The Role of the Rule of Reason,

the Standard of Reasonableness and the Principle of

Proportionality in Assessing Fair Taxation.

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I declare that the work presented in this thesis is my own.

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ABSTRACT

The central question in this thesis asks how the rule of reason, the standard of reasonableness and the principle of proportionality may function in assessing fair individual taxation and efficient and fair tax systems. This question is answered by investigating the case law of selected jurisdictions on the standard of reasonableness and the principle of proportionality particularly regarding human rights and international trade in their interaction with taxation.

This work also discusses how the international canons of taxation, (equity, certainty, and economy) may be balanced via proportionality coupled with reasonableness. Would there be an optimal solution to combine those canons and other fundamental tax principles? How would be possible and desirable in terms of efficiency and fairness to apply an international standard of reasonableness in tandem with the principle of proportionality to tax issues that have reciprocal consequences in different jurisdictions, such as cross-border situations addressing tax avoidance, fiscal supervision, non-discrimination, and other tax issues that may go to the foundations of many tax systems? The hypothesis that is also tested is whether they may be regarded as overarching principles of law.

The above fundamental questions are also posed in the light of international human rights that may be the ground and the foundation for fair taxation. Nevertheless, it is worth noting that the subject of this thesis is proportionality and reasonableness in the interaction of fundamental freedoms, fundamental rights - with some regard to trade and taxation. The focus is not on any specific issues that are analysed as an illustration of how those principles may work and whether or not they achieve fairness.

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Introduction

The main statement of this thesis is that the principle of proportionality, coupled with the notion of reasonableness, is a fundamental tool to achieve fairness,[1] effectiveness and consistency in the interpretation and application of other principles and rules, particularly concerning the interaction between taxation and fundamental rights. This work will also examine some aspects of barriers to trade, since the role of proportionality and reasonableness appear to be relevant to tax issues that may affect domestic and international trade.[2] As a corollary to this analysis, the issue of proportionality in tandem with reasonableness as a general principle of law in its own right (and, arguably, an overarching principle of law) will also be discussed. Overall, this thesis will also seek to give greater clarity to the role of proportionality and reasonableness as applied to taxation.

Reasonableness and proportionality are generally regarded as standards of judicial review or principles for the interpretation and application of other legal principles and rules. The reasonableness test may just require a rational - as a general logical relationship between ends and means - interpretation of any law, to avoid absurd results. In general, the reasonableness standard of review may either narrow or broaden the scope of normative acts according to their purpose and within their specific or general context. Proportionality may have the same objective - to avoid unreasonableness or absurdity in law in search of more fairness and consistency, adding the ingredients of balance, conciliation, optimization of effectiveness[3] and efficiency. As a result, it may require a higher degree of scrutiny through which

[1] On the conception of fairness and fair taxation see Chapter I, section 3.

[2] Although this thesis mainly deals with reasonableness and proportionality as applied to taxation and fundamental rights, the notions of non-discrimination and equality - to which reasonableness and proportionality are fundamental - are widely applied to domestic tax barriers to trade (see for example the dormant-commerce clause in the US) and EU Law (see the objective of internal market and the fundamental freedoms of goods, services, capital and persons in the EU) and the core principle of non-discrimination within the WTO.

[3] The more weight given to one principle may be detrimental to other principles and interests at stake in each case. On the role of the principle of proportionality as an optimal principle, see Alexy, Robert, "On the Structure of Legal Principles" (2000) *Ratio Juris 13/3*, p. 298; Schwarze, Jürgen, *European Administrative Law* (Sweet and Maxwell, 1992), p. 690; Beatty, David M., *The Ultimate Rule of Law*, (OUP, 2004), p. 163. See also, in particular, Chapter III.2.3 (c.4 and d) on the jurisprudence of the ECHR.

principles must be balanced against each other and any measure must be reasonably proportionate or necessary to its legitimate ends.[4] Whereas the proportionality test may accept only the less intrusive measure to the overall interests at stake, the reasonableness test may accept a more intrusive measure, if it is not absurd, irrational, or illogical.

However, the above distinction is not Cartesian, as both principles may interact and sometimes are interchangeable.[5] Thus, proportionality coupled with reasonableness may scrutinize at the same time fairness and consistency, and sometimes even the efficiency of tax principles and rules, as well as their optimization and interplay with other legal principles.[6] This subject may be of interest not only to practitioners but also to legal theoreticians as it deals with fundamental issues of taxation, including tax policy, in domestic and international jurisdictions, as illustrated below and in Chapter I.

Cases of discrimination are remarkable illustrations of how reasonableness and proportionality work in tandem as tools to assess the fairness and the consistency of apparently discriminatory rules, such as the joint taxation of couples.[7] There must be a reason why they should be taxed jointly. Treating the family as a tax unity may be reasonable either for tax avoidance or simplification purposes. However, joint taxation may be disproportionate where this tax treatment results in taxing spouses or civil partners more heavily than non-married couples who live together, particularly if there is an underlying policy or constitutional objective for the State to recognize, protect and encourage the family.[8]

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[4] See more elaborate descriptions of the principle of proportionality in concert with reasonableness in Chapters I, sections 2 and 3; III, section 2.3.a; and IV, section 1, and the first paragraph of the Conclusion.

[5] See Chapter I, section 2, on the distinctions and similarities between both principles.

[6] See Chapter I, section 2.

[7] On discriminatory taxation, see Chapters II.3; III, sections 2.5 and 3.2; and IV, sections 2, 3, and 4. Particularly on joint taxation of couples, see Chapters II.2 and III.2.5.a.

[8] See Chapter I, section 2, and its references to other examples, which are analysed in all following Chapters on the essential role played by reasonableness and proportionality in the concepts of equality and non-discrimination.

The same role of reasonableness and proportionality can be seen in a different set of cases, where there is no issue of discrimination, such as retrospective taxation.[9] There must be a reasonable basis (not caprice, for example) for a later tax rule to catch previous transactions. Even if the reason is legitimate, such as to tackle tax abuse, the retrospective rule may be disproportionate to its objective, regarding transactions that have occurred a long time ago or have been performed with a business purpose other than tax avoidance. In addition, the rationale for retrospective taxation must contrast with and balance against the legitimate or reasonable expectation of those concerned.

Different courts have already discussed these issues and other cases on the basis of principles of proportionality and reasonableness. Nevertheless, there are other issues still untested by judicial decisions, such as the conflicting interests of source and residence taxation, in which proportionality and reasonableness may have an underpinning role. One of these issues may be the limits of taxation at source and its interaction with the tax system of the country of residence.[10]

Here it is also worth pointing out the method used to prove the main statement of this thesis and the characteristics of both proportionality and reasonableness. As unwritten and judge-made principles and standards of review, analysing their origin and their evolution within domestic and international courts is a starting point. Thus, where proportionality and reasonableness come from as well as their differences as rules of interpretation will also be discussed.[11] From national jurisdictions to international courts - such as the International Court of Justice, the European Court of Human Rights, the European Court of Justice, and international trade organizations such as the World Trade Organization - the principle of proportionality has evolved to balance and construe the legal principles underpinning domestic and

[9] On retrospective taxation and proportionality coupled with reasonableness, see Chapters II.4; III.2.6; and IV.8.

[10] The source taxation principle is based on a benefit principle that must be balanced with the residence principle, which is based on the ability to pay principle. See Chapter I, section 3.

[11] See Chapter I, sections 1 and 2.

international issues.[12] Proportionality and reasonableness may not only be general legal principles, but may also be applied to specific national claims to tax and to fundamental rights in tax matters.

This thesis relates to taxation, but for two reasons it will also discuss some non-tax cases. First, these non-tax cases have described the characteristics of proportionality and reasonableness, and may reveal them as general or, arguably, overarching principles of law, which is one of the objectives of this work. Secondly, comparing some tax cases with non-tax cases may also demonstrate that tax law is not a field of law separated from others, such as competition law, administrative law, environmental law, international and constitutional law, as if they were unrelated or could not sometimes interact with each other.

Tax measures are not only used to address and enforce economic and social policies, but also may sometimes affect other legal principles and rules, such as the fundamental rights and freedoms. A tax - as any other regulatory measure - may have a confiscatory effect on goods or assets or prohibit an economic activity and thus may breach the rights to property and to freedom.[13] A tax measure may hinder or

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[12] On General International Law see Cannizzaro, Enzo, *Il Principio della Proportionalità nell'ordinamento Internationale* (Giuffrè, Milano 2000), and the more specific article by that author "The Role of Proportionality in the Law of International Countermeasures", (2001) EJIL Vol. 12 No. 5, pp.889-916.

On international trade and the role of proportionality principle, see Hilf, Meinhard, and Puth, Sebastian, "The Principle of Proportionality on its way into WTO/GATT Law"**,** in *European Integration and International Co-ordination* (Kluwer Law International, 2002), p.199; Armin Von Bogdandy, Petros C. Mavroidis, Yves Meny, (Eds.); Osiro, Deborah A, "GATT/WTO Necessity Analysis: Evolutionary Interpretation and its Impact on the Autonomy of Domestic Regulation" (2002) Legal I.E.I., 29(2), pp.123-141;. On the main principles of law applied by the WTO, such as abuse of rights, good faith, balancing of rights and obligations, necessity and proportionality, see also Petersmann, Ernst-Ulrich, "Human Rights, Constitutionalism and the World Trade Organization: Challenges for World Trade Organization Jurisprudence and Civil Society" (2006) LJIL 19, pp.633–667.

On human rights and proportionality, analysing some national jurisdictions and the European Court on Human Rights, see Clayton, Richard, "Regaining a sense of proportion: the human rights act and the proportionality principle" [2001] E.H.R.L.R. 5; McBride, J., "Proportionality and the European Convention on Human Rights", in E. Ellis (ed.) *The Principle of Proportionality in the Laws of Europe* (Hart Publishing, Oxford 1999); and **Arai-Takahashi, Yutaka, *The Margin of Appreciation Doctrine and the Principle of Proportionality in the Jurisprudence of the ECHR*** (Intersentia, Oxford 2002).

[13] On excessive and confiscatory taxation and proportionality, see Chapters II.2; III.2.7, b) and c); and IV.2.1.

establish (un)reasonable requirements for the exercise of the international human right to move or to change residence from one country to another, even for tax purposes.[14] Any regulatory measure and legal obligation that may affect fundamental rights is also submitted to the tests of proportionality and reasonableness.[15]

As a result of globalisation and economic liberalisation, there are no longer any rigid national borders, and "the less the State retains its monopoly as an international actor and the more systems of dispute settlement we are likely to find."[16] With respect to international tax law, mechanisms provided by double or multilateral taxation conventions may provide examples of dispute settlement in which reasonableness and proportionality may be efficient and convincing legal tools, depending on how appropriate for each case.[17] Bilateral investment treaties may also deal with tax matters and the settlement of disputes may be based on proportionality and reasonableness as standards of review.[18] As well, international and regional free trade agreements - such as the WTO, the Mercosur, the Nafta, the EFTA, the Asia-Pacific Economic Cooperation (APEC), and the Association of Southeast Asian Nations Free Trade Area (ASEAN) - may be based on non-discrimination to avoid unjustifiable protective tax and non-tax measures.[19] Furthermore, in the European Union the proportionality principle has been an essential instrument in ascertaining and enforcing the internal market and the fundamental freedoms of persons, capital,

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[14] See Chapters III.2.5; and IV, sections 5.3 and 6.2 (exit taxes).

[15] On fundamental rights, see extensively Chapter III.2.

[16] See Higgins, Rosalyn, "The ICJ, the ECJ, and the Integrity of International Law" (2003) 52 ICLQ, p.12.

[17] See the Conclusion, section 2.4.

[18] See Chapter I, section 3.

[19] Regarding trade barriers, this work analyses the WTO decisions only, since some regional free trade agreements do not have a court or a separate body (quasi-judicial), such as the Appellate Body of the WTO, to decide issues raised from their interpretation and application. Other agreements that provide a court, such as the EFTA, or a panel, which issues binding decisions, such as NAFTA, are just regional comprising only a few countries unlike the WTO. But it is interesting to note that NAFTA has as one of its main standards of review the reasonableness principle, which may be regarded as a broad application of the principle of proportionality where it may have the "requirements of suitability, necessity, transparency, participation and perhaps, as suggested by some, even proportionality" (Ortino, Federico, "From 'Non-Discrimination' to 'Reasonableness': a Paradigm Shift in International Economic Law?" 2005 Jean Monnet Working Paper 01/05, p.39).

services and goods. Both domestic tax legislation in national jurisdictions and EU tax legislation have been construed and sometimes struck down in the light of the rule of reason and proportionality.[20]

This work will also focus on how this principle has spread worldwide from national jurisdictions[21] and will make some comparisons between international courts, particularly the ECHR and the WTO, with the EU and the American jurisprudence.[22] Although the comparison will be mostly between the U.S. and some international courts, the principle of proportionality cannot be attributed to only a few nations or communities, since "it is a fundamental idea common to all civilised countries and extending far beyond the legal system."[23] The comparison with the American system may also be relevant because the seeds of the proportionality principle may be regarded as having been sown and developed originally in the U.S. from the rule of reason and the reasonable standard of review. In addition, reasonableness and proportionality have been applied to tax issues that have reciprocal consequences in different jurisdictions, such as worldwide unitary taxation,[24] transfer pricing,[25]

[20] Although the concept of proportionality as it is understood in international law and some national jurisdictions may not have been considered as a very familiar concept in the common law (Singh, Mahendra P., *German Administrative Law in Common Law Perspective*, (Springer, 2001), p.160 et seq.), its notion and reasoning has been applied by and large in human rights' situations in common law countries (see Clayton, Richard op. cit. n.2, particularly, Canada, New Zealand, Australia, South Africa, and the United Kingdom) not to mention other areas of law including taxation. On the distinction between the *common law* and *civil law* concepts of reasonableness and proportionality, see Chapter I on reasonableness as a standard and the *Wednesbury* principle.

[21] In this thesis, only one domestic jurisdiction, the US, will be analysed, as there would not be enough room within the word limit for further investigation.

[22] On the close relationship between the principles of proportionality and subsidiarity concerning Federalism, see the interesting comparison between the US and the EU made by Edward T. Swaine, "Subsidiarity and Self-Interest: Federalism at the European Court of Justice" (2000) 41 Harv.I.L.J., pp.1-60. That author suggests that the same interest regarding the judicial control via proportionality and reasonableness tests exists in the U. S. and in the EU (op. cit. p. 6-9, 51, and 58). See also Rosenfeld, Michel, **"Constitutional Adjudication in Europe and the United States: Paradoxes and contrasts"** (2004) 2 I.J.C.L, pp.633–668.

[23] Messerschmidt, Klaus, "Efficiency and the Principle of Proportionality" available at <www.eurofaculty.lv/papers>, p.5 (last visited 8 July 2010). From a comparative perspective the principle of proportionality has been described as the classical example of "borrowing" or transposition of one jurisdiction to another (Lenaerts, Koen, "Comparative Law and EC Law", in *Comparative Law before the Courts,* Canivet, Guy, Andenas, Mads and Duncan Fairgrieve (Eds.), (2004) BIICL, p.121).

[24] See Chapter II, section 5 (*Barclays* case).

controlled foreign companies,[26] thin capitalisation rules,[27] and the necessity of rules on cross-border situations addressing tax avoidance,[28] balanced allocation of taxing rights between States,[29] taxation on grounds of environmental protection,[30] and other tax issues that may go to the foundations of many tax systems. Nevertheless, it is worth noting that the subject of this thesis is proportionality and reasonableness in the interaction of fundamental freedoms, fundamental rights - with some regard to trade - and taxation. The focus is not on any specific issues but certain issues are discussed as an illustration of how those principles may work and achieve their objectives.

Equally, whether or not proportionality and reasonableness may undermine the separation of powers between the legislature and the judiciary will be analysed as fundamental constitutional issues arise from this.[31] The apparent judicial activism of the Courts where they apply those principles may have a clear purpose of balancing conflicting interests and rules in order to make them more compatible with the fundamental rights and values of the rule of law. By so doing, and depending on how convincing the rulings are, the Judiciary may also strengthen the acceptability of its

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[25] See Chapter II, final part of section 5; Chapter IV, section 5.3 (*Société de Gestion Industrielle SGI* case); the Conclusion, section 2.4; and *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995.

[26] CFC legislation may also be tested under the proportionality principle and "should not go beyond what is necessary to prevent the abuse or the clearly unintended use" (Observation 27.7 made by the in Netherlands on Article 1 of the *Model Tax Convention on Income and on Capital*, January 2003, OECD, p.67). See also Chapter IV, section 6.2 (*Cadbury Schweppes* case).

[27] See Chapter IV, section 6.2 (*Lankhorst-Hohorst* case).

[28] See Chapter s III, section 3.2.b (*Dominican Republic Cigarettes* concerning evasion and *Bovine Hides* on tax avoidance cases); and IV, section 6.2 (*ICI v Colmer* and *Emsland-Starke* cases, inter alia).

[29] See Chapter IV, section 5.3 (*Marks & Spencer* and *Rewe Zentralfinanz* cases).

[30] See Chapter IV, section 4 (*Commission v Italian Republic*, C-21/79; and *De Coster* cases, inter alia). See also Chapter III, section 3.2.c, the cases *US – Gasoline* and *Brazil -Retreaded Tyres*, in which legitimate measures were justified under the exceptions to protect environment, but failed to comply with the chapeau of Article XX of the GATT.as disguised discrimination according to the proportionality reasoning.

[31] See the Conclusion, sections 1 (proportionality in tandem with reasonableness) and 3 (costs and benefits of proportionality coupled with reasonableness).

decisions and make different legal systems socially fairer in circumstances that may transcend national borders.[32]

With regard to all the other principles of each legal system, proportionality in concert with reasonableness may aid conciliation and balance them in a more acceptable and convincing way. The relationship between proportionality and reasonableness will be also analysed in order to test the following statement: the better way to interpret and ascertain the meaning of the term "reasonable" appears to be via the proportionality test, just as it seems that the better way to keep proportionality flexible is to apply it through the more open-ended notion of reasonableness.[33]

Finally, this work will discuss whether the broader and necessary application of proportionality to international human rights, tax and trade matters may be regarded as its final evolution or just a step towards further developments or alternatives.[34] Where different jurisdictions may impose economic protective tax measures on imports and exports, or claim to tax the same income - for example with respect to worldwide taxation, transfer pricing, thin capitalization and CFC rules, and to other specific or general anti-avoidance rules or principles - many disputes arise. In the same vein, the issue of the interaction between two or more tax treaties, or of a source country in contrast with a residence country, may be analysed according to the proportionality test as it may be seen as a possible way to achieve a rational and political consensus.

The first Chapter will consider the origin, the differentiation and the general importance of proportionality and reasonableness in search of fair taxation.

The second Chapter will comment on some aspects of the notion of reasonableness according to the US Supreme Court and its difference, if any, from the proportionality principle in tax matters. It will discuss issues such as equality, non-discrimination, retrospective legislation, "use tax" as a disguised sale tax, interstate

[32] See Chapters III, sections 1 (ICJ), 2 (ECHR) and 3 (WTO); and IV (ECJ).

[33] See Chapter I, section 2, last paragraph and its footnotes, and section 1 of the Conclusion.

[34] See section 2.2 of the Conclusion on the role of proportionality coupled with reasonableness in evolving new principles of Law.

commerce and taxation, worldwide unitary taxation, and transfer pricing rules as illustrations of how reasonableness and proportionality may work.

The third Chapter will discuss the proportionality principle in the light of the jurisprudence of the International Court of Justice, the Appellate Body of the World Trade Organization, and mainly the European Court of Human Rights. How far these international tribunals accept the principle of proportionality as a general principle of international law will be considered as well as how it is related to tax matters, particularly regarding fundamental rights and trade.

The fourth Chapter will discuss the characteristics of the so-called "core" principle of European Law, especially in tax matters, and its distinction from the notion of reasonableness. Particularly in this Chapter there is a discussion of how proportionality has been applied to the four fundamental freedoms and their tax consequences; how the rule of reason was created via proportionality reasoning, and its interaction with tax and non-tax overriding requirements in the public interest; how that principle was useful in determining principles of a specific tax (VAT) and making them effective; and how the legitimate expectation of non-retrospective tax legislation was inferred from proportionality as a vital instrument to balance different and sometimes apparently conflicting principles and rules.

Lastly, the advantages and the disadvantages of proportionality and reasonableness and whether these principles have complied with their objectives will be considered. Overall, this thesis will seek to assess the extent to which proportionality coupled with reasonableness may be an essential instrument to weigh different legal principles, rules or measures, particularly regarding taxation and its interaction with human rights, fundamental freedoms and international trade, in order to apply them effectively, consistently and fairly.

I. The relationship between the rule of reason, the standard of reasonableness and proportionality. Their distinction and their general importance regarding fair taxation.

This Chapter will focus on the origins of the principle of proportionality, its distinction from and its relationship with the rule of reason and the standard of reasonableness, and their general role in assessing fair taxation.

I.1. The origins of the standard of reasonableness, the rule of reason, and the principle of proportionality.

The reasonableness standard of review has its roots in equity and in the rule of reason[35] and may be part and parcel of the proportionality principle, according to which all rules must be proportionate to their objectives (i.e., a reasonable relationship between ends and means) under a three-pronged test of suitability, necessity and balancing or proportionality in the narrow sense. The latter principle also derives from the broad and general objective of equity and fairness in law,[36] as well as from the foundations of modern constitutionalism.[37]

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[35] See the origin of a constitutional standard of reasonableness as applied under the due process clause, in Chapter II, sections 1, 1.1, and 1.2 on the US; and further, on the explicit role of the rule of reason in the US (Chapter II, section 2); and in the EU, see Chapter IV, section 2.2. In the UK, see the notion of the rule of reason and standard of reasonableness that can be found as early as the end of the sixteenth century in *Rooke's* (1598) 5 Rep. 99b case (Lord Halsbury in *Sharp v Wakefield* [1891] AC 173, cited in Wade, H.W.R., *Administrative Law* (OUP, 1994), p. 387, and Singh, Mahendra P., (2001), p.151, and in the 20th century, in *Wednesbury* [1948] 1 KB 223, the statement by the court on the reasonableness standard of review, see this Chapter, next section. Jean-Paul Costa pointed out that the first expression of the principle of proportionality in France goes back to 1933 when the *Conseil d'Etat* decided the famous *Benjamin* (CE 19 May 1933) case dealing with the freedom of assembly ("Legal Concepts in the European Court of Human Rights' Case Law: the Influence of Various National Traditions", Council of Europe, European Court of Human Rights, JPC/nk, unedited paper of 07/10/2003, for a lecture at Inner Temple, London, on 13 October 2003). As the seed of the rule of reason, see Cicero (106-43 BC), according to whom "True law is right reason in conformity with nature" (*Est quidem vera lex recta ratio naturae congruens*, de Re Publica III.22.33).

[36] Although equity deals not only with equality but also with natural justice and fairness (see *Snell's Equity*, Sweet & Maxwell, 2005, pp.4-5), a parallel can be made with proportionality, which has its roots in the notion of retributive justice and appropriate distributive justice (see Schwarze, Jürgen *European Administrative Law*, Sweet & Maxwell, 1992, pp.678-9). Alexy cites R. von Krauss (*Der Grundsatz der Verhaltnismassigkeit*, Hamburg, 1955, p.41), who mentions the "natural right in a timeless sense of the individual to be protected from burdens to the extent that they exceed the degree necessary" (apud Alexy, R., *A Theory of Constitutional Rights*, Oxford, 2002, p.69, n.90). According to Karl Larenz, the proportionality principle is a substantive principle, "that directly results from the notion of justice, fair measure, moderation, often modifying the equality principle" (*Metodologia da Ciência do Direito*, Calouste Gulbenkian, 1997, footnote 110, p.501).

[37] See Chapter II, section 1, on the US (*McCulloch v Maryland* [1819] 17 U.S. 316). According to the historical origin of the proportionality principle, J. J. Gomes Canotilho states: "The proportionality

The rule of reason may generally be regarded as a legal method of construction and interpretation through which the scope of laws may be either narrowed or broadened according to their purpose and within their specific or general context. It may also convert a rule into a principle by taking into account other principles and policies and striking a reasonable balance between them, which is one of the essential features of the principle of proportionality coupled with reasonableness. Dworkin pointed out the following classic example:

> "The first section of the Sherman Act states that every contract in restraint of trade shall be void. The Supreme Court had to make the decision whether this provision should be treated as a rule in its own terms (striking down every contract 'which restrains trade', which almost any contract does) or as a principle, providing a reason for striking down a contract in absence of effective contrary policies. The Court construed the provision as a rule, but treated that rule as containing the word 'unreasonable', and as prohibiting only 'unreasonable' restraints of trade. This allowed the provision to function logically as a rule (whenever a court finds that the restraint is 'unreasonable' it is bound to hold the contract invalid) and

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principle was initially related to issues concerning executive power limitations, considered as a remedy to administrative limitations of the individual freedom. Based on this connotation, the State has adopted the principle as a positive maxim in the eighteenth century. However, this principle was introduced to the administrative law as a general principle of legal rights only in the nineteenth century" (*Direito constitucional*, p.386). See also Emiliou, Nicholas, *The Principle of Proportionality in European law* (Kluwer, 1996), Chapter 1. See also *Solem v Helm* case [1983] 463 U.S. 277, in which Justice Powell's majority opinion traced the history of proportionality rules regarding the Eighth Amendment of American Constitution (prohibitions on excessive fines and forfeitures) to the Magna Carta of 1215 (paragraphs 20-21, 'fines should be graded according to offense seriousness and should also not deprive the offender of his livelihood') and the English Bill of Rights of 1689 (Sullivan, E. Thomas, and Frase, Richard, *Proportionality Principles in American Law – Controlling Excessive Government Actions*, OUP, USA 2009, pp.136, 149, 244 n.93). The constitutional principle of practical concordance and the unity of the Constitution - the Constitution as a whole - require that rights and values in collision be limited according to the principle of proportionality in search of an optimal solution (Martin, Maik, and Horne, Alexander, "Proportionality: Principles and Pitfalls – Some Lessons from Germany" (2008) Judicial Review 13(3) at p.174, citing case law and the doctrine of Professor Konrad Hesse, former judge of German Federal Constitutional Court; Kommers, Donald P., "Unity of the Constitution as a Logical-Teleological Entity", in *The Constitutional Jurisprudence of the Federal Republic of Germany* (Duke University Press, 1997) at p.45; and Hesse, Konrad (*Elementos de Direito Constitucional da República Federal da Alemanha* (Fabris, Porto Allegre 1998) at pp.66-67, translation of the German 20th edition *Grundzüge des Verfassungsrechts der Bundesrepublik Deutschland*).

substantially as a principle (a court must take into account a variety of other principles and policies in determining whether a particular restraint in particular economic circumstances is 'unreasonable')."[38]

This creative standard of reasonableness may address not only the issue of arbitrariness in law, but also its purposive interpretation by applying a logical method of relationship between ends and means that depends to an extent on each jurisdiction and the values at stake.[39] In this task of striking a reasonable balance between the various interests in play, reasonableness is close to proportionality, as analysed further in the next section.[40]

I.2. Their interaction, their differentiation, and their classification as rules, standards or principles.

A clear illustration of how the rule of reason works in tandem with the standard of reasonableness and proportionality is the concept of discrimination. The reasoning on equality and the non-discrimination provision in international and domestic jurisdictions is quite similar, construing the prohibition of discrimination as containing the word 'unreasonable'. Thus, only unreasonable discrimination would be unlawful, which may demonstrate once more that the rule of reason as a basis for legitimate differentiation lies at the heart of reasonableness and proportionality.[41]

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[38] Dworkin, Ronald, *Taking Rights Seriously* (HUP 1978) pp. 27-28. The cases mentioned are *Standard Oil Co. of New Jersey v. US* [1910] (221 US 1) and *US v. American Tobacco Co* [1911] 221 US 106. See also Chapter II.1.2. Emphasizing the constitutional clause of the right to contract and freedom of commerce and the Congress' intent to protect them, Chief Justice Edward White concluded that "the law covered only 'unreasonable' restraints of trade and that a common-law standard of reasonableness should be used to identify the actions that the act prohibited" (Barbara C. Steidle, in *The Oxford Guide to US Supreme Court Decision*s, Kermit L. Hall (Ed.) 1999, p.293).

[39] On the role of the legal standard of reasonableness in requiring a purposive interpretation to legislation, see Chapter II.1.3; and also on its task of "weighing up and striking a reasonable balance between the social claims" and the various interests at stake, see Hart, H.L.A., *The Concept of Law*, OUP (1961), pp.128-29.

[40] Particularly to its third prong, proportionality in strictu sensu (balancing). From the case law of the German Federal Constitutional Court (BVerfG) it has been rightly suggested that proportionality in the narrow sense is "identical with the Law of Balancing" (supra note 18, Alexy, 2002, p. 401). This states: "The greater the degree of non-satisfaction of, or detriment to, one principle, the greater must be the importance of satisfying the other" (Idem, p.401).

[41] See the US Supreme Court cases *Quaker* [1928] 277 US and *Hoeper* [1931] 284 U.S. 206. Chapter II.3; in the ICJ see *Minority Schools in Albania* case (PCIJ, Series A/B, n. 64, p.19), of 1935, Chapter III.1; in the ECHR see the *Belgian Linguist* cases of 1963 and 1964 decided on 23 July 1968 in which

Besides the above issue of discrimination and some brief illustrations given in the Introduction, one hypothetical example may also aid to explain how the reasonableness standard may work and differ from the proportionality test. Higher income tax rates for those who weigh over 180 pounds - on grounds of health protection and ability to pay - may lack a reasonable justification and be regarded as unreasonable for being irrational, unfair and arbitrary. However, a similar measure according to a reasonably flexible standard combining earnings, age, height and other medical recommendations by the public authority could be reasonable and (arguably) suitable to decrease obesity, particularly if there was also a tax incentive for those who try to lose weight. A different conclusion would be most likely reached under the proportionality principle, as it is generally understood under its three-pronged test of suitability, necessity and balancing. Higher taxation on overweight people may be unnecessary, as there may be other measures less intrusive to the fundamental rights to property and freedom to achieve the same or higher levels of healthy protection.[42] At the same time, the underlying policy or principle of health protection must be weighed against other policies or principles, such as the ability to pay principle and unfair discrimination on grounds of weight, which must be reconciled with each other. Thus, according to the proportionality principle, the questioned measure may be disproportionate, although it might be reasonable to tackle obesity.

It has been suggested that reasonableness and proportionality are "different models - one looser, one tighter - of the same juridical concept", which would be the

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the Court (in a Grand Chamber) construed the non-discrimination Article under the standard of reasonableness and the proportionality principle as a legal principle in its own right (Chapter III.2.3.a). In the same vein, see the jurisprudence of the European Court of Justice, when it construed the principle of non-discrimination and analyzed its direct and indirect effects, it clearly adopted the rule of reason and proportionality reasoning (see Chapter IV, sections 2 and 3). Within the WTO also, all the explicit exceptions to the non-discrimination principle as well as the general prohibition on 'arbitrary or disguised discrimination' were construed in the light of the reasonableness standard and the proportionality reasoning (Chapter III.3.2.c). All these jurisdictions have construed the concept of equality and non-discrimination, inserting the *reasonableness* notion coupled with proportionality test within the wording of statutory law, according to a purposive interpretation in search of fairness.

[42] Other less restrictive measures, though indirectly related to tackling obesity, would be to tax junk food or "fattening food of little nutritional value", which, like taxes on cigarettes, alcohol and gambling, might also encourage taxpayers to live healthier. On some economic flaws of the idea of tackling obesity through the tax system, see The Economist August 1st 2009 (and some Papers at www.economist.com/fattaxes) (last visited 8 July 2010).

avoidance of arbitrariness.[43] According to the less intensive form of unreasonableness (like the English *Wednesbury* principle[44]), a court should strike down or set aside a decision or a measure "only if it is 'so unreasonable that no reasonable authority could ever come to it'. Whereas the principle of proportionality, as it has been developed in EU case law, holds that the decision of a public body should be quashed only if its adverse effects on a legally protected interest or right go further than can be justified in order to achieve the legitimate aim of the decision."[45]

It may be worth analysing whether reasonableness and proportionality are in themselves rules or principles.[46] Reasonableness seems to function as a rule or method of interpretation of statutory law (such as the rule of reason analysed above), and sometimes as a separate standard explicitly provided by law, such as the

[43] Laws J. in *R. v. MAFF, ex parte First City Trading Ltd* [1997] CMLR 250, at 278-9, paras. 67-9, apud Green, Nicholas, " Proportionality and the Supremacy of Parliament in the UK", in *The Principle of Proportionality in the Laws of Europe* (Hart Publishing, 1999), p.155.

