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The future of the Swedish CFC legislation applied to third countries

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Summary

The purpose of the paper is to investigate both the Swedish position and the position of ECJ regarding Swedish CFC-legislation towards third countries. It will be investigated if the Swedish position is compatible with ECJ's interpretation of the fundamental freedoms and Sweden's international obligations regarding tax treaties. The CAT has delivered a decision in a case where it tackled the issue whether the Swedish CFC rules are applicable to Switzerland, which is a third country. *The issue is today not settled* when the Swedish Tax Agency has asked the Swedish Supreme Administrative Court (SAC) to confirm the decision number 6/05. On 12 September 2006, it was established in the *Cadbury Schweppes* case that the UK´s CFC legislation violates articles 43 EC and 48 EC when it occurs between Member States and it does not target only "wholly artificial arrangements intended to escape the national tax normally payable".

The CFC legislation of UK and of Sweden CFC have many similarities. One difference which may be significant though, is that the Swedish rules do not take into consideration any reason for the establishment and may be applicable irrespective of reasons.[1] The absence of a "motive test" in the Swedish CFC legislation indicates, in my opinion, that the ECJ may find that the Swedish regulation to a larger extent than the rules of the UK, "goes beyond what is necessary to achieve the objective". It is therefore, I feel, more likely that the Swedish CFC rules are contrary to the EC Law in a situation involving a third country than it is that the UK rules are. The main objective of the EC Treaty constitutes an internal market with an economic and monetary union, and not a certain treatment of third countries. Due to that is it, I feel, unlikely that third countries will receive a larger protection than Ireland was given in the *Cadbury Schweppes* case.
Because the countries Sweden has concluded a tax treaty with have not had the opportunity to approve Swedish CFC rules, can it be argued that it is contrary to the obligations deriving from the tax treaty to apply CFC rules on companies located in those States.

[1] Mattias Dahlberg, 2005, p. 143.

Abbreviations

CAT	Swedish Council for Advance Tax Rulings
CFC	Controlled foreign corporation
ECJ	European Court of Justice
GATT	General Agreement on Tariffs and Trade
ICTA	Income and Corporation Taxes Act 1988
MFN	Most Favoured Nation
OECD	Organization for Economic Co-operation and Development
SAC	Swedish Supreme Administrative Court
STA	Swedish Tax Agency

1 Introduction

In States with CFC legislation, taxation on dividends and capital gains is imposed on the controlling shareholder resident in the State of the controlling shareholder (Home State). It is designed to influence in which countries companies choose to establish legal entities and the controlled foreign corporation (CFC) legislation exists in many EC Member States, such as in the UK, Finland, Spain, Estonia, Sweden, Denmark and France among other.

On 12 September 2006, it was established in the *Cadbury Schweppes* case that the UK´s CFC legislation violates articles 43 EC and 48 EC when it occurs between Member States and it does not target only “wholly artificial arrangements intended to escape the national tax normally payable”.[2] The Swedish CFC legislation when it applies towards members of companies located in a Member State is as a result of the ruling likely to constitute a violation to the EC law. The position of ECJ regarding Swedish CFC legislation towards countries which have not signed the EC Treaty (third countries) is today uncertain because the ECJ has not ruled in a case where the issue has been tackled. The question of whether the Swedish CFC legislation to third countries restricts EC Law is of great importance when a large number of low tax jurisdictions are located outside the EU. Examples are Swedish members to companies located in Liberia, Bahrain, the Seychelles, Maldivian and Thailand under certain conditions subject for Swedish CFC taxation[3]. It is sure that it is in the Swedish government’s interest to keep applying CFC taxation. The CFC legislation is an important part of the Swedish tax legislation and if it violates EC Law Sweden risks losing huge sums of tax revenue. This is because the widely accepted main objective with all CFC legislation is to protect the domestic tax base from erosion.[4] Without CFC rules, a taxpayer is free to establish companies without economic substance in low-tax jurisdictions for the sole purpose of transferring profits and reducing the overall tax burden of the corporate group.[5]

What the position of Swedish Council for Advance Tax Rulings (CAT) towards Swedish CFC legislation to third countries was stated on 4 April 2005, when the CAT delivered a decision[6]. *The issue is today not settled* when the Swedish Tax Agency has asked the Swedish Supreme Administrative Court (SAC) to confirm the decision number 6/05. In this paper I intend to examine the decision and respond to whether it is likely to

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[2] See *Cadbury Schweppes* case C-196/04, paragraph 75.
[3] See enclosure to Swedish Income Tax Code chapter 39a.
[4] Renata Fontana, *The uncertain future of CFC regimes in the Member States of the European Union- Part 1*, 2006, p. 260.
[5] Renata Fontana, *The uncertain future of CFC regimes in the Member States of the European Union- Part 1*, 2006, p. 261.
[6] See *Skatteverkets rättsfallssamling* 6/05.

be compatible with the EC Law and Sweden's international obligations regarding tax treaties.

1.1 Subject and purpose

The purpose of this paper is to investigate both the Swedish position and the position of ECJ regarding Swedish CFC-legislation toward third countries. The following questions will be investigated.

1. What is the Swedish position regarding its CFC-legislation towards third States?

2. Is the position compatible with ECJ's interpretation of the fundamental freedoms and Sweden's international obligations regarding tax treaties?

1.2 Delimitation

The study avoids describing the manner in which other Member States have solved the issue regarding their CFC legislation towards third countries. I will not investigate if it matters to them if there is a tax treaty between the Member State and the other country concerned.

1.3 Method and material

While providing a response to the questions, I studied relevant case law from the ECJ, relevant legal doctrine and a decision from the Swedish Council for Advance Tax Ruling (CAT)[7] regarding the Swedish CFC rules applied to third countries.[8] I have used a traditional legal method in the investigation.

Since it has not been examined by the ECJ whether a Member State's CFC rules towards third countries violate the provisions in EC law, much of the research on how the ECJ may rule has been focused on the ruling in the *Cadbury Schweppes* case and the court's use of the fundamental freedoms.

I have investigated if and to what extent the decision in the *Cadbury Schweppes*, and other cases by ECJ concerning the protection of fundamental freedoms to third countries may provide guidance in the matter.

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[7] My own abbreviation of the Swedish Council for Advance Tax Rulings.
[8] See *Skatteverkets rättsfallssamling* 6/05.

1.4 Outline

In the second chapter I will describe common characteristics of CFC regimes and how the regulation looks regarding tax treaty. The legal status of the OECD commentary will also be described. In order to provide a response of what the EC Law may say regarding Swedish CFC legislation, it is explained in the third chapter how harmonization occurs and what the objective with the EC Treaty is. The decision of the CAT and the ruling in Cadbury Schweppes are described in the fourth and fifth chapter. The analysis starts in chapter six and continues to chapter eight, where I intend to respond to the two questions stated in section 1.1.

2 CFC rules and tax treaties

To understand the investigation of this paper, it is necessary to be aware of certain things regarding CFC legislations and tax treaties.

2.1 Common characteristics of CFC regimes

In States with CFC regimes, taxation is frequently imposed on the controlling shareholder resident in the State of the controlling shareholder (Home State). CFC legislation makes use of a legal principle dealing with the neutralization of cross-border tax differentials by raising the tax burden on investments abroad to the domestic level. The policy of taxation is commonly referred to as capital export neutrality (CEN).[9] Many countries have CFC rules that target only passive investment, which constitute income such as dividends, interest, royalties, rents and capital gains which in today's virtual world, often with a few mouse clicks can be transferred from one State to an other.[10]

The legislation often does not have as an objective to target portfolio investments, which are characterized by a small percentage of voting shares. CFC rules can be recognized by the following restrictions which all occur in CFC regimes.[11]

- The unattractiveness of cross-border investment when the resident taxpayer must bear the temporary costs resulting from the advanced taxation of the CFC company's profit
- A taxation of the resident taxpayer if the CFC realizes losses and no dividends are distributed
- A temporary or permanent economic double taxation imposed on a resident taxpayer
- The Home State adopts a "fictitious dividend" approach, since dividends are taxed in the Home State to the extent of the CFC's accrued profits, but no tax is withheld by the Host State until the actual distribution, creating a situation of excess or a permanent loss of foreign tax credit
- High compliance and administrative costs imposed by the companies established in CFC regimes.

[9] Jens Schönfeld, October 2006, p. 443.
[10] Fontana Renata, *The uncertain future of CFC regimes in the Member States of the European Union- Part 1*, 2006, p. 262.
[11] Renata Fontana, *The future of CFC regimes in the Member States of the European Union - Part* 2, 2006, p. 323.

2.2 The Swedish CFC rules compared to the UK's CFC rules

In order to estimate the impact the ruling in the *Cadbury Schweppes* case has on Swedish law, it is necessary to be aware of the differences between the two countries' CFC rules.

