumvented via the liberal countries. Weber observes that the introduction of the *erga omnes* principle can be explained by the wish to create a global liberalized capital market and the wish to create an open market with free competition. The latter reason is identified by Kimms, Haferkamp and Rohde as well. Rohde furthermore suggests that the *erga omnes* principle may have been introduced in order to temper the fear of creating a "fortress Europe" within an increasingly globalizing world economy. Also, Servais submits that the liberalization towards third countries is not only desirable from an economic point of view, but also inevitable given the current degree of liberalization of capital worldwide. In addition to the above literature, in *Skatteverket v. A* the CJ explicitly recognized the objective of ensuring the credibility of the single Union currency on world financial markets and the aim of maintaining financial centres with a worldwide dimension within the Member States as underlying reasons for the introduction

certain requirements in order to benefit from the Agreement's preferential regime.

13 *Cf.* Article 1, sub d, of the Code.

14 See: A.F.P. Bakker, *The liberalization of capital movements in Europe. The Monetary Committee and Financial Integration* (Dordrecht: Kluwer Academic Publishers, 1996), 230 and 233.

15 Bakker, 233.

16 See for an elaborate overview and literature references: D.S. Smit, *EU Freedoms, Non-EU Countries and Company Taxation* (Alphen aan den Rijn: Kluwer Law International, 2012), 390.

of the unilateral liberalization *erga omnes*.[17]

It can therefore be said that the introduction of the *erga omnes* principle, although revolutionary, was a thought-out decision.

2.3 However, in order to meet the concerns raised by several Member States, a number of derogations to the *erga omnes* liberalization were inserted. First, a tax carve-out provision was included. In brief one can say that under this clause Member States would retain the right to apply a different fiscal regime with respect to capital depending on the place where it was invested or the residence of the owner. This provision was basically inserted by certain Member States that were worried that they would be obliged to extend tax credits to companies in tax havens.[18] The tax carve-out provision was, however, subsequently interpreted by the CJ as a mere codification of the CJ's case law in the field of direct taxation and thus has no real autonomous meaning anymore.[19]

2.4 Secondly, a standstill clause was included in the Treaty. In brief one can say that reciprocity considerations were a significant motive for the insertion of this clause. In addition, it ensured that existing capital restrictions under EU law and the OECD Codes of liberalisation could be maintained. It also prevented possible undesirable takeovers of major EU enterprises by substantive third-country companies. Lastly, it was felt that the liberalization of capital *erga omnes* without further restrictions might harm existing Union policy in both the Union's internal and external relations.[20]

2.5 Hence, the *erga omnes* liberalization was clearly not intended to be unconditional.

3. Impact on direct taxation in the relations with third countries

3.1 As stated above, the CJ's case law in the field of direct taxation has had a significant impact on the Member States' tax policies in the area of direct taxation, at least within the Union. The core question is whether the same conclusion applies in the relations between Member States and third countries. In this regard, three types of direct tax measures must be distinguished.

3.2 First, direct tax measures that only apply to investments that involve a *definite influence* by the investor over the investee enterprise are not caught by the free movement of capital. This means that, in general terms, direct tax measures that are targeted at relations within a group of multinational enterprises

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17 ECJ 18 December 2007, C-101/05, *Skatteverket v. A* [2007] ECR I-11531, para. 31.

18 See Bakker, at 234 and 248, fn. 30.

19 ECJ 6 June 2000, C-35/98, *Verkooijen* [2000] ECR I-4071, para. 61.

20 See, for example, Bakker, 233.

(MNEs) only, are not protected under Article 63 TFEU.[21] Examples of these type of measures are thin capitalization rules, CFC-rules and group consolidation rules.

3.3 Secondly, direct tax measures that generally apply to investments, thus irrespective of the actual degree of influence by the investor over the investee company, *do* fall within the ambit of Article 63 TFEU. Recent case law of the CJ explicitly says that this is irrespective of the actual degree of influence by the investor.[22] The only benchmark is whether the direct tax measure is not specifically targeted to groups of companies. Large majority investors from third countries (MNEs) can thus be protected as well, even although they confer a definite influence over the investee enterprise. Reversely, MNEs from the Union investing outside the Union can thus be protected as well.