[44] Paul Craig summarised that well known principle stated in *Associated Provincial Picture Houses Ltd*. v. *Wednesbury Corporation* [1948] 1 KB 223, at 228-30, regarding the two meanings of the term "unreasonable", as follows:

> 1. "In one sense 'unreasonable' was used simply as a synonym for a host of more specific grounds of attack, such as taking account of irrelevant considerations, acting for improper purposes and acting *mala fide*, which, as the Master of the Rolls accepted, tend to run into one another."
> 2. "The other sense of the term unreasonable is that which now has become known the *Wednesbury* test: a decision can be challenged if it is so unreasonable that no reasonable public body could have made it. To prove this would require something quite extreme."

(Craig, Paul, "Unreasonableness and Proportionality in UK Law", *The Principle of Proportionality in the Laws of Europe* (Hart Publishing, 1999), p.94).

[45] De Burca, Gráinne, "Proportionality and *Wednesbury* Unreasonableness: The Influence of European Legal Concepts on UK Law" (1997) 3 EPL 561, at 562, apud Walter van Gerven, op. cit. p.59. Comparing the *Wednebury* reasonableness standard with the proportionality principle Craig again may be right to suggest that proportionality is more structured, requires more reasoned analysis from the decision-maker, including the Courts that may decide "on grounds which are more readily identifiable and ascertainable", and may encourage more transparency (Craig, Paul, supra. n.32, p. 99).

[46] There are two main differences between rules and principles according to Dworkin (supra note 20 pp. 24-26). First, rules are all-or-nothing norms, either they are applicable in a case or they are not, whereas principles may allow some degree of optimization in their application and enforceability as they must take into account other competing principles with which they must be reconciled. Secondly, principles have a dimension of weight and importance that is lacking in rules. Sometimes rules may function as principles. See Alexy, Robert (2002) Ibid, pp.44-66, and "On the Structure of Legal Principles", *Ratio Juris*, 13/3, (2000).

concepts of ‘reasonable person’, ‘reasonable care’, ‘reasonable profit’ or ‘reasonable tax rate’.[47]

Likewise, the proportionality test seems to function as a principle and not a rule of interpretation though it may comprise a set of rules (its three tests). According to Alexy‘s distinction between rules and principles, proportionality would not be a principle as its three sub-principles (suitability, necessity and balancing) are not weighed against other things and “they do not take precedence in one situation and not in another.”[48] Actually, in that sense proportionality would be a legal method consisting in a set of three rules for interpretation and application of other rules and principles. However, taking into account other criteria for characterization of principles, such as a higher legal status, evolution and significance for the legal system[49] or the “dimension of weight and importance”[50], proportionality would be a principle of law.

Like the rule of reason, the proportionality test works as a principle or a tool to elicit further principles from rules. Similarly, where reasonableness is an explicit word contained in statutory law (such as ‘reasonable consumer”, “reasonable profit”, etc) it functions as a standard, which is similar to a principle by being flexible, open-ended and requiring a balance between competing interests and principles.

Besides the word *reasonable*, the word *necessary* as explicitly provided in statutory law may require a scrutiny of proportionality. On the difference between

[47] Under Dutch tax law, interest is deductible if the transaction is performed for valid business purposes or if the interest is actually taxed at a reasonable tax rate. The Dutch Supreme Court stated in the Case 36358, of February 8, [2002], that a tax rate of 10% in the other state was reasonable in comparison with similar group finance regimes taxed domestically (see de Bruin, Daan, “Netherlands Supreme Court Interprets ‘Reasonable Taxation’,” 2002 ITR.). See also the OECD Reports on Harmful Tax Competition that seem to be in search of a reasonable level playing field among all countries and jurisdictions that does not undermine the fairness and integrity of each country's tax system. According to the 2004 Progress Report, “although a low or zero effective tax rate is the necessary starting point of an examination of a preferential regime, it alone is not sufficient to find harmfulness. Any evaluation requires an overall assessment of each of the above factors and once a regime has been identified as potentially harmful the economic effects would have to be examined (where necessary)” (see Introduction, note 2).

[48] (2002) Ibid, p.66 and note 84.

[49] Ibid, p.46.

[50] Dworkin (1978), p.26.

proportionality and reasonableness, Graig pointed out an interesting decision of the European Court of Human Rights,[51] according to which the word "necessary" was apparently more clearly ascertained, since it was regarded neither as "synonymous with indispensable" nor as having the malleability of expressions like "admissible", "useful", "reasonable" or "desirable". A "pressing social need" was implied by the word necessary.[52] Whereas the ECHR took the view that *necessary* would be somewhere between *indispensable* and more flexible expressions such as *useful, ordinary, admissible, desirable* or *reasonable,*[53] the Appellate Body of the WTO considered it closer to one of the poles of that 'continuum' as *indispensable* rather than to the other pole as *making a contribution to*.[54] "Such a contribution exists when there is a genuine relationship of ends and means between the objective pursued and the measure at issue."[55]

It has also been suggested, "When one passes beyond the most general and abstract level of analysis there are more differences and similarities between the concepts".[56] Although they may interact with and aid each other, the degree of fairness of the balance appears to be higher in proportionality and arguably absent in reasonableness according to the UK common law, *Wednesbury* principle for example.[57] Furthermore, proportionality "doctrine directs attention not only to the interests or considerations weighed against each other, but also to the relative weights which the primary decision-maker attached to the various interests or considerations."[58] As

[51] *Sunday Times* v. *UK* (1979-80) 2EHRR 245, paras. 59, 62, 65, in Craig, Paul, "Unreasonableness and Proportionality in UK Law" (1999), op.cit. p.93

[52] Ibid, See also on the interpretation of the wording 'necessary' within the ECHR, in the *Handyside* case on Chapter III.2.3.b; and.within the WTO agreements, Chapter III.3.2.b.

[53] See *Handyside* (Application No. 5493/72) in Chapter III.2.3.b. (proportionality and other fundamental rights).

[54] *Korea - Various Measures on Beef* Report, paras. 161-162 and 164. See Chapter III.3.2.b.

[55] *Brazil – Measures Affecting Imports of Retreaded Tyres*, para 145. See also Chapter III.3.2.b.

[56] Feldman, David, "Proportionality and the Human Rights Act" in Evelyn Ellis (ed.), *The Principle of Proportionality in the Laws of Europe* (Hart, 1999), p.127.

[57] Whereas the notion of unreasonable may mean that no reasonable authority could reach a specific decision, proportionality may require a test of fairness of the balance of all possible solutions or measures (Ibid, p.127-8).

[58] Ibid, p.128.

already said, proportionality may go further than the notion of reasonableness in some jurisdictions, since the requirements of necessity and suitability may determine whether a disputed measure is less restrictive or not to the relevant interests in play. Indeed, if one might draw a line between reasonableness and proportionality, where both principles may co-exist, that distinction (scrutiny of which necessary and available measure is the least restrictive within an overall balance of the interest at stake) seems to be their significant difference. However, as already pointed out in the Introduction, this distinction is not Cartesian, as proportionality and reasonableness may sometimes be interchangeable and intertwine with each other.[59]

A clear demonstration of that interaction, as also shown further,[60] is over whether the better way to interpret and ascertain the meaning of the term "reasonable" would be via the proportionality test, just as whether a better way to keep proportionality flexible would be to apply it through the more open-ended notion of reasonableness. Thus, the principle of proportionality may be applied according to the more flexible standard of reasonableness,[61] which may permeate its three-pronged test (suitability,

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[59] See for example in the US the roles played by balance and necessity (less restrictive measure) when the Supreme Court applies the standard of reasonableness (Chapter II). According to Hart (1961, p.132), "the open texture of law means that there are, indeed, areas of conduct where much must be left to be developed by courts or officials striking a balance, in the light of circumstances, between competing interests which vary in weight from case to case."

[60] See Chapters III.2.2 and IV.2.2. See also the analysis of unreasonable measures that are unreasonable because they fail to pass the test of proportionality, particularly regarding discriminatory tax measures, anti-avoidance tax measures and retrospective tax measures (Chapters II, sections 3 and 4; III, sections 2.3, 2.5, 2.6, and 3.2; IV, sections 6.2, 6.3, and 8.

[61] As it is in taxpayer and consumer protection, which is one of imperative requirements that may justify trade restrictions (such as effectiveness of fiscal supervision, tax avoidance, environmental taxation, and fiscal coherence), the ECJ applied the proportionality principle and stated, "that it is necessary to take into account 'the presumed expectations of an average consumer who is *reasonably* well informed and *reasonably* observant and circumspect'" in Jans, Jan, "Proportionality Revisited," (2000) L.I.E.I. Vol. 27, No. 3, op. cit. p.251-2 (*Estee Lauder* Case C-220/98 [2000] ECR I-117 para. 27). See also the legitimate expectation of taxpayers as reasonable citizens, Chapter IV.8.1.

necessity and balancing or proportionality 'stricto sensu')[62] as appears from the jurisprudence of international[63] and some domestic courts.[64]

I.3. Their general importance to fundamental tax principles and issues (equality, legal certainty, tax avoidance, international human rights, international trade and double taxation) in search of fairness. What is tax fairness?

If proportionality coupled with reasonableness comes from and serves the purpose of fairness since its conception,[65] it is worth recalling what fairness is about and investigating whether there is a common idea about its definition. Likewise reasonableness and to some extent the principle of proportionality itself, fairness cannot be strictly defined, since it is a standard, not according to a particular subjective view, but to what can be generally accepted in a democratic society. Individuals within the same community and different peoples and nations may sometimes disagree on philosophical and practical characteristics of fairness or equity; however, one may suggest that one of its most basic requirements is

[62] In this sense, any restrictive measure to a fundamental right or freedom must be reasonably adequate, reasonably necessary, and reasonably balanced with other interests and rights at stake. Overall, see Chapters III.2 on the ECHR and III.3 on the WTO, and IV on the ECJ.

[63] See on the WTO Chapter III.3. sections 2.b regarding "necessity" that requires a reasonable relationship between ends and means and reasonably available alternative measures; and 2.c. about the reasonable exceptions to discrimination and the reasonable balance of competing rights under the chapeau of Article XX of the GATT. See also *Vastberga Taxi* (Application No. 36985/97) decided by the ECHR, on striking a reasonable balance between the importance of what is at stake requiring that the means employed must be reasonably proportionate to its legitimate aim (Chapter III.2.7.b).

[64] In a case concerning the prohibition of a commercial activity (hiring out workers to building contractors), the justification was to avoid tax evasion, and breaches of labour and welfare law. The German Constitutional Court recognized that there was an alternative measure less restrictive to the professional freedom: a more effective control on and supervision of building sites. Notwithstanding, the Court held that the individual could not expect that "public resources, which are only limited, should be used beyond what can be *reasonably* expected of society to extend the official department responsible for combating these undesirable state of affairs" (BVerfGE 77, 84 (110f), apud Alexy, 2002, p.400). See also BVerfGE 41, 251 (264), where the Court speaks of "an overall balancing between the seriousness of the infringement and the weight and urgency of its justifying reasons" (idem p.102 and n. 217). In the US, the balancing test has been considered as "the favorite intellectual constant in contemporary American constitutional law for analyzing claims about rights" (Durham, W. Cole, "General Assessment of the Basic Law - an American view", in *Germany and its Basic Law - Past Present and Future - A German-American Symposium*, Editors: Paul Kirchhof and Donald P. Kommers, Nomos (Baden-Baden, 1993), p.42. See also Chapter II.1 on the US jurisprudence.

[65] See section 1 of this Chapter and note 36.

equality.[66] A sense of fairness seems to exist even when children at early stage ask why different treatment is given to their siblings or classmates. Also, according to a more general view, fairness "can broadly be seen as a demand for impartiality."[67] This does not mean that a specific rule may not favour more vulnerable people or specific economic and social activities, such as tax incentives that must be justified on grounds of relevant economic and social reasons and principles.

A fair tax base is traditionally and rightly "described as a matter of ´horizontal equity´, while the specification of tax rates is characterized as a question of ´vertical equity.´"[68] Both of these types of equity are required by the ability to pay principle,[69] according to which taxes should be limited to an affordable amount, taking into account traditional sources of revenue, such as income, consumption and wealth. Each of these sources, separately as well as taken together, should form a fair tax base that should not be excessive or confiscatory.[70]

It is also my opinion that fairness requires a reasonable balance between all the relevant interests at stake. Moreover, fair rules or decisions must further and be founded on the fundamental rights of those concerned, be practical, enforceable,

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[66] To treat equal people in equal circumstances in an equal way (horizontal equity) and treat differently those who are not equal (vertical equity), James and Nobes, *The Economics of Taxation*, Financial Times-Prentice Hall, New York 2000, p. 78.

[67] See Sen, Amartya, *The Idea of Justice* (Harvard University Press, 2009) p. 54. It is intellectually and morally attractive the notion of justice as fairness by which Rawls elaborated two basic rules for setting up impartial institutions. First, as individuals are rational, free and morally equals, each person should have a basic liberty compatible with similar liberty for others (liberty principle). Secondly, as social and economic differences seems to be inevitable, they should be arranged so that they are both reasonably expected to be to everyone's advantage (greatest benefit of the least advantaged people, as the "difference principle"), and attached to positions open to all under conditions of fair equality of opportunities (Rawls, John, *The Idea of Justice* (original edition of 1971 and revised edition of 1999 by Oxford University Press 1999) and *Justice as Fairness a Restatement* (Belknap Press of Harvard University Press, 2001). For a constructive and critical analysis of justice as fairness, see again Sen, Amartya (2009), pp. 55 and sequitur.

[68] Duff, David, "Tax fairness and the tax mix," paper presented at the third workshop on The Social Contracted Revisited, Oxford 23-25 April 2008, p. 4, The Foundation for Law, Justice and Society in affiliation with The Centre for Socio-Legal Studies, University of Oxford, www.fljs.org.

[69] The ability to pay principle is a general principle of tax fairness that is appropriate for allocating public costs whose benefits are indeterminate and generally shared, reflecting a principle of political equality; whereas the benefit principle justifies the allocation of costs of publicly provided goods and services to their users only, such as highways, collection of waste and sewage (Duff, David, idem pp. 3-5).

[70] On excessive and confiscatory taxation and the role of reasonableness and proportionality in assessing their fairness, see Chapters II, section 2; III, sections 2.7.b) and c), 2.8; IV, section 2.1.

effective, and based on objective factors (as opposed to subjective impressions or bias). Indeed, any concept of fairness may be more acceptable, if permeated by standards of reasonableness and proportionality to be ascertained by a majority of decisions makers, if a consensus is not possible. In other words, reasonableness and proportionality are legal tools to weigh and optimize the different principles and interests in play, this task being inherent in my view in the concept of fairness.[71] On the one hand, proportionality coupled with reasonableness requires a fair balance between the public interest and individuals regarding human rights,[72] as well as a fair exercise of rights balanced with the rights of other States under international agreements.[73] On the other hand, a fair allocation of taxing rights between different countries is derived from the rule of reason that may require a fairness test as set out by the principle of proportionality in tandem with the standard of reasonableness.[74] Fair balance also requires impartiality, objective justification, and avoidance of subjective reasoning. Thus, decision-makers should be consistent, base their decisions on objective factors, and step out of themselves.[75] This idea of multiple interests and fair balance is opposed to both a utilitarian view of taxation and the rational choice theory as the pursuit of self-interest only, at least where the legitimate interests of others are not taken into account properly. However, taxpayers can act in their self-interest where they avoid or minimize taxes, as any reasonable homo economicus would do, but within a social context that requires a balance of the

[71] Besides the examples of non-discrimination, retrospective taxation and tax avoidance given in this section, showing an explicit relationship between fairness and proportionality coupled with reasonableness, other cases illustrate that interconnection, such as the fairness of tax penalties (Chapters III.2.7.b, and IV.2.1, *Louloudakis*, Case 262/99), substantive tax measures (Chapter IV, section 7.1), procedural tax measures (Chapter IV, sections 7.3, and 8.5).

[72] See Chapter III, sections 2.5.a (*Johnston* case), 2.6.b (*Compania Naviera S.A. v. Belgium* case), 2.7.b (*Janosevic v Sweden* case), 2.7.d (*Bulves* case), among other cases.

[73] See Chapter III, section 3.2.c (*US – Shrimps* case).

[74] On the imperative requirement in the general interest called balanced allocation of taxing rights within the European Union, derived from the rule of reason, to which proportionality is closely connected, see Chapter IV, section 5.2. See also the analysis of fair apportionment in the US, in Chapter II, sections 1.1 (*Complete Auto Transit* case) and 5 that are permeated by the standard of reasonableness.

[75] To reach a fair decision judges can step into parties' shoes to better grasp their arguments, but at the same time stepping back from any personal subjective involvement. A parallel can be made here with Rawls's original position according to which individuals being morally equals, rational and free, would minimize bias and prejudices by setting up fair institutions with a highest minimum standard of justice (see note 67).

principles of equality, individual freedom, legal certainty, and the right to property against some other competing principles, such as horizontal and vertical equity, equality of opportunities, abuse of rights, and good faith for instance.[76]

Furthermore, if "taxation is all about drawing distinctions",[77] and the classification of taxes, allocation of tax jurisdiction, determination of tax rates, of tax basis, and of taxpayers all involve distinctions, then non-discrimination may tend to be one of the most important and sensitive principles of taxation. Thus, the power to tax can be controlled by the reasonableness standard of review and proportionality, which lie at the core of discrimination, as will be explained further.[78]

Another set of cases in which the proportionality principle may work in concert with reasonableness deals with retrospective legislation that may impair the obligations and rights that arise from previous transactions. In the light of the implicit or expressed principles of constitutions - such as the rule of law, principles of legality, certainty, predictability, and ability to pay - that should be proportionally weighed in interpreting and applying retrospective laws, what would be the reasonable result? The example of the principle of non-retrospective legislation will be further discussed and compared because not only "there is a close link between the principle of proportionality and non-retroactivity",[79] but also it can be seen as one of the clearest examples of how the courts in different countries and international jurisdictions have inferred the unwritten principle of non-retroactivity in tax matters. Any retrospective measure must be justified according to its necessity and proportion to its objectives, and by balancing it with the legitimate or reasonable expectations of the taxpayers. In the words of the US Supreme Court on retrospective legislation, "the question is not whether the legislative action affects contracts incidentally, or directly or indirectly, but whether the legislation is addressed to a ***legitimate end*** and

[76] See below more general analysis about tax avoidance and fairness, particularly notes 82-84. The homo economicus may be not separated from the homo sociologus, the homo psychologicus, the homo ethicus, and the gentleman, who pay fair taxes for the price of civilization.

[77] Thuronyi, Victor, *Comparative Tax Law*, Kluwer, 2003, p.82.

[78] See Chapters II.3; III, sections 2.5 and 3.2; and IV, sections 2, 3, and 4.

[79] Ibid, p.144.

the measures taken are ***reasonable and appropriate to that end***" (emphasis added).[80] In the sense of fairness requiring a balance of competing interests, any public interest to justify retrospective taxation to tackle loopholes or abusive transactions must be weighed against the individual rights or legitimate expectations and personal circumstances of those concerned.[81]

However, the above issues of non-discrimination and non-retroactivity are neither the only, nor perhaps the most important, examples of the relevance of the proportionality principle in tandem with reasonableness that may be applied to tax issues in search of fairness. For instance, if "equity and certainty are in conflict,"[82] regarding the implementation of anti-avoidance rules - general or specific - proportionality coupled with reasonableness may be the analytical tool to give them a proper and legitimate justification and construction. Thus, equity and certainty may be balanced and reconciled through proportionate anti-avoidance rules that must take into account other principles, such as the general principle of good faith.[83] Anti-

[80] *Home Building & Loan Assn. v. Blaisdell*, [1934] 290 US 398, at 438, Supreme Court(Chapter II.1.2 and also relating to taxation the cases *US v. Hudson* [1937] 299 US 498; *Welch v. Henry et al.* [1938] 305 US 134, and *US v. Darusmont* [1981] 449 US 292 (Chapter II.4). See also the ECHR cases explicitly applying the proportionality principle (Chapter III.2.6) and the analysis of the ECJ cases at Chapter IV.8.

[81] "Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions" *General Motors Corp. v. Romein* [1992] 503 U.S. 181. On legitimate expectation and retrospective taxation, see extensively also Chapter IV, section 8.

[82] "Tax equity demands that artificial tax avoidance schemes should be of no effect, yet certainty demands that the tax laws should be such that an individual can arrange affairs in the expectation that he will not have to pay tax" (Tiley, John, *Revenue Law*, 2005, p.101-02). On proportionality, tax avoidance and discrimination see *Hoeper* in the US (Chapter II.3), and, on tackling tax avoidance to justify retrospective taxation, *Milliken v. US* [1931] 283 US 15, *US v Carlton* [1994] 512 U.S. 26, *Nichols v. Coolidge* [1927] 274 US 531, *Boldgett v. Holden* [1928] 275 U.S. 142, and *Untermayer v. Anderson* [1928] 276 U.S. 440 (Chapter II.4); within the ECHR see the cases on retrospective legislation and tax avoidance (Chapter III, section 2.6.b); within the WTO, see *Bovine Hides* and *Dominican Republic - Cigarettes* cases (Chapter III.3.2.b); and within the ECJ see the cases analysed in Chapter IV, sections 6 and 8.4.

[83] The general principle of good faith also appears to be relevant in determining whether there is abuse of law to be caught by general or specific rules that must be construed according to the principle of proportionality coupled with reasonableness. See the following cases that were explicitly decided on abuse, good faith and proportionality grounds: *Intersplav* and *Bulves* regarding the right to a tax refund decided by the ECHR (Chapter III.2.7.d); and by the ECJ the following cases in Chapter IV, *De Lasteyrie du Saillant* Case C-9/02 [2004] ECR I-2409 (section 6), *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise* Joined cases C-354/03, C-355/03 and C-484/03 [2006] ECR I-483 (carrousel fraud cases) and *Federation of Technological Industries* and *Telios* Joined Cases C-354/03, C-355/03 and C-484/03 [2006] ECR I-483 regarding joint tax liability requiring reasonable behaviour, good faith and proportionality

avoidance rules are also justified by their objective of raising tax collection and avoiding artificial transactions with no business purpose. The issue of how specific anti-avoidance rules - such as rules relating to transfer pricing, controlled foreign companies, and thin capitalization, - are justified and interpreted as proportionate and adequate to their objectives needs to be addressed. If apparently indeterminate rules may be necessary for anti-avoidance purposes, the notion of reasonableness and the proportionality test may be used to assure a desirable margin of certainty and predictability pursuant to the objective of fairness. Once freedom is recognized as a fundamental right, including the freedoms of contract and effective management exercised by the taxpayer, the proportionality principle may also act as a reasonable restrictor of this freedom and, at the same time, as a reasonable limitation to the power to tax. The role of balancing may also be present in weighing up the relevant economic factors to ascertain the open-ended notion of tax abuse.[84]

Both the standard of reasonableness and the principle of proportionality are also relevant to interpret and apply other legal principles and rules, particularly vague ones, such as equality.[85] Vague standards, such as reasonableness itself and its corollaries, such as 'reasonable person',[86] must be as objectively ascertainable as possible to achieve fairness and certainty in law. Perelman emphasizes that the limit of interpreting vague concepts is their unreasonableness or unacceptability,[87] which not only results from the inconsistency of rules, but also from their construction in the light of their purpose and the legislative intent. The introduction or application of

(section 7.3); *Schlossstrass*e Case C-396/98 [2000] ECR I-4279 concerning retrospective taxation, legitimate expectation and good faith (section 8.3).

[84] See for instance *Halifax* Case C-255/02 [2006] ECR I-1609 and *Part Service* Case C-425/06 [2008] ECR I-897 cases, Chapter IV.7.2.

[85] According to Cass R. Sunstein, standards "like 'equality' and 'reasonable' are vague because they need a great deal of determination to have meaning for particular cases" (*Reason and Political Conflict*, Oxford University Press, 1996, p.124).

[86] The standard of 'reasonable person' applies in tort law, criminal law, and administrative law, in which equality has a fundamental role in its objective ascertainment (see Moran, Mayo, *Rethinking the Reasonable Person: an Egalitarian Reconstruction of the Objective Standard* (Oxford University Press, 2003).

[87] *Etica e Direito,* p. 682, *Le raisonnable et le deraisonnable en droit* (LJDJ, 1984). See, also, Emiliou, (1996), n.20, pp.254, 270, 273 and Takis Tridimas (1999), p.140, about the close affinity of the notion of proportionality to that of reasonableness. That close relationship is quite logical since in order to be necessary and proportionate, "the means must be reasonable" (Messerschmidt, Klaus, note 17, p.4).

forms and special rules of legal argumentation is necessary to meet the requirements of a more ascertainable law or legal rule, with as much certainty and predictability as possible. On the other hand, some degree of uncertainty and indeterminacy in law may be inevitable, as in life itself. One never knows when, where and how one will die, but one should reasonably know how one's gains and transactions might be taxed. Other uncertainties or ambiguities in law may reflect the lack of consensus at the legislative level in adopting precise and complete concepts or terms. This malleability of legal rules provides another layer of complexity in the search for certainty and predictability of law, as well as in determining its meaning.

Proportionality in concert with reasonableness may also play a fundamental role in making more effective some principles and rules. Moreover, effectiveness may be also regarded as closely related to fairness, which is the ultimate objective of proportionality.[88] It has been rightly suggested that if the application of a system or some principles and rules lack fairness, they may fail in "political acceptability" and may tend to fail in effectiveness "as enforcement becomes difficult and non-compliance grows."[89]

Furthermore, the reasonableness standard and the proportionality principle are broadly applied in different jurisdictions not only as techniques for the determination of open-ended concepts, but also in the interpretation, construction and even derogation of legal rules, or more precisely, in considering some statutory rules as unconstitutional and so null and void.

According to Larenz, the proportionality principle widely dominates tax law, especially at the level of justice and the ability to pay,[90] where the necessity of its application is even clearer. A lack of its consistent application may lead to arbitrariness and uncertainty, which would be repulsive to human rights, fundamental freedoms and fairness in international tax relations.

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[88] On effectiveness, see Chapters III, sections 2.1, 2.3.c)2 and d); IV, sections 8.5 and 9; and section 2.3 of the Conclusion.

[89] Piccioto, Sol, *International Business Taxation* (W&N 1992), p.83.

[90] *Derecho Justo – Fundamentos de Etica Juridica*, (1985), p.141

In terms of the economics of taxation, a test for taxes is to raise revenue without harming enterprises too much[91], except perhaps for sin taxes. In other words, the economic test requires a reasonable balance between those objectives. If a tax were easy to avoid, it would lack one of those requirements. The canons of taxation (fairness, efficiency, and simplicity) should be pursued together and the simpler a tax the less fair it may be. Thus, a reasonable balance between those objectives should exist within a tax system and its particular taxes to make them more efficient and fair[92] as well as the whole tax system.[93] In the light of the general public interest and fundamental rights, any tax measure or rule might be scrutinised first on the political and legislative stages and secondly on the judicial level under the proportionality principle coupled with reasonableness.

Between different jurisdictions there appear to be conflicting interests in applying some principles and rules, such as an international "trade neutral allocation of tax jurisdiction"[94] and those concerning source and residence countries.[95] The benefit principle tends to favour source countries (generally developing countries), and the ability to pay principle is more connected to residence countries (a principle usually advocated by developed countries). What could be the limit for the application of

[91] The Economist, September 19th, 2009, p.17.

[92] The role of proportionality coupled with reasonableness may be seen as remarkable in assessing any particular tax, such as VAT, as analysed in Chapter IV.7.

[93] According to David G. Duff the concept of tax fairness should be considered in the light of three broad goals: 1. the collection of revenues to finance public expenditures, 2. the regulation of social and economic behavior, and 3. the distribution of economic resources. Regarding the first goal the combination of two principles - benefit principle and ability to pay – is a useful criteria to assess its fairness; whereas for the second the justice of the regulatory goal and the rational relationship between its objective and its distributional effects are more appropriate to assess tax fairness; and lastly for the third goal, broader considerations of distributive justice should be taken into account for assessing fairness ("Tax fairness and the tax mix", 2008, pp 1-8). Proportionality may be clearly applied to all three goals; to the first by combining the benefit and the ability to pay principle, assessing not only which revenue is more appropriate to each principle, but also assessing the two principles themselves; to the second by assessing the legitimate ends of regulatory goals and the appropriate means to reach them; and to the third by assessing the criteria for the distribution of economic resources as proportionality has its roots in the notion of retributive justice and appropriate distributive justice (see note 36).

[94] Van Thiel, Servaas, "General Report" in Lang, Michael, Herdin, Judith, and Hofbauer, Ines (Eds.), *WTO and Direct Taxation* (Kluwer, 2005), p.47.

[95] See inter alia, *Source versus Residence – Problems arising from the allocation of Tax Rights in Tax Treaty Law and Possible Alternatives*, Lang, Michael, Pistone, Pasquale, Schuch, Josef and Staringer, Claus (Eds.), (Kluwer, 2008).

both principles? Proportionality and reasonableness may interact with them in order to achieve more fairness in an international scenario.[96] Regarding double taxation conventions, many of their articles may be interpreted in the light of proportionality and reasonableness to achieve more fairness in the allocation of profits, enforcement of tax claims, and the exchange of information.

Sometimes the vaguer notion of reasonableness contained in the Vienna Convention (Article 32(b))[97] may not be the most persuasive reasoning and the only method for solving tax disputes. The well established test of proportionality used by the ECHR to restrict state immunity under international law and convention rights[98] may be regarded as a decisive rule to apply to fiscal sovereignty in some circumstances. Also regarding the interpretation and application of bilateral investments treaties, the proportionality and reasonableness tests may have a relevant role in general, particularly in tax matters and the fiscal sovereignty of States.[99] The host country may impose tax measures that fall foul of the "fair and equitable treatment"[100] and the "national treatment and the most favoured nation" clauses, as well as the expropriation requirements that may be breached by general or specific tax rules.

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[96] The rationale for applying the principle of proportionality to the equitable apportionment of resources between watercourse states (*Gabcikovo-Ngymaros Project* case, ICJ Reports, 1997,7, apud Cannizzaro, "The Role of Proportionality…" (2001) EJIL 12, p.898) may similarly be extended to the issue of fair apportionment of tax where income is related to two or more countries.

[97] *Supplementary means of interpretation*
"Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
(*a*) leaves the meaning ambiguous or obscure; or
(*b*) leads to a result which is manifestly absurd or unreasonable."

[98] See Higgins, R, (2003), n.2, p.10.

[99] See Walde, Thomas and Kolo, Abba, "Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty", (2007) Intertax, Volume 35, Issue 8/9, pp. 424-449.

[100] On this clause, see Tudor, Fiona, "The Fair and Equitable Treatment Standard", in *International Law of Foreign Investment* (OUP, 2008). On the express application of the principle of proportionality to treaty investment disputes within the 'fair and equitable treatment' clause, see inter alia Xiuli, Han "The Application of the Principle of Proportionality in *Tecmed v Mexico*" (2007) Chinese Journal of International Law, Vol. 6, No. 3, 635-652. In this article Prof. Han Xiuli points out that China has agreed to over 300 bilateral investment treaties including the fair and equitable and expropriatory requirement clauses, and states that proportionality may philosophically be compatible with the Chinese doctrine of moderation.

In conclusion, the reasonableness standard as a judicial tool to construe any law and control its constitutionality was developed by the American system of jurisprudence[101] and may have become an implicit and explicit source for jurisprudence for various countries. The case law of community and international courts, such as the European Court of Justice, the European Court of Human Rights and the Appellate Body of the WTO, may have also founded their core decisions on the principle of proportionality in tandem with reasonableness.[102] As an apparently indeterminate concept, the notion of reasonableness has evolved throughout the years, and has sown the seeds of proportionality. Their role in taxation may be pervasive, possibly covering essential issues, such as equity, fairness, legal certainty, avoidance, evasion, enforcement, simplicity, tax incentives, non-prohibitive or reasonable taxation, tax rates and tax basis, public policies, equality and non-discrimination, fundamental rights and freedoms, as well as further development of new principles. Other issues will be covered, such as whether the principle of proportionality coupled with reasonableness may be regarded as an overarching principle or method of interpretation and application of law as applied in domestic and international courts. The emphasis will be given to tax matters and their interaction with international trade and with fundamental rights, which may be the foundation and the ground for fair taxation and efficient tax systems.