The UK and Sweden have both had CFC legislation for a long time, the UK since 1984, and Sweden since 1989. Sweden has recently adopted new CFC rules, though, and the regulation entered into force on 1 of January in 2004. The legislation applies to fiscal years beginning after December 31 2003, which means, that for companies or individuals with a fiscal year of 1 January to 31 December, 2004 was the first year when the new rules were applicable.[12] The Swedish CFC rules can be found in the Swedish Income Tax Code chapter 39a and the UK legislation is contained in the Income and Corporation Taxes Act 1988 (ICTA), relevant schedules 24-26 and sections 747-756.

The Swedish CFC legislation has a lower threshold for its applicability than both the UK legislation and other CFC regimes in general since it targets companies or individuals which at the end of the fiscal year, hold or control at least 25 percent of the capital or the voting rights in certain low-taxed foreign legal entities.[13] The UK legislation has a higher demand on the controlling shareholder's influence when it applies to companies, or individuals, which control more than 50 percent of the share capital or voting power in a foreign low-taxed entity. The Swedish rules apply to foreign companies' members in a Swedish corporation group that is not taxed or taxed at a rate below 15,4 percent, whereas the corresponding rate in the UK is 22,5 percent before the net income of the company is to be calculated under the Home State's tax rules. In Sweden, income for corporation groups in some jurisdictions are on a white list and is therefore not to be subject to CFC taxation, even if the effective tax rate is below 15,4 percent. An equivalent regulation does not exist in the UK.

As the reader perhaps has noted, the UK and the Swedish CFC rules have many similarities. One difference which may be significant though, is that the Swedish rules do not take into consideration any reason for the establishment and may be applicable irrespective of reasons.[14] The UK legislation contains a "motive test", which compromises two cumulative conditions for a taxpayer to demonstrate to be excepted from CFC tax. The first condition requires the tax payer to demonstrate that, if there is a reduction in UK tax as a result of the transactions of the foreign subsidiary, the lower tax is not the purpose, or one of the main reasons for the transaction. The second condition states that the taxpayer must demonstrate

[12] Jan Kallqvist, 2006, p. 1.
[13] Fontana Renata, *The uncertain future of CFC regimes in the Member StateStates of the European Union- Part 1*, 2006, p. 260.
[14] Mattias Dahlberg, 2005, p. 143.

that the diversion of profits from the UK to the subsidiary is not the main motive, or one of the main motives for the existence of the subsidiary. The absence of a "motive test" in the Swedish CFC legislation indicates, as I see it, that the ECJ may find that the Swedish regulation in a larger extent than the rules of the UK, "goes beyond what is necessary to achieve the objective". It is therefore, in my view, more likely that the Swedish CFC rules are contrary to the EC Law in a situation involving a third country than it is that the UK rules are.

2.3 The compatibility of Swedish CFC rules with tax treaties

Sweden has concluded tax treaties with approximately 80 different States in order to prevent double taxation and its CFC legislation applies to companies located in States with which the country has concluded tax treaties.[15] For the situation where a tax treaty does not include a special provision on a CFC regime, a potential conflict may be at hand.[16] Some Swedish tax treaties, where a provision on a CFC legislation does not exist, may be interpreted as if they include foreign companies. Because the countries Sweden has concluded a tax treaty with have not had the opportunity to approve the Swedish CFC rules, it can be argued that it is contrary to the obligations deriving from the tax treaty to apply CFC rules and impose restrictions on companies located in those States.[17]

2.4 Swedish tax treaties' relationship with the OECD Commentary

Many of the Swedish treaties are based upon the model treaty of OECD.[18] For interpretation of tax treaties, different interpretation methods can be used. The *static interpretation* method gives the result that the outcome is based upon the circumstances and insights of the parties at the time the treaty was concluded and the *ambulatory interpretation* method is taking later developments into account. For interpretation of tax treaties based upon the model of OECD, it is recommended by the OECD that the parties should apply the non-binding Commentary distributed by the organization. In the 2003 update to the Commentary of article 1, CFC regimes were both expressly recommended by the OECD and regarded as compatible with tax treaties.[19]

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[15] Mattias Dahlberg, 2005, p. 143
[16] Renata Fontana, 2006, p. 363.
[17] Mattias Dahlberg,, 2005, p. 138 and 140.
[18] Mattias Dahlberg, 2005, p. 138 and 147.
[19] Paragraph 23 of the 2005 Commentary on article 1 of the OECD Model, as amended in 2003.

Not all countries were satisfied with the statement, and after the Commentary was released, several countries, including Belgium, The Netherlands, Ireland, Portugal, Luxembourg and Switzerland, submitted observations where they disagreed with it.[20]

The legal status of the OECD Commentary is disputed by scholars.[21] For example, in Wattel's opinion, the Commentary should at the time of the conclusion of the treaty be considered to have received parliamentary approval and therefore be part of the context of the treaty. If a later version of the Commentary conflicts with an older version or with the text of the treaty which was concluded, there does not exist any democratic legitimacy and the new version should be given little or no weight for interpretation of the treaty.[22] In my opinion, Wattel's suggestion of interpretation is suitable in the area of taxes because lots of things impossible to predict are constantly changing due to, for example, national tax policies and legal development deriving from the ECJ. Since tax treaties are important when they deal with lots of tax revenue for the States it is crucial for the concluding parties to be able to control what a tax treaty will include in the future.

[20] The observations have been published in the 2003 edition of the Commentary.
[21] Peter J Wattel and Otto Marres, 2003, p. 234.
[22]Peter J Wattel and Otto Marres, 2003, p. 224.

3 Harmonization through EC Law

Harmonization of Community Law occurs through several different measures which I will describe. The purpose of the chapter is to explain how harmonization occurs and what the objective with the EC Treaty is. This is because being aware of it is necessary when predicting whether Swedish CFC legislation violates EC Law.

3.1 The objective of the EC Treaty

The objective with the EC Treaty is expressed in article 2 EC, and constitutes the establishing of a common market and an economic and monetary union. According to article 4 EC it shall be accomplished by ”the adoption of an economic policy which is based on the close coordination of Member States' economic policies, in the internal market and the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition”.

Knowing the purpose of the provisions is important when investigating what the Community Law may state regarding different measures, as article 5 EC states that "the community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein".

3.2 Objective with the free movement of capital's protection to third countries

The free movement of goods, of workers and services, and the right of establishment all have in common that they constitute fundamental freedoms in the EC Treaty and that they *only apply between Member States*. The free movement of capital in article 56 EC is different since it offers protection to third countries and citizens from those countries can claim protection under the article.[23]

The extension of the freedom to include third countries took place through the Maastricht Treaty in 1990. The purpose of extending the provision is unclear other than that the drafters wanted to increase the liberalization between Member States and third countries. Article 56 EC is formulated as an obligation to the Member States but according to Ståhl article 7 in directive 88/361/EEC, which was established for the implementation of the

[23] This occurred in the joined cases *Sanz de Lera,* C-163/94, C-165/94 and C-250/94 1995 ECR I-4821 where one of the parties was a Turkish citizen.

previous article, has the character of a political commitment rather than a legal binding obligation to the Member States.[24] Her interpretation is supported by the no longer valid article 67 EC on the free movement of capital, which in my view seems to have a political aim as it states that Member States should strive for a "progressive coordination" regarding the movement of capital to and from third countries, and they should "endeavour to attain" the highest degree of liberalization.

3.3 Positive and negative harmonization and their problems

Positive and negative harmonization are instruments, which are used to achieve the objectives with the EC Treaty. Positive harmonization happens through voluntary agreements between the Member States which lead to secondary legislation. Negative harmonization is when the ECJ, through its application and development of the four freedoms forces Member States to stop applying a measure. The four fundamental freedoms can be regarded as the fundamental foundations of the Treaty and it has been stated by the ECJ that all four freedoms are directly applicable.[25] The four fundamental freedoms consist of the free movement of goods, of workers and services, the right of establishment and the free movement of capital. In the case law of ECJ regarding tax is it understood that, in the absence of harmonization, the Member States are free to exercise their sovereignty under the condition that they do so consistently with EC law.[26]

The reason why ECJ's application and development of the four fundamental freedoms can be referred to as negative harmonization is because when the ECJ rules that a legislation of a Member State restricts a fundamental freedom, the Member State has no choice but to stop applying the measure. If a Member State does not do that it would be contrary to article 10 EC, which states that the Member States shall take all appropriate measures to ensure fulfillment of the obligations arising from the EC Treaty. A problem with negative harmonization is that legal uncertainty follows when generally formulated Treaty provisions receive their scope through ECJ's interpretation of individual cases.