3.4 Lastly, direct tax measures that are specifically targeted at capital transactions also fall within the scope of the free movement of capital. This could be the case, for example, where the application of dividend-stripping rules is involved.

3.5 To sum up, direct tax measures can be scrutinized under the free movement of capital in third country situations as well, unless the tax measure is designed to apply within groups of companies (MNEs) only.

3.6 The next question is whether the interpretation of the concept of restriction/discrimination is more limited compared to the interpretation given to this concept in an intra-Union context? On balance, one can conclude that the concept of discrimination underlying the free movement of capital under Article 63(1) TFEU, as this provision applies between Member States and third countries does not diverge from the interpretation given to this concept in the context of the Treaty freedoms as they apply between Member States.[23]

3.7 Nonetheless, in *FII* the CJ has recognized that a Member State may be able to demonstrate that a restriction on capital movements to or from non-Member States is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States.[24] From *Polydor* one can furthermore infer

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21 ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para. 118; ECJ 13 March 2007, C-524/07, *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107, para. 32.

22 For example CJEU 13 November 2012, C-35/11, *Test Claimants in the FII Group Litigation 2*, para. 65.

23 See, for example, ECJ 20 May 2008, C-194/06, *Orange European Smallcap Fund* [2008] ECR I-3747, para. 96; ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] I-11753, para. 168.

24 ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] I-11753, para.

that such a distinction can be necessary inasmuch as the instruments which the Union has at its disposal in order to achieve the uniform application of Union law and the progressive abolition of legislative disparities within the common market have no equivalent in the context of the relations between the Union and the respective third country.[25]

3.8 As far as the justification grounds in situations involving third-country investments are concerned, the following is observed. Reasons relating to the lack of reciprocity[26], loss of income[27], and administrative difficulties[28] are never acceptable in a third-country context (nor in an intra-Union context).

On the other hand, depending on the precise objective and nature of the contested direct tax measure and subject to the principles of suitability and necessity, there may be in particular be more room to accept reasons relating to the need for effective fiscal supervision.

Within the Union, the CJ has accepted the need for effective fiscal supervision in the abstract as a justification for a restrictive tax measure, but has nonetheless rejected such a defence, on grounds of proportionality, in virtually each concrete case in an intra-Union context. The reason is that reliance by the Member State on the Mutual Assistance Directive constitutes a less restrictive means to ensure effective fiscal supervision.[29] In addition, the CJ has repeatedly held that there is nothing to prevent the tax authorities concerned from requiring the taxpayer himself to produce the proof that they consider necessary in order to assess, clearly and precisely, whether the claimed tax benefit should be allowed.[30] Accordingly, general exclusions of a certain tax benefit on the grounds that the required information cannot be provided under the Directive are not permitted.

3.9 The need for an effective fiscal supervision can be accepted as a valid justification ground in third-country situations if there is no international instrument in force that provides for the possibility of exchange of information between the Member State and third country at hand.[31] If there is

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25 ECJ 9 February 1982, 270/80, *Polydor and others* [1982] ECR 329, para. 20.

26 CJEU 10 February 2011, C-436/08 and C-437/08, *Haribo and Österreichische Salinen*, not yet reported, para. 128.

27 *Ibid.*, paras. 125 *et seq.*

28 ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] I-11753, paras 155-156 read in conjunction with para. 172.

29 ECJ 26 June 2003, C-422/01, *Skandia* [2003] ECR I-6817, para. 42; ECJ 9 November 2006, C-520/04, *Turpeinen* [2006] ECR I-10685, para. 36.

30 *Cf., inter alia,* ECJ 3 October 2002, C-136/00, *Danner* [2002] ECR I-8147, para. 49; Opinion of Advocate General Kokott delivered on 15 February 2007, C-464/05, *Geurts and Vogten* [2007] ECR I-9325, point 53; ECJ 10 March 2005, C-39/04, *Laboratoires Fournier* [2005] ECR I-2057, paras 23-24.