[101] See the following Chapter, sections 1 to 4.

[102] See Chapters III and IV.

II. American Legislation and the US Supreme Court

The importance of this Chapter lies in the analysis of the origin of both the principles of proportionality and reasonableness and their relationship with the rule of reason,[103] particularly in relation to the Due Process Clause enshrined in the American Constitution. Reasonableness and proportionality themselves will be investigated as to whether or not their reasoning may be regarded as an essential tool for interpretation and application of principles and rules, such as equality and discrimination. It may not be a new finding that proportionality coupled with reasonableness may be at the heart of discrimination, in searching for fairness in each case. It has also been suggested that "proportionality is key to preventing excessive government intrusion into individual autonomy and also to striking a meaningful balance between the federal government's limited powers and the state's police power."[104]

Furthermore, how the reasoning of proportionality in both of its forms - strict and loose - permeates judicial decisions will be demonstrated, particularly within the tax field, regarding not only equality and discrimination, but also retrospective taxation, worldwide unitary taxation and transfer pricing rules. All these rules and principles may be construed and interpreted in the light of reasonableness and proportionality in balancing public interest, policy reasons, fairness, legal certainty, predictability, equality, ability to pay, non-abusive tax avoidance and other taxpayer's rights as will be shown in this Chapter. These particular issues have been chosen not only to illustrate how the standard of reasonableness - sometimes interchangeable with the principle of proportionality - may be applied in search of fairness and consistency in each case before the Supreme Court, but also to point out some arguable inconsistencies and unfairness that may be contradictory to its alleged objectives.

[103] The rule of reason may be regarded as a method of construction and interpretation of the law through which the scope of laws may be reasonably either narrowed or broadened according to their purpose and within its specific or general context. As a result, exceptions to general or specific rules may be construed by taking into consideration imperative or pressing social needs under the test of proportionality. See Chapter I, section 1, Chapter II section 2 and within the EU context, Chapter IV, section 2.2.

[104] Sullivan, E. Thomas, and Frase, Richard, *Proportionality Principles in American Law - Controlling Excessive Government Actions* (OUP, USA 2009), p.83.

Finally, wherever possible, some distinctions will be drawn between tax and non-taxes cases regarding how proportionality and the rule of reason govern them.

II.1. The constitutional clauses regarding reasonableness and proportionality standards of review. The rule of reason.

II.1.1 The role of proportionality in American federalism and an overview of the constitutional grounds for proportionality and reasonableness.

It is worth noting that an aspect of the test of proportionality between ends and means has been existent in American jurisprudence since the beginning of its constitutionalism. In *McCulloch v Maryland*, Justice Marshal stated:

> "Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end, and which are not prohibited, but consistent with the letter and spirit of the Constitution, are constitutional." [105]

It has been suggested that the US Supreme Court has applied a stricter test of proportionality to state actions under the First, Fifth, and Fourteenth Amendments, as discussed below, though only to laws that restrict fundamental rights or draw distinctions on grounds of unreasonable classification.[106]

The First Amendment[107] provides for freedom of speech that is enforced to an extent that any restriction to this right is closely scrutinized as "debate on public issues … [should be] … uninhibited, robust, and wide-open."[108] Thus, any kind of taxation that

[105] [1819] 17 U.S. 316. This case concerned a State tax that was declared unconstitutional, since it had been imposed on a bank incorporated by the Federal Union. Marshall's "ever immortal words" (L.Y.F., *Virginia Law Review*, Vol. 19, No. 7, May, 1933, p.722) dealt with the implied powers of the Union, in this case to create the Bank of the United States, as one of the 'usual means' of carrying out the enumerated powers of the Federal Union (see also Tushnet, Mark, "US: Eclectism and Pragmatism", *Interpreting Constitutions - a Comparative Study*, (OUP, 2006), pp.7-54.

[106] Tribe, Lawrence, *American Constitutional Law*, (1987), ch. 16:6-13, apud Beatty (2004), pp.162 and 182.

[107] First Amendment: "**Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances."**

[108] [1964] 376 U.S. 254 at 365, *New York Times Co. v. Sullivan*, Justice William Brennan.

appears to be a restriction to or discriminatory against the freedom of the press is also submitted to a strict test of scrutiny.[109]

The interpretation of the Fifth (1791) and Fourteenth (1868) Amendments,[110] which established the protection of the due process clause, has broadened and applied the reasonableness standard in particular cases from different fields of law,[111] including federal and state taxation.[112]

Also, by virtue of the Fourth Amendment of the American Constitution, the Judiciary is empowered to review the reasonableness of search and seizure measures (*unreasonable searches and seizures*).[113] The Supreme Court construed 'reasonableness' as "requiring a balancing of the strength of the government interests supporting the search or seizure against the nature and degree of the intrusion on the citizen's privacy, liberty, and/or property rights."[114] The case law on 'unreasonable searches and seizures' clearly demonstrates how 'proportionality' intertwines with and interchanges with 'reasonableness' as a standard of judicial review, applying the ends-means reasoning to assess the seriousness of the offences and sometimes the least-intrusive means test.[115]

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[109] See further discussion on this issue, the *Grojean* case, this Chapter section 3.

[110] Fifth Amendment: "No person shall be…., nor be deprived of life, liberty, or property, without due process of law;…"
Fourteenth Amendment: "…. nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

[111] As Justice Stevens also stated in *Ewing v. California*, "the Due Process Clause directs judges to employ proportionality review in assessing the constitutionality of punitive damages awards on a case-by-case basis. See, for example, *BMW of North America, Inc. v. Gore* [1966] 517 U.S. 559, 562."

[112] See the following sections 2, 3, 4 respectively regarding excessive taxation, tax discrimination and retrospective taxation.

[113] A close relationship between proportionality and unreasonableness under the Fourth Amendment may also be seen in *Atwater v City of Lago Vista* [2001] 532 U.S. 318.

[114] Sullivan, E. Thomas and Frase, Richard S., (2009), p.97.

[115] See *Atwater v.City of Lago Vista* above, penultimate note, *Terry v Ohio* [1968] 392 U.S. 1, *McDonald v United States* [1985] 472 U.S. 479, *Welsh v Wisconsin* [1984] 466 U.S. 740, *Tennessee v Garner* [1985] 471 U.S. 1, and other cases analysed by Sullivan and Frase (2009), pp.97-103.

A proportionality test is also a standard of review under the Eighth Amendment, according to which "excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted."[116] In contrast with other jurisdictions, the Supreme Court has held the death penalty to be constitutional under the test of proportionality.[117]

The commerce clause prohibits restrictions on interstate trade, whether or not discriminatory, unless the measures concerned comply with the requirements of objective justification based on a valid reason other than protectionism (in case of discrimination) or their costs do not exceed their benefits (in case of non-discriminatory measures).[118] Those state regulations are then scrutinized under the test of objective justification and cost-benefit analysis, which have similarities with

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[116]Beatty (2004), p.182, by mentioning *Lockyer v. Andrade* [2003] 538 U.S. 63 and *Ewing v. California* [2003] 538 U. S. 11, under the Eighth Amendment ("Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted."). In the latter case Justice O'Connor stated, that this Amendment "prohibits ... sentences that are disproportionate to the crime committed," and that the "constitutional principle of proportionality has been recognized explicitly in this Court for almost a century" (at 284, 286).

[117] In *Stanford v Kentucky* [1989] 492 U.S. 361, by a majority of four to five, the death penalty was regarded as proportional and neither cruel nor unusual punishment for even criminals of 16 or 17 years of age. See Jackson, Vicki C, and Tushnet, Mark, *Comparative Constitutional Law*, (Foundation Press, 1999), pp.153-57, and the Chapter III.2.c.3 on proportionality and the right to life under the European Convention on Human Rights.

[118] In *C & A Carbone, Inc., et al., Petitioners v. Town of Clarkstown* [1994] 114 S. CT. 1677, 128 L, Justice O'Connor, concurring in the judgment, summarized the types of discrimination and protectionism that are unconstitutional under the commerce clause:

"The scope of the dormant Commerce Clause is a judicial creation. On its face, the Clause provides only that '[t]he Congress shall have Power . . . To regulate Commerce . . . among the several States . . .' U. S. Const., Art. I, §8, cl. 3. This Court long ago concluded, however, that the Clause not only empowers Congress to regulate interstate commerce, but also imposes limitations on the States in the absence of congressional action: ……. We have generally distinguished between two types of impermissible regulations. A facially non-discriminatory regulation supported by a legitimate state interest which incidentally burdens interstate commerce is constitutional unless the burden on interstate trade is clearly excessive in relation to the local benefits. See *Brown Forman Distillers Corp.* v. *New York State Liquor Authority*, 476 U.S. 573, 579; *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142. Where, however, a regulation 'affirmatively' or 'clearly' discriminates against interstate commerce on its face or in practical effect, it violates the Constitution unless the discrimination is demonstrably justified by a valid factor unrelated to protectionism. See *Wyoming* v. *Oklahoma* [1992] 502 U. S. (slip op., at 15-16); *Maine* v. *Taylor* [1986] 477 U.S. 131, 138. Of course, there is no clear line separating these categories. 'In either situation the critical consideration is the overall effect of the statute on both local and interstate activity.' *Brown Forman Distillers*, *supra*, at 579."

proportionality reasoning.[119] In tax matters, the Supreme Court developed the doctrine of 'nexus' with the taxing state and the requirement of 'fair apportionment' under the commerce clause,[120] also based on the reasonableness standard which may function as a principle. States have the right to tax interstate commerce if a four prong test is met, according to *Complete Auto Transit, Inc. v. Brady*[121] that requires the tax:

(1) be applied to an activity with *substantial nexus* with the taxing state,

(2) be fairly apportioned,

(3) does not discriminate against interstate commerce, and

(4) is fairly related to the services provided by the state.

Whereas some American commentators also see similarity between the rulings on the commerce clause and the proportionality reasoning of the European Court of Justice[122], others consider that this was "an American rendition of the principle of proportionality found in German and European Union law."[123] My view is that, regarding discriminatory measures, the US reasoning is the same as the objective justification on grounds of necessity and balancing (typical of proportionality), whereas concerning non-discriminatory measures the scrutiny of cost-benefit is different from proportionality by the margin of discretion of the public authorities. In other words, when the US courts assess whether local benefits exceed or not trade costs, there is no deference to the discretion of States, which is present in

[119] Regarding cost-benefit analysis and proportionality see Trachtman, Joel P., "Trade and … Problems, Cost-Benefit Analysis and Subsidiarity" (1998) EJIL, 9, p.64; and on the difference between proportionality and cost-benefit analysis, see Chapter III, section 3.2.b, on the WTO.

[120] See also section 5 (*Container* and *Barclays* cases).

[121] [1977] 430 U.S. 274. See also Hellerstein, Walter, "The US Supreme Court's State Tax Jurisprudence", pp.108-18, in *Comparative Fiscal Federalism Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, by Avi-Yonah, Reuven S., Hines Jr, James R. and Lang, Michael (Kluwer Law International, 2007).

[122] Bermann, George A., Goebel, Roger J., Davey, William J., Fox, Eleanor M., *Cases and Materials on European Community Law*, American Case Book Series (West Publishing Company, 1995), p.358).

[123] Sullivan and Frase (2009) supra, p.57. Contrasting the Supreme Court decisions on the commerce clause and the European Court of Justice on restrictions on intra-community trade, see also Maduro, Miguel, *We, the Court - the European Court of Justice & the European Economic Constitution* (Hart Publishing, 1998), pp.90-95.

proportionality.[124] Regarding the criterion of fair apportionment the standard of reasonableness must take into account the legitimate interests of other states based on objective factors as should happen with the transfer pricing rules and in the fair allocation of taxing rights between States.

Summing up the case law of the Supreme Court, Sullivan and Frase point out that there are two rigid standards of scrutiny: the strict and the rational. Whereas the former is applied to more fundamental liberties and suspect classes, the latter is applied to a 'garden-variety socio-economic legislation'.[125] The strict scrutiny is more rigorous and closer to the test of proportionality in its three prongs – suitability, necessity and balancing of the all interests at stake, as decided in *Harper* (to tax the right to vote) and *Hoeper* (joint taxation of couples).[126] The rational basis is more deferential to intrusive measures and may be closer to the reasonableness standard of review, as demonstrated in *Lehnhausen*.[127] However, there is also an intermediate scrutiny according to which medium-high protection is provided for gender discrimination, state encroachment of federal powers, violation of free speech by content neutral regulation, criminal matters, severe fines and forfeitures.[128] *Grosjean* on State taxation and the right to free speech as well as cases on retrospective taxation are examples of this intermediate scrutiny, where the relationship between ends and means, as well as the balance of the interests at stake are also clearly present.[129] Thus, the intensity of scrutiny may also vary in tax matters for which the Supreme Court developed similar standards of review to assess the intrusiveness of excessive or discriminatory taxes in violation of the fundamental rights, the due

[124] See further on this issue, Chapter III, sections 3.2.b (last paragraph) and 3.3.

[125] Idem, 2009, p.203, n 11.

[126] See both cases in section 3 of this Chapter. As happened in *Harper*, sometimes a right is regarded as so precious that no further analysis of least restrictive measures is made to scrutinise the questioned restriction (*v.g*. the imposition of a tax to exercise the right to vote).

[127] See section 3 of this Chapter. See further Chapter I, section 2, on examples of measures that would pass the test of reasonableness but fail the test of proportionality.

[128] Sullivan and Frase (2009) supra, pp.5, 52-53.

[129] On *Grosjean* see section 3 of this Chapter; on retrospective legislation see *Home Building* in the next section (1.2); and on retrospective taxation, section 4.

process and commerce clauses, varying the degree of scrutiny according to the values and interests in play.

All the above illustrations show the foundations of proportionality and reasonableness on constitutional clauses that may have a similar construction based on the rule of reason. This point is analysed in the following section, since it may be suggested that proportionality and the broad reasonableness standard of review have their origin in the rule of reason and in the interpretation of the constitutional clause of contract protection.

II.1.2. Constitutional clause on contract protection (the rule of reason, reasonableness and proportionality)

This section aims at investigating the relationship between the rule of reason[130] in the US and the standard of reasonableness that may be interchangeable with the proportionality principle. This investigation leads to and corroborates the conclusion that the principle of proportionality coupled with reasonableness in relation to other fields of law is the same as that applied in tax matters. It may also aid in drawing some distinctions between tax and non-taxes cases, and from them to infer its main purpose: the search for fairness in a logical, principled and reasoned way.

To demonstrate this, it is worth starting with two sets of cases in which the Supreme Court applied the notion of reasonableness and necessity to restrict the apparently broad wording of the constitutional clause on contract protection.[131]

The first set of cases concerns retrospective legislation that may impair the obligation of previous contracts. The constitutional prohibition on the impairment of contracts, literally interpreted, seems to be absolute ("No State shall […] pass any ... Law impairing the Obligation of Contracts"), with no room for any exceptions, but the Supreme Court had to decide whether or not reasonable or necessary impairments should be admissible. The landmark case was *Home Building & Loan Assn. v.*

[130] On the origin of the rule of reason and its broader general relationship with the standard of reasonableness and proportionality, see Chapter I, sections 1 and 2.

[131] Article I, Section X, clause 1 of the American Constitution states "No State shall […] pass any Bill of Attainder, ex post facto law, or Law impairing the Obligation of Contracts […]."

Blaisdell,[132] in which it was held that to ascertain the scope of the constitutional prohibition of interfering with contractual obligations, the course of judicial decisions should be examined taking into account not only the fair and reasonable aim of contracts, but also of any law including the Constitution. Thus, the Supreme Court stated that it was beyond question "that the prohibition is not an absolute and is not to be read with literal exactness like a mathematical formula".[133] The question that should be answered is whether the law that retroactively applies to the obligation of a contract has a legitimate purpose, as well as whether the adopted measures are reasonable and appropriate for that purpose.[134] This decision may be compared in two ways with the reasonableness of retrospective taxation as analysed in section four of this Chapter. First, a similarity between them in relation to the application of the same standard of reasonableness functioning as a principle[135] of interpretation regarding tax matters, suggesting that this field of law is not out of touch with general legal principles of interpretation.[136] Secondly, the degree of scrutiny might differ, but again the rationale behind the construction of laws in the light of the rule of reason and proportionality seems to be the same search for fairness in each case.[137]

The second set of cases deals with any other impairment of the obligation of contracts. In *Lochner v. New York*[138], the Supreme Court stated:

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[132] [1934] 290 US 398.

[133] 290 US 398, 428.

[134] *Blaisdell*, idem, 438: "The question is not whether the legislative action affects contracts incidentally, or directly or indirectly, but whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end."

[135] See Chapter I, sections 1 and 2, on how reasonableness may be interchangeable with proportionality as a principle particularly in its role of balancing.

[136] Tim Koopmans, Professor of Constitutional Law and former judge at the European Court of Justice, pointed out that taxation is the clearest illustration of active judicial imposition of substantive legal standards on areas of law which were characterised by administrative discretion, stating that, "by extending constitutional rules and principles, such as equal protection and protection of legal certainty, to tax matters the courts have helped to transform fiscal administration into tax law" in *Courts and Political Institutions: a Comparative View* (CUP, 2003), p.275.

[137] A retrospective measure must be not only appropriate to its legitimate end, but must also comply with the legitimate expectations of citizens based on fairness, as the Court stated in *General Motors Corp. v. Romein* [1992] 503 U.S. 181. See this Chapter, section 4, on retrospective taxation.

[138] 198 US 45.

> "The [state] act must have a more direct relation, *as a mean to an end, and the end itself must be appropriate and legitimate*, before an act can be held to be valid which interferes with the general right of an individual to be free in his person and in his power to contract in relation to his own labor."[139]

In this case, the Court gave no weight to the social purpose and utility of the measure, but only regarded public health, safety and morals in contrast with the individual liberty of contract, to invalidate the law that imposed maximum hours of daily work.[140]

It has been suggested that it is hard to ascertain vague terms like "liberty" or "property" that do not make a choice among substantive values.[141] However, what may be more interesting here is to point out again the relationship between reasonableness and proportionality with regard to the relationship between legitimate ends and means.[142] The terminology 'proper', 'not going beyond the limits of a constitutional right', particularly the term 'reasonable', was contained in some laws and constitutional provisions such as the protection of equality. The Framers of the Constitution also acknowledged that its "broad provisions are subject to legal rules of interpretation that derive from *common sense* and that the construction must be natural and reasonable."[143] Thus, the Judiciary was left with the task of ascertaining

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[139] Idem at 57-58.

[140] The Supreme Court also invalidated minimum wage laws, laws protecting unionizing and consumer protection laws, but later on started giving broad deference to state socio-economic legislation (Sullivan and Frase (2009) supra, pp. 62-63).

[141] This has not been the problem with *Lochner*. What was wrong with *Lochner* was that the Court chose "wrong values to enforce, wrong in the sense that complete laissez-faire capitalism was neither required by the historical understanding of ´liberty, nor did it meaningfully enhance the freedom of the vast majority of Americans in the industrialized age, particularly after the onset of the Great Depression." (Tribe, Laurence, Dorf, Michael, *On Reading the Constitution*, Harvard University Press, 1991, p.66).

[142] On *Lochner* and proportionality, from a comparative perspective, see Engel, Christoph, "The Constitutional Court - Applying the Proportionality Principle - as a Subsidiary Authority for the Assessment of Political Outcomes" (Bonn, 2001), http://papers.ssrn.com/abstract=296367, p.2 (last visited 8 July 2010); Beatty (2004) supra, pp.135-6, 185 and 187; and also Caruso, Daniela "*Lochner* in Europe: A Comment on Keith Whittington's Congress Before the *Lochner* Court" (2005) 85 B.U.L. Rev, pp.867-880.

[143] Sullivan and Frase (2009) supra, p. 172, citing The Federalist no. 83 (Alexander Hamilton).

the reasonableness of the facts analysed in the light of the circumstances and the reasonable purpose of the law.[144]

The interpretation of the Sherman Act is one of the landmark examples of the introduction of *reasonable* and *unreasonable* expressions in the law.[145] Justice White reasserted the necessity of attributing a meaning to the vague terminology '*restraint to trade'*. This ascertainment should follow the sense of preserving the individual right to contract without hindering interstate trade, considering that the free circulation of goods is the goal protected by the law.[146] Thus, the Supreme Court stated again that the standard of the rule of reason - universal in its application - was clearly required to provide effectiveness to the remedies provided by law, preventing unreasonable limitations on the freedom of contracting, adopting an ends-means relationship as well as balancing the constitutional freedom of contract, legitimate restrictions and the purpose of the Act concerned.[147]

A similar reasonableness standard may be required in tax matters concerning reasonable profits, reasonable taxation, and reasonable or acceptable tax avoidance. The point that may be made here is that, where fundamental rights and principles are in play, such as the fundamental freedom of contract, they may be limited by imperative requirements or pressing social needs in the general interest. However, these limitations must be tested according to the reasonableness and proportionality standards of review in order to make them most effectively and rationally compatible with each other. Furthermore, where the margin of discretion is apparently unlimited or broad enough to defy the requirements of legal certainty and non-arbitrariness,

[144] The proportionality rationale in the form of the alternative means test was applied in *US Trust Co. v. New Jersey* [1977] 431 US 1, which also concerned the constitutional clause of contract protection. Justice Blackmun construed Article I, Section X, clause 1 of the American Constitution as not applicable when a statute is "reasonable and necessary to serve an important public purpose," but not where there were less drastic alternative means. See also Wolfe, Christopher, *La Transformacion de la Interpretacion Constitucional* (Civitas, 1991), p.446.

[145] The issue at stake was whether the '*restraint of trade'* expression within the law should be literally interpreted. See also Chapter I, section 1.

[146] Justice White's vote (US/221/1).

[147] Ibidem.

proportionality coupled again with reasonableness may consistently be used to ascertain their boundaries.

In this section, the rule of reason and its relationship with the standard of reasonableness (ends and means) and proportionality (balancing) was analysed within the context of non-tax cases, particularly concerning the fundamental freedom of contract with reasonable restrictions and limitations to retrospective legislation (*Home Building*) and any other possible impairment such as in *Lochner*. This section also served the purpose of showing that tax law is not a separate body of law with its own rules and principles of interpretation, in which there might be no room for the fundamental principle of proportionality and the pervasive notion of reasonableness.

The next section will illustrate a distinction between reasonableness and arbitrariness and how the former standard may give prevalence to a purposive interpretation of laws over a literal method of construction.

II.1.3. Reasonableness as a determinant of either the preponderance of the literal meaning, or the legislative intention – The possible distinction between what is reasonable and what is non-arbitrary

According to Repetti, in 1945 the Supreme Court pronounced a decision revealing American jurisprudence's position regarding the tension that exists between the search for a strict and a literal meaning of the law, and the legislator's intent.[148] The former is the generally prevailing interpretation technique of the common law, specifically in the United States. Thus, every time a literal meaning or a sense that was divergent from a law's purpose needs to be put aside, the reasonableness rule is used as the interpretation technique. The idea of proportion or adequacy also lies beneath this technique. Every time the literal meaning proves inadequate to the proposed goal or to the legislator's objective, the *golden rule* (literal technique) is surpassed by some other method or interpretation of the rules, although always based on reasonableness. The legislator's objective has to be valid, reasonable, and in accordance with the constitution. In order to give preponderance to the clear and

[148] *US v. American Trucking Associations* [1940] 310 U.S. 534 , apud *Comparative Income Taxation* (Kluwer, 1997), p.145.

literal meaning of the legislative language, it is also important to notice the possible difference between absurd and unreasonable results.

The decision in question also showed that the Supreme Court frequently followed that objective instead of the literal words, even weighing up the case where a clear meaning would not provide absurd results, but only unreasonable ones, divergent from the purpose established in the legislation. Absurdity and reasonableness remain as vague terms, endowed with indeterminacy. It is possible to infer that the absurd is something that totally breaks rules, conditions and reason. Unreasonableness would be at a lower intensity level, not actually breaking rules and limits, and always analysed in the light of concrete circumstances. The retroactivity of a more severe law to be applied to facts which had occurred more than three years earlier could be considered absurd; given that the reasonable time limit was two years (see *Welch v. Henry*[149], concerning income tax).

Thus, the *American Trucking* case is a landmark decision in which the Supreme Court applied the standard of reasonableness to give preference to a purposive interpretation over a literal method. This might bring more uncertainty to tax law interpretation where legal certainty and clarity are required by taxpayers; however, my view is that the purpose of the standard of reasonableness is to bring more rationality to laws making them more logical, consistent with other rules and principles, and as fair and effective as possible. Moreover, a right balance between the open-ended standard of reasonableness and certainty can be achieved through proportionality as shown in the dilemma about tax avoidance (legal certainty opposing equity).[150]

The next section will consider another relevant characteristic of reasonableness.

II.1.4. The living and changeable notion of reasonableness in new circumstances.

The application of the due process clause has often been invoked to bar the enforcement of a tax similar to the sales tax (domestic/local tax payable on retail

[149] See section 4 of this Chapter on retrospective taxation.

[150] See Chapters I, section 3; and IV, sections 6.1 and 7.2.

sales) by state legislation. The *use tax* was collected in the state of the acquirer of out-of-state products consumed or used in the buyer's state. Although the financial burden always falls on the purchaser, the vendor has the duty to collect the tax. Sales taxes are only charged on the transactions completed in each state. With the lack of a specific anti-tax avoidance rule, such state tax could be avoided if the sale is performed in the vendor's state or even in a third state, and the goods consumed in the purchaser's state. This is the reason why states that already collect sales tax also implement a use tax, payable on goods acquired out of the state in which they are used.[151] If the sellers do not collect the use tax in an interstate sale, the buyers in their other state had to collect the use tax, as if they were the taxpayers as the users of goods brought into their state. As a matter of fact, the use tax is the equivalent to the sales tax that would be due in an intrastate sale had the seller an establishment in the taxing state.

In 1967, the Supreme Court considered as reasonable the collection of use tax payable on goods acquired outside of the purchaser's state, but only if the vendor had a physical presence or there was a nexus between the vendor and the state that had implemented the tax.[152] Consequently, the state would inform the taxpayer located in another state who would be charged with the tax. However, twenty-five years later, the Supreme Court abandoned the due process clause criteria as a constitutional obstruction to the imposition of the use tax in the case of sales through mail order.[153] The Supreme Court held that a state had jurisdiction to bring action against people who had minimum contact with the state, without offending the traditional notions of *fair play and substantial justice*, having stated:

> "This Court's due process jurisprudence has evolved substantially since *Bellas Hess*, abandoning formalistic tests focused on a defendant's presence within a State in favor of a more flexible inquiry

[151] Doernberg, Richard, and Hinnekens, Luc, *Electronic Commerce and International Taxation* (Kluwer, 1998) pp.282-3.

[152] *National Bellas Hess v. Illinois* [1967] 306 US 753 and *National Geographic Society v. California Board of Equalization* [1977] US 551, in which it was held that physical presence was required by local agents or retailers, for instance, and not only for interstate mail.

[153] *Quill Corp. v. Heitkamp* [1992] 504 US 298.

> into whether a defendant's contacts with the forum made it **reasonable**, in the context of the federal system of Government, to require it to defend the suit in that State."[154]

Thus, the formal-physical presence criterion was abandoned as a consequence of the application of the standard of reasonableness under the due process clause that is flexible and adaptable to new, relevant economic circumstances. From a physical presence to determine the taxpayer's connexion with a state, the standard of reasonableness accepted a new reality (electronic sales and virtual presence in another state) as a factor of connection for tax purposes as well. However, the fact undeniably remains that modern trade incorporates several commercial activities exclusively performed through mail and electronic communications, regardless of the trader's physical presence, and even if his or her intentions are exclusively addressed to out-of-state customers. Based on these underpinnings, and taking into consideration economic circumstances and the flexibility of the reasonableness standard, the decision in *Bella Hess* was overturned, a ruling that would allow the collection of the use tax without impinging on the due process clause.

Due to its indeterminate aspect, the due process clause has proved changeable throughout the years, according to differing socio-economic circumstances. This adaptability can be seen and is indeed demonstrated by this tax jurisdiction issue.

This and the previous sections (1.1 to 1.4) discussed some constitutional foundations for the general standard of judicial review of reasonableness and its different applications to fundamental rights, other constitutional protections, as well as its characteristics of giving prevalence to a purposive interpretation over a literal one, and flexibility. Where reasonableness functions more as a principle, particularly in its role of balancing different interests or other principles at stake, it is close to proportionality that itself functions in tandem with the standard of reasonableness.

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[154] Idem, at 299. However, the Court struck down the use tax under the commerce clause whose requirement of physical presence remained valid, as "due process concerns the fundamental fairness of governmental activity, and the touchstone of due process nexus analysis is often identified as "notice" or "fair warning." In contrast, the Commerce Clause and its nexus requirement are informed by structural concerns about the effects of state regulation on the national economy" (Ibidem, 2.b). The Court left for the Congress to regulate the issue, and concerning internet services it enacted another extension of the Internet Tax Free Act in October 2007 (Pub. L. 110-108), granting exemption from state and local taxation to internet access until the first of November 2014.

In the next sections, the main tax issues of excessive taxation, tax discrimination, retrospective taxation, and the extra territorial effects of domestic legislation will be analysed in the light of reasonableness and proportionality inferred from a number of clauses of the American Constitution.

II.2. Excessive taxation (due process clause, reasonableness and proportionality).

Under the apparently broad 'formula' of due process of law in the American Constitution, no person can be deprived of life, freedom or his/her assets without due legal process. That is, the deprivation of freedom or expropriation should be allowed only according to the broad concept of the rule of law, which may be ascertained in each case via a broad or strict notion of the rule of reason and proportionality.[155] Thus, the Supreme Court has based itself on the Due Process Clause to control the constitutionality of statutes that had unreasonable and inconsistent restrictions on the freedom and property of citizens.

If an activity, such as the production and sale of ice cream, is regarded as lawful and legitimate, it can be taxed provided that the tax "be reasonable in amount and not prohibitive."[156] In this case, an excise tax of seven cents per quart on all ice cream sold - which amounted to more than 30% of the wholesale price - was held invalid on the grounds that it was so excessive as to tend to ruin and suppress a legitimate business. There was also evidence in the market that, if the excise tax were passed on to consumers, there would be losses due to a substantial sales decrease.

As will be discussed further[157], the expressions 'reasonable' and 'proportionate' may be interchangeable, and where a close scrutiny is applied to any measure or rule to be

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[155] In *TXO Production Corp. v. Alliance Resources* [1993] 509 U.S. 443, concerning excessive awards, the Court reiterated that it had already "recognized that the requirement of proportionality is implicit in the notion of due process" (509 U.S. 443, 479).

[156] *Martin v. Nocero Ice-Cream Co* [1937] 269 Ky. 151, 106 S.W. 2d 64.

[157] See in this Chapter *Quaker*, *Lehnhausen*, and *Grosjean* cases on section 3 (non-discrimination); and *Hudson* , *Welch* and. *Darusmont* cases on section 4 (retrospective taxation). See also the ECHR cases explicitly applying the proportionality principle to the analysis of reasonableness (Chapter III.2.2); *Vastberga Taxi*, on striking a reasonable balance between the importance of what is at stake requiring that the means employed must be reasonably proportionate to its legitimate aim (Chapter III.2.7.b); and WTO cases (Chapter III.3), sections 2.b regarding "necessity" that requires a reasonable relationship between ends and means and reasonably available alternative measures; and 2.c. about the reasonable exceptions to discrimination and the reasonable balance of competing rights under the chapeau of Article XX of the GATT.

considered as reasonable, it must be adequate, necessary and (depending on the fundamental principles and rights in play) the least intrusive one.

It is interesting to note that the Supreme Court recognized that legislators had a broad margin of appreciation in regulating certain activities or products, regarding them as harmful or inconvenient on public moral or health grounds.[158] The Supreme Court has considered excessive taxation, stating that, if laws passed within the legitimate sphere of legislative power and reasonable enforcement 'for the security of private rights, the harshness, injustice and oppressive character of such laws will not invalidate them as affecting life, liberty or property without due process of law.'[159] However, a tax prohibiting an activity would be unreasonable, disproportionate and consequently unconstitutional (*null and void*), if the occupation is legitimate and the product is harmless.[160] As an open-ended and flexible concept, the term "reasonable" may be brought into play to consider a rate of tax as substantially harmful to a kind of business, but not to another, due to different market competition. A specific tax rate that may be prohibitive at any one time, due to a change in circumstances may not be prohibitive any longer at another time. This was expressly stated in *Glenn v Field Packing Co.* by the Supreme Court regarding an excise state tax on oleomargarine.[161] If proven that a kind of margarine is seriously unhealthy, a prohibitive tax could be imposed on it without violating the due process clause. The analysis of prohibitive taxation via proportionality reasoning is also made by the

[158] *Rast v. Van Deman and Lewis Co*. case, [1916] 240 US 342, in which the Court said that regarding the harmfulness and inconvenience of some goods, "not the courts, but legislatures, may be the best judges, and. it may be, the conclusive judges." See also *Mugler v. Kansas* case [1887] 123 U.S. 623. See also *Various Items of Personal Property v. US* case, [1931] 282 US 577, in which the Court upheld the excessive taxation, penalties charges and confiscation of alcoholic beverages, on grounds of due process as well: "Whether the exaction be a tax or a penalty; or partly the one and partly the other, there is no constitutional objection to enforcing it by forfeiture of the offending property."