The second instrument constitutes approximation of national law by secondary legislation according to article 3 (1) (h) EC. Because such

[24] Ståhl Kristina, 2004, p. 49.
[25] Free movement of goods: Case C-74/76 *Ianelli and Volpi/Meroni* [1977] ECR I-557, paragraph 13; Free movement of workers: Case C-48/75 *Royer* [1976] ECR I-497 paragraph 19-23; right of establishment Case C-2/74 *Reyners* [1974] ECR I-631paragraph 19-31, free movement of services Case C-33/74 *van Binsbergen* [1974] ECR I-1299; free movement of capital: Case C-524/04, *The Test Claimants in theThin Cap Gruop Litigationv. Commissioners of Inland revenue,*, paragraph 102.
[26] See Case C-279/93 *Finanzamt Köln-Altstadt v. Roland Schumacker* [1995] 1-225, paragraph 25 and *Verkooijen* C-35/98 2000 ECR I-4071 paragraph 32.

measure is not connected with an abolishing of the Member States' legislation, it can be referred to as positive harmonization.[27]

A problem with positive harmonization by political decisions is that it is hard for Member States to agree on which measures to have similar rules regarding. Some Member States, for example Ireland and The Netherlands, feel that they have to make their country attractive for companies to invest in by imposing lower taxes than the rest of the Member States. The different conditions of the Member States lead to different wishes when all Member States want to protect their own tax base and it is therefore difficult to come to an agreement. Positive harmonization has the advantage that it many times increases the predictability for the Member States of what the EC law says. It also makes it easier for Member States to draft laws in their own countries when they have agreed on the content in the secondary legislation.

3.4 Different opinions regarding harmonization by MFN treatment

The essential core of the Most Favoured Nation (MFN) concept is that a State (the debtor State) accepts a clause meaning it must not discriminate subjects of another State (the creditor State) against subjects of a third State (the most favoured State).[28]
Countries have agreed on MFN treatment in a number of bilateral and multilateral treaties. One significant is in article 1 GATT, which provides for MFN treatment in connection with trade in goods. It covers excise duties as well as customs duties and may also be applied to direct taxes, for example income tax.[29]

A disputed issue is *whether Community Law requires harmonization through MFN treatment* in tax treaties, and if so, on what legal basis and to what extent this would be.[30] If the MFN treatment is required within the EU, the principle would protect Member States and not third countries, giving the result that EU Member States are prohibited from including more favourable clauses in treaties with third countries than they have with other Members in the EU.[31]

It is certain that the EC Treaty does not contain any rule which explicitly provides for MFN treatment. Some authors are of the opinion that MFN treatment is set out in article 10 EC which contains an obligation for the Member States to cooperate with each other. An argument against such interpretation is that the article lacks the necessary strength to establish MFN treatment within Community Law since article 10 EC is a broad and

[27] Pannier Mattias, Gütt Tilman and Andenas Mads, p. 760.
[28] Cordewener Axel, 2006, p. 241.
[29] Fortuin Alexander, 2007, p. 147, Cordewener Axel, 2006, p. 242.
[30] Cordewener Axel, 2006, p. 246, Schuch Josef, 2006, p. 6.
[31] Pistone Pasquale, 2006, p. 239.

general clause. Its vague content does not have direct effect and can therefore not be relied on by individuals before national courts.[32]

A different solution is indicated by Advocate General Ruiz-Jarabo who suggests that the four fundamental freedoms combined with the general prohibition of discrimination on grounds of nationality in article 12 EC constitutes a legal basis for the principle.[33] The wording of article 12 (1) prohibits "any discrimination on grounds of nationality" and advocates for the theory that the rule must include the equal treatment of different foreigners when it guarantees the equal treatment of foreigners with regard to every Member State's own nationals.[34]

3.4.1 Impact of the *D* case

Klaus Vogel, Daniel Gutmann and Ana Paula Dourado view the ECJ's decision in the *D* case as meaning that the MFN treatment is not required by Community Law.[35] Tom O'Shea is of the same opinion when he comments the verdict by saying that the D *case* demonstrates that Member States can, in the absence of Community harmonization rules, enter into DTCs which contain
by their nature different provisions[36].

The legal issue in the *D* case looked at whether it is compatible with the fundamental freedoms provisions of the EC Treaty for a Member State to conclude tax treaties with two Member States which treat non-residents different.[37] The ECJ held that the Member State was not violating EC law since it is not legally relevant to compare the situation of non resident persons belonging to different countries. Vogel means that CFC clauses in tax treaties may be considered as rules on allocation of tax powers and the following two conclusions may in his opinion be inferred from the *D* case, which may be a relevant argument for justifying compatibility of CFC legislation to third countries with EC law.[38]

- The ECJ has recognized that the structure and level of the Member States' taxes is intrinsically non-neutral.
- As the ECJ has recognized that EC law does not prohibit different tax treatment of non-residents, it has confirmed that EC law does not require capital import neutrality within the EU, and therefore, it also does not require that a Member State taxes any cross-border situation according to a capital import neutrality principle.

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[32] Cordewener Axel, 2006, p. 244.
[33] See Opinion of Advocate General Ruiz-Jarabo, Case C-376/03*, D. v. Inspectaeur van de Belastningsdienst/Particulieren/Ondernemingen buitenland te Heerlen*, paragraph 83-97.
[34] Cordewener Axel, 2006, p. 245, Schnitger Arne, 2006, p. 154.
[35] Klaus Vogel, Daniel Gutmann and Ana Paula Dourado, 2006, p. 84.
[36] O'Shea Tom, 2005, p. 194.
[37] See case C-276/03 *D*.
[38] Klaus Vogel, Daniel Gutmann and Ana Paula Dourado, 2006, p. 89.

Dr. Arne Schnitger is of a similar opinion. He wonders whether the approach of Advocate General Leager in his opinion in the *Cadbury Schweppes case* is in line with the decision of the ECJ in the *D case*[39]. The reason as why Dr. Arne Schnitger questions the approach is because Advocate General Leager concluded that the UK CFC legislation restricts the freedom of establishment.

[39] Dr. Arne Schnitger, 2006, p. 154.

4 The Swedish position on its CFC legislation applied to third countries

The CAT has delivered a decision in a case where it tackled the issue whether the Swedish CFC rules are applicable to Switzerland, which is a third country[40]. CAT has a special function of distributing decisions that are binding for tax authorities but not on tax payers. It is not recognized as a court under article 234 EC and can not refer cases in respect of advanced rulings to the ECJ.[41]

The issue is today not settled when the Swedish Tax Agency has asked the Swedish Supreme Administrative Court (SAC) to confirm the decision number 6/05. The Swedish Supreme Administrative Court has so far not done that and since the compatibility of CFC regimes with EC law generally falls outside the competence of domestic courts, is it likely that the case eventually will reach ECJ which will deliver a preliminary ruling what the EC law says.[42]

4.1 The decision of the CAT

In the following sections the decision of the CAT will be described.

4.1.1 Background

On 4 April 2005, the CAT received an application from a parent company owning a captive in Switzerland.[43] The company wanted the CAT to deliver decisions about the following questions:

1 Does the tax treaty between Sweden and Switzerland prevent the Swedish CFC rules being applied?
2 Does article 56 EC prevent the practice of the Swedish CFC rules?

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[40] See *Skatteverkets rättsfallssamling* 6/05.
[41] Renata Fontana, *The uncertain future of CFC regimes in the Member States of the European Union- Part 1,* 2006, p. 263.
[42] Mattias Dahlberg, 2005, p. 267.

4.1.2 Response concerning tax treaty and EC law

The CAT held that application of the Swedish CFC rules did not violate the tax treaty Sweden had concluded with Switzerland because the income the subsidiary pays tax for in Switzerland was found to constitute a different income than the one the Swedish CFC legislation imposes on the parent company.[44]

The wording of article 56 (1)EC states "Within the framework of the provisions set out in this chapter all restrictions on the movement of capital between Member States and Member States and third countries shall be prohibited". The CAT found that the country's CFC regime is incompatible with that article based on the following reasoning.

To determine whether the restriction of the free movement of capital was justified, the CAT applied a rule of reason-formula developed in ECJ case law and, according to which national measures liable to hinder or make less attractive the exercise of the fundamental freedoms must satisfy four conditions.[45] Measures shall (1) be applied in a non-discriminatory manner, (2) be justified by imperative requirements in the general interest, (3) be suitable for securing the attainment of the objective which they pursue and (4) not go beyond what is necessary to attain this objective. The CAT found that the restriction was justified on the objective of tax avoidance since article 56 EC should have a more limited scope regarding CFC rules to third countries which, according to the CAT, could be inferred from the content in articles 57, 59 and 60 EC. The risk of tax avoidance, therefore, approved as a justification.

Regarding proportionality, it was stated that even though the Swedish rules do not take into consideration any reason for the establishment and may be applicable irrespective of reasons, it does not "go beyond what is necessary to achieve the objective" of tax avoidance, and the legislation can therefore be applied towards Switzerland.