31 ECJ 23 April 2008, C-201/05, *Test Claimants in the CFC and Dividend GLO* [2008] ECR I-2875, para. 95; ECJ 18 December 2007, C-101/05, *Skatteverket v. A* [2007] ECR I-11531, para. 63; ECJ 27 January 2009, C-318/07, *Persche* [2009] ECR I-359, para. 70; CJEU 28 October 2010, C-72/09, *Établissements Rimbaud*, not yet reported, para. 44; CJEU 10 February 2011, C-436/08 and C-437/08, *Haribo and Österreichische Salinen*, not yet reported, para. 67; ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] I-10983, para. 72.

no international exchange of information instrument in force, Member States are not required to allow the taxpayer to provide proof to the contrary.[32]

However, there must be an actual need for exchange of information.[33] In addition, the need for effective fiscal supervision must be substantiated by the Member State involved.[34] The absence of an international instrument providing for the exchange of information does therefore not automatically allow a *categorical* exclusion of third country investors.[35] However, the lack of exchange of information can allow a categorical exclusion of third country investors where the contested rule aims at combating tax avoidance.[36]

It is unclear whether the CJ requires a minimum standard for the international exchange of information (i.e. upon request only, or automatic/spontaneously as well).

3.10 Finally, the Treaty provides for a "standstill clause" relating to the free movement of capital. This provision can justify a direct tax restriction as well provided that i) the tax measure already existed on 31 December 1993 and ii) involves direct investment, including real estate, establishment, the provision of financial services or the admission of securities to capital markets. Hence, tax measures applied to small portfolio investors are, in principle, not justified under the standstill-clause.

As far as the considerations underlying the standstill clause under Article 64(1) TFEU are concerned, it is apparent that Member States wished to partially maintain their sovereignty with respect to capital movements between the Member States and third countries. In brief, one can establish reciprocity considerations were a significant motive for the insertion of this clause.[37] In addition, it ensured that existing capital restrictions under EU law and the OECD Codes of liberalisation could be maintained.[38] It also prevented possible undesirable takeovers of major EU enterprises by substantive third-country companies.[39] Lastly, it was felt that the liberalization of capital *erga omnes* without further restrictions might harm existing Union policy in both the Union's internal and external relations.[40] There is, however, no evidence that Article 64(1) TFEU was explicitly designed to preserve Member States' sovereignty in the area of direct taxation. Nonetheless, the CJ has accepted to apply the standstill clause in the field of direct taxation as well without further deliberation.[41]

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32 ECJ 28 October 2010, C-72/09, *Établissements Rimbaud*, not yet reported, paras. 49-50.

33 ECJ 22 January 2009, C-377/07, *STEKO Industriemontage* [2007] ECR I-299, para. 55.

34 ECJ 11 June 2009, C-521/07, *Commission v. the Netherlands* [2009] ECR I-4873, para. 49; CJEU 10 May 2012, C-338/11 to C-347/11, *Santander Asset Management SGIIC SA et al.*, not yet reported, para. 54.

35 ECJ 22 January 2009, C-377/07, *STEKO Industriemontage* [2007] ECR I-299, para. 55.

36 ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] I-10983, para. 72.

37 See Bakker, 233.

38 Bakker, 247, at fn. 29; D. Servais, *Een Europese financiële ruimte* (Luxembourg: Bureau voor officiële publikaties der Europese Gemeenschappen, 1995), 65, at fn. 59.

39 A. Honrath, *Umfang und Grenzen der Freiheit des Kapitalverkehrs* (Baden-Baden: Nomos Verlagsgesellschaft, 1998, 131.

40 Bakker, 233; Servais, 65.

41 See, for example, ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] I-11753, para. 174 and ECJ 18 December 2007, C-101/05, *Skatteverket v. A* [2007] ECR I-11531, para. 44.

3.11 In the field of direct taxation, the essential question appears to be: how should one determine whether an applied direct tax restriction already existed on the specified date?

The question upraises what should hold when a direct tax measure that existed on a specified date is amended afterwards.

Obviously, no peculiarities arise when a direct tax restriction already existed before the specified date and was not amended afterwards. In such case, an existing restriction can be identified. Conversely, a new restriction exists once a direct tax restriction is introduced after the specified date which did not exist on or before that date.