[159] *Knowlton v. Moore* [1900] 178 US 41, 44. In this case, the Court analysed whether or not a succession tax which was construed to fall on the recipients of the property transmitted rather than on the estate of the decedent was arbitrary and confiscatory.

[160] See above *Martin v. Nocero Ice-Cream Co*.

[161] [1933] 290 US 177, in which the Supreme Court affirmed the decision from the Kentucky Court of Appeals holding that an excise tax on oleomargarine confiscatory and prohibitive of the exercise of a legitimate business under the State Constitution and the Bill of Rights.

European Court of Human Rights,[162] and the justification for restrictions to trade in goods on public health and environmental grounds in the European Court of Justice is also based on the proportionality test.[163]

Whereas the substantive analysis of the due process clause may be regarded as an evolution of a living Constitution, tax sovereignty and the exercise of police power by the legislature may have justified the apparently more self-restrained approach to tax matters with respect to declaring unconstitutional some taxes based on their confiscatory nature. Additionally, a constant concern regarding tax collection may have contributed to that self-restraint. A closer and more obvious relationship between due process and proportionality with regard to equality may be seen in the following analysis regarding non-discrimination.

[162] See Chapter III, section 2.7.c.

[163] See Chapter IV, sections 2 and 4.

II.3. Tax discrimination (due process, equality principle and proportionality coupled with reasonableness).

The influence of the notion of reasonableness and proportionality in determining the equality principle[164] in taxation is noteworthy. As already pointed out, taxation is about drawing distinctions,[165] and proportionality coupled with reasonableness have been extensively applied as legal tools to make any distinction, and particularly discrimination, acceptable and justifiable. Some degree of fairness may also be necessary to draw distinctions and make taxes reasonably acceptable by, and enforceable on, taxpayers either as citizens with political rights or as enterprises that are ultimately controlled by individuals.

Moreover, as has been suggested, if there is "*no objective and reasonable justification*" for different or distinct treatment of similar situations, there is no equality,[166] not only according to the European Court of Human Rights, but also to other international and domestic jurisdictions, including the U.S. where 'suspect' differentiation is subject to a 'strict scrutiny' or a strict proportionality test.[167]

In a landmark case concerning equality, *Quaker City Cab. Co. v. Pennsylvania*[168], the Supreme Court had to decide whether the higher taxation of corporations in comparison with individuals carrying on the same business activities would be admissible or not under the equal protection clause. Justice Brandeis discussed the

[164] Although only the Fourteenth Amendment explicitly provided the equal protection principle, it is settled law that also the equality principle is enshrined in the Fifth Amendment and falls within the general protection of due process which is fundamentally based on *fairness* (*Maxwell v. Bugbee* [1931], 250 US 525; *Coolidge v. Long* [1931] 282 US 582; *Heiner v. Donnan* [1932] 285 US 312; *Helvering v. Lerner Stores Corp*. [1941] 314 US 463).

[165] See Chapter I and Thuronyi (2003), p.82.

[166] Meussen, Gerard, Conclusion, p.173, in *Eucotax Series on European Taxation: the Principle of Equality in European Taxation* (Kluwer Law, 1999*)*, pp.169-174, 1999,

[167] Fredman, Sandra, (2002), pp.116-7. See also on the ECHR, Chapter III, sections 2.3.a, and 2.5; and in EU taxation, Chapter IV, sections 2.4, and 3-5.

[168] [1928] 277 US 389.

essentials of the equality principle concerning a tax case, suggesting that the following requirements should be met: [169]

a) Reasonableness of classification, based on real differences among individuals or taxed objects.
b) The existence of a justifiable purpose for the classification.
c) Logical connection between the pursued purpose and the classification that will provide the conditions to achieve this purpose.

The relationship between means and ends required by law is crystal-clear. It entails a substantial analysis of the alleged motive, which undoubtedly reflects the key concept of reasonableness and proportionality. The role of balancing different or opposing interests at play is lacking. However, this balancing can be sometimes implicit and the interests of those concerned were in this case on the one hand corporations being taxed as individuals, and on the other, the public interest in taxing them based on their privileges to act as corporations. The Court held unconstitutional the heavier taxation of corporations, with the dissenting vote of Justice Brandeis.[170]

In a unanimous later decision, the Court formally overturned *Quaker* pointing out compelling reasons why corporations could be taxed differently by comparison with individuals and partnerships.[171] In *Lehnhausen* the legal issue was the alleged

[169] Brandeis dissenting said: "In other words, the equality clause requires merely that the classification shall be reasonable. We call that action reasonable which an informed, intelligent, just minded, civilized man could rationally favor. In passing upon legislation assailed under the equality clause we have declared that the classification must rest upon a difference which is real, as distinguished from one which is seeming, specious, or fanciful, so that all actually situated similarly will be treated alike, that the object of the classification must be the accomplishment of a purpose or the promotion of a policy, …, and that the difference must bear a relation to the object of the legislation which is substantial, as distinguished from one which is speculative, remote, or negligible, to this limitation of reasonableness, the equality clause has left unimpaired, both in range and in flexibility, the state's power to classify for purposes of taxation" (277 US 38).

[170] See Case Comment**, "Taxation. Discrimination between Corporations and Individuals in State Taxation"** *Columbia Law Review*, Vol. 33, No. 4 (April 1933), pp.738-739; "**The Corporate Character of the Taxpayer as a Basis of Classification in State Property Taxation"** *Harvard Law Review*, Vol. 44, No. 3 (January 1931), pp.443-447.

[171] *Lehnhausen v. Lake Shore Auto Parts Co* [1973] 410 U.S. 356. Justice Douglas stated the following, justifying the purpose of the differentiation and its logical connection with the classification referring to the dissenters in *Quaker* led by Brandeis and the privileges granted on corporations:

> " The continuity of the business, without interruption by death or dissolution, the transfer of property interests by the disposition of shares of stock, the advantages of business controlled

discriminatory nature of the property tax the State of Illinois imposed on corporations only, leaving individuals free from the tax charge, for a number of reasons, such as practicalities for assessment and enforcement, fairness, and some privileges granted to corporations.[172] Justice Douglas cited among others cases *Allied Stores of Ohio v. Bowers*, in which it was stated that the equal protection clause provided by the Fourteenth Amendment "imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of state taxation."[173] Thus, the Court concluded that *Quaker* was outdated; there have been no reason any longer why corporations could not be taxed differently from individuals, giving states a large discretion to impose their taxes on those grounds. This standard of reasonable tax discrimination may be loose, although some rationality must justify the differentiation between classes of taxpayers and the relationship between the ends of discrimination and the means to achieve it.

However, where taxation is in play with other specific federal rights, apart from equal protection, the scrutiny of the Supreme Court is strict and not just rational.[174] Again Justice Douglas cited in *Lehnhausen* the classic examples of taxes that discriminated against newspapers, struck down under the First Amendment (*Grosjean v. American Press Co*., 297 U.S. 233) or that discriminated against interstate commerce (see *Michigan-Wisconsin Pipe Line Co. v. Calvert*, 347 U.S. 157) or required licenses to engage in interstate commerce.[175] In the *Grosjean* case, the issue at stake was the constitutionality of a license tax of two per cent of the gross receipts for the privilege of engaging in advertisement business in publications having a circulation of more than 20,000 copies per week, in addition to all other taxes and licenses levied and assessed in the State of Louisiana. In this case the Supreme Court closely scrutinized the purpose of the license tax and the class of

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> and managed by corporate directors, the general absence of individual liability, …. It is this distinctive privilege which is the subject of taxation, not the mere buying or selling or handling of goods which may be the same, whether done by corporations or individuals." Id., at 161-162.

[172] See the previous note.

[173] [1959] 358 U.S. 522, 526 -527.

[174] See this Chapter, section II.1.1 on those two types of scrutiny.

[175] *Lehnhausen*, footnote 3 of the Opinion of the Court delivered by Justice Douglas.

taxpayers (newspapers and other publications) who could ultimately bear their burden as an indirect and direct restriction to their activities. The Court held that the license tax was invalid under the First and Fourteenth Amendments and stated,

> "The form in which the tax is imposed is in itself suspicious. It is not measured or limited by the volume of advertisements. It is measured alone by the extent of the circulation of the publication in which the advertisements are carried, with the plain purpose of penalizing the publishers and curtailing the circulation of a selected group of newspapers."[176]

On its face the license tax was charged on advertisements but indirectly targeted the publications, particularly newspapers. This analysis of the end result of a specific tax to ascertain its validity under the equal protection and other constitutional clauses is quite similar to the test of justification for indirect discrimination.[177] Furthermore, in this case taking into account the volume of circulation and not the number of advertisements was considered as inappropriate to the objective of a license tax on advertisement business. In other words, there was no reasonable relationship between ends and means.

Although the term proportionality may not have been systematically and clearly distinguished from reasonableness in the above tax cases, it is right to suggest that the way the Supreme Court reasoned and decided some cases demonstrates a clear application of a test of justification in assessing discrimination, ends and means relationship, and reasonableness as in the *Quaker*, *Lehnhausen*, *Grosjean*, and *Container*[178] cases.

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[176] [1936] 297 U.S. 233, 251.

[177] See further cases of indirect discrimination, for example *Darby v Sweden* (Chapter III.2.5.c) and *Schumacker* (IV.5.1), in which the ECHR and the ECJ did not apply the proportionality principle in an explicit way, but adopted the same rationale as the test of justification to accept or not discrimination. Although Mr Darby and Mr Schumacker were not residents in comparison with residents they were discriminated against as the newspapers in the *Grosjean* case.

[178] [1983] 463 US 159, which is analysed in section 6 of this Chapter.

Regarding equality, and also tax avoidance, another interesting case is *Hoeper v. Tax Commission of Wisconsin.*[179] In this case, the progressive tax on married couples was assessed on their joint income, subjecting them to a higher rate than the one that would be applicable to each of them separately. The Supreme Court struck down the blatantly clear tax discrimination between married and single persons under the due process clause, and refused the justifications that had been offered on grounds of necessity to tackle tax avoidance that could exist between the spouses. The other justification that was disallowed was the greater and different privileges enjoyed by couples in comparison with single persons that could validate a difference of tax treatment. Contrasting this decision with *Quake*r and *Lehnhausen*, if it were possible to treat marriage as a business venture, one might consider as permissible to tax married couples as a transparent partnership but not as a corporation. The Court stated that the discriminatory tax rule was clearly "a revenue measure, and not one imposing regulatory taxes." In terms of tax avoidance, the measure could be regarded as excessive and as such disproportionate, since other measures would be available to control tax avoidance, taking into account fiscal supervision to check if one and not the other spouse have actually accrued income.

The joint taxation of spouses would be lawful where a constitutional provision provided for a more favourable tax regime for single persons to the detriment of married couples, or another constitutional allowance for taxing the economic or social benefits of marriage, or if an earlier regime were still valid in which the wife did not have any right to her own income. This decision is also quite interesting from a comparative perspective, since other constitutional courts reached the same conclusion via a proportionality test.[180]

Fredman[181] pointed out an interesting contrast between the US Supreme Court and the European Court of Human Rights regarding discrimination and equality, noting that, whereas for the latter sex discrimination takes priority in terms of strict scrutiny,

[179] [1931] 284 U.S. 206.

[180] See Chapter III, section 2.5.a (ECHR).

[181] Fredman, Sandra, (2002), p.118. See also on the strict scrutiny for a category of rights, Sullivan and Frase (2009) supra, p. 5.

for the former, race is on the top of the hierarchy of issues requiring scrutiny. From a tax perspective, it may be suggested that, for both Courts, discrimination in taxation might be somewhere in between the top and the bottom of a virtual hierarchy and may vary according to the underlying criterion for classification.[182] Another side of the coin of tax discrimination is to use a tax measure as a requirement for exercising a fundamental right, such as the right to vote[183] and to move or change residence (exit taxes).[184] Arguably the same may be equally true of the right to change nationality or citizenship, which can be conditional on proportionate tax measures, such as the requirement of a minimum period of time for taking effect or demanding the payment of tax on potential gains previously crystallized to tackle tax avoidance.

It may be suggested that the proportionality principle coupled with reasonableness - or reasonableness in the form of strict scrutiny - has become more important than the equality principle, as the latter may not be properly applied from a perspective of fairness without the aid of the former. Both of them may be prerequisites for a fair interpretation and application of any fundamental right; however, while equality determines the application of fundamental rights to every person in a similar way, proportionality concretely allows the compatible construction, allocation, fair balance and application of all fundamental rights, including equality.

Under either the juridical notion of reasonableness or proportionality, the due process clause was applied to different legal rules and principles. The objective of its application and development was to make different rules and principles effective and compatible with the rule of reason that had also evolved based on the due process clause. The next section will consider how both standards of review may demonstrate the relative importance of each principle. Alternatively, it may be construed as an

[182] See Chapter III on the ECHR, particularly sections 2.5 on tax discrimination and 2.8.

[183] In *Harper v. Virginia Board of Elections* decided on 24 March 1966 (383 U.S. 663) the Supreme Court held unconstitutional the poll tax of US$ 1.50 charged on every individual to be entitled to vote based on the invidious discrimination against those who did not pay the tax or were less wealthy, taking into account that the right to vote is too precious to be restricted. This decision overruled *Breedlove* [1937] 302 US 277, in which was considered "*reasonable* to limit the poll tax in the manner of the statute" (one dollar per year, exempting under 21 and over 60 years old); see also Hall, Kermit L. (1999), pp.32 and 123. On this issue of implied limitations to some fundamental rights and proportionality, see Chapter III, section 2.3.c.3.

[184] See cases regarding exit taxes in the European Community (*N* Case C-470/04 [2006] ECR I-7409 , Chapter IV.5.3, and *De Lasteyrie,* Chapter IV.6. See also the European Court of Human Rights (Chapter III, sections 2.5.c and 2.7.b, particularly *Riener,* Application No. 46343/99).

overarching principle from which many others may derive, such as the principle of non-retrospective taxation.

II.4. Retrospective taxation (the relationship between reasonableness and proportionality).

In the light also of the due process clause, retrospective legislation may violate the right to property or freedom, depending on some factual circumstances. In fact, like many other jurisdictions the United States does not have an explicit constitutional rule that prohibits retrospective legislation, except for criminal charges.[185] The system of jurisprudence of the Supreme Court insists on denying the limitless application of this principle, basing its position on the due process clause.

The Supreme Court considers as constitutional all retroactive tax measures, once the retroactivity is applied to periods close to the period when a draft law is discussed in and afterwards passed by Congress. This is the case with tax laws whose purpose consists of encumbering income acquired either during the year that the law was enacted, or during the legislative session prior to its enactment taking place. It is equally important to consider the magnitude of alterations that were introduced, as well as the taxpayer's recognition of the possibility of change that may occur in the legislation.[186]

In a unanimous decision in *Milliken v. US*[187], the Supreme Court reiterated its case law allowing the retroactivity of more burdensome tax laws, always paying attention to the peculiar circumstances of each case. Among these circumstances, the specific type of the disputed tax, predictability, and the taxpayers' own behaviour should be taken into account. In *Milliken* a father made a donation (gifts in contemplation of death) to his children in December of 1916. These gifts were taxed at the same tax rate as that applied to testamentary disposals, according to the principle of equality of estate taxation. The purpose of this tax on gifts was also to tackle tax avoidance of

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[185] **Section 9 of the US Constitution**, clause 3: "No Bill of Attainder or ex post facto Law shall be passed." The same prohibition is addressed to States under clause 1 of Section 10 of the US Constitution.

[186] See *US v. Hudson* [1937] 299 U. S. 498; *Welch v. Henry et al.* [1938] 305 U.S. 134 , and *US v. Darusmont* [1981] 449 U.S. 292 decisions.

[187] [1991] 283 US 15.

estate tax on transfers at death, under the law already in force in 1916. Nevertheless, in 1918 new legislation was introduced increasing the tax rates of both gifts in contemplation of death and testamentary transfers of property, following the equality principle and the tax avoidance purpose that underlined the original Law. Two years later, in 1920, the father passed away and the gifts were taxed at the higher rate. Apparently, as submitted to the Court, to apply tax rates "not in force when the gift was made" and to "the value of the property not when given, but at the uncertain later time of the death of the donor" was blatantly retrospective and contrary to legal certainty and predictability under the due process clause. However, the Court stated that it was foreseeable that a gift in contemplation of death would be taxed at the rate in force at the moment of death (1920), since the legislation in force at the time of the gift was made (1916) had already provided for the equal treatment of both situations. In other words, the taxation at higher rates was justified on grounds of equal treatment of both situations (gifts in contemplation of death and transfers at death), taking into account as well that a reasonable taxpayer could have predicted under the law of 1916 that a higher rate could come into force before his or her death.

However, in *Nichols v. Coolidge*, *Boldgett v. Holden*, and *Untermayer v. Anderson*[188], the donations were regarded as having been given without any prediction or anticipation of testament, and they occurred prior to the more recent law. Application of the new law to these cases would be unreasonable and arbitrary, in violation of the due process clause enshrined in the Fifth Amendment. Nevertheless, what would be considered a reasonable time to admit reasonableness as one of the circumstantial elements of each case? There is no fixed time since the notion of reasonable time itself will depend on numerous other factors (the nature of the tax, taxpayers' behaviour, legislative intent, and statutory purpose, to name but a few).

Nonetheless, in *Welch v. Henry*,[189] the Supreme Court held again that the due process clause did not prohibit retroactive legislation, except when the consequences were extremely harsh and oppressive. In this particular case, the tax payable on dividends

[188] 274 US 531, 275 US 142, and 276 US 440.

[189] Supra note 131, p.147.

was based on a 1935 statute, the applicability of which relied on the base period of 1934 being extended to a distribution that was made in 1933. The assumption that the shareholders who received the dividends might have refused them on realising that their earnings could be subsequently submitted to another tax or to an increase of pre-existing taxes was excessively hypothetical. This could be seen as a generally broad consideration of predictability without taking into account the possible disappearance of the dividends after one or two years: they could be consumed, invested or even lost in some other economic activity. In fact, the reasonableness principle and the notion of predictability itself could have reached their boundaries, in the sense that even the majority had agreed with the relatively open notion of "recent transactions." This notion has played a fundamental role in the acceptance of retroactivity of the law in question. The new statute could refer to these "recent transactions" when applied to income received in the year of the legislative session prior to the enactment of the law. For instance, a specific law that was enacted in 1935 was applied to income declared in 1934 but received in 1933 -- two years before the law's enactment. The Wisconsin Supreme Court considered that the current tax might have been approved or might have reached the limit of admissible retroactivity. Six judges from the United States Supreme Court, led by Justice Stone,[190] affirmed that they could not say that the tax had exceeded that limit.

Another justification for retrospective legislation is to amend errors of previous statutes on grounds of tackling tax avoidance, as decided in *United States v. Carlton.*[191] In this case, the Court applied the same standards for reviewing retroactive economic legislation, requiring a legitimate purpose and rational means. In other words, again without mentioning the word proportionality, a rational or reasonable relationship between ends and means is required. Thus to collect tax from "those who had made purely tax-motivated" transactions, having taken advantage of an uncorrected version of the statute, was regarded as legitimate purpose.[192] In addition, the necessary and more efficient way to achieve that purpose was to enact a

[190] *Welch v. Henry*, pp.4-5.

[191] [1994] 512 U.S. 26. See Thuronyi (2003) pp. 78-9.

[192] Apud Thuronyi (2003), op. cit. p.79 and n. 73.

retrospective amendment to make clear the real intent of the legislature, correcting a technical imperfection in the previous legislation.

Summing up the US case law on retrospective taxation, one may suggest that there must a reasonable relationship between ends and means and a balance must be struck between the legitimate public interest in pursuing a retrospective measure and the rights of those concerned. The similarity of requirements for retrospective legislation seems to be quite clear when compared with other domestic and international jurisdictions. This fact may point out that the proportionality reason that served as a basis for these decisions tends to be the same irrespective of inevitable procedural and substantive constitutional dissimilarities among different jurisdictions.[193]

This section has demonstrated how proportionality and reasonableness are flexible and more qualitative than quantitative in order to secure other principles such as predictability. Due to its open-texture nature and flexibility, proportionality may also cause conflicts between different tax jurisdictions regarding cross border transactions, as discussed in the next section.

[193] See Chapters III, section 2.6, on the ECHR, and IV, section 8, on the case law of the ECJ.

II.5. Domestic notions of reasonableness and proportionality and their international tax dimension (due process and commerce clauses).

State income tax that may affect international jurisdictions is another controversial tax considered legitimate by the Supreme Court in the light of the due process clause. State income tax encumbers global profits of unitary groups of multinational enterprises that operate in each state, proportional to the average of salaries, properties and sales performed in or attributable to the state, regarding their global values (national and international).[194] In the *Container Corporation* case, the Supreme Court upheld the presumption that a group of companies is unitary when the overseas subsidiary company operates in the same business field, considering that the purpose of this is probably to achieve a better usage of the controlling company's resources. Although a *bright line rule* could be reasonable and practical, the Supreme Court rejected that precise rule including the substantial flow of assets, because the constitutional requirement was a flow of values, not a flow of assets or goods.[195] Again, the criteria that allow taxation based on the global profits of the company considered unitary - once there is a relevant and reasonable connection with each state - were yet to be precisely defined. In this case (*Containe*r), however, Justice Brennan explained that the component of justice or reasonableness of the income distribution formula had two requirements, according to the notions of fairness and reasonableness that are at the heart of the proportionality principle:

> 1) 'internal consistency': according to which "the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed"; and

[194] For instance, if a unitary global business has 8% of its payroll, 3% of its properties and 4% of its purchases in California, according to State law, the average of 5% obtained based on the three rates will be taken into consideration to determine the state income tax. That is, the franchise tax should be 5% payable on the global profit of the company. See Picciotto, Sol, *International Business Taxation* (1992), p.237).

[195] Picciotto (1992), idem, p.238. See also on "fair apportionment" Hellerstein, Walter, "The US Supreme Court's State Tax Jurisprudence", pp. 113-18, in *Comparative Fiscal Federalism Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, by Avi-Yonah, Reuven S., Hines Jr, James R. and Lang, Michael (Kluwer, 2007).

2) ‘external consistency’: according to which “the factors or factors used in the formula must reflect a reasonable sense of how income is generated.”[196]

The *Barclays Bank PLC v. Franchise Tax Board of California*[197] case is interesting in this respect because, until then, all precedents were only related to American multinationals companies. This was the first time the Supreme Court heard a case in which a non- American multinational was involved. The Supreme Court held in June 1994, with only two dissenting votes by Justices O’Connor and Thomas, that the interested parties insufficiently demonstrated the unreasonableness of the state’s tax system, and that the rules against vagueness of concepts were not mechanical (e.g., reasonableness). In addition, the decision also held that taxpayers could have demonstrated methods of calculation or reasonable approximations to the tax authority. Once the taxpayer failed to demonstrate this, the tax authority could not refute them. The decision included the consideration that multiple taxation is not an inevitable consequence of the system and that the existing alternative of separate accounting would not defeat this. Indeed, it could even increase the risk of double taxation. Furthermore, the decision emphasized that since the U.S.-U.K. Treaty had a provision applicable to state income taxes, the federal government would not be impeded in acting *with one voice* in international trade. However, this provision was included, allowing the states to collect taxes within reasonable limits, until Congress decided to intervene in this situation. In fact, state double taxation was likely to occur in this system. Salaries were one of the factors taken into account because they were higher in California than in the other sixty countries where the English Bank operated. This difference could genuinely distort the taxation result, as argued in the case. Yet again, the peculiarities of this case played a crucial role in reaching a majority conclusion concerning the reasonableness of the state tax system, in

[196] [1983] 463 US 159, “The Constitution does not "invalidat[e] an apportionment formula whenever it may result in taxation [463 U.S. 159, 170] of some income that did not have its source in the taxing State . . . ." *Moorman Mfg. Co.*, supra, at 272 (emphasis added). See *Underwood Typewriter Co*., 254 U.S., at 120 -121. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by `clear and cogent evidence' that the income attributed to the State is in fact `out of all appropriate proportions to the business transacted . . . in that State,' [Hans Rees' Sons, Inc.,] 283 U.S., at 135 , or has `led to a grossly distorted result,' [*Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968)]." *Moorman Mfg. Co*., supra, at 274.”

[197] [1994] 114 S. Ct. 2268.

accordance with certain legal-economic parameters considered relatively reasonable and possibly rather subjective.[198]

Finally, it was argued in the *Barclays* case that the existence of a prior California state law represented an incompatibility with the due process clause. This provided for the presentation of a reasonable estimate method by the taxpayer, in order to reduce the burden's submission or compliance with the arithmetical calculation based on percentages, salaries, sales and assets. It was also claimed that there was a lack of standard measurements or models to determine which estimates would be accepted or not. This discretion without any limitation could be interpreted as a violation of due process, so that the taxpayer did not have to demonstrate damage or injury existing in such arbitrary application. While proclaiming the majority decision of the Supreme Court, Justice Ginsburg considered the term "reasonableness" as a guideline, an instrument to assure that the movement would follow its course alongside a specific line.[199] The decision admitted a legal revision in a myriad of subjects, sometimes incorporated by express texts of laws – from the Constitution itself (Fourth Amendment) to the very tax laws – giving rise to an idea of uncertainty or indeterminacy, but providing the reassurance that it would be analysed and revised by impartial people, based on rational underpinnings. The point that may be made in comparison with proportionality is that this principle may go further than the notion of reasonableness or rationality, since it may require the application of the less restrictive measure and not only measures that are not absurd. In other words, according to the proportionality principle the Court could have scrutinized whether the worldwide taxation formula was less restrictive and less burdensome to the taxpayers in order to tax the real economic income.

The use of the term *reasonable* by the legislator in an open and flexible manner is another contemporary problem. This flexible notion is used as an element of a type of tax rule to restrain the use of means considered abnormal, inadequate and abusive,

[198] On that arguable decision, see Oliver, J. David B., "Unitary Taxation: the Denouement?" [1994] EC Tax Review, 3. 72-3; and Sandler, Daniel, "Slicing the Shadow – the Continuing Debate over Unitary Taxation and Worldwide Combined Reporting" [1994] BTR, 6, 572-597.

[199] 114 S.Ct. at 2278 (1994 Harvard Law Review, 108:141,).

such as the concept of reasonable expenditure, reasonable business purpose, "valid economic reasons",[200] and still the notion of reasonable tax rate.[201]

Likewise, Section 482 of the United States Federal Revenue Code is an illustration of indeterminate legal terminology - the interpretation and application of which were explicitly informed via the proportionality and reasonableness principles by the judiciary. The language of this legal provision is apparently extensive, endowing the tax authority with discretionary (but not arbitrary) power.[202]

A fair market value in the case of prices in comparable circumstances by unrelated taxpayers is the appropriate standard that should be followed (*arm's length pricing*). The interpretation of Section 482 concludes that the tax authority's determination of any adjustment on taxable profits is presumably correct, considering that taxpayers have the burden of proof in a sense that it would be "unreasonable, arbitrary, capricious."[203] In another decision, the Judiciary pointed out that "the reasonableness" of the result was the most relevant aspect for the application of that legal provision, and not the peculiarities of the examination method utilized by the tax authority.[204]

According to Dworkin's terminology, the best elucidation for legally indeterminate concepts was to resort to the moral concept of reasonableness, which was currently

[200] See Merger Directive (90/334/EEC), Article 11(1)(a), which is analysed in Chapter IV, section 6.3.

[201] See Chapter I, section 2, note 47.

[202] According to IRC, Section 482: In any case of two or more organizations, trades, or businesses… owned or controlled directly by the same interests, the [Internal Revenue Service] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [them], if [it] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any [of them].

[203] *American Terazzo Strip Co. v. Commissioner* case [1971] 56 TIC 961, 1971. In: Gustafson, Charles H., Peroni, Robert J. and Crawford Pugh, Richard, *Taxation of International Transactions: Materials, Text and Problems*, 33, (3d ed. 2006), p.367.

[204] *I. Du Pont de Nemours & Co. v. US* [1979] 606 F 2d 445: "The amount of reallocation would not be easy for us to calculate if we were called upon to do it ourselves, but s.482 gives that power to the [IRS] and we are contend that his amount (totaling some $18 million) was within the zone of reasonableness." The Fiscal Court analyzed another case of transfer pricing, approaching the profit margin, due to some contracts, and the risks involved between the foreign subsidiary and the controlling company in the United States. The profit margin of the subsidiary was higher than 200%, which was maintained, while the tax authority had arbitrated a margin of only 23%. (See Pagan, Jill and Wilkie, Scott. *Transfer Pricing Strategy in a Global Economy*, 1993, p.75-97).

used as a method of interpreting and applying the law.[205] In opposition, it was disregarded as a way to revoke an arbitrary law itself, due to its absolute lack of reasonableness, akin to the analysed precedents including the application of the due process clause. An apparently arbitrary tool may be the appropriate answer to avoid the taxpayers' arbitrariness in artificially transferring profits from one corporation to another controlled company, with the sole aim of saving tax. If, on the one hand, the instrument is considered arbitrary due to its relative indeterminacy, on the other hand it guarantees to taxpayers the possibility of proving the contrary. In this case, taxpayers' performance can be relatively important not only by the form, but also by the substance of the transaction in searching for relevant economic benefits other than tax avoidance, in which proportionality may have a fundamental role.[206]

This Chapter has demonstrated the main characteristics of the rule of reason, reasonableness and proportionality that may be regarded as similar to those notions as applied in other jurisdictions. Having had its origin in the constitutional jurisprudence of the Supreme Court, subsequently, even without express constitutional provisions, ideas regarding reasonableness and proportionality were further developed.

However, the same idea for its flexibility and open-ended nature, though effective and rational, may result in disparities and apparently insoluble conflicts between different tax jurisdictions such as those analysed in this section, since a reasonable price or profit for one tax jurisdiction may not be reasonable or fair for another one in cross border transactions. The role of proportionality may also be relevant in determining the solutions via multilateral or bilateral tax treaties and their interpretation. The next chapters will describe how different and similar outcomes were achieved in international courts, such as the European Court of Human Rights, the Appellate Body of the WTO, and the European Court of Justice. Similar issues of the ability to pay, equality, discrimination, excessive tax and penalties, tax retrospective legislation, and tax avoidance, will be discussed in the light of

[205] *Taking Rights Seriously*, supra, p.136.

[206] See Chapters III, section 2.6.b; and IV, sections 6, 7.1, and 7.2.

proportionality and reasonableness in order to compare them and evaluate their advantages and disadvantages.

This Chapter analysed the role of reasonableness and proportionality as standards of review in a domestic jurisdiction and the next Chapter will discuss their function in international jurisdictions, particularly their interaction in tax matters, international trade and human rights.

III. International Jurisdictions and Proportionality and Reasonable Standards of Review (the International Court of Justice, the European Court of Human Rights and the World Trade Organization).

The analysis of the proportionality and reasonableness principles is also relevant in the field of international law, due to its remarkable importance for the interpretation and application of treaties, particularly with regard to human rights conventions.

First, the approach of the International Court of Justice regarding proportionality will be analysed in this Chapter. Although the ICJ has apparently not yet decided any tax cases, the analysis of its jurisprudence will serve the purpose of demonstrating to what extent the proportionality and reasonableness tests would be the same principles as applied by other jurisdictions, and whether or not they could be regarded as general principles of international law.

Secondly, the international law on human rights will be discussed as proof of the general application of the proportionality and reasonableness principles, particularly the former as to whether it can be regarded as an overarching principle of Convention interpretation and application. Regarding tax matters, unlike the ICJ, the ECHR has broadly applied proportionality in tandem with reasonableness, particularly in the areas of tax discrimination, fiscal penalties, and protection of property. The contrast with national and other international jurisdictions will be made where appropriate to discuss whether the principle is the same and whether there are different degrees of judicial review and adjudication of proportionality and reasonableness.