[44] The tax treaty between Sweden and Switzerland is incorporated in SFS 1987:1182.
[45] The same formula has been used in *Futura Participations and Singer* case C-250/95 [1997] paragraph 26, and *De Lasteyrie du Saillant* case C-9/02 [2004], paragraph 49.

5 The ruling in the *Cadbury Schweppes* case

The *Cadbury Schweppes* case will be described closely as it is important when finding out what the EC law may say regarding Swedish CFC legislation to third countries. This is because both the Advocate General and the ECJ agreed on what fundamental freedom was restricted and it was expressed under which conditions CFC legislation between Member States is justified and proportional. The main objective of the EC Treaty constitutes an internal market with an economic and monetary union[46], and not a certain treatment of third countries. Due to that it is, in my opinion, unlikely that third countries will receive a larger protection than Ireland was given in the *Cadbury Schweppes* case.

5.1 Background and the opinion of the Advocate General

Cadbury Schweppes is a UK resident company and the parent company of a group of companies, which included two group financing subsidiaries resident in Ireland. In Ireland where the subsidiaries were subject to a tax rate of 10 percent, and the UK parent company was issued an assessment of more tax on the dividends, by the UK on the basis of the CFC legislation it applied. The demands on tax from the UK led to an appeal by Cadbury Schweppes, where the company argued that the CFC rules contained in the ICTA constitute a restriction of its fundamental freedoms under the EC Treaty. The issue reached the Special Commissioners of Income Tax, which chose to stay the proceedings and to ask the ECJ for advice via the Preliminary ruling procedure.

According to the Advocate General, the freedom which was to be examined was the freedom of establishment in article 43 EC. Establishing subsidiaries in Ireland for the purpose of benefiting from a more favourable tax regime did not, according to the Advocate General Leger, in itself, constitute an abuse of the freedom of establishment and such behaviour is in Advocate General's view considered as a legitimate location factor.[47] The CFC rules of the UK constituted a hindrance of the freedom of establishment because they did not claim tax on dividends from subsidiaries resident in UK but only from subsidiaries resident in Ireland. Such difference in treatment created a tax disadvantage.[48] The regulation was, according to the Advocate General, proportionate to and compatible with the provisions of Community law if the CFC rules only apply to (1) wholly artificial arrangements

[46] The objectives with the EC Treaty is expressed in article 2 EC.
[47] Opinion of Advocate General Leger, *Cadbury Schweppes* case C-196/04, paragraph 24.
[48] Opinion of Advocate General Leger, C-196/04, paragraph 74 and 75.

intended to circumvent national law and (2) allows tax payers to be exempted from the legislation "by providing proof that the subsidiary is genuinely established in the State of establishment and that the transactions which have resulted in a reduction in the taxation of the parent company reflect services which are actually carried out in that State and were not devoid of economic purpose with regard to that company's activities".[49] The ground for justification he approved was tax avoidance.[50]

5.2 The arguments brought forward by the UK and the Cadbury Schweppes

The UK Government, supported by the Danish, German, Swedish, French, Portuguese and Finnish Governments, suggested first that the ICTA does not constitute a restriction since the resident company does not pay more tax than it would have done on those profits made by a subsidiary established in the UK. Second, they submitted that the legislation is intended to counter tax avoidance, involving "the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax State by means of the establishment of a subsidiary in that State and the effecting of transactions intended primarily to make such a transfer to that subsidiary".[51]

Cadbury Schweppes said that the CFC regime of the UK was contrary to articles 43 EC, 49 EC and 56 EC.[52] The applicants together with the Commission and the Governments of Belgium, Ireland and Cyprus, further meant that the circumstances are not sufficient to conclude that there is a "wholly artificial arrangement intended solely to escape that tax".[53]

5.3 The judgement by the ECJ

In the following sections the judgement by the ECJ will be described.

5.3.1 The applicability of EC law

The ECJ stated that the ICTA has restrictive effects on the free movement of services and the free movement of capital, but when such effects are an unavoidable consequence of any restriction of the freedom of establishment, it does not justify an independent examination of articles 49 EC and 56 EC.[54] Since the legislation concerns taxation of profits established outside

[49] Opinion of Advocate General Leger, *Cadbury Schweppes* case C-196/04, paragraph 151.
[50] Opinion of Advocate General Leger, case C-196/04, paragraph 104.
[51] See *Cadbury Schweppes* case C-196/04, paragraph 48.
[52] See case C-196/04, paragraph 21.
[53] See case C-196/04, paragraph 63.
[54] See case C-196/04, paragraph 33.

of the UK, the legislation must be examined in the light of articles 43 EC and 48 EC, granting freedom of establishment.[55]

The first argument by the UK does not, according to the ECJ, change the fact that the CFC rules of the UK constitute a restriction on the freedom of establishment within the meaning of articles 43 EC and 48 EC.[56] This is because the legislation makes the resident company have to pay tax for another legal person which would not have happened if it was a subsidiary resident in the UK and that difference in treatment creates a tax disadvantage. Because the ICTA was applied differently to companies in the UK, it resulted in a tax advantage which restricted the freedom of establishment.[57]

5.3.2 Different justifications

The ECJ used a rule-of- reason formula developed in previous case law and according to which a restriction is permissible only if (1) it is justified by overriding reasons of public interest, (2) its application is appropriate to ensure the attainment of the objective pursued and (3) does not go beyond what is necessary to attain it.[58]

The ECJ responded to the second argument by the UK by stating that ”the need to prevent the reduction of tax revenue is not one of the grounds listed in article 46 (1) EC or a matter of overriding general interest which would justify a restriction on a freedom introduced by the Treaty”.[59] The argument was further investigated, and the concept of establishment within the meaning of 43 EC and 48 EC was found to involve the “actual pursuit” of an economic activity in an other State.

In order to justify a restriction on the ground of *prevention of abusive practices*, the legislation must prevent conduct involving “*the creation of wholly artificial arrangements which do not reflect economic reality*”, with a purpose to escaping the tax normally due on the profits generated by activities carries out on national territory.[60] CFC legislation targeting creations of wholly artificial arrangements which do not reflect economic reality may, similar to what was approved in *Marks and Spencer*, be justified since it “undermines the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and therefore jeopardise a balanced allocation between Member States of their power to impose taxes”.[61] Such conduct was presented by the ECJ as a

[55] See *Cadbury Schweppes* case C-196/04, paragraph 32.
[56] See case C-196/04, paragraph 46.
[57] See case C-196/04, paragraph 43-46.
[58] See case C-196/04, paragraph 47.
[59] It was also stated in case C-136/00 *Danner*, paragraph 56.
[60] See case C-196/04, paragraph 48.
[61] See case C-196/04, paragraph 56 and *Marks and Spencer* case C-446/03, paragraph 46.

fictitious establishment, such as a "letterbox" or "front" subsidiary.[62] Special meaning could be given to the word "wholly", in the context of "wholly artificial arrangements", in relation to tax planning practises. *Some form* of artificial arrangements to allow tax structuring to obtain certain taw advantages does therefore seem to be possible without violating ECJ's interpretation of the freedom of establishment.[63]

The ECJ found that the ICTA legislation is not proportionate since it goes beyond what is necessary to achieve the objective of prevention of abusive practises which was approved as a justification and "in order for the legislation to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality".[64]

5.3.3 The ruling

The ECJ ruled that articles 43 EC and 48 EC should be interpreted as "precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable".[65] The ECJ stated that Cadbury Schweppes must be given an opportunity to produce evidence ascertainable to third parties that the CFC is actually established and that genuine activities are carried on. Objective evidence should in particular consist of premises, staff and equipment.

The ECJ left it up to the national court to decide whether or not the exceptions in the UK CFC legislation, in particular the motive test in relation to the specific situation of Cadbury Schweppes, are sufficient to limit the application of the rules to wholly artificial arrangements intended to escape the national tax normally payable.

The ruling gives as result that provided that the two Irish subsidiaries were actually carrying on business as group financing companies in Ireland, the UK can not apply its CFC rules.[66]

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[62] See *Cadbury Schweppes* case C-196/04, paragraph 68.
[63] See Meussen Dr Gerard, *Cadbury Schweppes: The ECJ significantly limits the application of CFC rules in the Member States*, p. 16.
[64] See case C-196/04, paragraph 65.
[65] See case C-196/04, paragraph 76.
[66] Meussen Dr Gerard, 2007, p. 17.

6 Which fundamental freedom Swedish CFC legislation may violate

Here, a response will be provided on which fundamental freedom that can be applicable to the Swedish CFC legislation in relation to third countries. After that I intend to examine the scope of that freedom to find out whether the Swedish CFC rules may constitute a restriction.