3.12 In this regard, one can conclude the following. A standstill clause is not applicable in the case of posterior amendments of the underlying tax legislation which actually result in increasing restrictive effects in a particular case compared to those under the previous legislation.[42] In other words, if the taxpayer is worse off under the new legislation compared to the rules as they stood on the specified date, the standstill clause involved remains inapplicable, even if the underlying legislation has, in substance, not changed or at the same time abolishes or mitigates one or more restrictive elements that previously existed.[43]

3.13 On the other hand, if an existing restriction has been reduced after the said date, the standstill clause remains applicable.[44] In such a case, the taxpayer is better off compared to the situation prior to the amendment. The same applies where the underlying tax legislation is amended afterwards, but does not lead to increasing or decreasing restrictive effects in a particular case compared to the previous legislation.[45] In such a case, the taxpayer is neither better nor worse off under the new legislation compared to the rules as they stood on the specified date. This might be different, however, where the amended legislation is based on an approach which differs from that of the previous law and which establishes new procedures.[46] In addition, once an existing

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42 By analogy, ECJ 23 April 2009, C-460/07, *Puffer* [2009] ECR I-3251, para. 86; ECJ 22 December 2008, C-414/07, *Magoora* [2008] ECR I-10921, para. 45; ECJ 20 September 2007, C-16/05, *Tum and Dari* [2007] ECR I-7415, para 53; ECJ 12 December 1995, C-469/93, *Amministrazione delle Finanze dello Stato v. Chiquita Italia SpA* [1995] ECR I-4533, para. 63.

43 ECJ 19 February 2009, C-228/06, *Soysal* [2009] ECR I-1031, paras 54-55.

44 An analogy can be drawn in this latter regard with *Danfoss*. In this case, the ECJ ruled in the context of a standstill clause in the field of VAT that where after the entry into force of the Sixth Directive, the legislation of a Member State is amended in such a way as to reduce the scope of existing exclusions and thereby is brought into line with the objective of the Sixth Directive, that legislation must be considered to be covered by the said derogation; ECJ 11 December 2008, C-371/07, *Danfoss and AstraZeneca* [2008] ECR I-9549, para. 32.

45 ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para. 196.

46 ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para. 192; ECJ 23 April 2009, C-460/07, *Puffer* [2009] ECR I-3251, para. 93. On the other hand, the

restriction has been abolished, it cannot be reintroduced.[47]

3.14 Finally, once it has been established that a restrictive direct tax measure infringes a standstill clause, Member States are subsequently required to disapply the contested restriction in such a case, but only *to the extent* this restriction did not already exist on the specified date.[48]

3.15 Broadly speaking one can conclude that the standstill clause under Article 64(1) TFEU applies to relatively larger third-country investments and *limits* the protection that third-country investors could otherwise derive from the free movement of capital as guaranteed under Article 63(1) TFEU. This is under the condition that the restrictive direct tax measure being applied already existed by the end of 31 December 1993.

4. The procedure of approval under Article 65(4) TFEU: a (slight?) shift of competence from the CJ back to the Member States

4.1 Until the entry into force of the Lisbon Treaty on 1 December 2009, only the CJ was competent to decide whether a restrictive tax measure infringes the free movement of capital as laid down in Article 63(1) TFEU. However, through the entry into force of the Lisbon Treaty, a new procedure was introduced, which specifically aims at covering the adoption by a Member State of restrictive tax measures concerning one or more third countries. As was the case under the Treaty, Article 64(3) TFEU allows the Council to unanimously adopt measures which constitute a step backwards in Union law as regards the liberalization of the movement of capital to or from third countries. To date, however, the Council has never used this power in the field of direac taxation. Through the entry into force of the Lisbon Treaty, a fourth paragraph has been added to the tax carve-out provision under Article 65 TFEU.

4.2 Article 65(4) TFEU stipulates that in the absence of such Council measures

"*the Commission or, in the absence of a Commission decision within three months from the request of the Member State concerned, the Council, may adopt a decision stating that restrictive tax measures adopted by a Member State concerning one or more third countries are to be considered compatible with the Treaties in so far as they are justified by one of the objectives of the Union and compatible with the proper*

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mere introduction of procedural amendments does not, however, necessarily render the standstill clause inapplicable; *cf.* CJEU 11 February 2010, C-541/08, *Fokus Invest AG* [2010] ECR I-1025, paras 45 *et seq.*

47 ECJ 18 December 2007, C-101/05, *Skatteverket v. A* [2007] ECR I-11531, para. 49. In the same vein in the context of the standstill clause included in the Association Agreement with Turkey: CJEU 9 December 2010, C-300/09 and C-301/09, *Toprak and Oguz*, not yet reported, para. 60.