Third, this Chapter will discuss international law concerning international trade within the WTO agreements to examine the extent to which proportionality and reasonableness are applied to discriminatory measures, including direct tax measures, and to the balance of rights between sovereign States.

III.1. The role of proportionality within the jurisdiction of the International Court of Justice.

Based on some of the most important decisions of the International Courts in question, Corten[207] emphasizes the initial ambiguity concerning the notion of what "reasonableness" is. His work starts with empirical cases and "reasonable" functions to achieve a relative systematisation, pointing out methods in its formal and substantial definition. Founded on an International Court of Justice decision, Corten initially notes that "reasonable" and "equitable" in any case are dependent on circumstances.[208]

The following examples of legal rules illustrate the express application of the terminology "reasonable": the 1969 Vienna Convention on the Law of Treaties (Art 32.2) mentions reasonable interpretation, namely, the non-prevalence of a particular interpretation that reaches "absurd and unreasonable" results. In addition, the recognition of freedom of the high seas and the regulation of the discretionary power of sovereign states, as the second Article of the 1958 Geneva Convention on high seas establishes that this freedom should be carried out by all states "with reasonable regards to the interests of the other states." [209]

A close relationship between the non-discrimination principle and reasonableness may be noted in the early case law of the Permanent Court of Justice. In the *Minority Schools in Albania* case,[210] the Court stated, "equality in law precludes discrimination of any kind; whereas equality in fact may involve the necessity of different treatment in order to attain a result which establishes equilibrium between

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[207] Corten, Olivier, "The Notion of 'Reasonable' in International Law: Legal Discourse, Reason and Contradictions" (CUP, 1999) in *International and Comparative Law Quarterly* 48 at pp.613-625, which is a brief explanation of his doctoral thesis *"L'Utilisation du Rasonable par le Juge International"* (Bruylant, 1997)

[208] *Continental Shelf* (Tunisia, Lybian Arab Jamahiriva) ICJ Rep. 1982, for Go. *In: Carta…*, v. 48, p. 613-625, July 1999. op.cit., p.613.

[209] See also the Convention on the Law of the Non-navigational Uses of International Watercourses, 21 May 1997, 36 ILM (1997) 700, Art. 5; Treaty Establishing the European Community (Consolidated Version), 24 Dec. 2002, OJ (2002) C 325/33, Art. 77; European Convention on Human Rights, 4 Nov. 1950, ETS 5, Art. 5(3), apud Shany, Yuval, "Toward a General Margin of Appreciation Doctrine in International Law" [2005] EJIL 16, p.914, note 45.

[210] PCIJ, Series A/B, n. 64, p.19 (1935).

different situations." As Malcolm Shaw pointed out based on the jurisprudence of international courts, the appropriate test of acceptable differentiation in such circumstances will centre upon what is just or reasonable or objectively and reasonably justified."[211]

The International Court of Justice has explicitly applied the proportionality principle as such in three different types of cases. First, with an apparently substantive approach, it tries to ascertain the meaning of the arbitrary taking or expropriation forbidden by International Public law, as it may be considered unreasonable.[212] Secondly, the Court ascertains the requirements for the use of force according the proportionality principle, since States are allowed to use forceful measures in self-defence only if they are necessary and proportional.[213] Concerning the law of State responsibility, it is generally accepted that the principle of proportionality is a "key element" for controlling the States' right to redress unlawful international acts.[214] Thirdly, apparently in a different way, the Court applies a rule of proportionality in maritime delimitation cases. Although this latter rule concerns the relationship between shelf awarded and the length of coastlines, it is applicable as an element of

[211] *International Law* (CUP, 2008), p.288, citing the jurisprudence of the ICJ, the ECHR, the Inter-American Court of Human Rights.

[212] Corten, *op.cit.*, (1997), p.623, mentioning the *Eletronica Sicula* ICJ case, Resp. 1989, 76. The three stages to determine a behaviour's reasonableness, according to the standard legally adopted are: (a) The Legitimate Objective or Purpose -- in principle, States have a discretionary power to proceed with a requisition. (b) The Casual Link -- that State must then demonstrate that the alleged legitimate purpose is the actual basis of the requisition. (c) The Proportionality Criterion -- sufficiency of the causal link. Assuming that the measure is effective, judges will then assess the proportionality between the measure and the purpose sought. This implies a comparison of the behaviour in question with the standard of what is generally done, or what should legally be done, in similar situations.

[213] As Yuval Shany has pointed out these requirements exist separately under *jus ad bellum* and *jus in bello.* See, e.g., *Legality of the Threat or Use of Nuclear Weapons* [1996] ICJ Rep 226, at 245; Protocol I, Art. 51(5)(b), "Towards a General Margin of Appreciation Doctrine in International Law" [2005] EJIL 16, p.915 note 53.

[214] Moreover, the role of proportionality is dual: external and internal according Cannizzaro idem, pp. 897-99. In the *Case Concerning the United States Diplomatic and Consular Staff in Tehran* of 1980 and in the *Gabcikovo-Nagymaros Project* case of 1996, the ICJ assessed not only the means according their objectives, but also the appropriateness of the aims themselves. In the former case, the ICJ held 'that the intrusion of diplomatic premises and the seizure of the personnel revealed that Iran pursued a different aim, unconnected with the breach and thus disproportionate' (idem p. 897). In the latter case, the ICJ held that Slovakia could not unilaterally divert the Danube River and implement a project of exploitation in its own territory only because Hungary had failed to comply with a bilateral treaty requiring both countries to carry out a joint project. In this situation Slovakia "should have pursued a different aim: that of restoring the normative balance between the parties and asking for compensation" (ibidem, p.898)

equity "in order to establish the necessary balance between States with straight, and those with markedly concave or convex, coasts."[215] This role of equity principles as part of international law aims "to balance up the various considerations which it regards as relevant in order to produce an equitable result."[216] This points out a clear similarity between equity and proportionality in their role of balancing all the relevant factors to decide a case.[217]

Thus, one may suggest that in these fields of law (State responsibility for wrongful acts, the use of force, and expropriation) the International Court of Justice has applied the proportionality principle as a fundamental tool to scrutinize State measures, balancing the interests in play. As Human Rights Conventions are a fundamental part of international law, the next section will analyse the European Court of Human Rights jurisprudence that also regards the proportionality principle coupled with the notion of reasonableness as key principles of law.

[215] See para. 98 *North Sea Continental Shelf Cases (Federal Republic of Germany and Denmark; Federal Republic of Germany and Netherlands)*, Judgment of 20 February 1969. See also Higgins (2003) , p.229.

[216] ICJ Reports (1982) 18 at para. 71, apud Higgins, Ibidem, p.228.

[217] See Chapter I, section 3.

III.2. The European Court of Human Rights: Proportionality and reasonableness tests in tax matters and in general.

In this section, the origin and development of the principle of proportionality within the ECHR case law will be analysed and compared with other national and international courts. First, general principles of the Convention will be considered having the objective of classifying the standards of reasonableness and proportionality within its legal framework. In other words, whether proportionality may be regarded as an overarching principle within the Convention and to what extent the jurisprudence of the Court may aid in considering it as a general principle of international human rights law and of international law. This may have relevant effects on tax law. Besides some leading cases on reasonableness and proportionality, other landmark examples will be cited regarding their application in tax matters. The main cases of retrospective taxation and avoidance, joint taxation of spouses and others regarding discrimination, as well as the application of tax principles, such as the ability to pay and fiscal sanctions, will be analysed and contrasted with other domestic and international jurisdictions.[218] Furthermore, this section will demonstrate whether or not the principle is the same as applied in other jurisdictions and its relationship with the margin of appreciation doctrine. Finally, the degree of scrutiny using either a loose or a tighter test of proportionality will be analysed to ascertain its role within the scope of taxation and human rights.

III.2.1. General Principles of Human Rights Conventions and the origin of proportionality and reasonable standards of review in the ECHR.

As Robert Blackburn[219] insists, the fundamental aim of all international human rights treaties is to secure individual rights "and not lay down mutual obligations between states which are to be restrictively interpreted." This characteristic is derived from the legal nature of the Convention itself as a law-making treaty (*traité-loi*) rather than

[218] For an extensive overview and analysis of the tax cases decided by the Commission and the Court, see Baker, Philip, "Taxation and the European Convention on Human Rights" [2000] B.T.R. 4, 211-377; and European Taxation (Netherlands), Cengage Learning, Volumes 49, Issue 6 (June 1, 2009); and 50 Issue 6 (June 1, 2010).

[219] "The Institutions and Processes of the Convention", in Blackburn, Robert and Polakiewicz Jörg, *Fundamental Rights in Europe, the ECHR and its Member States, 1950-2000,* (OUP, 2001), p.28, with express reference to the *Commission Report, Golder v United Kingdom* of 1 June 1973.

a contractual treaty (*traité-contrat*).[220] Thus, the Convention is "not designed to create reciprocal rights and obligations between Member States, but to maintain and strengthen public order aimed at the protection of human rights."[221] Further, as a law-making treaty, the Convention must not be interpreted restrictively. The Court may well have extended some obligations by narrowing the scope of limitations to some fundamental rights.[222] On the other hand, as a legal and living instrument according to the Court's own jurisprudence, some principles may be regarded as characteristic or predominant in guiding its decisions. Among these principles, Steven Greer[223] mentions the following: effective protection; legality; democracy; commonality, autonomous and evolutive interpretation; subsidiarity and review; and proportionality. Although some of these may not be strictly considered as principles of interpretation, it is worth noting them and how they interact and to consider whether or not there is an overarching principle of interpretation.

Another feature of other jurisdictions is that there is a close relationship between the proportionality principle and the standard of reasonableness. To prove this within the ECHR it will be useful first to observe the term 'reasonable' as expressly found in some articles of the European Convention on Human Rights. It will also be important to analyse how reasonableness is ascertained and to what extent it may be close to the evolution of proportionality as an unwritten principle. Furthermore, as discussed in the following sections, the notions of reasonableness and proportionality themselves are at the heart of the concept of discrimination as construed by the Court.

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[220] See Matscher, F., "Methods of Interpretation of the Convention", in *The European System of Protection of Human Rights*, Macdonald, R.ST.J.; Matscher, F.; Petzold, H. (Eds.), (Kluwer, 1993), p.66; and Arai-Takahashi, Yutaka, (2002), p.248, both citing the following authoritative cases referring to the Convention as a law-making treaty, *Wemhoff v Germany* (judgment of 27 June 1968, paragraph 8) and *Golder v UK* (judgment of 21 February 1975, paragraph 36), among others.

[221] Arai-Takahashi, idem,, ibidem. See also Matscher, F. idem, ibidem.

[222] Matscher, F., idem, pp.66-7.

[223] *The Margin of Appreciation: Interpretation and Discretion under the European Convention on Human Rights*, Human Rights Files no. 17 (Council of Europe Publishing, 2000) pp.15-20.

III.2.2. The meaning and ascertainment of reasonableness via proportionality reasoning.

Articles 5 (right to liberty and security) and 6 (right to a fair trial) of the European Convention on Human Rights assure, respectively, to any detainee the right to trial within a "*reasonable* time", and to every individual a fair and public hearing again within a "*reasonable* time."[224]

Initially, the State may justify the length of the process. Only after the justification is presented, can a marginal review take effect, usually applying the margin of appreciation doctrine.[225] Hence, this formal standard is applied to investigate the conduct's reasonableness and is followed by five cumulative elements.[226] First, if any explanation for the delay is not provided, it is considered unreasonable. Second, the justification should be presented rationally, defined as a series of propositions that attempt to explain the reason for the delay. Third, there has to be a mutually subjective comprehension of the explanation provided. If the delay in certain steps of the procedure is not understandable, the conduct is considered unreasonable. The fourth formal element requires a justification free from contradictions and incompatibilities among distinct aspects of the explanation. Finally, the fifth element of this formal standard requires an explanation provided by relevant legal authorities. This requirement is not fulfilled, according to international legal standards, merely because the domestic law was invoked and fulfilled. These five formal elements provide a minimum legal certainty to the application of an imprecise concept such as *reasonableness*. One may suggest that at the heart of this notion of reasonable lies the fourth requirement of consistency or lack of contradiction. According to Habermas,[227] this minimum legal certainty represents the procedural reason or

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[224] Art 3 (right to free elections) of the First Protocol states that the Convention's parties should hold elections within "*reasonable* intervals" with no further definition.

[225] See this Chapter section 2.4. See also Steven Greer (2000), supra, p.36, and Eissen, Marc-André , *The Length of Civil and Criminal Proceedings in the Case-Law of the European Court of Human Rights*, Human rights files No. 16 (Council of Europe Publishing, 1996).

[226] Apud Corten (1997), ibidem.

[227] Apud Corten, (1997), p.622-3.

justification, remaining rational, coherent and logical, even within acceptable contemporary patterns of rationality, deprived of an ontological basis.

However, this formal standard is not sufficient according to international and domestic democratic standards of the rule of law. A substantive standard is also demanded, similar to the concepts adopted by national and international Courts.[228] This substantial standard assumes a sufficient relationship of cause between the legitimate purpose and the measure supposedly considered as reasonable. Here also proportionality plays its role in ascertaining "the acceptability both of delays in civil and criminal proceedings, with the complexity of a case being weighed against the time taken to resolve it, and of interferences with an individual's access to a court."[229]

Thus, a conclusion is drawn from the evolving case law of the Court, on three set of cases under Articles 5 and 6 where they refer to the wording *reasonable*. They are provided by Article 5 paragraph 1 (c), which allows detention on remand if justified by "*reasonable* suspicion of having committed an offence or when it is *reasonably* considered necessary to prevent his committing an offence or fleeing after having done so",[230] and its paragraph 3 (the right to a trial within a *reasonable* time),[231] and Article 6 paragraph 1 (the entitlement to a fair and public hearing within a *reasonable* time).[232] The conclusion in my view is that the legal conventional wording *reasonable* relates to an unwritten proportionality reasoning which takes into account all the circumstances of the case in assessing the measures applied by public authorities in contrast with the treatment of a person presumed to be innocent

[228] See Chapters II and III.

[229] McBride, Jeremy, "Proportionality and the European convention on human rights", in *The Principle of Proportionality in the Laws of Europe* (Hart, 1999), p.27.

[230] See case law cited by Eissen, Mar-André, "The Principle of Proportionality in the Case Law of the European Court of Human Rights", in Macdonald, R.ST.J.; Matscher, F.; Petzold, H. (Eds) *The European System for the Protection of Human Rights* (Kluwer Law International, 1993) p.132, n.32.

[231] See the case law cited by Eissen, Mar-André, idem, ibidem, n.33, regarding both rights enshrined in Article 5 (of remand on *reasonable* suspicion and to a fair trial within *reasonable* time), with the applicant's express allegations on grounds of proportionality and less restrictive measures. See also the Commission decision in *N.D. v Federal Republic of Germany* (Application No. 11703/85).

[232] See *Stran Greek Refineries and Stratis Andreadis v. Greece* (Application No. 13427/87), analysed further under Article 6 (right to a fair trial) in the next section 2.3.c.2, in which a whole assessment was necessary to ascertain the *reasonable* time limit of the trial (paragraphs 51-56 of the judgment).

until proven guilty. As already analysed, the standard of reasonableness is sometimes interchangeable with proportionality as a principle, particularly in its role of balancing.[233]

Founded also on Article 5 of the Human Rights Convention, Perelman[234] considers that reasonableness does not lead to a single solution. He suggests that it implies a plurality of possible solutions, although considering that there are certain limits, such as absurd or illogical results. In this sense the margin of discretion would still be broad. Dworkin[235] has a different perception by defending a correct answer even to very complex cases. He explains that judges and arbitrators should have a limited margin of discretion and a radical ethical attitude while seeking a fair decision, in accordance with the integrity of the principles and rules of the system.[236]

In this section, the relationship between the standards of reasonableness and proportionality have been analysed as an aid to ascertaining what is reasonable. In the following section, the explicit origin of proportionality and its inherent relationship with reasonableness will be discussed. The extent to which proportionality evolved as a legal principle in its own right and eventually as an overarching principle of interpretation and adjudication will also be analysed.

III.2.3. Fundamental rights, reasonableness and proportionality as an unwritten and overarching principle.

[233] At Chapter I, sections 1 and 2. See also the *Dassonville* case in which the ECJ construed the wording 'reasonable' as being proportionate to a legitimate objective (Chapter IV, section 2.2).

[234] Chaim Perelman considers unreasonable to be that which is not acceptable, categorically affirming: "The vagueness of certain terminology in legal or statutory texts gives latitude to the interpreter, but there are limits to this power of appreciation, once certain expressions such as 'common interest,' 'urgency' and 'equity' are not considered as 'empty expressions.'" (*Etica e Direito…, op.cit.*, p.432, in the 1984 original publication as *Le Raisonnable et le dé Raisonable en Droit. Au-dela du Positivisme Juridique*, LGDJ, Paris 1984.)

[235] *Taking Rights Seriously*, pp.31-39 and 68-71.

[236] Integrity means in this context a coherent legal system in search of fairness.

a) Discrimination: reasonableness coupled with proportionality. Its relationship with tax matters.

As discussed in Chapter I, section 3, taxation deals mainly with drawing distinctions, whereas a political and natural sense of fairness as well as constitutional values may require the enforcement of the equality principle as a fundamental right in each individual case. Thus, the test of reasonableness, whether or not intertwined with proportionality, may justify discrimination and may influence the assessment of fair individual taxation and tax systems.[237]

According to Article 14 of the Convention, rights protected by the Convention must be recognized "without discrimination on any ground" or, in the French version, "sans distinction aucune." Based on its plain meaning, it is perfectly clear that the Convention has prohibited discrimination in any form. However, the European Court of Human Rights has interpreted the English and French versions based on the equality principle assured by the Convention itself, proclaiming that the principle is violated only if a distinction has no objective and reasonable justification, drawing such conclusion from principles which guide the legal practice of a large number of democratic States. In earlier cases,[238] the European Commission of Human Rights stated, in accordance with the general doctrine on discrimination, but with no express reference to proportionality, that certain differentiations might be legitimate.[239]

For the first time in the *Belgian Linguist* cases decided on 23 July 1968,[240] the European Court of Human Rights by its Plenary (Grand Chamber) referred to proportionality as a legal principle apparently in its own right. Taking into account the principle of equality and the notion of discrimination, the Court drew a

[237] On specific tax discrimination issues under the tests of proportionality and reasonableness, see this Chapter, section 2.5.

[238] Applications No. 104/55 and 167/56 cited in Application No. 2299/64 decided on 12 December 1966.

[239] The reasoning on discrimination in other international and domestic jurisdictions is quite similar, which may demonstrate once more that the rule of reason for legitimate differentiation lies at the heart of reasonableness, proportionality and equality.

[240] See the case "*Relating to certain Aspects of the Laws on the Use of Languages in Education in Belgium" v. Belgium* (Applications No. 1474/62; 1677/62; 1691/62; 1769/63; 1994/63; 2126/64).

reasonable and bright line rule between justified and unjustified differences of treatment. The Court accomplished this by introducing the notion of *reasonable discrimination* under which there must be a *reasonable* relationship of *proportionality* between means and ends:

> "…. the principle of equality of treatment is violated if the distinction has no objective and reasonable justification. The existence of such a justification must be assessed in relation to the aim and effects of the measure under consideration, regard being had to the principles which normally prevail in democratic societies. A difference of treatment in the exercise of a right laid down in the Convention must not only pursue a legitimate aim: Article 14 is likewise violated when it is clearly established that there is no reasonable relationship of proportionality between the means employed and the aim sought to be realised."[241]

Proportionality was established as "the second component of an objective and reasonable justification – the first being the legitimate aim – and not an additional condition."[242] The Court also expressly provided an interpretation of discrimination and equality very similar to those interpretations given by a large number of democratic states, adding the express reference to proportionality. Not only has the American Supreme Court provided the same interpretation, for example concerning the due process clause, equality and discrimination,[243] but so have European and other non-European national jurisdictions. In the same vein, the European Court of Justice, when construing the principle of non-discrimination, and analysing its direct and indirect effects, clearly adopted the rule of reason and proportionality

[241] Paragraph 10 of the judgment, Ibid. n.181. A good summary of the facts and conclusion of the case is found in *The Margin of Appreciation: Interpretation and Discretion under the European Convention on Human Rights,* p.39 by Steven Greer. On this case see also Partsch, Karl Josef, "Discrimination", in *The European System for the Protection of Human Rights*, (Kluwer, 1993), pp.578-82.

[242] Eissen, Mar-André, (1993), p. 145. It may be right to affirm that proportionality reasoning underpins the justification of the Court where it refers to the expression "without reasonable foundation" regarding for example the right of property as occurred in *James and others* and *Mellacher and others*.

[243] See Chapter II.3.

reasoning[244] All these jurisdictions have construed the concept of equality and non-discrimination, inserting the *reasonableness* notion coupled with the proportionality test within the wording of statutory law, according to a purposive interpretation in search of fairness.[245]

Not only is a legitimate aim required to justify discrimination, but so is the existence of reasonable and necessary measures to achieve the aim pursed in search of fairness; or, in other words, those measures must not be excessive.[246]

Steven Greer concludes according to the case law of the Court that four factors draw the line between discrimination (which is prohibited) and "different" treatment (which can be justified).[247] First, there must be a less favourable treatment between comparable groups; secondly, the practice must be reasonable and rational; thirdly, the effects of the treatment must be disproportionate to its own objectives and pursue a fair balance between the public interests and the fundamental rights. A fourth factor consists in pondering whether the treatment in question is considered as discriminatory in other democratic states. As the first requirement for a complaint to be decided on grounds of discrimination is the existence of comparable situations, the question of justifications and proportionality may not be addressed where those comparable factual and legal situations are not found.[248]

Another feature of proportionality common to other jurisdictions as a method of legal reasoning is the role of balancing, contrasting and reconciling the public interests at stake and the fundamental rights in play,

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[244] See Chapter IV, sections 2 and 3.

[245] This technique is the same as 'the rule of reason' by which the wording *reasonable* is implicit in 'restrain to trade', such as in the US (Chapter II.2) and in the EU (Chapter IV.2.2). See also Chapter I, and more particularly, Dworkin and Hart on the notion of reasonableness.

[246] In *National Union of Belgium Police v Belgium* (Application No. 4464/70**)** (paragraph 49) the Court stated "that the test of proportionality requires that consideration be given to whether the disadvantage suffered by the applicant in pursuit of a legitimate aim is excessive" (Jacobs and White, 2002, p.428).

[247] Greer, Steven, (2000), supra, p. 11.

[248] See case law mentioned by Partsch, Karl Josef, "Discrimination" (Kluwer, 1993), pp. 585-87.

> "Article 14 does not prohibit distinctions in treatment which are founded on an objective assessment of essentially different factual circumstances and which, being based on the public interest strike a fair balance between the protection of the interests of the community and respect for the rights and freedoms safeguarded by the Convention."[249]

The same rationale above seems to be applicable to the right to property, which has a close relationship with procedural and substantive tax measures as discussed in the next section.

b) The right to property, its three rules and the overall assessment of proportionality. Its intrinsic relationship with taxation.

The right to property is closely related to tax matters. There are two express restrictions provided by the first and second paragraphs of Article 1 of the First Protocol. First, persons could legitimately be deprived of their possessions "in the public interest and subjected to the conditions provided for by law and by the general principles of international law." Second, the right of a State is not impaired in any way "to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties." In *Handyside*, the Court stated that the Contracting States were the only judges to assess the necessity for an interference with the right to property, having restricted itself "to supervising the lawfulness and the purpose of the restriction in question."[250] But then ten years later the Court expressly introduced the notion of proportionality as a requirement also of an interference with the right to property in *James*.[251] As discussed previously in connection with the concept of

[249] *Belgian linguistic* case, paragraph 8 of item 7 (*3. Decision of the Court*).

[250] *Handyside v the UK* (Application No. 5493/72), paragraph 62. See also Arai-Takahashi (2002), p.153.

[251] "Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest', but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised (see, amongst others, and mutatis mutandis, the above-mentioned *Ashingdane* judgment, para. 57)" (*James and others v UK*, Application No. 8793/79 of 21 February 1986, Grand Chamber, paragraph 50). See also *Mellacher and others v. Austria* (Application No. 11070/84), paragraphs 47-8; Greer, Steven, (2000),

discrimination, proportionality is an essential element of the 'reasonable and objective justification.'

On the other hand, according to the settled case law of the Court, the right to property comprises three distinct rules. The above two (deprivation of possessions and control of use of property), which are expressly limited in the general or public interest, and a third one that recognizes the "principle of peaceful enjoyment of property," which is more general and apparently unlimited.[252] As stated in *Pressos Compania Naviera*[253] following the authority of *James and Others*, the express limitations are to be construed according to the general principle of enjoyment of possessions and "there must be a reasonable relationship of proportionality between the means employed and the aim sought to be realised by any measure depriving a person of his possessions."[254] In *Stran*[255] the Court considered a retrospective law neither as an expropriation (second rule) nor as a measure to control the use of property (third rule), but under the first rule as affecting the right to peaceful enjoyment of possessions. The Court then proceeded to apply the test of balancing conflicting interests to this retrospective law. Thus, all three distinct rules that compose the right to property are subject to the test of proportionality. Moreover, the third rule comprises also the right of a State 'to secure the payment of taxes or other contributions or penalties', which must be appropriate within the broad margin of appreciation subject also to the test of proportionality.

One question arguably remains unclear: whether or not the protection against procedural and substantive tax measures falls exclusively within the above third rule

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supra, p.13; and Arai-Takahashi (2002), pp.151-4, mentioning some previous Commission's Reports regarding the right to property and proportionality.

[252] See *Draon v. France*, (Application No.1513/03), Grand Chamber, para 69, citing also *Pressos Compania Naviera S.A. and Others*.

[253] *Pressos Companhia Naviera S.A. and Others v. Belgium* (Application No. 17849/91).

[254] *Pressos Compania Naviera*, paragraph 38. See further analysis of this case on retrospective legislation, this Chapter, section 2.6.a and c.

[255] *Stran* (Application No. 13427/87), at paragraphs 68 and 69 in which the Court scrutinised "whether a fair balance was struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights", what is an essential feature of proportionality. See also further comments on this case in this Chapter, section 2.6.c, contrasting retrospective legislation in tax and non-tax cases.

of Article 1 of the First Protocol, "to secure the payment of taxes".[256] In other words, the issue that seems to be open is whether only procedural tax measures are covered by this rule while substantive taxation could be caught by the first rule (the right to peaceful enjoyment of possessions) or the second (expropriation) or by the first part of that third rule (a measure to control the use of property).

From the case law of the Court analysed below it is clear that all rules regarding the right to property are construed in the light of the same rationale. Even if Article 1 did not provide express reference to tax measures, the right to property would cover taxation matters, since a tax may be confiscatory (expropriation),[257] or simply affect the enjoyment of possessions or control the use of property in a manner incompatible with the rule of law principle.[258] In all these cases, tax measures were tested under the proportionality and reasonableness standards. For example, a tax rate of 100% on income could be regarded as confiscatory and disproportionate to the objective to tax income taking into account other principles such as the principle of ability to pay and the freedom to undertake a waged activity. Other fundamental rights could be unreasonably impaired since to live, to enjoy possessions, to marry, and exercise other rights such as the freedom of movement, the individual should have income available to spend. Nevertheless, as the case law stands at present, and is further

[256] In *Gasus* (Application No. 15375/89) the Court rightly drew a distinction between substantive and procedural tax rules, but it was "not called upon to ascertain whether this right, as the wording of the provision may suggest, is limited to procedural tax laws…" (Application No. 15375/89, paragraph 60).

[257] In the *Hentrich v France* case (Application No. 13616/88), the Court held a French law with anti-avoidance purposes, which authorized the fiscal authorities to buy property sold at undervalue market price, as a de facto expropriation. Then, under the test of proportionality the law violated Article 1 of Protocol 1, second rule (expropriation, at paragraphs 35-36), and not the third rule (to secure payment of taxes), because there was no possibility to challenge the State's right of pre-emption and there were less restrictive alternatives to avoid tax evasion. See also Jacobs and White (2002), pp.360-1. See further analysis of this case this Chapter section 2.7.b.

[258] In *Dangeville* (Application No. 36677/97), in which the issue was the right to recover tax unlawfully collected, the Court stated the following approach to the similar rules regarding the right to property and decided the case in the light of the more general protection of enjoyment of possessions:
"However, as regards the payment of a tax, a more natural approach might be to examine the complaints from the angle of a control of the use of property in the general interest "to secure the payment of taxes", which falls within the rule in the second paragraph of Article 1 (see *Building Societies*, cited above, p. 2353, § 79).

The Court considers it unnecessary to decide this issue, since the two rules are not "distinct" in the sense of being unconnected, are only concerned with particular instances of interference with the right to peaceful enjoyment of property and must, accordingly, be construed in the light of the principle enunciated in the first sentence of the first paragraph." (Application No. 36677/97, at paragraph 51).

demonstrated below, not only procedural measures (which may encompass retrospective legislation), but also substantive tax measures may be regarded as those "to secure the payment of taxes."

Generally where a measure is blatantly unlawful with no legitimate aim the Courts such as the ECJ and the ECHR refrain from examining its proportionality.[259] However, they may assess this even when apparently squarely unlawful measures or when the requirements of general or public interest are not met. This feature of scrutinizing even where it would not be necessary is intriguing and may serve the purpose of a complete and persuasive justification, as occurred in *Dangeville*.[260]

From the evolution of a living Convention, it may be suggested that proportionality was incorporated into the right to property initially as a requirement of the necessity assessment leaving room to regard it as a general principle of law. Moreover, it has been rightly suggested that the requirement of proportionality and other principles such as legality and purposiveness within Articles 8(2) through 11(2) are "likewise part and parcel of the rule of law principle."[261]

Proportionality is not only related to the core concept of discrimination and the right to property; it is also intrinsically related to other fundamental rights enshrined in the Convention. This may prove that proportionality is more than a simple principle derived from the notion of the rule of reason in justifying rational differentiations and the reasonable relationship between ends and means, as will be further substantiated in the following sections.

c) Proportionality and other fundamental rights.

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[259] See, regarding the ECJ jurisdiction, Chapter IV sections 1 and 8.

[260] (Application No. 36677/97). First, the Court concluded that there was no general interest to restrict the right to recover tax unlawfully collected (paragraph 58). Then the Court went on to state that "Both the negation of the applicant company's claim against the State and the absence of domestic procedures affording a sufficient remedy to ensure the protection of the applicant company's right to the peaceful enjoyment of its possessions upset the fair balance that must be maintained between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights" (paragraph 61).

[261] Emberland, Marius, *The Human Rights of Companies: Exploring the Structure of ECHR Protection* (OUP, 2006), p.45.

As proportionality spreads from Article 14 to other rights, such as the right to property discussed above, it may be suggested that, like in other jurisdictions, it may have turned into a general and overarching principle of interpretation and application of human rights law as follows:[262]

c.1) Express Limited Rights (to freedoms of expression, thought, association, movement and to private life), proportionality and taxation.

The second paragraphs of Articles 8 to 11 provide legitimate exceptions to the rights to private life, freedom of thought, of expression and of association. These exceptions are required to be necessary and in accordance with the law, but the Court added the requirement of proportionality ("proportionate to a pressing social need") in order to render them acceptable.[263] In the landmark *Handyside* case the Court also provided for some guidelines to ascertain the meaning of necessity and pressing social need.[264] It has been suggested that in *Handyside* proportionality was viewed "not as an autonomous condition – although that is a proposition which is not untenable – but rather as a corollary to 'necessity in a democratic society.'"[265] Had proportionality remained limited to the construction of exceptions or derogations and only linked to the assessment of what is 'necessary', then perhaps it could not be considered as an overarching principle in its own right.

In *Riener v Bulgaria*[266] the right to private and family light was discussed in the light of the proportionality of the restrictions, which in this case was for tax reasons. A Bulgarian national was banned from leaving her country and visiting some of her

[262] On its supra- or overarching nature, see the next section (2.4).

[263] *Handyside v the UK*, paragraphs 48-50. See Greer, Steven (2000) supra, pp.9-10.