6.1 The applicability of the freedom of establishment

In the *Cadbury Schweppes* case the ECJ ruled that the freedom of establishment was restricted. However, the *Cadbury Schweppes* case concerned two Member States, and due to the fact that article 43 and the freedom of establishment is only valid between Member States it does not provide any protection to third countries. It means that it does not put any restrictions on CFC rules to third countries.[67]

6.2 The applicability and scope of free movement of capital

The only freedom which may be referred to preventing CFC legislation to third countries is the free movement of capital article 56 (1) EC. This since the free movement of capital is the only fundamental freedom that offers protection to third countries and citizens from third countries can claim protection under the article.[68] The issue whether the ECJ may find the free movement of capital applicable to CFC legislation to third countries is therefore important and it is my purpose to examine whether the ECJ is likely to use the free movement of capital to restrict the Swedish CFC rules.

The meaning of the free movement of capital has been interpreted by the ECJ to have direct effect.[69] The concept of "capital movement" is further clarified in Directive 88/361/EEC, adopted on 24 June 1988, where it is stated that the expression has a wide scope including financial investment,

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[67] The ECJ expressed the same opinion in Case C-524/04, *The Test Claimants in theThin Cap Gruop Litigationv. Commissioners of Inland revenue,*, paragraph 102.

[68] Citizens from third countries claimed protection in the joined cases *Sanz de Lera,* C-163/94, C-165/94 and C-250/94 1995 ECR I-4821 where one of the parties was a Turkish citizen.

[69] As example in *Sanz de Lera,* joined cases C-163/94, C-165/94 and C-250/94 1995 ECR I-4821.

establishment and direct investments.[70] The ECJ has declared that the Directive is non exhaustive and that tax provisions constitute restrictions which are covered by the free movement of capital both between Member States and in situations involving Member States and third countries.[71]

6.2.1 Articles suggesting a limited scope of the free movement of capital to third countries

In the decision of the CAT, it was said that the free movement of capital should have a limited scope regarding CFC rules to third countries which, according to the CAT, could be inferred from the content in articles 57, 59 and 60 EC. Since the CAT does not have the competence to interpret EC law does the statement has little legal importance. The articles are in my view worth looking at. Regulations indicating a limited scope of the free movement of capital are found in articles 57-60 EC and the content of the articles will be briefly described in the following.

Article 57 EC allows Members States to introduce and uphold restrictions on the free movement of capital to and from third countries and according to article 57 EC the Council can adopt measures which restrict the free movement of capital to and from third countries such as direct investments, investment in real estate, establishment, the provision of financial services or the admission of securities to capital markets. The term "direct investment" in Article 57 EC comes from Annex II of the First Directive for the implementation of Article 67 of the Treaty.[72] There, it is stated that the expression means "investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or maintain lasting and direct links between the person providing the capital and the entrepreneur to whom the undertaking to which the capital is made available in order to carry on an economic activity". According to the same article Member States may have the right to maintain national restrictions for those types of capital movements that were in force at the end of 1993.

Perhaps the exception in article 57 EC can be used to justify the Swedish CFC legislation because the tax law is by nature a typically dynamic area, with many amendments due to the political ruling among other. According to article 57 EC, the Council can adopt measures which restrict the free movement of capital to and from third countries such as direct investments, investment in real estate, establishment, the provision of financial services or the admission of securities to capital markets.

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[70] The name of the directive is "COUNCIL DIRECTIVE of 24 June 1988 for the implementation of Article 67 of the Treaty" (88/361/EEC).
[71] See *Van Hilten* case C-513/03, paragraph 3 and 36, *Sandoz* C-439/97 1999 ECR I-7041 and *Verkooijen* C-35/98 2000 ECR I-4071.
[72] Council Directive JOCE 1960 P43/921, Series-II Chapter 1956-1962, p. 49. English special edition.

Article 59 EC and 60 EC give Member States and the Council the option to, under certain circumstances, generally limit capital movement to and from third countries by using economic sanctions and safeguard measures.

A lack of cases where the ECJ has commented on the articles makes it, in my view, difficult to predict the application of article 57-60 EC in a situation regarding the Swedish CFC legislation to third countries.

6.3 The relationship between the freedom of establishment and the free movement of capital

Sometimes is the conduct of a Member State that both restricts the free movement of capital and the freedom of establishment. Under those circumstances, knowing which freedom is applicable is important to be aware of. This is because the free movement of capital is the only fundamental freedom that provides protection to third countries. The relationship in situations regarding two Member States and in matters concerning a Member State and a third country will be investigated.

6.3.1 Between Member States

In the ruling of *Cadbury Schweppes*, the ECJ stated, similar to what the Advocate General did in his opinion, that when restrictive effects on the free movement of services and the free movement of capital, are an "unavoidable consequence of any restriction of the freedom of establishment", it does not justify an independent examination of articles 49 EC and 56 EC. The CFC legislation therefore had to be examined in the light of articles 43 EC and 48 EC, granting freedom of establishment.[73] The statement agrees with previous case law where the ECJ has found it needless to examine a violation of the free movement of capital when a breach of the freedom of establishment is established.[74] Due to such manner of investigation, until now, the ECJ has examined only a few cases where the issue regarded whether national tax legislation is compatible with the free movement of capital. For example it was first when a restriction of the freedom of establishment could not be established, that the ECJ concluded that a Swedish tax rule violated the free movement of capital in Case C-436/00 *X and Y v. Riksskatteverket.*

[73] See *Cadbury Schweppes* case C-196/04, paragraph 32-33 and the Opinion of Advocate General, paragraph 31-36.

[74] Case C-436/00 *X and Y v. Riksskatteverket* [2002] ECR 1-10829, paragraph 30, joined cases C-397/98 and C-410/98, *Metallgeschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue, HM Attornet General* [2001] ECR I-1727, paragraph 75.

In the EC Treaty the following is stated regarding the relationship between the two freedoms. In article 58.2 EC concerning free movement of capital, it is stated that the provisions of the chapter “shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty”. In article 43 EC is it stated that the freedom of establishment shall apply on restrictions on setting-up of agencies, branches, or subsidiaries. It includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the country where such establishment is effected, and such establishment is also “subject to the provisions of the chapter relating to capital”. The wording of the two articles makes it obvious that the freedoms do not exclude each other, and also that the drafters of the provisions were aware that the same conduct can be covered by more than one freedom. To find an answer to the question concerning which freedom to apply and when, one has to see what the ECJ has said in prior court cases.

In the ruling of ECJ in *Baars,* is it expressed that the facts in the case must be examined when the *definite interest* in a company of another Member State falls within the scope of the freedom of establishment rather than the free movement of capital.[75] Advocate General Kokott further described the relationship between the free movement of capital and the freedom of establishment in the *Bouanich* case, where he stated that both freedoms may apply simultaneously to the same situation without excluding each other.[76] Different EU nationals can according to him claim protection from different freedoms, however, as the freedom of establishment contains “the right to take up and pursue activities as self-employed persons and to set up and manage undertakings” in another Member State. In his view should the provisions of article 43 EC and 48 EC be interpreted as the shareholder must exercise control over the undertaking. If the usual rights protecting minority shareholders are associated with his holding, then only the provisions on the free movement of capital is applicable, and not freedom of establishment.[77]

Advocate General Alber states a similar opinion in *Fidium Fianaz* (C-452/04) and *Konle* (C-302/97). According to him “the centre of gravity” in a case must be investigated. If the free movement of capital is directly restricted, then the freedoms applies and if the free movement of capital is indirectly restricted by a restriction of the freedom of establishment, that means the latter freedom first should be subject for examination.

Based on the rulings of the ECJ and statements of Advocate General Alber and Advocate General Kokott case C-196/04it is concluded by Fontana that

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[75] Case C-251/98, *C. Baars v. Inspecteour det Berlastningsdienst Particulieren/Ondernemingen Gorinchem* [2000] ECR 1-2787, paragraph 22.
[76] Advocate General’s Opinion, Case C-265/04, *Margareta Bouanich v. Skatteverket,* paragraph 71.
[77] Advocate General’s Opinion, Case C-265/04, *Margareta Bouanich v. Skatteverket,* paragraph 72.

the ECJ has adopted the position that a controlling interest, meaning more than 50 percent of the share capital or voting power, falls within the scope of the freedom of establishment rather than the free movement of capital.[78]

The manner of applying the two freedoms is criticized by Wattel, who is a professor of European Tax Law. He argues that the scope is arbitrary when investments in companies with a shareholding of 49 percent are practised as a movement of capital and a shareholding of 51 percent as an establishment.[79]

6.3.2 Between a Member State and a third country

To what extent the free movement of capital is applicable regarding Member States' relations with third countries is an issue that is very much discussed in the doctrine and there is yet no clear cut answer to the question since the ECJ has provided very little guidance in the matter.[80] A reason for the limited case law is that the provision is fairly new. It entered into force on 1 July 1990.[81]

In the *Van Hilten* case C-513/03 the legal issue regards an old lady who has died and her estate included immovable property, investments in quoted securities and bank accounts both in Member States and in third countries. The legislation being investigated was the Law of Succession under Netherlands law, and according to which a Netherland national who dies within 10 years of ceasing to reside in that Member State, is to be taxed as if he or she had continued to reside in the country. In its ruling, the ECJ expressed that "although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community Law".[82] The Law of Succession was found not to constitute a restriction. The reason is due to that the Law of Succession does not discourage nationals from making investments in other countries, as nationals who does that receives identical treatment.