48 *Cf.*, by analogy, ECJ 7 November 1996, C-126/94, *Cadi Surgelés and others* [1996] ECR I-5647, para. 28 and para. 30.

functioning of the internal market. The Council shall act unanimously on application by a Member State."

4.3 The above procedure was already proposed during the process of drafting the European Constitution of 2004 under Article III-158(4) and has subsequently been incorporated without any changes and, to the author's knowledge, without any further publicly-available deliberations, in the Lisbon Treaty. From the preparatory work on the European Constitution, one can only infer that the addition was proposed "to meet the concerns of some Member States over these provisions", *i.e.* those relating to the free movement of capital.[49] These considerations thus shed very little light on the background and purport of the new procedure and its impact in the field of direct taxation.[50] Nonetheless, it must be assumed that the new procedure governs direct tax measures as well, at least to the extent such measures fall within the ambit of Article 63(1) TFEU. This is evidenced by the fact that Article 64 TFEU, to which this provision refers, governs direct tax restrictions as well.[51]

4.4 Yet, the new procedure, which to the author's knowledge has not been examined in detail in the scholarly literature until now[52], raises many

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49 Conference of the Representatives of the Governments of the Member States, Brussels, 29 April 2004, PRESID 16, CIG 73/04, Meeting of Focal Points (Dublin, 4 May 2004) working document, 121.

50 According to Snell, this provision demonstrates the Member States' distrust of the Court when it comes to deciding on tax matters and their willingness to curtail the free movement of capital to and from third countries; J. Snell, 'Free movement of capital: Evolution as a non-linear process', in *The Evolution of EU Law*, eds P. Craig & G. De Búrca (Oxford: Oxford University Press, 2011), 554.

51 See, for example, ECJ 12 December 2006, C-446/04, *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, paras 174 *et seq.*

52 In the academic literature, this provision has already received some attention. Fraga submits that it is highly probable that the scope of the freedom of capital will be reduced, because regulating a fully liberalized regime can only, by definition, restrict such a regime, and because national tax regimes are explicitly considered able to limit capital flows; F.L. Fraga, Review of *The Free Movement of Capital and Foreign Direct Investment. The Scope of Protection in EU Law*, by S. Hindelang, *European Journal of International Law*, 21 (2010): 499. O'Brien believes that this new provision indicates that all 27 Member States have agreed that the ECJ must not be the final decision-maker in third-country tax cases; O'Brien, 'Canada, Capital Movements and the European Union', *Canadian Tax Journal* 2 (2009), 290. She nonetheless takes the view that it is difficult to imagine a tax restriction with respect to one or more third countries that would not be consistent with the functioning of the internal market. This is because the extension of Article 63(1) TFEU to third countries in 1994 was ostensibly to support the euro as an international reserve currency, and no specific objective related to the internal market has been identified. Since the euro has already achieved global status as an important international currency, she submits that it will be difficult to show that a restrictive tax measure could jeopardize achievement of that goal; O'Brien, 'Taxation and the Third Country Dimension of Free Movement of Capital in EU Law', at 661-66 and 666. Flynn wonders whether the strong *erga omnes* commitment survives; L. Flynn, Review of *The Free Movement of Capital and Foreign Direct Investment: The Scope of Protection in EU Law* by S. Hindelang, *European Law Review* 6 (2010): 892-895. Barnard considers the new procedure

questions.

4.5 The first question is whether the new procedure is only concerned with newly adopted direct measures, or whether it also covers direct tax measures already in force in the Member States. It is submitted that it would go one step too far if a restrictive tax measure prohibited under Article 63(1) TFEU prior to the entry into force of the Lisbon Treaty were all of the sudden to be declared permissible by virtue of the new procedure of Article 65(4) TFEU. It follows that restrictive direct tax measures already in force should, as a matter of legitimate expectations, not be covered by this provision at least to the extent taxpayers would otherwise be deprived from their enforceable rights based on Article 63(1) TFEU.