[264] "The Court notes at this juncture that, whilst the adjective "necessary", within the meaning of Article 10 para. 2 (art. 10-2), is not synonymous with "indispensable" (cf., in Articles 2 para. 2 (art. 2-2) and 6 para. 1 (art. 6-1), the words "absolutely necessary" and "strictly necessary" and, in Article 15 para. 1 (art. 15-1), the phrase "to the extent strictly required by the exigencies of the situation"), neither has it the flexibility of such expressions as "admissible", "ordinary" (cf. Article 4 para. 3) (art. 4-3), "useful" (cf. the French text of the first paragraph of Article 1 of Protocol No. 1) (P1-1), "reasonable" (cf. Articles 5 para. 3 and 6 para. 1) (art. 5-3, art. 6-1) or "desirable"." (paragraph 48 of the judgment). See also Arai-Takahashi (2002), supra, pp.7-8.

[265] Eissen, Marc-André (1993), supra, pp.126-7.

[266] (Application No. 46343/99).

relatives living abroad because of her tax debts. Regarding her rights to private and family life the Court stated,

> "The applicant's right to respect for her private and family life was also considered as irrelevant and no attempt was made to assess whether the continuing restrictions after certain lapse of time were still a proportionate measure, striking a fair balance between the public interest and the applicant's rights …"[267]

The freedom of movement as guaranteed by Article 2 of the Fourth Protocol is also construed according to the principle of proportionality. This right, which comprises the freedom to move within and leave any country and choose one's residence, may also be limited on a number of grounds, such as "national security or public safety,...for the protection of health or morals, or for the protection of the rights and freedoms of others." The principle of proportionality has a crucial role in ascertaining the legitimacy of those objectives and the appropriateness of the measures implemented to pursue them. In *Riener v Bulgaria*[268] the freedom of movement was extensively discussed in the light of the proportionality of the restrictions, which was for tax reasons. This case will be discussed further below, since it has far-reaching implications within the context of European Law for its interplay with the fundamental freedom of persons and the principle of proportionality.

c.2) The right to a fair trial (Article 6); the right to an effective remedy (Article 13) and the proportionality principle.

Article 6 is also closely scrutinized under the proportionality test. The leading case which expressly applied the proportionality principle to the right to a fair trial is *Ashingdane v. the UK.* of 1985.[269] In this case, the Court not only referred to the

[267] Paragraph 141 of the judgment. Furthermore, proportionality is also a fundamental tool used to ascertain the necessity of the use of force, defence of life, and other limitations under Article 2 (right to life), inter alia see *Osman v.UK* [1998] EHRR 101 and *McCann and Others v. the United Kingdom* (Application No 18984/91**)**, Grand Chamber, Art 2(2).

[268] (Application No. 46343/99), see this Chapter section IV.2.7.b.

[269] (Application No. 8225/78).

authority of the *Belgian Linguistic* case, but also adopted the same rationale to scrutinize limitations on the exercise of fundamental rights with no detriment to their essential meaning.[270] In some cases, the Court held reasonable the length of the proceedings even under a proportionality reasoning,[271] but disproportionate the interference with the core right to a fair trial.[272] The Court may assess not only the reasonableness of factual and legal limitations to the right to a court and the length of the proceedings under Article 6(1), but also the presumption of innocence under Article 6(2), on proportionality grounds.[273] In some cases of retrospective legislation, there appears to be 'prima facie' no basis for the Court holding it invalid without a proportionality assessment.[274]

Equally, the right to an effective remedy provided by Article 13[275] of the Convention is closely connected to the proportionality principle. Article 13 may be regarded as a corollary to one of the maxim of equity, according to which where there is a right there must be a remedy.[276] This right is distinct from the right to a fair trial as it is an autonomous one and the effective remedy required is not necessarily a judicial

[270] Paragraph 57 of the judgment.

[271] See this Chapter, section 2.2.

[272] See, inter alia, the above *Stran* case in which the Court reiterated its settled case law regarding the equality of arms, the rule of law and the notion of fair trial "preclude any interference by the legislature with the administration of justice designed to influence the judicial determination of the dispute" (paragraph 49). See further on this case this Chapter, section 2.6.c.

[273] *Vastberga Taxi Aktiebolag and Vulic v Sweden* (Application No. 36985/97), paragraphs 92 (the right of access to a court), 106 (length of proceedings based on the length to access to a court), and 112-3 (right to presumption of innocence). See further analysis of this case in section 2.7.b in relation to fiscal penalties and proportionality.

[274] In *Stran*, there was no mention of the proportionality reasoning under Article 6 (fair trial), in which retrospective legislation was passed by the Parliament to address a pending judgment in favour of the position of the Government. The Court held that the right to a fair trial was impaired by the attitude of one of the parties and previous proceedings, particularly the arbitration decision that had been both initiated but afterwards challenged by the own government. On the other hand, the interference with the right to property via a retrospective law undermining the compensation settled by arbitration was considered unjustifiable on proportionality grounds.

[275] Article 13 reads as follows, "Everyone whose rights and freedoms as set forth in this Convention are violated shall have an effective remedy before a national authority notwithstanding that the violation has been committed by persons acting in an official capacity."

[276] In other words, 'equity will not suffer a wrong to be without a remedy' (Meagher, Gummow, Lehane , *Equity, Doctrine & Remedies* (Butterworths, 1992), p.71,).

protection. "Ombudsman and other non-judicial procedures"[277] may meet the essential requirement of effectiveness "in practice as well as in law."[278] As proportionality has as one of its fundamental roles of making rights as effective as possible in practice and in law, it may serve the purpose of assessing whether or not an appropriate remedy is provided on substantive and procedural grounds.[279] The Grand Chamber reiterated in *Kudla*[280] that Article 13 requires "the provision of a domestic remedy to deal with the substance of an 'arguable complaint' under the Convention and to grant appropriate relief."[281] In analysing whether the relief granted is appropriate or not the Court applies the proportionality reasoning in a tax context, as arose in *Reiner v Bulgaria*:[282]

> "…. a domestic appeals procedure cannot be considered effective within the meaning of Article 13 of the Convention, unless it affords a possibility to deal with the substance of an 'arguable complaint' under the Convention and to grant appropriate relief."[283]

From the case law on Article 13, one may draw the conclusion that proportionality has the dual role of assessing the appropriateness of domestic remedies in terms of their effectiveness in practice and in law, and the adequacy itself of the national authority's decision providing a specific remedy.

c.3) Absolute rights, implied limitations and proportionality and some tax cases.

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[277] Jacobs and White (2002), p.463.

[278] Ibidem, p.465, citing *Metropolitan Church of Bessarabia and others v Moldova* (Application No. 45701/99, paragraph 137; *Delelic v Croatia* (Aplication n. 2448/03.

[279] In *Krasuski* (Application No. 61444/00), paragraph 65, the Court pointed out the effective nature of this right stating that it may vary "depending on the nature of the applicant's complaint; however, the remedy required by Article 13 must be "effective" in practice as well as in law (see, among other authorities, *Kudła*, cited above, § 157)." See also Jacobs and White (2002), p.461.

[280] (Application No. 30210/96) Grand Chamber, unanimous, cited as an authority in *Krasuski* (supra).

[281] Paragraph 157 of the judgment, also referring to authoritative case law of the Court.

[282] (Application No. 46343/99). See further on this case, this Chapter III.2.7.b.

[283] Paragraph 142 of the judgment.

It has already been suggested[284] that according to the ECHR jurisprudence only those rights that may be restricted, as not being absolute, could be subject to the test of proportionality. However, there is compelling case law to demonstrate otherwise.

On the one hand, the reasonableness test, which can be coupled with the proportionality principle, is applicable to both categories of rights, either limited or absolute. On the other hand, in the case of unqualified rights, apparently not providing for restrictions, such as the prohibition on torture and inhuman and degrading treatment, "regard has been had to the objective behind a strict security regime being pursued and not just its effects on the prisoners concerned."[285] The prohibition of the death penalty may also be seen as involving the proportionality principle in ascertaining reasonable limits to penalties, by contrasting the right to life and necessary punishment depending on the seriousness and gravity of a crime.[286]

Concerning also the apparently absolute prohibition on forced or compulsory labour under Article 4, proportionality may ascertain whether that proscription may apply to a particular act. In the *Van der Mussele v Belgium*[287] case the Court did not regard the free service of a pupil *avocat* as a "burden which was so excessive or disproportionate to the advantages attached to the future exercise of that profession

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[284] Spencer, Maureen, and Spencer, John, *Human Rights Law in a Nutshell* (Sweet & Maxwell, 2007), pp.18-20.

[285] Mc Bride, Jeremy (1997), p.28, citing *Ensslin, Baader and Raspe v Germany* 14 DR 64 (1978). See also Mowbray, Alastair, *The Development of Positive Obligations under the European Convention on Human Rights* (Hart, 2004), Chapters 3 on Article 3, and pp. 224-6 on "negative rights" such as Article 3.

[286] See concerning Article 3 the following cases: *Ilascu and Others v Moldova and Russia* (Application No. 48787/99; regarding death row extradition and proportionality, *Soering v. UK* (Application No. 14038/88). Although the death penalty may be expressly permitted by Article 2 as a derogation from the right to life, having been expressly proscribed only by Article 1 of the Sixth Protocol, the Court has been denying the extradition to countries where capital punishment may be lawful as in *Soering*, based on Article 3, because of the disproportionate effects of death row phenomenon and the proportionality of the extradition decision itself (paragraph 110 of the judgment, Plenary). See also Buergenthal, Thomas and Shelton, Dinah and Stewart, David P., *International Human Rights* (3rd ed. West Publishing, 2002), pp.175-76). See further on the prohibition of death penalty on grounds of proportionality principle, the decisions of the constitutional courts of South Africa and Hungary, and on its permission the US Supreme Court decisions in Jackson, Vicki C, and Tushnet, Mark, *Comparative Constitutional Law* (Foundation Press, 1999), pp.153-57 and 605-07, and Chapter II.1 under the Eighth Amendment and proportionality.

[287] (Application No. 8919/80), paragraph 37. See Eissen, Marc-André, (1993) supra, p.139.

that the service could not be treated as having been voluntarily accepted beforehand." Thus, the Court applying the principle of proportionality to the facts and to the legal requirement for a professional qualification, concluded that "the burden imposed on the applicant was not disproportionate," and that there was not "a considerable and unreasonable imbalance between the aim pursued - to qualify as an avocat - and the obligations undertaken in order to achieve that aim."[288] In this case, the Court expressly stated that its assessment did not ascertain whether the pupillage would fall within the wording of services not included in the prohibition of compulsory labour, under paragraph 3 of Article 4 of the Convention. The proportionality reasoning did not require in this case the classification of the Belgian pupillage in the light of its legal context and purpose as a 'normal civic obligation'.[289] However, one may suggest that a different kind of free service might fairly derogate from the prohibition of forced labour.

It is interesting to point to a similar case on forced labour regarding the collection of taxes. In the *Four Companies v Austria*[290] case, the Court held that "the obligation for employers to withhold tax on wages and other contributions of their employees is not compulsory labour and does not go beyond normal civic obligations."[291] Whereas in the *Van der Mussele* case the Court did not apply the express derogation of normal civic obligation from forced labour, in the *Four Companies* case the Commission straightforwardly dismissed the complaint on the basis of that limitation provided by paragraph 3 of Article 4. There was no further consideration of proportionality, particularly concerning the necessity justification and the analysis of less restrictive alternative measures to enforce tax collection. It is clear that this system of enforcement had a legitimate aim of facilitating the supervision and efficiency of tax collection. Whether or not there are other less burdensome alternatives for employers with similar efficiency and practicability in a fair balance between the interests at stake seems to be open to debate. On the other hand, what appears to be more certain

[288] Idem, ibidem, paragraphs 38-41 of the judgment..

[289] Paragraph 41 of the judgment.

[290] (Application No. 7427/76), Commission Decision on admissibility.

[291] Operative provision of the decision.

is the disproportionate nature of a measure requiring companies to withhold income tax from the employees of their suppliers. Or still, to require companies or individuals to withhold a corporate tax due by their service providers.

Under Article 50, the proportionality test can be a determining factor for the acceptability of a claim for costs.[292] Even regarding the express prohibition against retrospective application of more severe criminal law under Article 7 of the Convention, proportionality may aid to construe it under special circumstances.[293]

Other set of rights enshrined in the Convention are neither limited nor absolute but, according to the case law of the Court, do have implied limitations such as the rights to vote and to marry under, respectively, Article 3 of the First Protocol and Article 12. In these cases, proportionality is a fundamental tool to override some unreasonable restrictions.[294] Prisoners must be entitled to exercise the right to vote and the same could be applied to the right to marry, which has implied limitations. One may contrast the implied and purposive limitations of rights according to their nature and the theory of implied powers as "usual and appropriate means" of carrying out any enumerated powers, under the test of appropriate means to legitimate ends within their scope and spirit.[295] A similar comparison can be made between the role of reasonableness and proportionality by the application of the rule of reason in restrictions to trade.[296]

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[292] Mc Bride, Jeremy (1997), supra, p.28, citing *Campbell and Fell v UK* (Applications No. 7819/77, 7878/77).

[293] See the following cases illustrating the inapplicability of Article 7 in Jacobs and White (2002), pp.211-15, particularly *Papon v France* (Application No. 54210/00), *CR v United Kingdom* (Application No. 20190/92).

[294] In a case concerning the dismissal of a tax inspector from his former job as a KGB agent (*Ždanoka v. Latvia* Application No. 58278/00), the Grand Chamber of the Court summarised its case law on Article 3 of the First Protocol (which could interact with Article 10 of the Convention), asserting that the former right is under a less stringent test than those applied to Articles 8-10, but also subjected it to the principle of proportionality (paragraph 115, 'c', of the judgment).

[295] See *McCulloch v Maryland*, Chapter II.1.1.

[296] Another area in which proportionality may play a fundamental role is over whether or not and to what extent a positive obligation of the State exists under Article 1 ("The High Contracting Parties shall secure to everyone within their jurisdiction the rights and freedoms defined in Section I of this Convention") to ensure that the rights enshrined in the Convention are guaranteed (*Ilascu and Others v Moldova and Russia*, Application No. 48787/99, paragraph 332. See also Jacobs & White (2002), p. 28; and Eissen, Marc-André, (1993), pp.139-40.

d) Conclusion.

From this section one may draw the conclusion that proportionality is pervasive and has become one of the fundamental principles of interpretation and application of the European Convention on Human Rights. Indeed, the previous sections extensively covered the fundamental rights under the principle of proportionality coupled with reasonableness that was the legal tool to interpret and ascertain them with examples of tax and non taxes cases.[297] Articles 5 (right to liberty and security) and 6 (right to a fair trial) were covered in section 2.2; Article 14 (non-discrimination) in section 2.3.a); Article 1 of the First Protocol (right to property) in section 2.3.b); Articles 8 to 11 (the express limited rights to freedoms of expression, thought, association, movement and to private life) in section 2.3.c.1); Articles 6 (core right to a fair trial and not only length of the proceedings) and 13 (right to an effective remedy) in section 2.3.c.2); Articles 3 (prohibition on torture and inhuman and degrading treatment), 4 (prohibition on forced labour), 7 (non-retrospective application of more severe criminal law), 12 (right to marry), and 3 of the First Protocol (right to vote) in section 2.3.c.3). Schwarze[298] is absolutely right to suggest that proportionality's effectiveness "is not linked to a particular fundamental right, but covers the entire range of fundamental freedoms", being its main purpose "to give substance and meaning" to their protection.

Furthermore, as a general principle of interpretation and application of legal rules and principles, the proportionality principle can be regarded as an *optimizing principle*[299] which gives as much life and effectiveness as possible to all fundamental

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Lastly, where those absolute rights may compete with themselves or other fundamental rights, the proportionality principle also seems to take on the relevant role of contrasting and balancing the conflicting interests or principles in play *(Belgian linguistic cases*, paragraph 8 of item 7 quoted in this section III.2.3.a, and *Chassagnou and Others v France*, Applications No. 25088/94, 28331/95 and 28443/95). See also *Reiner v Bulgaria* this section at c.1 above on the express limited rights, and section 2.7.b below on fiscal sanctions, freedom of movement and protection of the rights of others, as competing rights.

[297] More extensive analysis of tax cases and tax principles and rules is made in the following sections (5, 6 and 7).

[298] (1992), p.679.

[299] Beatty (2004), p.163. See also Schwarze (1992), p.679. In the context of the margin of appreciation of States to regulate the right to a fair trial and proportionality, the Court reiterated by its Grand Chamber in *Prince Hans-Adam II of Liechtenstein v. Germany* (Application No. 42527/98) at

rights that may apparently be conflicting with each other in a specific case. On the other hand, optimization is also pursued by the balance between the general interest and fundamental rights as both serve the purpose of the twin concepts of "individual and society" and there seems to be no reason why there should be a clash between them.

The next section will analyse proportionality in its interaction with the margin of appreciation doctrine and consider further whether or not the former is an overarching principle that may affect and govern other Convention principles, particularly with regard to tax principles and rules.

III.2.4. The margin of appreciation doctrine and its interference with the proportionality principle. Tax and non-tax matters.

a) Notion of the margin of appreciation. Differences from the proportionality principle.

The objective of this section is to demonstrate that the principle of proportionality goes even further than just to permeate the whole range of fundamental rights. As an overarching principle, proportionality also governs the margin of appreciation doctrine. The case law of the Court is extensive on this doctrine, which has not been strictly defined or exhaustively ascertained. What has been suggested is that "no simple formula can describe how it works", "its casuistic, uneven, and largely unpredictable nature" having remained its most outstanding characteristic.[300] Broadly speaking, the margin of appreciation doctrine primarily serves the purpose of recognizing the States' sovereignty in terms of choice of policies and their

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paragraph 45, "In this context, it should be recalled that the Convention is intended to guarantee not theoretical or illusory rights, but rights that are practical and effective."

[300] Greer, Steven, *The European Convention on Human Rights: Achievements, Problems and Prospects* (CUP, 2006), p.223. See also Macdonald, R. St. J. "The Margin of Appreciation", in *The European System for the Protection of Human Rights*, Macdonald, R.ST.J.; Matscher, F.; Petzold, H. (Eds), (1993), pp. 83-124;

implementation,[301] as they are in principle in a better position than the European Court to assess them.[302] Only where those policies and respective measures may disproportionately affect the fundamental rights, then the Court exercise its judicial review to override the former by giving precedence to the latter.

The margin of appreciation in social and economic policies is very wide according to settled case law of the Court.[303] However, this does not hinder the Court from reviewing the facts of the case and taking into account all the relevant principles of interpretation and application of the Human Rights Convention, such as the principle of proportionality, the evolutive and dynamic interpretation and the comparative approach.

In *Handyside*,[304] the Court mentioned for the first time the doctrine of the margin of appreciation, stating that is very broad, but at the same time expressly introduced proportionality under Article 10, implying that this latter principle should guide and govern the former.[305] The confiscation of property (books) was justified essentially on moral grounds under Article 10, which falls within the broader notion of the general interest under the right to property. Then, ten years later, the Court expressly introduced the notion of proportionality as a requirement also to interfere with the right to property in *James*.[306] Subsequently, there has been no room to apply the

[301] Macdonald refers to the margin of appreciation as an illustration of the general approach of the ECHR "to the delicate task of balancing the sovereignty of Contracting Parties with their obligations under the Convention" (Ibid, p.83). Similarly, Arai-Takahashi describes the margin of appreciation as a reference "to the latitude a government enjoys in evaluating factual situations and in applying the provisions enumerated in human rights treaties" (2002, Ibid, p.2).

[302] The Court held in a number of cases that "because of their direct knowledge of their society and their needs, the national authorities are in principle better placed than the international judge to appreciate what is 'in the public interest'" (*James*, paragraph 46; and *Pressos Compania Naviera*, paragraph 37). See Arai-Takahashi (2002), p.157, and Steven Greer, (2000), p.8.

[303] See again *James*, under the test of proportionality, particularly at paragraphs 47-50.

[304] See the previous sections 2.3.b. on the right to property and 2.3.c.1 on proportionality and limited rights.

[305] Unlike Article 10 in this same case where the Court stated that the Contracting States were the only judges to assess the necessity for an interference with the right to property under Article 1 of the First Protocol, having restricted itself "to supervising the lawfulness and the purpose of the restriction in question" (*Handyside*, paragraph 62). See also Arai-Takahashi (2002), p. 53.

[306] (Application No. 8793/79), at paragraph 50. See previous section 2.3.b on the right to property and proportionality.

doctrine of margin of appreciation except within the boundaries of the test of proportionality.

In *Stec and Others v UK*[307] the Court by its Grand Chamber stated the general principles that govern the scope of the margin of appreciation doctrine, "according to the circumstances, the subject-matter and the background."[308] This case concerned non-discrimination, but due to the broad scope of these principles they tend to be the same for other fundamental rights.

The assessment of the margin of appreciation is not prior to the proportionality review, as the latter may assess not only the legitimacy of a policy which interferes with fundamental rights but also the measures chosen to implement that policy in the public interest. In other words, the assessment of proportionality is a necessary requirement for applying the margin of appreciation doctrine according to the rule of law in terms of legal and principled justification. Furthermore, not only are the objectives and the measures to achieve them submitted to the margin of appreciation and to proportionality, but also their consequences.[309] If the margin of appreciation doctrine fundamentally "enables the Court to balance the sovereignty of Contracting Parties with their obligations under the Convention"[310], there may not be a better way to balance national sovereignty and international obligations to comply with individual rights than via the application of the proportionality principle. As Steven Greer points out, the key issue of margin of appreciation is that "the legitimate exercise of discretion by States under the Convention hinges critically on the

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[307] (Applications No. 65731/01 and 65900/01). See further analysis of this case grounded on proportionality in this Chapter, section 2.5.b, regarding tax discrimination on grounds of sex.

[308] See *Petrovic v. Austria* (Application No. 20458/92), § 38. As a general rule, very weighty reasons would have to be put forward before the Court could regard a difference in treatment based exclusively on the ground of sex as compatible with the Convention (see *Van Raalte*, cited above, § 39, and *Schuler-Zgraggen v. Switzerland*, § 67). On the other hand, a wide margin is usually allowed to the State under the Convention when it comes to general measures of economic or social strategy (see, for example, *James*, § 46; *National and Provincial Building Society and Others v. the UK*, § 80), unless it is "manifestly without reasonable foundation" (ibidem, paragraph 52).

[309] Arai-Takahashi (2002), supra, p.157.

[310] Macdonald, (1993), p.123.

appropriate application of principles which enable the Convention to be properly interpreted."[311]

In a number of cases, the Court reiterated its deference to the margin of appreciation doctrine, but always directly or indirectly assessing and striking a fair balance between the competing interests using proportionality reasoning. As analysed in the previous section, proportionality pervades all fundamental rights enshrined in the Convention in practice and in law. There has been left no room for applying the margin of appreciation to some rights without consideration of proportionality.[312] As has been rightly suggested, proportionality is the "yardstick"[313] of evaluation as well as "a corrective and restriction"[314] of the margin of appreciation doctrine. Conversely, when the Court recognizes to States a wide margin of appreciation to initially chose the means to implement their policies and even assess them via proportionality,[315] that margin does not hinder the judicial review of the Court on the

[311] *The Margin of Appreciation: Interpretation and Discretion under the European Convention on Human Rights (2000),* p. 7. In his latest work on the European Convention Rights, Steven Greer approaches the margin of appreciation in the same way still and primarily under the subordination to what he called as 'Convention's primary constitutional principles', (2006), p.225). Assuming the classification proposed by Greer (idem, pp.195-230) between these primary constitutional principles (the rights principle linked to the effective protection, the democracy principle, the principle of 'priority to rights', and the principles of legality, procedural fairness, and the rule of law) and secondary constitutional principles, both proportionality and the margin of appreciation would be within the latter, but proportionality as analysed in the previous section is closely related not inherent to the effective protection, fairness, legality or lawfulness, whereas in his own words "the central function of the principle of proportionality is to facilitate the consistent application of the 'democracy', 'rights', and 'priority to rights' principles" (idem, p.217). In other words, one may suggest that even assuming proportionality as a secondary constitutional principle, there would be no proper and substantive primary constitutional principles without it.

[312] Either proportionality is considered together with margin of appreciation, or on its own. On the other hand, some authors pointed out that the margin of appreciation has never been invoked regarding Article 2 (the right to life), Article 3 (the prohibition of torture), or Article 4 (the right against forced labour), having had a very limited role in respect of Articles 5 and 6 (Greer, Steven, 2006, p.225). On the important role of proportionality in relation to Articles 2, 3, and 4 mentioned above, see the previous section. Arai-Takahashi (2002) on p.8, indicated that the Court justified the extension of the margin of appreciation doctrine to all Convention rights via the general exercise of 'balancing', but "with the exception of four non-derogable rights", under Article 15 (derogations in time of emergency), paragraph 2, which prohibits derogations from Article 2 (right to life), Article 3 (proscription of torture), Article 4 (prohibition of forced labour) and Article 7 (non retrospective criminal law).

[313] Arai-Takahashi (2002), pp.18 and 128.

[314] Matscher, F. 'Methods of Interpretation of the Convention' (1993), p.79.

[315] See Arai-Takahashi (2002), pp.156-7.

same grounds of proportionality.[316] This principle is so rooted in and inherent to the Convention that States must apply it to their own policies first and then to measures that may affect the effectiveness of fundamental rights to not only respect but also strengthen them under the subsequent review of the Court.

At least five differences between the margin of appreciation and the principle of proportionality can be identified. First, the margin of appreciation is more a doctrine[317] or a principle of justification[318] rather than interpretation, whereas proportionality may be treated as a principle of interpretation, application and justification. Secondly, whereas the former is considered as 'uneven and largely unpredictable',[319] and either 'more rhetorical than substantive' and 'transitional' or not a principled doctrine or in favour of a minimalist approach regarding a common denominator of human rights protection,[320] proportionality is more predictable, fundamentally substantive in practice and in law, and permanent, which in most cases reaches its main objectives of consistency, effectiveness and fairness. Thirdly, whereas the former applies to only some fundamental rights (and may possibly extend to others, except to the four non-derogable rights),[321] the latter is considered either as inherent to or applicable to all of them. Fourthly, regarding competing enshrined and not enshrined rights the margin of appreciation doctrine appears to have little role in comparison with proportionality.[322] Fifthly, when States exercise their margin of discretion they may (or perhaps must) observe the proportionality principle; however, ultimately it has an ancillary role within the Convention in

[316] Another characteristic of the relationship between the margin of appreciation and proportionality is the more weight given to the former the less stringent the latter test tends to be. "Conversely, the narrower the margin, the more exacting the proportionality test will be" (Dembour, 2006, p.71, also analyzing *James*, and Arai-Takahashi, 2002, p.2).

[317] See Greer (2006), p.222.

[318] See Macdonald, "The Margin of Appreciation" (1993), p.123.

[319] See Greer (2006), p.223.

[320] See Arai-Takahashi (2002), p.18.

[321] See the analysis of non-derogable rights (to life, non-torture, unforced labour, non-retrospective criminal penalties), in the previous section, as well as n.357.

[322] See above section 2.3.c.4 on competing rights, *Chassagnou* (Applications No. 25088/94 and 28331/95).

respect of its own assessment, which is necessarily subjected to proportionality as assessed by the Court.[323]

Furthermore, although they may intertwine, proportionality is more pervasive within the Convention, and governs as an overarching principle the margin of appreciation itself as well as other principles, such as effective protection in law and in practice. According to the jurisprudence of the Court, it may be right to conclude that there is no method of construction and adjudication of fundamental rights as effective as the proper consideration of proportionality coupled with reasonableness.

b) The margin of appreciation in taxation.

Particularly with respect to taxation, the Commission recognized from the earliest cases that the margin of appreciation is broader than in other areas.[324] The *Svenska*[325] case dealt with the broad margin of appreciation of States concerning fiscal, economic and social policies. In this case, there was an implicit reference to the proportionality principle by regarding the measure as not "disproportionate" or "an abuse."[326] In addition, that decision stated broad limitations on the power to tax under the right to property,[327] as the applicants disputed the destination of a special profit tax and social contribution to Public Funds for pensions and acquiring participations in some public companies. Regardless of the broad margin of appreciation, the

[323] As analyzed above the margin of appreciation is the sovereignty remained with States to adjudicate fundamental rights whereas the proportionality is the way the Court assess whether or not national sovereignty was properly exercised within the Convention.

[324] In *GG and TV and Company v Iceland* (Application No. 511/59) the issue was related to a once-for-all tax of 25% on wealth above a certain limit, and the Commission taking into account the critical economic circumstances, did not take it for consideration and regarded as "manifestly ill-founded." In *Wasa Li* (Application No. 13013/87), the Commission stated that "…a margin of appreciation is left to them and it must be wider in this area than it is in many others. … A government may often have to strike a balance between the need to raise revenue and other objectives in its taxation policies. The national authorities are obviously in a better position than the Commission to assess those needs and requirements" (Paragraph 6 of the decision).

[325] *Svenska Managementgruup AB v Sweden* (Application No. 11036/84).

[326] Paragraph 14 of the judgment. In this case, the applicant had to pay a new tax equal to a certain reasonable percentage of its profits and increase in social pension charges of 0 .2-0 .5 per cent.

[327] "The levying of a tax or other contribution would only be in violation of the right to peaceful enjoyment of possessions if the person concerned was saddled with an intolerable burden or if his financial situation was overturned" (Heading of the decision).

judicial review of the Strasbourg organs allows them to assess the legality, reasonableness and proportionality of any tax measure that may interfere with fundamental rights.[328]

In *Hentrich*[329] the Court also reiterated the margin of appreciation but again submitted it to the principle of proportionality regarding the right of pre-emption to counteract tax evasion under the right to property. In *Riener*,[330] the Fifth Section of the Court unanimously mentioned the authority of *Hentrich* and gave prevalence to the full assessment of proportionality with the analysis of less restrictive measures as occurred in *Hentrich* with no further consideration of the margin of appreciation.

Regarding tax discriminations, the Court also gives deference to States to assess "whether and to what extent differences in otherwise similar situations justify a different treatment", but subjecting the margin of appreciation to the proportionality test.[331] Any difference of treatment must pursue a legitimate aim and there must be a reasonable relationship of proportionality between the aim and its means.

Summarizing the case law of the Court in relation to the weight given to the margin of appreciation, Jacobs & White conclude,

> "So, as has been seen, there is little room for choice where the discrimination is based on sex, race, nationality, religion, legitimacy of children, and sexual orientation. However, in matters of, for example, housing policy designed to ensure an adequate supply of housing for the poorer section of the community, there will be a wide

[328] See again *Wasa Li*, at the heading Complains, paragraph 2, "However, it is well-established in the Commission's case-law that the powers of taxation are not immune from review under the Convention (cf. for example No. 8531/79, Dec. 10.3.81, D.R. 23 p. 203)." See the analysis of *A.B.C.D. v UK*, Application No. 8531/79, in section 2.6.a. on tax avoidance, retrospective taxation and proportionality.

[329] *Hentrich v France* case (Application No. 13616/88), at paragraph 39. See further on this case, section 2.7.b, on fiscal penalties and proportionality.

[330] *Riener v Bulgaria* (Application No. 46343/99). See section. 2.7.b) also on fiscal penalties.

[331] *Van Raalte* case (Application No. 20060/92, decided by Grand Chamber), paragraph 39, and *Karlheinz Schmidt* case (Application No. 13580/88) paragraph 24. See section 2.5.b.

margin. There is a similarly wide margin of appreciation in relation to policies in the area of taxation."[332]

The following sections will illustrate how proportionality coupled with reasonableness has been applied to some tax issues, mainly discrimination, retrospective taxation, excessive taxation, and in so doing recognizing or originating other tax principles such as ability to pay and conditions for clarity and precision in statutory tax law.

III.2.5. Tax discrimination and the proportionality principle coupled with reasonableness.

As discussed in the previous sections, proportionality lies at the heart of the concept of discrimination and governs the margin of appreciation. The following examples of tax discrimination will be assessed on grounds of proportionality in a search for fairness and consistency in the light of the evolving and dynamic interpretation of the Court.

III.2.5.a) The joint taxation of married couples and family taxation.

In *Lindsay*,[333] the Commission decided that the different taxation of married and unmarried couples would not be discrimination, the standard of reasonableness and the margin of appreciation doctrine. This case was the second to apply Article 14 to a tax case.[334] It may be worth analysing two aspects of the decision. First, it may rightly be suggested that the aim of encouraging women to work was legitimate, and the favourable tax regime for married women was a proportionate measure. In this situation, the effect was a positive discrimination in favour of married women as breadwinners in comparison with married men who were the main source of income.

[332] (2006), p.429.