The guidance from the *Van Hilten* case is according to me limited, as the content in the Netherlands's succession law is different from CFC legislation since the latter rules do not target all nationals. When applying CFC rules, it is in my view possible that the ECJ will express that it constitutes a restriction. The reason is that CFC taxation is only imposed on controlling shareholders who receive money from companies located in certain countries and not capital from companies situated in all countries.

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[78] Fontana Renata, *The future of CFC regimes in the Member States of the European Union - Part* 2, p. 321.
[79] Fortuin Alexander, 2007, 146.
[80] Fontana Renata, *The future of CFC regimes in the Member States of the European Union - Part* 2, p. 321, Fortuin Alexander, 2007, 146.
[81] It entered info force due to the Directive 88/361.
[82] Case C-513/03 *Van Hilten,* paragraph 36.

In the joined cases in *the Sanz de Lera and other* C-163/94, C-165/94 and C-250/94 individuals had in three different situations tried to travel from Spain to third countries with money in a briefcase. The issue in the three cases was whether it was consistent with the provision on free movement of capital to require authorization or declaration in advance as a condition for exporting money from a Member State. The ECJ found that the free movement of capital applied and ruled that the requirement for authorization was not consistent with the conditions in article 56 EC, but a claim in declaration could be accepted.[83] As the legal concern in *The Sanz de Lera and other* did not regard tax, is it uncertain to what extent the ruling is relevant concerning CFC rules to third countries.[84]

The ruling in a recent case does according to me, suggest that the ECJ now interprets the free movement of capital in the same way it does when it applies between two Member States. The issue in *Thin Cap Group Litigation* case concerned national tax provisions to third countries, where the legislation examined was the UK thin capitalization rules. When responding to whether the rules are compatible with the fundamental freedoms to third countries, the ECJ expressed that the free movement of capital would not apply since the UK legislation *targets relations within a group of companies.*[85] The Advocate General delivered a slightly different motivation when he indicated that the free movement of capital was not applicable since the company was *directly or indirectly controlled* by the parent company resident in a third country.[86] By saying that, he meant that situations involving third States fall outside the scope of article 43 EC and "direct investments" to third countries fall outside the scope article 56 EC.

The Advocate General's and the ECJ's interpretation of the content of the free movement of capital, may in my opinion indicate that only shareholders and portfolio investments owning less than 50 percent of the votes are entitled to protection under article 56 EC when a third country is involved. The purpose of a scope of the free movement, only providing safeguard for investors not controlling a company located in third States, seems to me somewhat curious and the interpretation also limits the reach stated in the EC Treaty. This as article 56 EC does not require a certain level of ownership for applicability and "capital movement" according to Directive 88/361/EEC, has a wide scope when as well financial investment, establishment and direct investments are included.

The ECJ will be required to provide a response to the issue in a pending case. On July 2003, a Group Litigation Order (GLO), referred to as the "*CFC Dividend Group Litigation*", was made in the High Court of Justice,

[83] See the ruling in C-163/94, C-165/94 and C-250/94 *the Sanz de Lera and othe*r..
[84] Mattias Dahlberg, 2005, p. 267.
[85] Case C-524/04, *The Test Claimants in the Thin Cap Gruop Litigation v. Commissioners of Inland revenue,*, paragraph 101.
[86] AG Geelhoue's Opinion, Case C-524/04, *The Test Claimants in the Thin Cap Gruop Litigation v. Commissioners of Inland revenue,*, paragraph 96.

Chancery Division where one issue concerns the CFC regime of the UK.[87] On 18 March 2005, the High Court asked the ECJ for a preliminary ruling and submitted several questions, including the question of *whether or not protection under the EC Treaty applies to CFCs resident in third countries.*

[87] Case C-201/05, *The Test Claimants in the CFC and dividend Group Litigation.*

7 Considerations for the ECJ concerning the Swedish CFC rules applied to third countries

It is far from sure, whether and under which circumstances, the Swedish CFC legislation constitutes a restriction on the Community Law when it applies to third States. In such ruling, the ECJ will have to take position regarding a number of things, some of which will be discussed in this chapter.

7.1 Whether the free movement of capital is applicable

Under the circumstance that the ECJ limits the scope of the free movement of capital between a Member State and a third country its ruling in the *Thin Cap Group Litigation* case, the following can be concluded regarding the free movement of capital's applicability to Swedish CFC legislation.

The CFC legislation in Sweden has a relatively low threshold for its applicability when it targets companies or individuals which at the end of the fiscal year, hold or control at least 25 percent of the capital or the voting rights in a certain low-taxed foreign legal entity. The Swedish CFC rules condition of voting power will in my view constitute a problem if the ECJ does not interpret 25 percent of voting power to constitute a controlling interest, because under such circumstance the Swedish CFC rules may be subject to investigation whether they restrict the free movement of capital or not.

If the ECJ interprets 25 percent as a significant degree of control over the CFC, is it due to the ruling of ECJ in *Thin Cap Group Litigation* case likely that the legislation falls under the scope of article 43, which does not provide protection for third countries, instead of article 56. Because the freedom of establishment does not provide any protection to third countries is the Swedish CFC legislation under such circumstance accepted under community law.

In my view it is likely that the ECJ will interpret the controlling power as at least 50 percent of the voting rights in the low-taxed company, which will give the result that Swedish CFC rules, when they target individuals or companies owning 25-49 percent of the shares in a company located in a

third country, may be subject for ECJ's investigation regarding a restriction of the free movement of capital.

7.2 Restriction of the free movement of capital to third countries?

In my view it is probable that the Swedish CFC rules, similar to what the CAT concluded in its decision, will be found to constitute a restriction of the free movement of capital to third countries. The commonly expressed opinions in favour of the possibility that Swedish CFC legislation restricts the free movement of capital and the arguments suggesting an opposite result will be presented.

7.2.1 Arguments in favour of it

The wording in article 56 EC states the following:

> 1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
>
> 2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Article 56 EC gives the impression of an obligation and does not suggest that restrictions between Member States and third countries should be looked on differently than restrictions between two Member States.

Advocate General Leger identified in his opinion of *Cadbury Schweppes* case a restriction by making a comparison between the tax treatment of a resident taxpayer with a CFC in another Member State and a resident taxpayer with a local subsidiary. Because the former company was treated less favourably than the latter, constituted the UK legislation a restriction.[88] Such a comparison was made in the *Cadbury Schweppes* case. Swedish CFC rules, similar to the legislation of the UK, make the resident company have to pay tax for an other legal person which would not have happened if it was a subsidiary resident in the Home State. As the ECJ in the *Cadbury Schweppes* case stated that "such difference in treatment constitutes a restriction", is it an indication that the ECJ may find that the Swedish CFC rules toward third countries restricts the free movement of capital.

This view is supported by the ruling in the joined cases *the Sanz de Lera and other*, where the ECJ did not make a distinction between the restriction

[88] Opinion of Advocate General Leger, *Cadbury Schweppes* case C-196/04, paragraph 78.

of the free movement of capital when it is applied to a third country and when it is applied to a Member State. The reason is that the ECJ extended its decision in the *Bordessa* case which dealt with a similar problem involving two Member States, without further concerns.[89]

7.2.2 Argument pointing in the opposite direction

Article 5 EC states that "the community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein". Due to that the purpose of extending the free movement to capital to include third countries is uncertain other than the drafters wanted to increase the liberalization between Member States and third countries, it suggests that the objective, is rather limited and not of the same importance as the internal market, which is the objective with the other fundamental freedoms. Article 7 in directive 88/361/EEC is valid and established for the implementation of the previous article. According to Ståhl has article 7 in directive 88/361/EEC character of a political commitment rather than a legal binding obligation to the Member States, which indicates that the scope of the free movement of capital is limited.[90]

Because third countries do not have to fulfil all the requirements imposed on the Member States, the idea that citizens from non-EU countries should be able to claim protection under the free movement of capital creates an asymmetrical pattern which is inconsistent with the international principle of reciprocity.[91]

In the book "European Community Law on the Free Movement of Capital and the EMU", Mohamed argues that there is no reason why the European Union should unilaterally and in full scale extend the free movement to third countries. According to him, such a provision would deprive the European Union of bargaining power in relation to third countries because it will be difficult for Member States to make third countries agree whether they should treat capital movements from the European Union in the same generous way. The best way for accomplishing liberalization is therefore, in the view of Mohamed, to establish agreements with third countries where the same favourable treatment also is received by citizens and companies in Member States.[92]

[89] Case C-358/93 and C-416/93, *Criminal proceedings against Aldo Bordessa, Vicente Mari Mellado and Concepion Barbero Maestre*.
[90] Ståhl Kristina, 2004, p. 49.
[91] Russo Raffaele, Szudoczky Rita and other, 2006, p. 635.
Pistone Pasquale, 2006, p. 236.
[92] S. Mohamed, 1999, p. 217.