4.6 Another question is how one should determine under this procedure whether a restrictive tax measure can be considered compatible with the Treaties. Article 65(4) TFEU provides that restrictive tax measures can be considered compatible with the Treaties in so far as they are justified by one of the objectives of the Union and compatible with the proper functioning of the internal market. It is therefore suggested that, for the sake of consistency, equality and neutrality, the Commission and, alternatively, the Council should stay close to the principles developed by the CJ in this regard when making use of their new powers.[53]

4.7 The last question is whether and to what extent the competence to determine whether a restrictive tax measure is permissible under Union law has been shifted from the CJ to the Commission and, alternatively, the Council. Where a request of a Member State has been submitted, it is only the Commission, or alternatively the Council, that is exclusively competent to assess the compatibility of the restrictive tax measure with the Treaties. According to Article 263 read in conjunction with Article 288 TFEU, the legality of this decision can be assessed by the CJ solely on grounds of lack of competence, infringement of an essential procedural requirement, infringement of the Treaties or of any rule of law relating to their application, or misuse of powers. Not only the Member States but also legal persons may institute proceedings against the decision made by the Commission, or alternatively the Council, before the CJ, but only if the decision is of direct and individual concern to them.[54] Put differently, they must qualify as an interested party.

4.8 Although the new procedure seems to imply a shift of competence from the CJ back to the Member States in the field of direct taxation, until now there

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unusual given that this procedure allows the Council, and not the ECJ, to decide on the legality of national measures; C. Barnard, *The Substantive Law of the EU*, 3rd ed. (Oxford: Oxford University Press, 2010), 565.

53 See also O'Brien who favours a restrictive interpretation of the new provision; O'Brien, 'Taxation and the Third Country Dimension of Free Movement of Capital in EU Law', 661-662.

54 *Cf.* Article 263 TFEU.

are no reported cases where any Member State has made use of this new procedure.

5. Conclusion and final remarks

5.1 Within the Union, the Treaty freedoms prohibit that Member States tax income from transnational investment less favourably than income derived from a comparable domestic investment, unless a valid justification exists. The core question is whether the same conclusion applies in the relations between Member States and third countries. In general terms, one can establish that in the field of direct taxation, large third-country investments face a relatively low protection, whereas small third-country investments face a relatively high protection under the free movement of capital under Article 63(1) TFEU. Hence, in general terms it can be said that direct tax measures that are designed specifically for MNEs are not caught by the free movement of capital (and hence Member States fully retain their tax sovereignty in this respect) whereas other direct tax measures, notably those focussing on small portfolio investors, can be scrutinized under Article 63 TFEU, especially if these measures are adopted after 31 December 1993.

The Netherlands, for example, has amended its dividend withholding tax act as per 2012 in order to avoid discussions about the compatibility with Article 63 TFEU in third country situations. As per 2012, certain types of portfolio investors outside the EU (e.g. exempt pension funds, sovereign wealth funds) are entitled to a full refund of Dutch dividend withholding tax.

5.2 It is noted, however, that the CJ's case law in the field of direct taxation has not fully materialized yet as far as third countries are concerned. In addition, past case law of the CJ has demonstrated that the interpretation of Article 63 TFEU may have had an implicit political dimension as well. In some cases, Article 63 TFEU was interpreted more restrictively than its literal wording suggests, as a result of which direct tax measures that are specifically targeted to MNEs are excluded from the scope.[55] The future development of the CJ's case law in the field of direct taxation is therefore difficult to predict.

5.3 Finally a new approval procedure under Article 64(4) TFEU, introduced under the Lisbon Treaty, seems to imply a shift of competence from the CJ back to the Member States in the field of direct taxation, until now there are no reported cases where any Member State has made use of this new procedure. Here too, it remains to be seen what the impact will be on Member States' sovereignty in the field of direct taxation in third country relations.

5.4 To sum up, the impact of the free movement of capital under Article 63 TFEU on Member States' policies in the area of direct taxation in third country

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55 See, for instance, ECJ 10 May 2007, Case C-494/04 (Lasertec), ECR 2007, p. I-3775 on thin capitalization rules; ECJ 6 November 2007, Case C-415/06 (Stahlwerk Ergste Westig), ECR 2007, p. I-151, Summ.pub, on cross-border loss compensation.

relations is less substantial compared to the impact within the Union, especially as far as the taxation of MNEs are concerned. Conversely, as concerns small portfolio investors, the impact of the free movement of capital under Article 63 TFEU on Member States’ policies in the area of direct taxation in third country relations does not seem to substantially deviate from the impact within the Union.