[333] *Lindsay v. United Kingdom* (Application No. 11089/84). See also comments on this case and on the same issue decided by the Commission (*Hubaux v. Belgium*, Application No. 11088/84,), Baker, Philip, "Taxation and the European Convention on Human Rights" [2000] B.T.R. 4, p.252, part 6 on Article 14, (d) Taxation of husbands and wives).

[334] *A,B,C,D, v UK* (Application No. 8531/79) was the first (see analysis in section 2.6.a).

The discrimination between married and unmarried couples may be arguably justified. The Commission referred to the *Belgian Linguistic* leading case,[335] but did not accept that married and unmarried couples were in comparable situations. The Commission gave much more weight to the margin of appreciation doctrine than to other principles that govern the construction and application of fundamental rights, such as commonality, effective protection, proportionality, with no consideration at all as to whether different treatment between married and unmarried couples was seen as discriminatory in other democratic states. It seems to be that in some areas the Commission was ready to accept the statutory law with no due regard to constitutional court rulings.[336]

Other constitutional courts had decided in favour of taxpayers regarding the more burdensome taxation of married couples in comparison with unmarried couples (*cohabitees*) in democratic jurisdictions. Besides the U.S. and Germany, two more domestic jurisdictions, Italy[337] and Spain,[338] applied the reasonable and objective test under the proportionality reasoning to override that discrimination. The lack of other examples of decisions of constitutional courts may result from the fact that many other democratic states do not adopt a mandatory joint taxation of spouses within a system of progressive taxation.[339] Even the European Court of Justice in the *Schumacker*[340] case took into consideration the legitimate aim of the split system for

[335] See this Chapter, section 2.3.a.

[336] See for example the German Constitutional Court decision (delivered previously to *Lindsay* case) that balanced the equality of rights of the two sexes, the constitutional protection of the family, and the purpose of 'bringing the working wife back to the home' (6 BVerfGE 55, decision of 17 January, 1957, excerpted in Kommers, Donald, *The Constitutional Jurisprudence of the Federal Republic of Germany* (DUP, 1997), p.498; and the US Supreme Court on Chapter II, section 1.2. (*Due process, equality principle and proportionality*), *Hoeper v. Tax Commission of Wisconsin,* decided in 1931, 284 U.S. 206.

[337] The Constitutional Court in the decision 179 of 1976 held that the joint taxation of married couples was unconstitutional on grounds of its unreasonableness and irrational justification in the light of equality, the ability to pay, and the constitutional protection of the family.

[338] Thuronyi (2003), pp.93. See judgment of the Constitutional Court of Spain No. 45/89 (STC 45/1989), of 20 February 1989, based on the principle of proportionality to guarantee non-discrimination between married couples and cohabitees in light of the protection of family.

[339] For an overview in Europe, see Soler Roch, María Teresa, *Family Taxation in Europe* (Kluwer, 1999), in particular also the role of neutrality principle to avoid that married people are penalised because they are married (at p.5).

[340] Case C-279/93 [1995] ECR I-225. See Chapter IV.5.1.

couples based on the ability to pay principle recognized as a fundamental principle of domestic and international law as opposed to joint taxation.

Taking into account an autonomous and evolving interpretation adopted by the Commission and the Court, it may be suggested that the *Lindsay* ruling is no longer controlling. In other words, if in most democratic states (even in the UK) there is no longer tax discrimination between married couples and cohabitees,[341] the Court would probably take a different view, overturning its conclusion in the *Lindsay* case, without overriding its governing principles. In *Shackell*[342] the Court had the opportunity to explicitly liberate itself from the narrow and discriminatory view taken by the Commission in *Lindsay*, but it failed to do so by a majority of its First Section. In *Shackell* the discrimination was against a cohabitee widow, to whom the entitlement to social security benefits as a widow of her cohabitee on his death was denied.[343] Whereas in *Lindsay* the discrimination was against marriage, in *Shackell* the discrimination concerned the reverse situation of cohabitation of a couple, although living together as a family with three daughters. The Court also based the decision in *Shackell* on Article 12 (which grants special treatment to marriage) to accept a more favourable treatment for formally married couples, whereas it upheld in *Lindsay* less favourable taxation. Arguably, the Court may be right on a technical view, but this should not restrain it from taking into account all the significant factual and legal circumstances of each case to avoid discrimination and enforce legitimate rights. The problem with these apparently unfair decisions may be the formalistic

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[341] The separate taxation for spouses was introduced by the 1988 Act, in the following year after the Commission Decision in *Lindsay*. One might suggest there was a close coincidence of dates, having had the unfair and more burdensome taxation of married couples remedied according to the margin of appreciation by the State. See further on UK taxation, Tiley, John, "Tax, Marriage and the Family" (2006) C.L.J. 65(2) pp.289–300.

[342] *Joanna Shackell v UK* (Application No. 45851/99)

[343] The Court in its judgment of 27 April 2000, stated, "… that decision of the Commission dates from 1986, that is, over 14 years ago. The Court accepts that there may well now be an increased social acceptance of stable personal relationships outside the traditional notion of marriage. However, marriage remains an institution which is widely accepted as conferring a particular status on those who enter it. The situation of the applicant therefore is not comparable to that of a widow" (paragraph 1). The remedy for this unfairness might have been on grounds of equity, either squarely accepting a putative marriage between the cohabitees or allowing the deceased to reveal his will from the grave through his cohabitee.

approach adopted by some judges regarding the analysis of comparability or analogy between two or more situations and the weak role of proportionality.

Proportionality is also an aid to an evolving interpretation, since a measure regarded as non-discriminatory and proportionate in an earlier case may become discriminatory and disproportionate under new economic and social circumstances.

Shackell seems to be inconsistent with the ruling in the *PM*[344] case and the rationale of the *Marckx* case.[345] In the latter, the Commission and the Court stated that married and unmarried women were in comparable situations in relation to their relationship with their respective daughters, whereas in *Shackell* a formerly unmarried widow with three daughters was not comparable with a widow previously married with children.[346]

In *PM*, the issue was the right of an unmarried father to tax deductions regarding maintenance payments paid to the mother of his daughter. The British government tried to compare this situation based on marriage taxation policy with the previous decisions in *Lindsay* and *Shackell*, since the only reason why the taxpayer could not deduct those payments was he had never been married to his daughter's mother. Nonetheless the Court rightly distinguished his situation from the previous case law[347] and unanimously stated that,

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[344] *PM v UK* (Application No. 6638/03), Fourth Section, judgment of 19 July 2005.

[345] (Application No. 6833/74) judgment of 13 June 1979. In this case the Court held discriminatory, disproportional and with no reasonable justification the difference of treatment between married and unmarried women as in the *PM* case analysed below, regarding the difference in tax treatment between married and unmarried fathers. Perhaps, the Commission might have decided differently if the married couple had children to afford and any tax allowance for children could not compensate the heavier tax burden on married couples in comparison with cohabitees also with children. In *Lindsay*, the married couple had children and the comparison should have been between unmarried couples with children.

[346] It would have been more consistent with the *Marckx* judgment (by the Grand Chamber), had the Court by its First Section accepted in *Shackell* the similarity between married and unmarried women with children and then decided the case on less lenient proportionality grounds. On *Marckx* and the evolving and progressive interpretation of the Court, see also Partsch, Karl Josef, "Discrimination" (1993), pp.588-9.

[347] The Court concluded that the applicant was in a relevantly similar position of a separated father who had been married before (at paragraph 27).

> "In the present case, the applicant has been acknowledged as the father and has acted in that role. Given that he has financial obligations towards his daughter, which he has duly fulfilled, the Court perceives no reason for treating him differently from a married father, now divorced and separated from the mother, as regards the tax deductibility of those payments. The purpose of the tax deductions was purportedly to render it easier for married fathers to support a new family; it is not readily apparent why unmarried fathers, who undertook similar new relationships, would not have similar financial commitments equally requiring relief."[348]

Having decided on the comparability question, the Court went on to reason on the justification issue for a different tax treatment on grounds of the legitimate aim of the legislation at stake and its proportionality. Although the Court could have expressly reversed *Lindsay* on the criterion for comparable situations (married and unmarried couples), it did not need to, as this rule was not justified in the *PM* case, having given particular regard to the civil rights granted to and obligations imposed on unmarried fathers.[349] Whereas both separated fathers, unmarried and married, could not be treated differently following the *PM* ruling, married and unmarried couples could, according to *Lindsay*. One may suggest that equality and equitable treatment can be granted to them only when they are separated but not while living as spouses. In line with the current legal obligations of cohabitees, who may have reciprocal obligations and rights, any difference of treatment for encouraging formal and longer commitments, assuming a public, legitimate interest, should be in favour of, and not against, marriage.[350] Again, *Lindsay*'s rationale does not hold water.

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[348] Paragraph 28 of the judgment.

[349] Besides the obligation of financial help, unmarried fathers "can claim equal rights of contact and custody with married fathers", Jacobs and White (2002), supra, p.428.

[350] John Tiley observed another cause of "inequity" between civil partners and spouses on one hand and those who decided to live together without marriage or civil partnership on the other hand, regarding the exemption from capital gain tax provided for private residence ("Tax, Marriage and the Family" [2006] C.L.J., p.295). Whereas for the former only one residence can be exempt, for the latter each one of those living together can have an exempt private residence.

Another kind of tax discrimination may occur with unmarried couples who live together but cannot marry since one of them or both spouses were previously married, having no provision for divorce in their country. In *Johnston v. Ireland*[351] the Court decided that there was no positive obligation for the State to remedy the different tax treatment between married and unmarried couples as a consequence of a constitutional prohibition on divorce. However, regarding all three applicants together (non-divorced spouse, his lady partner and their daughter), the Court held that it was a breach of Article 8 regarding family and private life, also taking into consideration tax consequences for an illegitimate child.[352] The complexity of this case also lies in striking a balance between the principles of interpretation, which must be given more weight in each case, and the role of the Court itself within the Convention. With due regard given to the margin of appreciation and proportionality, the State was left with the task of choosing the means to remedy the situation ensuring that a "fair balance is struck between the demands of the general interest of the community and the interests of the individual."[353]

III.2.5.b) Tax discrimination on grounds of sex and strict proportionality.

On the other hand, it also appears to be difficult to reconcile the above decisions of the Court, such as *Lindsay*, with *Van Raalte v the Netherlands*[354] and *Burden and Burden v United Kingdom*[355], which concern discrimination on grounds of gender and family circumstances for tax purposes. A way to avoid inconsistency and probably unfairness in each case would be to apply either the narrow or the broad scope of the doctrine of margin of appreciation and proportionality in the light of

[351] (Application No. 9697/82).

[352] *Johnston* (Application No. 9697/82) case, paragraph 33: "An illegitimate child inheriting property from his parents is potentially liable to pay capital acquisition tax on a basis less favourable than a child born in wedlock."

[353] Idem, paragraph 77 of the judgment. In 1987 after the decision was held on 18 December 1986, the status of illegitimacy was abolished and the Minister of Justice for Ireland stated that it rectified the finding of a violation in *Johnston*. See comments on this case by Donncha O'Connell in *Fundamental Rights in Europe, the ECHR and its Member States, 1950-2000*, Robert Blackburn and Jörg Polakiewicz (Eds) (OUP, 2001), by pp. 454-5, at 467.

[354] (Application No. 20060/92).

[355] (Application No. 13378/05).

other principles of interpretation. Wherever the margin of appreciation seems to take precedence over proportionality, in my opinion a more utilitarian view appears to inform the jurisprudence of the Court, which gives prevalence to an undefined general interest. Thus, this utilitarianism supersedes a more liberal view, which gives more weight to the recognition of individual rights and their enforcement than to the notion of the general interest.[356]

In *Van Raalte*[357] an exemption from social contributions was granted only to unmarried, childless women of 45 or over. The reason why the exemption was not applied to men in the same circumstances of age and being childless was that men over 45 could still have their own children while this was considered unlikely for women. The justification for the exemption itself was not to impose an unfair emotional burden on women who could not procreate any more. Having to pay a contribution for childcare benefits would continuously remind them of their childless situation. Although the Court made a concession regarding this arguably acceptable justification, it straightforwardly rejected the discrimination based on gender, for which the margin of appreciation seems to be less broad and proportionality test less loose:

> "While Contracting States enjoy a certain margin of appreciation under the Convention as regards the introduction of exemptions to such contributory obligations, Article 14 requires that any such measure, in principle, applies even-handedly to both men and women unless compelling reasons have been adduced to justify a difference in treatment."[358]

It is also worth noting in this unanimous decision that the Court did not take into consideration the argument of the domestic courts, which claimed that if the exemption from social contributions was discriminatory, it should be declared null

[356] See Dembour, (2006), supra, pp.68-70.

[357] Supra, decided by Chamber, unanimously, on 28 of January 1997. See also Baker, Philip [2000] B.T.R., p.251, part 6 on Article 14, (c) Cases where discrimination was established, in which *Schmidt v. Germany* is also mentioned.

[358] Paragraph 42 of the *Van Raalte* case, in which the Court also expressly applied the principle of proportionality (paragraph 39).

and void and not be extended to other persons. Nevertheless, as the Court apparently accepted the legitimate aim of the exemption on unfair emotional burden grounds, its role was to avoid unjustified discrimination and not deprive some persons of legitimate benefits.

The case law of the Court tends to be stricter on sex discrimination, according to the evolving principle of interpretation under general or specific dynamic economic and social circumstances. In *Karlheinz Schmidt v Germany*[359], cited as an authority in *Van Raalte*, only men were obliged to work in the fire brigade or pay a levy instead. The Court appreciated the fact that there were enough volunteers, even women among them, and as a result no man was forced to be a fire worker but only men had to pay that duty.[360] The Court held this was unjustifiable discrimination, paying less regard to the margin of appreciation for the State and more attention to the factual situation and discriminatory effect on grounds of sex. The Commission had also held discrimination between men and women to be unjustified in more blatant cases and the legislation has been subsequently amended.[361]

On the other hand, notwithstanding different age limits for men and women to have the right to a pension, the Court accepted these, taking into account the justification given by the State and the scrutiny the European Court of Justice performed on grounds of proportionality for a transitional period concerning the same subject matter.[362] Although the application of the proportionality test by the European Court

[359] (Application No. 13580/88). See McBride, Jeremy (1997), supra, p.33, particularly the factual analysis of discrimination cases in which the margin of appreciation is much stricter.

[360] Paragraph 28 of the judgment.

[361] See *MacGregor v. United Kingdom* (Application No. 30548/96), in which only a man with an incapacitated wife had the right to an allowance and no allowance was granted a woman with an incapacitated husband (See Baker, Philip, idem p.252, and Meussen, Gerard, Conclusion in *Principle of Equality in European Taxation* (1999), supra, p.173). See also *Crossland v. United Kingdom* (Application No. 36120/97) and *Fielding v. United Kingdom* (Application No. 36940/97) in which a bereavement allowance was granted to women only and not to a man whose deceased wife was the breadwinner (apud Baker, Philip, idem p.251). All these cases were decided on the basis of reasonable justification and proportionality of discrimination. In the same line of reasoning, see also *Hobbs, Richard, Walsh and Geen v. the UK* (Applications No. 63684/00, 63475/00, 63484/00 and 63468/00).

[362] *Stec and Others v. The UK* (Applications No. 65731/01 and 65900/01), paragraph 58, Grand Chamber, majority decision by 16 to 1. On sex discrimination and the exceptions to which the equality principle is subject regarding social security, see Ellis, Evelyn, "Proportionality in European Community Sex Discrimination Law", in *The Principle of Proportionality in the Laws of Europe* (1999), pp.169-70, mentioning some cases decided by the ECJ based on the proportionality principle.

of Justice (ECJ) was not binding, it was regarded as persuasive, and one may rightly suggest that it is the same as the principle applied by the Court (ECHR). Nevertheless, it can be said that the latter jurisdiction applies the test of proportionality giving considerable weight to the margin of appreciation.[363]

In *Burden and Burden*[364] the Fourth Section of the Court rejected the same inheritance tax treatment of a couple engaged in a civil partnership to elderly siblings living together permanently. Whereas in *Lindsay*[365] the Commission considered the situations of married and unmarried couples as non-comparable, in *Burden and Burden* the Fourth Section assumed similarity among married, civil partnership couples and siblings firmly committed to living together. Nonetheless, the Fourth Section analysed the justification for not extending the same inheritance tax regime to them under the test of proportionality and gave more weight to the margin of appreciation of the State.[366] The Fourth Section developed the comparability of situations between married and unmarried couples[367] but seems to have failed to reach a more consistent decision with a stricter proportionality test, in the search for more fairness in each case. The Grand Chamber reiterated that a formal and binding agreement as a requirement for marriage and civil partnership was lacking in the case of the two elderly sisters. It adopted a formalistic approach and again substantiated its conclusion on a wider margin of appreciation of States in tax matters.[368] Although

[363] Evelyn Ellis (1999) points out on sex discrimination regarding social policy that there is a broader discretion of the Member States and that proportionality seems to be watered down, although the ECJ does not refer to the margin of appreciation doctrine (idem, p.180).

[364] (Application No. 13378/05). See Case Comment, "Taxation: Prospective Liability of Elderly, Cohabiting Sisters to Inheritance Tax - Difference in Treatment as Compared with Married Couples or those on Civil Partnerships" [2007] E.H.R.L.R. No.2.

[365] See this Chapter, section 2.5.a.

[366] "Any system of taxation, to be workable, has to use broad categorisations to distinguish between different groups of tax payers. The implementation of any such scheme must, inevitably, create marginal situations and individual cases of apparent hardship or injustice, and it is primarily for the State to decide how best to strike the balance between raising revenue and pursuing social objectives" (paragraph 60 of the judgment).

[367] The Grand Chamber overturned that assumption, stating, "The very essence of the connection between siblings is consanguinity, whereas one of the defining characteristics of a marriage or Civil Partnership Act union is that it is forbidden to close family members (see paragraph 17 above and, generally, *B. and L. v. the United Kingdom*, cited above)", at paragraph 62 of the judgment.

[368] Paragraph 65 of the judgment.

the Fourth Section (not the Grand Chamber) conceded that marginal cases of injustice can be inevitable, the precedent could be based on a firm commitment between the couples to live together and the special circumstances of fairness as rationale for a decision in favour of the very elderly sisters, which might not be generalised for future cases.

The problem with categorisations, even in an across-the-board application, is that they may cause some hardship in specific cases. Moreover, one of the roles of the Courts is to try to remedy these special cases; the notions of equity, reasonableness and proportionality are useful instruments for this. It is worth noting that the *Burden* decision was taken by a very narrow majority of four to three in the Fourth Section, having unanimously assumed the similarity between the situations at stake, but this was overturned by a majority of fifteen to two in the Grand Chamber.

It may be concluded from the *Burden* and the *Lindsay*[369] cases, that reasonableness and proportionality did not fail. What may have failed were a formulaic and formalistic criterion of comparability and a loose test of reasonableness and proportionality. In other words, the "rhetorical use of proportionality"[370] may have prevailed besides a lack of full explanation for the margin of appreciation, which may allow "marginal" injustices.[371]

III.2.5.c) Tax discrimination on grounds of fiscal residence.

In *Darby v Sweden*[372] the issue was a lack of justification for granting the possibility of exemption from a church tax (collected together with a municipal tax) only to residents of Sweden. Dr Darby, a Finnish citizen living in Finland and working part time in Sweden, could not apply for exemption from the church tax charged on his

[369] See the previous section 2.5.a.

[370] The explicit mention of proportionality in some cases "does not necessarily accompany a genuine, in particular, of the effects of the interference on the individual" (Arai-Takahashi, 2002, p.16).

[371] See this Chapter section 2.4 on the interaction between proportionality test and the margin of appreciation doctrine.

[372] (Application No. 11581/85).

income originated in Sweden.[373] As a non-member of the Lutheran Church, he could not opt for not paying the church tax only because he was not resident in Sweden. The Court decided against this tax discrimination, scrutinizing the legitimacy of the exemption only for residents. The initial justification obtained from the *travaux préparatoires* for the Bill of 1951 was that "the case for reduction could not be argued with the same force in regard to persons who were not resident in Sweden as it could in regard to those who were, and that the procedure would be more complicated if the reduction applied to non-residents."[374] The Court disregarded this explanation, which implied that reasons of simplification of the fiscal supervision discriminated against taxpayers on grounds of fiscal residence, as barely acceptable. The Court did not go into the details of the test of proportionality, as the justification was not reasonable, yet having noted, "the Government stated at the hearing before the Court that they did not argue that the distinction in treatment had a legitimate aim."[375]

The church tax might be justified since a reduction was provided pursuant to the freedom of religion and the part of the tax collected by the Church "was supposed to cover the costs borne by the parishes of certain administrative functions such as the keeping of population records and the maintenance of churchyards and other public burial-grounds."[376] Since a fair balance seemed to exist between the freedom of religion and the imposition of a Church tax, with the option of not paying the full amount for non-members and the rest of the levy being justified by some public interests, the test of proportionality appeared to be met.

III.2.6. Justification for retrospective taxation. Tax avoidance and proportionality.

[373] The Double Taxation Convention allocated the right to tax his income to the country of employment (Sweden).

[374] Paragraph 22 of the judgment. See, also, Partsch, Karl Josef, "Discrimination" (1993), p.589.

[375] Paragraph 33 of the judgment.

[376] Paragraph 22 of the judgment.

The only express prohibition on retrospective legislation concerns criminal law under Article 7 of the Convention. The proportionality principle may be applicable to the construction of the clear proscription of retrospective heavier penalties.

The point for discussion here is how the Court has developed, as in other jurisdictions,[377] restrictions on retrospective civil - as opposed to criminal - legislation including taxation, on the basis of the proportionality principle. Another issue that will be raised in this section is what difference, if any, exists between the proportionality tests applied to tax and to other economic and social matters, which may justify retrospective legislation in the public interest.

Regarding the relationship between retrospective legislation and proportionality, the Court pointed this out as a natural consequence in relation to the protection of property (Art 1 of the First Protocol), as well as in some cases relating to the right to a fair trial (Article 6) and discrimination (Article 14). All cases analysed below illustrate how proportionality not only governs those rights but also originates from the reasonableness notion and generates other unwritten principles of law such as a principle of non-retrospective taxation.

a) Retrospective legislation, tax avoidance, tax evasion and proportionality.

The first case that raised the issue of retrospective legislation as an interference with fundamental rights was a tax case, regarding the right to property and non-discrimination.[378] The issue at stake in this case was the justification for targeting retrospectively an artificial tax avoidance scheme, into which four lawyers had entered (to obtain a trading loss in partnerships dealing in commodity futures) with the sole purpose of offsetting it against their taxable earnings as solicitors.

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[377] See on retrospective taxation, proportionality and reasonableness, in the US, Chapter II.1.4, and in the EU Chapter IV.8.

[378] *A.., B., C. and D. v the UK* (cited above). See Baker, Philip, "Retrospective Tax Legislation and the European Convention on Human Rights" [2005] B.T.R. 4, pp.2-4.

The discrimination issue was not properly raised and the Commission straightforwardly rejected it because the applicants failed to demonstrate that the distinction between situations of artificiality was not "objective and inherent in the terms of any provision charging tax which must clearly distinguish between those who are to be liable and those who are not."[379] The fact that there were other situations of artificial losses which were not covered by the Statute was not sufficient to invalidate its legitimate aim, objectiveness and reasonableness. The fact that others should also have to pay tax in similar circumstances of artificial transactions cannot exempt those affected from it. One may conclude that there is no basis for a complaint only because the law did not differentiate between other situations of artificiality, since the role of the Court is to strike down unjustified discrimination at stake in each case and not to provide other discriminations that should have been made to cover similar situations.[380] It seems also that the Commission gave more weight to the blatant situation of an artificial transaction with "no commercial validity", and regarded the differentiation as justifiable and reasonable, leaving the statutory gap, if any, to be filled by future legislation.[381]

The aspect of artificiality also strongly affected the analysis of proportionality concerning whether or not blatant retrospective legislation was justifiable under the right to property. A written Parliamentary answer about the artificial tax scheme in question was made on 25 November 1977, and then on 11 April 1978 the Government announced that the legislation to make it ineffective would be retrospective. The new law came into force on 31 July 1978, being retrospectively applicable to transactions that had occurred since 06 April 1976, almost two years earlier than the first announcement about the possibility of retrospective legislation.

[379] *A.,, B., C. and D.* case, at 210.

[380] There is a parallel with the situation where the aim is legitimate, but those discriminating against were deprived of a right or a legitimate benefit as happened in *Van Raalte* (see section 2.5.b above). In *A.B.C.D.* the applicants were discriminated against but they were not deprived of a legitimate right or benefit, since the exemption from tax, which was the consequence of artificial transactions, was not regarded as a right or a legitimate benefit.

[381] The margin of appreciation of States may be broader in tax avoidance situations and the means available would be either to introduce a general and retrospective anti-avoidance rule addressing wholly artificial arrangements or to target the most relevant schemes, in terms of anti-avoidance tax policy.

The Commission analysed whether or not the measure was proportionate to its objectives, applying the proportionality reasoning under Article 1 of the First Protocol for the first time to the wording of "to secure the payment of taxes or other contributions or penalties."[382] The legitimate objective to justify retrospective legislation was not exactly the same as the previous analysis of discrimination, since the measure had a far-reaching aim to combat artificial tax avoidance. The Commission accepted the arguments of the British government on grounds of necessity for making the measure really effective with the objective of warning "the 'tax industry' that future artificial schemes of this kind would be legislated against in the same way."[383]

This decision, in terms of predictability and length of retroactivity, appears to contrast with other jurisdictions such as in the US, and the European Court of Justice.[384] However, taking into account the artificiality of the transactions, their abusiveness and the general message that should be passed on to taxpayers not to embark on any artificial transactions, this decision could be in line with the "sham" and "substance over form" doctrines. According to these principles, the tax effects of artificial transactions with no economic substance or valid commercial reasons are absolutely disregarded from the date they are carried out. The Commission gave more weight to the extreme artificiality of the transaction in question and its lack of any commercial validity than to that of formal protection against retrospective taxation; as if the tax had been due since the scheme had occurred. On the other hand, another measure which is possibly more effective according to proportionality and equality principles for all types of artificial transactions might be a general tax avoidance rule.[385]

[382] At 204.

[383] At 205.

[384] See Chapters II.4 and IV.8.4.

[385] On tax avoidance and proportionality, see Chapter IV, sections 6, 7.1 and 8.4.

Still with the objective of counteracting artificial tax avoidance, it is also worth noting the *M.A. and Others*[386] case, particularly the underlying reasoning regarding the legitimacy of retrospective legislation and its impact on those concerned. The legislation at issue had the aim of establishing the equality of tax treatment between salaries and remuneration from stock options. The Court primarily analysed the legitimate aim of the retrospective aspect itself, rather than the objective of the substantive legislation, in relation to which the States would have a broader margin of appreciation in terms of tax policy. This was clear when the Court stated that the higher tax rates were not confiscatory since they were the normal rates, albeit high, of the Finnish tax system. Thus, the real issue was the alleged retrospective application of the new law and the Court made a dividing line in this case between acceptable retrospective taxation and possibly unacceptable taxation. The requirement of artificiality again must be present for retrospective taxation, since the Court distinguished the cases of those who brought forward the date of exercise of the options for tax reasons and those who did not. The Tax Bill proposed in Parliament would catch only those who had changed the date of exercise of the option between the initial legislative proposal and the date on which it came into force. Thus, those who would have not changed the date of exercise, maybe because their original stock option programme already provided for a date of exercise between the Bill proposal and the date of its enforcement (the "pure cases" as referred to by the Court), would fall outside the scope of the new law and would have the more favourable tax rates on their gains. Whereas the artificiality in *A.B.C.D. v U.K.* was part of the transaction as a whole, here in *M.A. and Others* only the amendment to a genuine transaction was regarded as artificial as being solely tax motivated. The following quotation summarises the main issue of this case:

> "In this respect the Court considers that the applicants did not have an expectation protected by Article 1 of Protocol No. 1 that the tax rate would, at the time when they would have been able to draw benefits from the stock option programme according to the original terms of the programme, i.e. between 1 December 1998 and 31 January 2000,

[386] (Application No. 27793/95). See Baker, Philip, (2005), supra note 320, pp.5-8.

> be the same as it was in 1994 when the applicants subscribed the bonds. The Court does not exclude that the situation might have to be assessed differently, had the law applied (which it did not) even to cases in which the exercise of the stock options was possible before 1 January 1995 according to the relevant terms and conditions of the stock option programmes in question. In such a situation, in which the applicants did not find themselves, taxation at a considerably higher tax rate than that in force on the date of the exercise of the stock options could arguably be regarded as an unreasonable interference with expectations protected by Article 1 of Protocol No. 1.
>
> The retroactive application of the law in the applicants' case would not appear to have such drastic consequences as in respect of the so-called 'pure cases'. Whether it is compatible with Article 1 of Protocol No. 1 depends, first, on the reasons for the retroactivity and, secondly, on the impact of the retroactive law on the position of the applicants." [387]

In the above two cases taxpayers were not protected against retrospective taxation because they made artificial arrangements to avoid higher taxation. Thus, combating tax avoidance is a legitimate objective in the general interest to justify retrospective legislation where artificial schemes with this sole purpose are present. Furthermore, retrospective legislation may be proportionate and lawful according to the particular circumstances of each case.

Combating tax evasion was also recognised as a legitimate aim in the general interest to justify interference with the right to property, although retrospective taxation was not at stake.[388]

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[387] *M.A. and Others* (Applications No. 44814/98, 45401/99, 45732/99, 47463/99, 47724/99), at paragraph 1 of the judgment.

[388] See *Hentrich v France* case (Application No. 13616/88), on section 2.7.b, regarding fiscal penalties.

It is also interesting to contrast this aim of combating tax avoidance with tax evasion, since the latter seems to be more compelling to justify measures that may be more drastic. Retrospective legislation as a matter of principle is not necessary to counteract evasion, as there is no need of a new law but just the application of the previous law in force when the evasion occurred. Thus, any penalties provided by the law and submitted to the principle of proportionality would be enforced. In this sense, it is possible to differentiate avoidance from evasion by their legal consequences. Whereas evasion may trigger penalties, avoidance may do not so, according to the principle of proportionality. Moreover, the retrospective imposition of heavier fiscal penalties within the context of criminal law is expressly prohibited pursuant to Article 7 of the Convention.

b) Contrast between tax and non-tax retrospective legislation and proportionality.

One of the most egregious cases of non-tax retrospective legislation is *Pressos Compania Naviera S.A. v. Belgium.*[389] In this case, Belgian legislation extinguished, with retrospective effect going back 30 years and without compensation, higher claims based on tort, under which the right to compensation came into existence as soon as the damage occurred. The Court balanced the public interests at stake (huge financial burden, re-establishing legal certainty and application of limited liability as more in line with other jurisdictions) and the foreseeable right to compensation. This right was regarded as a legitimate expectation according to previous Belgian legislation and case law and was analysed under the right to property and the right to a fair trial. The Court then again reiterated its settled case law regarding all three rules of Article 1 of Protocol 1, particularly, "there must be a reasonable relationship of proportionality between the means employed and the aim sought to be realised by any measure depriving a person of his possessions."[390] Thus, under the test of proportionality the Court held:

[389] (Application No. 17849/91), in which the court by a majority of eight to one held that the retrospective Belgian legislation violated Article 1 of the First Protocol.

[390] Paragraph 38 of the judgment.

> "The financial considerations cited by the Government and their concern to bring Belgian law into line with the law of neighbouring countries could warrant prospective legislation in this area to derogate from the general law of tort.
> Such considerations could not justify legislating with retrospective effect with the aim and consequence of depriving the applicants of their claims for compensation.
> Such a fundamental interference with the applicants' rights is inconsistent with preserving a fair balance between the interests at stake."[391]

The claim under tort law was regarded as an asset (in line with previous case law), from which the Court concluded that the plaintiffs had a "legitimate expectation".[392] As the Court clearly granted more protection under Article 1 of the First Protocol, by safeguarding rights which arose prior to the enactment of retrospective legislation, it did not apply Article 6 (right to a fair trial), under which only pending cases would be protected.

Financial considerations per se, like in other jurisdictions[393], may not be regarded as a legitimate public interest to justify retroactive legislation. Even considerations of equitable treatment, ethical concerns, the need to legislate on a fundamental choice of society; fairness, and the proper organisation of the health service, such as liability for damages, may not justify retrospective legislation that substantially reduces the compensation of pending cases. All these justifications were rejected in the *Draon v France*[394] case, in which the Court closely scrutinised a retrospective law according to the proportionality principle. The margin of appreciation may be very broad, but

[391] Paragraph 43 of the judgment.