7.3 Different justifications that may be used

In order for legislation which is found to constitute a restriction to be approved by the ECJ, a ground for justification must be accepted. The ECJ applies two different types of justifications, which I will describe briefly. The first set of justifications are the ones which are written and set out in article 58 (1) EC.[93] Article 58 EC, also called the “escape clause”, applies to the free movement of capital both between Member States and in a situation involving a Member State and a third country. The ECJ has in two cases established that the article constitutes a codification of case law, developed in connection with the other fundamental freedoms, regarding the possibility to justify restrictions of the free movement.[94]

Article 58 (1) authorizes a Member State to apply (1) measures that distinguish taxpayers on the basis of residence and place if capital is invested and (2) related measures of administrative compliance. The article seems to be able to justify CFC rules but when looking at prior case law of the ECJ in rulings regarding two Member States, it indicates that article 58 (1) EC must be interpreted in the light of article 58 (3), which restricts the former article to situations where the legislation applied does “not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital”.[95] Five years ago, the ECJ expressed in a case concerning a third country that article 58 (1) cannot be relied on to pursue economic activities, which is the objective with CFC regimes.[96] Due to what the ECJ has expressed in earlier rulings, it is in my opinion unlikely that justification will be approved by it on the basis of article 58 (1) EC in a situation involving CFC rules to third countries.

The other category, and according to scholars the most important category of justifications, is the “unwritten or implied justifications”, which can be inferred from the EC Treaty and deduced from previous case law by the ECJ.[97] The justifications are used differently, as written justifications are the only means of justifying overt discrimination as a breach of the fundamental freedoms. In situations where the legal issue concerns covered discrimination and restriction, as being investigated in this analysis regarding CFC rules to third countries, justification may also be found among the unwritten justifications.

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[93] Fontana Renata, The uncertain future of CFC regimes in the Member States of the European Union- Part 2, 2006, p. 323.
[94] It was stated in *Verkooijen* C-35/98 2000 ECR I-4071 paragraph 43 and Case C-319/02 *Manninen*, paragraph 29.
[95] *Verkooijen* C-35/98 [2000] ECR I-4071 paragraph 37 et seq and Case C- 439/97 *Sandoz GmbH v. Finanzlandesdirektion für Wien, Niederösterreich and Burgenland* [1999] ECR I-7041, paragraph 23.
[96] Case C-466/98, *Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, paragraph 56.
[97] Renata Fontana, , *The future of CFC regimes in the Member States of the European Union - Part* 2, 2006, p. 323.

An unwritten formula which is developed in case law and commonly used by the ECJ is the rule of reason-formula and, according to which national measures liable to hinder or make less attractive the exercise of the fundamental freedoms must satisfy certain conditions.[98] To determine whether the restriction of the freedom of establishment was justified, the ECJ applied this formula in the *Cadbury Schweppes* case. According to this formula a restriction is permissible only if (1) it is justified by overriding reasons of public interest, (2) its application be appropriate to ensuring the attainment of the objective thus pursued and (3) not go beyond what is necessary to attain it.[99] The ECJ first rejected ”the need to prevent the reduction of tax revenue” as justification. The argument was further investigated and the concept of establishment within the meaning of the Treaty provisions was established to involve the “actual pursuit” if an economic activity through a fixed establishment in another State. The justification “prevention of abusive practices” was therefore approved, and the ECJ stated that such legislation must prevent conduct involving “the creation of wholly artificial arrangements which do not reflect economic reality”, with a purpose to escaping the tax normally due on the profits generated by activities carries out on national territory.[100]

7.3.1 Other requirements on justifications to third countries

While determining what is required for the justification to be justified, does it has to balance the interest of the internal Market and the objectives pursued by the EC Treaty. When applying the rule of reason test, the ECJ ought to, in my view, consider to separately analyse to what extent the justifications and proportionality test should be applied to third countries.

Justifications ought according to some tax experts be more easily applied to third countries than to Member States because the purpose with the fundamental freedoms between Member States is of a greater weight than towards third countries.[101]

The CAT found that the restriction was justified on the objective of tax avoidance since article 56 EC should have a more limited scope regarding CFC rules to third countries than to Member States. Whether the decision is correct is in my opinion most uncertain. A lack of cases where the ECJ has commented on the articles makes it, in my view, difficult to predict the application of article 57, 59 and 60 EC in a situation regarding the Swedish CFC legislation to third countries.

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[98] The same formula has been used in *Futura Participations and Singer* case C-250/95 [1997] paragraph 26, and *De Lasteyrie du Saillant* case C-9/02 [2004], paragraph 49.
[99] See *Cadbury Schweppes* case C-196/04, paragraph 47.
[100] See case C-196/04, paragraph 48.
[101] Ståhl Kristina, 2004, p. 54, S. Mohamed, 1999, p. 229.

Case law from the ECJ indicates that justifications apply in the same manner as between two Member States. In the ruling by the ECJ in the joined cases *the Sanz de Lera and other*, the ECJ did not make a distinction of the application of the free movement of capital when it applied to a third country. The reason is because the ECJ extended its decision in *Bordessa* case without further concerns.[102] Despite that the two cases did not deal with a tax issue, the ruling constitutes an indication that the ECJ applies the same rule of reason-formula to third countries.[103]

7.4 Choice of justification

The court has so far not ruled in a case regarding CFC legislation to third countries and it is therefore difficult to predict which justification the ECJ would approve.[104] A crucial question for the ECJ to take position concerning is *to what extent the fundamental freedoms to third countries should be safeguarded in the area of taxation.* Third countries are not members in the EU and the question is to what extent they should be allowed to take advantage of what the EC Treaty States.

In the decision of the CAT, the risk of tax avoidance was approved as a justification. To determine whether tax avoidance would be approved by the ECJ is in my view not possible but in previous case law regarding taxation between Member States the ECJ has had high demands for approving tax avoidance as a justification. The ECJ has required a legislation which examines every single case and it is certain that the current Swedish CFC rules do not fulfil this requirement, as the legislation does not take into consideration any reason for the establishment and the legislation may be applicable irrespective of reasons.[105]

In *Cadbury Schweppes* justification was approved on the ground of prevention of abusive practices, and in my view it is likely that the ECJ will approve that as a justification regarding CFC legislation to third countries, if the risk for tax avoidance or any other written or unwritten justification is not supported. This is because it would be curious if the ECJ does not justify a restriction regarding CFC legislation to third countries when it justifies a restriction which occurs between Member States. In order to justify a restriction on the ground of prevention of abusive practices, such a legislation must prevent conduct involving “the creation of wholly artificial arrangements which do not reflect economic reality”, with a purpose to escaping the tax normally due on the profits generated by activities carried

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[102] See the ruling in Case C-358/93 and C-416/93, *Criminal proceedings against Aldo Bordessa, Vicente Mari Mellado and Concepion Barbero Maestre*.

[103] Ståhl Kristina, 2004, p. 51.

[104] Mattias Dahlberg, 2005, p. 266.

[105] See Case C-270/83 *Comm v. France* paragraph 18, case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* [2002] ECR 1-11779, paragraph 37, case C-436/00 *X and Y v. Riksskatteverket* [2002] ECR 1-10829, paragraph 61.

out on national territory.[106] Such conduct was presented by the ECJ as a fictitious establishment, such as a “letterbox” or “front” subsidiary.[107] Schweppes had to be given an opportunity to produce evidence ascertainable to third parties that the CFC is actually established and that genuine activities are carried on. Objective evidence should in particular, consist of premises, staff and equipment. Special meaning could be given to the word “wholly”, in the context of “wholly artificial arrangements”, in relation to tax planning practises. *Some form* of artificial arrangements to allow tax structuring to obtain certain taw advantages does therefore seem to be possible without violating the ECJ’s interpretation of the freedom of establishment.[108]

The ruling gives as result that provided that the two Irish subsidiaries were actually carrying on a business as group financing companies in Ireland, the UK cannot apply its CFC rules.[109]

If the ECJ finds that the freedom of free movement of capital in third countries is entitled the same protection as the ECJ stated for between Member States in *Cadbury Schweppes,* it is obvious that the Member States will lose huge sums of tax revenue. A verdict stating that will give the result that CFC rules are no longer a useful device to fight tax competition.

7.5 Proportionality

The CAT stated that Swedish CFC rules do not “go beyond what is necessary to achieve the objective” of tax avoidance and the legislation can be applied towards third countries. This happened before the ruling in *Cadbury Schweppes* was delivered though, in which the ECJ found that the ICTA legislation is not proportionate.

What the ECJ would state regarding the Swedish CFC rules to third countries is once again uncertain, since it is not sure which justification may be approved. Because the Swedish legislation, different from what the ICTA does, does not take into consideration any reason for the establishment and the legislation may be applicable irrespective of reasons, it indicates, I feel,, that the ECJ may find that the Swedish regulation “goes beyond what is necessary to achieve the objective” and is found not to be proportional at least when it applies between Member States.

It is likely to me that the ECJ would conclude that the Swedish CFC rules to third countries are at least compatible with Community law when they target “wholly artificial arrangements intended to escape the national tax normally

[106] See *Cadbury Schweppes* case C-196/04, paragraph 48.
[107] See *Cadbury Schweppes* case C-196/04, paragraph 68.
[108] Meussen Dr Gerard, *Cadbury Schweppes: The ECJ significantly limits the application of CFC rules in the Member States*, p. 16.
[109] Meussen Dr Gerard, 2007, p. 17.

payable".[110] It would be curious if the ECJ does not at all permit Swedish CFC legislation to third countries when it finds the ICTA compatible with the provisions in the EC Treaty during those conditions.

7.6 Passive investments and CFC legislation

A problem that the ECJ ought to clarify before it rules in another CFC case is, according to Prof. Dr Gerard T.K Meussen, whether a CFC used as a holding company is entitled to protection under the EC Treaty. A vital aim for many CFC legislations is to target passive investments because they are easily transferred between countries.[111] As far as passive investments are concerned, such as dividends, interest, royalties, rents and capital gains, clearly the article 56 EC applies.[112] It is, according to Prof. Meussen, not certain if passive investment companies according to the verdict in the *Cadbury Schweppes* constitute a wholly artificial arrangement, as it could be argued that if the investments are situated in a third country, then the passive investment company is actively participating in the economic life of that country and therefore, CFC rules are against the Community Law.[113]

[110] See *Cadbury Schweppes* case C-196/04, paragraph 76.
[111] Fontana Renata, The uncertain future of CFC regimes in the Member States of the European Union- Part 1, 2006, p. 262.
[112] Fontana Renata, The uncertain future of CFC regimes in the Member States of the European Union- Part 2, 2006, p. 320.
[113] Prof. Dr Gerard T.K Meussen, 2007, p. 17.

8 Different ways of interpreting tax treaties

When the CAT in its ruling about the captive in Switzerland held that the Swedish CFC rules did not violate tax treaties, one member of the court disagreed[114]. He meant that because Switzerland has submitted an observation where it opposes the OECD Commentary of article 1, it is obvious that the country has never wanted Sweden to apply CFC rules on subsidiaries being resident within its territory. In doing so, he advocated for *the static interpretation method* to be applied, where the outcome is based upon the circumstances and insights of the parties at the time the treaty was concluded. The main arguments in favour of that method of interpreting international treaties are the legal certainty and the principle of pacta sunt servanda.[115]

Another interpretation method that may be used is the *ambulatory interpretation method*, which is taking later developments into account. An argument in favour of that interpretation method regarding interpretation of tax treaties, is that tax treaties are typically based on the circumstances at the time it was concluded and they often refer to the national law applicable at the time for its interpretation or implementation. In the area of taxes, circumstances as well as national law are constantly changing due to for example national tax policies and legal development deriving from the ECJ. If the static interpretation method is used on tax treaties instead of the ambulatory interpretation method, the result can be unreasonable or contrary to the obligations from the EC or WTO, since the outcome is based on references to assumptions which are obsolete.[116]

In my view, the Swedish Supreme Administrative Court (SAC) in Sweden ought to investigate the tax treaty between Sweden and Switzerland in the light of the Vienna Convention which can be used when it contains rules which provide guidance.[117] The Vienna Convention applies only to treaties concluded after its entrance into force in the contracting States, but the legislation is significant since it contains rules which correspond to a codification of unwritten international public law that is binding for countries.[118]

In my opinion, it is hard to predict how the SAC in Sweden will rule in the matter. It is not expected that the OECD will adopt a position against the compatibility of tax treaties and CFC regimes, because such a statement would have a profound effect on the OECD Member countries' tax

[114] See CAT's ruling number 6/05 on 4 April 2005 under the headline "skiljaktig mening".
[115] Peter J Wattel and Otto Marres, 2003, p. 222.
[116] Peter J Wattel and Otto Marres, 2003, p. 223.
[117] See the Vienna Convention articles 31-33 in section three.
[118] See the Vienna Convention article 4 and Peter J Wattel and Otto Marres, 2003, p. 225.

revenues[119]. Since there is no international court with the competence to analyze the compatibility between tax treaties and domestic law provisions, therefore, it does not exist any international case law which may provide guidance for the judges[120].

[119] Fontana Renata, *The uncertain future of CFC regimes in the Member States of the European Union- Part 1*, 2006, p. 262.
[120] Renata Fontana, , *The future of CFC regimes in the Member States of the European Union - Part* 2, 2006, p. 333.

9 Conclusion

On 4 April 2005, the CAT delivered a decision regarding a parent company owning a captive in Switzerland, a so called third country.[121] It held that application of the Swedish CFC rules did not violate the tax treaty Sweden had concluded with Switzerland. In its decision, the CAT recognized that the Swedish CFC regime was incompatible with article 56 EC, and while determining whether the restriction was justified, the CAT stated that article 56 EC should have a more limited scope regarding CFC rules to third countries. The risk of tax avoidance was approved as a justification and the Swedish legislation was concluded to be proportional. The issue is today not settled since the SAC has asked the STA to confirm the decision which has so far not been done. It is likely that the case eventually will reach ECJ that will determine what the EC law says.[122]

The legislation in *Cadbury Schweppes* had to be examined in the light of articles 43 EC and 48 EC, granting freedom of establishment. The freedom of establishment does not provide protection to third countries and regarding CFC legislation to third States, the important question is therefore whether article 56 EC granting free movement of capital will be found to be applicable by the ECJ. To what extent the free movement of capital is applicable regarding Member States relations with third countries is very much discussed in the doctrine and it is not certain since the ECJ has provided very little guidance in the matter.[123]

The ruling in *Thin Cap Group Litigation* case suggests in my view, that the ECJ now interprets the free movement of capital in the same way it does when it applies between two Member States giving the result that only shareholders and portfolio investments owning less than 50 percent of the votes are entitled protection under article 56 EC when a third country is involved. The CFC legislation in Sweden has a relatively low threshold for its applicability when it targets, companies or individuals which at the end of the fiscal year, hold or control at least 25 percent of the capital or the voting rights in a certain low-taxed foreign legal entity. In my opinion is it therefore likely that Swedish CFC rules, when they target individuals or companies owning 25-49 percent of the shares in a company located in a third country, may be subject to ECJ's investigation regarding a restriction of the free movement of capital.

The Sanz de Lera and other cases suggest that the ECJ interprets justifications between two Member States in the same manner as between a Member State and a third country. Since the ECJ has so far not ruled in a case concerning CFC rules to third countries and it is difficult to predict

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[121] See *Skatteverkets rättsfallssamling* 6/05.
[122] Mattias Dahlberg, 2005, p. 267.
[123] Fontana Renata, *The future of CFC regimes in the Member States of the European Union - Part* 2, p. 321, Fortuin Alexander, 2007, 146.

which justification the ECJ would approve.[124] A crucial question for the ECJ is *to what extent the fundamental freedoms to third countries should be safeguarded in the area of taxation.* Justifications ought according to many tax experts to be more easily applied to third countries than to Member States because the purpose with the fundamental freedoms between Member States is of a greater weight than towards third countries.[125]

What the ECJ would state regarding proportionality is uncertain, since it is not sure which justification may be approved.

Some Swedish tax treaties may be interpreted as they include foreign companies and because those countries have not had the opportunity to approve the Swedish CFC rules, it can be argued that it is contrary to the obligations deriving from the tax treaty to apply CFC rules and impose restrictions on companies located in those States.[126] There is no international court under the competence to analyze the compatibility between tax treaties and domestic law provisions, that there is no international case law, it is difficult to determine whether the decision of the CAT is compatible with international guidelines.[127]

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[124] Mattias Dahlberg, 2005, p. 266.
[125] Ståhl Kristina, 2004, p. 54, S. Mohamed, 1999, p. 229.
[126] Mattias Dahlberg, 2005, p. 138 and 140.
[127] Renata Fontana, *The future of CFC regimes in the MemberStates of the European Union - Part* 2, 2006, p. 333.

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