[392] Paragraphs 31 and 32 of the judgment.

[393] See Chapter IV.3 on proportionality and the overriding requirements in the general interest, which do not encompass lack of revenue, particularly the *ICI v Colmer* case; and IV.8.5 on proportionality and retrospective restrictions of limitation periods to recover taxes overly paid.

[394] (Application No. 1513/03), Grand Chamber, paragraph 85, for justification and application of proportionality. In this case the Court also held that it was unnecessary to consider the right to a fair trial as the right to property was sufficient to cover and remedy the damage in question.

the appropriateness of the chosen measures is closely or loosely scrutinised depending on the facts and circumstances of the case as well as the gravity and economic consequences to those whose rights or expectations are affected.

However, the Court seems to be more lenient regarding tax matters, if the *Draon* and *Pressos Compania Naviera* cases are contrasted with the *Building Societies*[395] case, where a tax measure aimed at overturning a precedent was retrospectively applied to pending cases. The facts of this case are complex and quite unusual, which may be a good opportunity to test the reasoning and consistency of proportionality in its interaction with other legal principles and rules. The applicants alleged that a retrospective tax statute violated the right to property, the right to a fair trial and the non-discrimination Articles. The Act of the British Parliament in question tried to validate retrospectively previous tax regulations, which had been regarded as null and void by the House of Lords, the highest court of the United Kingdom.[396] The main issue was the tax assessment of the Building Societies during a transitional period. These societies, such as Woolwich and the later applicants before the ECHR, stated that the Regulations had established a fiscal year longer than one year for the transitional period and the result was double taxation for a short period. The judgment of the House of Lords was in favour of Woolwich, but on the *ultra vires* basis of illegality of the regulations, without ascertaining whether double taxation had occurred. However, the ECHR in *Building Societies* dismissed the claim of other applicants based on the following reasons: there was no double taxation, therefore no wrongful expropriation;[397] the retrospective Act intended to reassert the original intention of the Parliament.[398] Regarding discrimination, the alleged comparable situation of a taxpayer that had vested rights to restitution as a result of various legal

[395] *The National & Provincial Building Society, The Leeds Permanent Building Society and The Yorkshire Building Society v. the United Kingdom* (Applications No. 21319/93, 21449/93 and 21675/93), holding unanimously that there was no violation of the right to property, and by a majority of eight to one, that there was no violation of that same right taken in conjunction with the non-discrimination principle (Article 14).

[396] *Regina v. ex parte. Woolwich Equitable Building Society*, [1990] 1 W.L.R. 1400. See also Dawn Oliver, "Retrospective Validation of Regulations: Who's With the Building Societies?" [1992] B.T.R. 301.

[397] See paragraphs 55-61 of the judgment.

[398] Idem, paragraphs 68-70 and 81-82.

proceedings (the *Woolwich* case that had been successful before the House of Lords) was not relevantly similar to the other Building Societies, since these latter applicants had not borne legal costs and risks of litigation.[399] The fact that the decision of the highest domestic Court had not ascertained whether or not there had been double taxation could not jeopardize the right of other applicants to challenge this issue. However, the Court reinterpreted the House of Lords' decision on the issue of double taxation.[400] Perhaps the most compelling argument was the retrospective nature of the statute itself and the original intent of Parliament that blocked this dispute in domestic courts[401] and eventually prevailed in the ECHR.

The Court stated that in *Building Societies* there was a technical deficiency in the statute and that retrospective legislation was predictable, to distinguish it from *Pressos Compania Naviera*.[402] It has been suggested that distinguishing *Pressos Compania Naviera* from *Building Societies* "requires the conclusion that in the former the expectation was 'legitimate' whereas in the latter it was not."[403] Actually, the former fell within the notion of a claim as an asset, which was protected since the retrospective legislation had no justification, while the latter fell within 'the assumption of vested rights to restitution.'[404] This was not upheld because retrospective legislation was justified on grounds of necessity and proportionality to

[399] Idem, paragraphs 87 and 89.

[400] A better position might be to leave the scope of the previous decision for the highest domestic court itself, or if it were possible to refer that issue to the domestic court.

[401] The applicants discontinued their action before the domestic courts due to the minimum chances of being successful, having no protection against retrospective law and the sovereignty of the Parliament.

[402] As the Court stated in the *Building Societies* case, paragraph 109,
"…. these two applicant societies must reasonably be considered to have anticipated at the close of the Woolwich 1 litigation that the Treasury would seek Parliament's approval to cure the technical defects in the 1986 Regulations and would not be content on public-interest grounds to allow a substantial amount of already collected revenue to be lost on account of a technicality.
…….It is also to be noted that the Leeds and the National & Provincial instituted their restitution proceedings after the authorities had formally decided to seek Parliament's approval for the retrospective validation of the 1986 Regulations and in the days immediately before the official announcement of that decision (see paragraphs 30–33 above). In these circumstances, those proceedings must be considered to have been an attempt to benefit from the vulnerability of the authorities' situation following the outcome of the Woolwich 1 litigation and to pre-empt the enactment of remedial legislation."

[403] Jacobs and White (2002), supra, p.357.

[404] Paragraph 70 of the judgment.

amend technical deficiencies in previous regulations. This also avoided a huge loss of revenue. Thus, what really distinguished both cases from each other was the degree of scrutiny, apparently more lenient with respect to taxation, at least when technical changes are involved.

The Court also differentiated *Building Societies*[405] from *Stran*[406] by stating that in the latter there was a settled right to compensation that was later impaired by a retrospective law. In *Stran* retrospective legislation was passed by the Parliament to address a pending judgment to favour the position of the Greek Government. Although the law was held constitutional by the national court on grounds of authentic interpretation, which had declarative and retroactive effects, the Court held that the right to a fair trial was impaired by the existence of the previous proceedings, specifically the arbitration decision that had already resolved the issue. On the other hand, the interference with the right to property via a retrospective law undermining the compensation settled by arbitration was considered unjustifiable on proportionality grounds. This was different from *Building Societies* as the claim in this latter case was still under way.

Although in *Building Societies* the issue was the legitimacy of a retrospective measure to correct deficiencies of previous regulations, arguably of a substantive nature, the Court regarded it as a procedural tax measure and gave more weight to the margin of appreciation than to the test of proportionality.

Finally, in *Building Societies* the issue of impairment to the right to a fair trial was also raised on grounds of proportionality, but unsuccessfully for the same reasons as the right to property.[407] This seems to point out that on the one hand the proportionality test searches for fairness and consistency, where the set of circumstances are the same. On the other hand, proportionality reasoning should not

[405] See *Building Societies*, paragraphs 67, regarding the right to property, and paragraph 112, regarding the right to a fair trial.

[406] (Application No. 13427/87); see also above section 2.3.a.

[407] See paragraphs 105 et *seq* of the judgment.

fail to take into account different aspects of the same set of circumstances where different rights are considered as a basis for a specific complaint.

c) Some conclusions on retrospective legislation and proportionality.

All the cases on retrospective legislation were decided on grounds of proportionality and under Article 1 of the First Protocol (right to property). In some cases, Article 14 (non-discrimination) was also considered, but again proportionality lay at the core protection of those rights in taxation matters as well. There is no scrutiny of the legality of retrospective measures other than according to the proportionality test. The general view of the Court is that any retrospective legislation must be legitimate in pursuing a public interest and also proportionate to that aim. Otherwise, it will breach the right to property or other fundamental right enshrined in the Convention.

On the other hand, concerning taxation, the States have a wide margin of appreciation that in some cases can apparently undermine the notions of proportionality and reasonableness as part of the rule of law.[408] This is illustrated by the contrast between the *Building Societies* case decided against the taxpayer and non-tax cases such as the *Draon, Stran* and *Pressos Compania Naviera* cases decided in favour of the applicants.

Regarding tax avoidance, it follows from *ABC and D* and *M.A. and Others*, also discussed in this section, that the Court was consistent and reached in my opinion a fairer balance between legal certainty and the right to property, on the one hand, and equity on the other, by applying the concept of artificiality in the sense of a lack of business purpose other than tax avoidance.

Another conclusion that may be drawn from the above case law of the Court, besides the construction of proportionality as an overarching principle, is that any tax imposition, collection, and enforcement may affect the right to property, being unlawful where disproportionately retrospective. Nevertheless, unlike some national jurisdictions previously examined, the European Court on Human Rights, at least with regard to retrospective taxation, has not yet developed a more consistent method

[408] Section 2.4.

of reasoning. The explanation for this may be the role of the Court as an international jurisdiction that tries to reach a minimum common level of protection taking into account other governing principles such as the margin of appreciation doctrine.

Although the Court leaves room for development via evolving[409] interpretation and proportionality in order to balance all the interests and common legal principles, its case law contrasts with other jurisdictions such as the European Court of Justice, which is analysed in the following Chapter.

As in other fields of law, proportionality in tandem with reasonableness governs tax law as an overarching general principle of law. In the next section, other tax issues will be analysed to illustrate how far proportionality may go not only in clarifying every fundamental right, such as the freedom of movement, but also in eliciting other legal principles from the existing ones and give them greater clarity.

III.2.7. The principle of lawfulness, fiscal penalties, excessive taxation, VAT rules, proportionality and the rights to property, to a court and to the freedom of movement.

In a number of cases illustrated below the Commission and the Court inferred further common and minimum guarantees for taxpayers based on the proportionality principle as applied to the right to property. In its role of balancing and reconciling principles and rules with each other, as well as ascertaining the public interest, proportionality has given origin to other specific principles such as those of lawfulness, legal certainty, predictability, clarity and protection against excessive taxation and fiscal penalties. These are elaborated below.

III.2.7. a) Lawfulness (clarity and predictability) in taxation and proportionality.

[409] On its characteristic of dynamic interpretation adapted to new socio and legal circumstances, see section 2.1 above.

First, in order to ascertain whether a fair balance is struck by an interference with the right to property in the light of proportionality, it is necessary to observe the principle of lawfulness, which in turn requires that the domestic law at stake be "sufficiently accessible, precise and foreseeable."[410] The degree of predictability is open ended according to the circumstances of each case and may be complied with even when those affected have to take appropriate legal advice to assess the consequences of their actions or transactions.[411] As a result, in a complex legal world, particularly in tax matters, the obligation may be required from taxpayers to seek legal advice to exercise the right to legal certainty and predictability. This is illustrated in *CBC-Union SRO v Czech Republic*,[412] in which the taxpayer questioned the clarity and predictability of the law regarding both transfer tax and gift taxes applicable to the same transaction (by auction). The taxpayer had relied on a written commentary by the Ministry of Finance stating that the transfer tax was due on a transaction in which the acquirer paid a lower market value for the property, but the tax base was provided by special regulations, and not by the parties. Other fiscal authorities and some courts had a different understanding with regards to both sets of rules - the transfer and gift taxes - according to which the former was due on a lower price paid and the latter on the difference between this price and the one fixed by special regulations. Although apparently confusing and complicated,[413] what seemed to be quite clear was the obligation to pay either the transfer tax or the gift tax on the difference between the price paid and the price under special regulations. No room was left for simultaneously paying both taxes over the same amount, or to pay nothing whatever over the difference between those prices.

[410] *Beyeler v Italy* (Application 33202/96), Grand Chamber, at paragraph 109, citing *Hentrich v. France* (Application No. 13616/88) and *Lithgow and Others* (Applications No. 9006/80, 9262/81, 9263/81, 9265/81, 9266/81, 9313/81, 9405/81). See also criminal cases taking into account not only statute but also case law - *S.W. and C.R. v. the United Kingdom* (Applications No. 47/1994/494/576 and 48/1994/495/577), and *Cantoni v. France* (Application No. 17862/91).

[411] *Cantoni v. France*, paragraph 35.

[412] (Application No. 68741/01).

[413] The law was amended for the following year leaving no space for doubt, making it clear that only the transfer tax was due based on the price provided by the special regulations.

From the above *CBC-Union SRO* case one may conclude that according to the rule of law and the principle of proportionality, which weighs up other principles such as legality, ability to pay, economic substance and legal form, tax simplification and fiscal supervision, the difference of price to be taxed by the gift tax and not by the transfer tax must not be fictional, divorced from commercial reality, and must be rebuttable.

In *Spacek v Czech Republic*[414] the Court also based its decision on grounds of proportionality and the requirement of predictability in taxation under the right to property. Some specific administrative accounting rules relevant to corporate taxation edited by the Ministry of Finance had not been published in the Official Gazette, but only in the Financial Bulletin of that Ministry. In principle, this was contrary to the legality principle, legal certainty and predictability on which the Commission gave a preliminary decision.[415] First, the Court reiterated that the term "law" is understood in its substantive and not in its formal meaning, but how to make it publicly known was primarily a matter for the Contracting States, subject to a review by the Court "determining whether the methods applied by the Contracting State are in conformity with the Convention."[416] The Court reaffirmed the importance of the margin of appreciation of States, but nonetheless submitted it to judicial review of the Court by scrutinizing the legitimate aim of the questioned measures and their proportionality. However, in the special circumstances, given the availability of access to those rules and their legal basis, which did not require its official publication, the Court relaxed those requirements of legal certainty and predictability. The Court took into account that both the applicant and its acquired company were aware of the accounting regulations, since they applied them in the previous year. Finally, as an overall assessment not only of all relevant facts but also legal rules and principles as required by proportionality reasoning, the Court stated, "the applicant company as a legal entity, contrary to an individual taxpayer, could

[414] (Application No. 26449/95), Third Section.

[415] Decision of 14 October 1996 on the same application (No. 26449/95).

[416] Paragraph 57 of the judgment. *Huvig v France* (Application No. 11105/84) concerned telephone tapping relating to tax evasion, in which the Court held that it was contrary to Article 8 of the Convention given the absence of clear statutory provision.

and should have consulted the competent specialists, the publication of the Regulations in the Financial Bulletin was sufficient."[417] The Court then held that there was no violation of the above principles and the right to property.

The issue of fiscal penalties was not raised separately in *Spacek v Czech Republic*, but could have been taken into consideration on proportionality grounds in line with the incipient case law of the Court on this subject as analysed in the next section.

In *Volokhy v Ukraine*,[418] the Court again applied proportionality in requiring clarity and precision according to the principle of lawfulness for an interference with the right to privacy. The issue in this case was the interception of correspondence, which was provided by statutory law and authorized by judicial decision, to avoid tax evasion. The legal framework provided legal clarity even on proportionality grounds, but failed in practice:

> "The Court notes in this connection that the requirements of proportionality of the interference, and of its exceptional and temporary nature were stipulated in Article 31 of the Constitution and Article 9 of the Law of Ukraine "on Search and Seizure Activities" of 18 February 1992 (see paragraphs 25 and 27 above). However, neither Article 187 of the Code of Criminal Procedure in its wording at the time of the events, nor any other provision of Ukrainian law contained a mechanism which would ensure that the above principles were respected in practice. The provision in question (see paragraph 26 above) contains no indication as to the persons concerned by such measures, the circumstances in which they may be ordered, the time-limits to be fixed and respected. It cannot therefore be considered to be sufficiently clear and detailed to afford appropriate protection against undue interference by the authorities with the applicants' right to respect for their private life and correspondence."[419]

[417] Paragraph 59 of the judgment.

[418] (Application No. 23543/02).

[419] Paragraph 51 of the judgment.

The requirement of proportionality *in practice* is another essential characteristic of the legal overarching principle of proportionality, which the Court has pointed out in other cases as well.[420] If the principle serves the purpose of giving life and meaning to fundamental rights, balancing and reconciling the apparently conflicting interests, in search of effectiveness and fairness, the principle itself must therefore in turn be effective and perform its objectives in practice.

III.2.7.b) Fiscal penalties and forfeiture under the right to property and their interaction with other fundamental rights (such as the freedom of movement) and proportionality.

This subject will illustrate further, how proportionality reasoning is pervasive within the Convention in tax matters. As discussed in the section on retrospective taxation, both the right to property and to a court may be breached depending on the degree of intrusiveness of tax measures. Here again the right to a court under Article 6 and the right to property will be discussed having regard to the limits of taxation, with particular focus on fiscal sanctions.

In *Gasus*,[421] the Court considered as legitimate according to proportionality and the right to property the enforcement of tax measures against the property of third parties, if the assets are in the possession of the tax debtor as a lessee. In this case, the Court held that procedural tax measures such as those for collection and enforcement would fall within Article 1 of the First Protocol, third sentence. As a result, they were expressly covered by the requirements of necessity and proportionality, but in a more lenient way. *Gasus*, a company based in Germany, which had retained its property title over equipment sold to a Dutch tax debtor, had its property seized by the Dutch tax authorities to enforce tax collection. The Court, adopting a broad view of the margin of appreciation and mentioning similar legislation in other countries, held by a majority of six to three on grounds of

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[420] See also on the requirement of proportionality in practice, in the *Riener v Bulgaria* case, strongly assessed on proportionality grounds, section 2.7.b below, and under Art 13 (effective remedy) *Krasuski*, among others in section 2.3.c.2 above.

[421] *Gasus Dosier- und Fördertechnik GmbH v. the Netherlands* (Application No. 15375/89). See also the discussion on this case regarding the distinction between procedural and substantive tax rules in section 2.3.b above.

proportionality that there was no violation of the right to property of the German owner.[422] The majority argued that the vendor should be aware of Dutch legislation, evaluate the financial situation of the debtor and adopt alternative measures such as a requirement of full payment in advance or an insurance to prevent the risk of the seizure of his property. The minority view argued that the proportionality test was the dividing line between what tax authorities can do to enforce tax collection and in this case the seizure of property of a third party (the vendor), which was not indispensable to prevent fraud or abuse, there having been no evidence of bad faith of the parties.[423] Furthermore, the amount of tax collected by seizure of third parties' property was negligible compared with the total amount of tax collected.[424] From this, the margin of discretion seems to be wide and proportionality narrow.

In contrast, the Court appeared to be stricter regarding the right to a court and restrictive measures that affect taxpayers. This occurred in *Janosevic v Sweden*[425] where the Court accepted that tax enforcement measures taken before a final decision over whether a tax and its surcharges are really due may infringe the right to a court. Having taken into account the justification for those early enforcement measures, the Court made the following statement, pointing out the necessary fair balance that there must be between the interests at play:

> "… the States are required to confine such enforcement within reasonable limits that strike a fair balance between the interests involved. This is especially important in cases like the present one in which enforcement measures were taken on the basis of decisions by

[422] The Court stated at paragraph 60 of the judgment: "In passing such laws the legislature must be allowed a wide margin of appreciation, especially with regard to the question whether - and if so, to what extent - the tax authorities should be put in a better position to enforce tax debts than ordinary creditors are in to enforce commercial debts. The Court will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation."

[423] Regarding the good faith of the parties involved, see *Lemoine v France*, discussed below within the context of VAT, in section 2.7.d where the ECHR took a different approach, as well as the ECJ (Chapter IV, section 7.3).

[424] Gasus might have been successful before the ECJ regarding the proportionality issue, taking into account the fundamental free movement of goods, as the Dutch legislation could be regarded as a restrictive and disproportionate measure that hindered intra-Community trade.

[425] (Application No. 34619/97).

> an administrative authority, that is, before there had been a court determination of the liability to pay the surcharges in question."[426]

Also in *Vastberga Taxi Aktiebolag and Vulic v Sweden*[427] the Court applied the proportionality principle to tax surcharges under the right of access to a court, the reasonable length of the proceedings and the right to the presumption of innocence. This case dealt with the enforcement of fiscal penalties earlier than a judicial determination because of incorrect information given to the tax authorities with respect to tax assessments. Domestic law provided for the application of the proportionality principle to such penalties on grounds of their reasonableness, but the applicants failed to demonstrate the circumstances in which the penalties could be reduced or cancelled. They also alleged the excessive length of the proceedings, the impairment of the right of access to a court and the right to presumption of innocence. Particularly regarding the right to presumption of innocence enshrined in Article 6 (2) of the Convention, the Court accepted presumptions of law and of fact provided by domestic legislation but submitted them expressly to the test of proportionality:

> "Thus, in employing presumptions in criminal law, the Contracting States are required to strike a balance between the importance of what is at stake and the rights of the defence; in other words, the means employed have to be reasonably proportionate to the legitimate aim sought to be achieved."[428]

Like the presumption of innocence, presumptive taxation based on a minimum wage may be subjected to the test of proportionality. In the *Fratrak* and *Balak* cases[429] a presumptive and irrebuttable minimum tax base was justified. In *Vastberga*, only rebuttable presumptions were acceptable. The different approach between tax base

[426] Paragraph 106 of the judgment.

[427] (Application No. 36985/97).

[428] Paragraph 116 of the judgment.

[429] See the following section.

and the imposition of penalties may be justified by public policy reasons and generally accepted canons according to which fair taxation is neither a sanction nor in principle a restriction on fundamental rights. The same can be said of retrospective taxation, in which proportionality coupled with reasonableness plays an essential role in justifying retrospective tax measures.[430]

In the *Vastberga* and *Janosevic* cases the right to property was not raised, as the issue was primarily the early enforcement of penalties under the right to a fair trial and not itself the excessiveness of penalties.[431] In contrast, in *Lemoine v France*[432] the Commission faced a different issue of excessiveness of a tax guarantee under the right to property, its early enforcement under Article 6 not having been at stake. On grounds of proportionality in *Lemoine*, the Commission held it to be disproportionate to secure tax debts of a lower amount against a higher value property. This measure went blatantly beyond what was necessary to secure the payment of the debt tax, In *Hentrich*, the power given to the fiscal authorities to buy property at its under-value declared by the owner to evade higher taxes on its transfer of ownership was considered as an expropriation "de facto." As such, the Court closely scrutinised it under the test of proportionality, stating that other less restrictive measures were available to tackle tax evasion in situations of selling property below the market price.[433] Four dissenting opinions considered that there was no violation of the right to property, applying also the proportionality test, but giving more weight to the margin of appreciation of the State.

[430] See the previous section 2.6.

[431] The fines were not challenged on their excessiveness probably because of their objective amount as they were equivalent to 20% or 40% of the unpaid tax.

[432] (Application No. 26242/95).

[433] ".... for instance, take legal proceedings to recover unpaid tax and, if necessary, impose tax fines. Systematic use of these procedures, combined with the threat of criminal proceedings, should be an adequate weapon" (paragraph 47 of the judgment). The Court went further stating that "the question of proportionality must also be looked at from the point of view of the risk run by any purchaser that he will be subject to pre-emption and therefore penalised by the loss of his property solely in the interests of deterring possible underestimations of price … Merely reimbursing the price paid - increased by 10% - and the costs and fair expenses of the contract cannot suffice to compensate for the loss of a property acquired without any fraudulent intent" (paragraph 48 of the judgment).

Where the Commission deals with clearly more serious offences, such as smuggling, it tends to apply a weak form of proportionality giving more weight to the margin of appreciation of States. In *X v Austria*[434] the Commission held proportionate the severe custom and duties penalties and the confiscation of smuggled goods. By contrast, the European Court of Justice in the *Louloudakis*[435] case went further in squashing harsh fiscal penalties. The main issue in *X* was the mandatory forfeiture of the goods, according to which there was no room for judicial discretion, and the cumulative penalties over the unpaid custom duties. The aim of the legislation, which was considered legitimate by the Commission, was the prevention of crime. The Commission also applied the principle of proportionality, taking into account the existing conditions and rules within other States at that time and the fact that Austrian legislation took into consideration the financial condition of those concerned regarding the fiscal penalties. This demonstrates that even where proportionality is apparently applied in its weak form there may be some special circumstances to justify or to minimise its lenient application; otherwise, the lack of justification could seriously undermine the rule of law and the role of judicial review regarding the effectiveness of fundamental rights.

Fiscal sanctions may also interfere with rights other than the right to property and to a fair trial. In *Riener v Bulgaria*,[436] the Court held that a fiscal sanction that restricts the right to freedom of movement might not be compatible with this fundamental right according to the proportionality principle. In this case, a travel ban and a confiscation of passport were imposed as temporary sanctions until tax debts were paid. Under Article 2(3) of the Fourth Protocol, restrictions on the exercise of the right to movement may be lawful if they are "in accordance with law and are necessary in a democratic society in the interests of national security or public safety, for the maintenance of *ordre public* (public policy), for the prevention of crime, for

[434] (Application No. 7287/75). The Commission gave weight to the *Handyside* reasoning regarding proportionality and the right of States to prohibit the circulation of goods (educational books) on moral grounds.

[435] Case C-262/99 [2001] ECR I-5547. See in Chapter IV.2.1 the *Louloudakis* case, which is similar to *Lindsay v C & Comrs* [2002] STC 588 ruling regarding the forfeiture of the smuggler's vehicle on grounds of the proportionality principle.

[436] (Application No. 46343/99).

the protection of health or morals, or for the protection of the rights and freedoms of others." The Court first held that the travel ban had the legitimate aim to secure payment of taxes, "maintaining of *ordre public*" and protection of the rights of others as it is the law in several States of the Council of Europe.[437] The Court then fully assessed the proportionality of this restriction taking into account the relevant facts of the case, such as that Mrs Riener's family was living abroad.[438] The legal background was also scrutinised including the automatic length for which the travel ban was imposed with no provision for further reassessments, citing among other authorities the UN Human Rights Committee decision in the case of *Miguel González del Río v. Peru*.[439] The Court made clear the necessary relationship between the legitimate ends and means, as well as less restrictive alternative measures, as follows:

> "It follows from the principle of proportionality that a restriction on the right to leave one's country on grounds of unpaid debt can only be justified as long as it serves its aim – recovering the debt (see *Napijalo v. Croatia*, no. 66485/01, 13 November 2003, §§ 78-82).
>
> That means that such a restriction cannot amount to a *de facto* punishment for inability to pay.
>
> In the Court's view, the authorities are not entitled to maintain over lengthy periods restrictions on the individual's freedom of movement without periodic reassessment of their justification in the light of factors such as whether or not the fiscal authorities had made reasonable efforts to collect the debt through other means and the likelihood that the debtor's leaving the country might undermine the chances to collect the money."[440]

[437] Paragraphs 114-17 of the judgment.

[438] Paragraph 126 of the judgment.

[439] Paragraph 121 of the judgment.

[440] Paragraphs 122-4 of the judgment.

This case is significant for its full assessment on proportionality grounds and its relationship with the margin of appreciation doctrine. The manifest public interest in recovering unpaid taxes coupled with the margin of appreciation of States "to frame and organise their fiscal policies and make arrangements to ensure that taxes are paid"[441] did not hinder the analysis of less restrictive available measures. Contrasting this case with those dealing with the right to property it may be suggested that the latter is more vulnerable to secure the payment of taxes than other fundamental rights, such as the rights to a fair trial and the freedom of movement.

Finally, the Court reiterated one of the main characteristics of the proportionality principle, according to which it must operate in practice and in law:

> "The Court considers that the 'automatic' nature of the travel ban ran contrary to the authorities' duty under Article 2 of Protocol No. 4 to take appropriate care that any interference with the right to leave one's country should be justified and proportionate throughout its duration, in the individual circumstances of the case. It notes in this context that in the domestic law of a number of member states prohibitions against leaving the country for unpaid taxes can only be imposed if there are concrete reasons to believe that the person concerned would evade payment if allowed to travel abroad. Also, in a number of countries there are limitations on the duration of the restrictions (see paragraphs 73, 77-80 above). Regardless of the approach chosen, the principle of proportionality must apply, in law and in practice."[442]

In other words, one may conclude that proportionality is applied to the analysis of all relevant facts and within the context of all applicable rules and principles in search of fairness in each case.

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[441] Paragraph 119 of the judgment.

[442] Paragraph 128 of the judgment. See also on the requirement for proportionality in practice, *Volokhy* (Application No. 23543/02) regarding the right to privacy in section 2.7.a above, and *Krasuski* (Application No. 61444/00) regarding effective remedies under Art 13, in section 2.3.c.2 below.

In contrast with fiscal sanctions, the Commission and the Court seem to be more cautious regarding excessive taxation, but have stated some noteworthy guidelines based on the proportionality principle coupled with reasonableness, as discussed in the following section.

III.2.7.c) Excessive taxation, ability to pay ('financial position') and proportionality.

In *Wasa Ömsesidigt, Försäkringsbolaget Valands Pensionsstiftelse, a group of approximately 15,000 individuals v Sweden*[443] the Commission held that a one-off tax to cover national debt and fund public pensions, to be collected from a specific category of taxpayers, was neither discriminatory nor against the right to property. First, the Commission reiterated[444] the following statement:

> "Under this supervision the Commission finds that, though it is certain that no general prohibition of taxes payable exclusively out of the tax-payer's capital can be derived from Article 1 (P1-1), a financial liability arising out of the raising of taxes or contributions may adversely affect the guarantee secured under this provision if it places an excessive burden on the person or entity concerned or fundamentally interferes with his or its financial position."[445]

Thus, excessive taxation may violate the right to property, although the margin of appreciation of the States is broad, taking into account financial, social and economic conditions of each jurisdiction. The Commission then scrutinised the legitimate social objective of continuing with low inflation "combined with the necessity of a further limitation of the national budget deficit."[446] Under the test of proportionality and analysing whether or not disproportionate taxation occurred, the Commission concluded that the one-off tax of 7% on the capital over a threshold of assets exceeding 10 million Swedish crowns from life insurance companies was justified,

[443] (Application No. 13013/87).

[444] *Svenska Managementgruup AB v Sweden* (Application No. 11036/84).

[445] Under heading "The Law", 1, paragraph 19, of the decision.

[446] Ibidem, at paragraph 21.

taking into account the favourable tax regime to which they were subject and which was still in force.

In two interesting cases[447] the Fourth Section of the Court held unanimously that the minimum wage might be taxed based on an apparently weak test of proportionality. Seemingly worse, the Court stated that a self-employed person may be taxed on the minimum wage even if he or she earned less than the smallest amount as occurred in *Fratrik*, with no substantive consideration for the ability to pay and equality principles. Particularly, no regard was given to less restrictive measures as the Court did in other cases or to the fact that the legitimate policy of extending the pension system could be reached without interfering with the financial situation of the taxpayer. Furthermore, even if the self-employed person did not work every month, as occurred in *Balaz*, he or she had nonetheless to pay the social contribution on the minimum amount, as the tax base was an average of what he or she had earned in the previous year (which would have indirectly taken into account the working period). However, there was still no consideration of the real earnings, particularly when the self-employed person earned less than the minimum wage. The concern of domestic legislation seemed to be fiscal evasion, simplification and efficiency (*e.g.* not to spend time supervising very small businesses) or in terms of policy to secure a pension for all, and not to favour financially unviable economic activities as a reasonable limit to entrepreneurship. Although in both cases the Court reiterated the statement of the Commission[448] that an "excessive burden" on taxpayers (individuals and legal entities) or a fundamental interference with their "financial position" may violate the right to property, the Court apparently again gave more weight to the margin of appreciation doctrine, by loosely scrutinising the domestic measures via the proportionality test.[449]

[447] *Balaz v Slovakia* (Application No. 60243/00) Fourth Section, decision on admissibility; and *Fratrik v Slovakia* (Application No. 51224/99) decision on admissibility.

[448] See *Wasa* and *Svenska*.

[449] See *Balaz*, paragraph 9 and also *Fratrik*, paragraph 16.

Both the decisions of the Court in *Balaz* and *Fratrik* contrast with the German Constitutional Court[450] on proportionality and on the balance between the legitimate aim of the legislation and its means. Whereas the German Court decided that the minimum wage must be exempted from taxation, according to the aim of providing a minimum mean of subsistence and avoiding disproportionate taxation, the ECHR merely pointed out that the minimum tax base of the social contribution was not lower than the minimum wage, which could be taxed regardless of the actual income of the self-employed. Furthermore, the Court agreed with the Government argument, stating that the self-employed person could avoid this by ceasing work and receiving unemployment benefits.

Social and economic objectives differ, and the margin of discretion of States seems to be broad. Although it is unfair to charge the self-employed who earn equal to or less than the minimum wage proportionally more, there might be more economic efficiency to favouring only the economically viable citizens and discouraging risky entrepreneurship. Again, social and economic objectives within the broad margin of appreciation took precedence over "marginal" situations of "unfairness" in the light of the minimum common standards of protection.

III.2.7.d) VAT and the rights to deduction and refund in the light of proportionality and reasonableness

The Court analysed the right to a VAT refund and deduction in two cases under the protection of the right of property, which was balanced with the public interest of avoiding abuse of the VAT system.

In *Intersplav*[451] the Court considered unjustifiable and disproportionate the systematic delays in obtaining a VAT refund, even after domestic court decisions

[450] Decision BVerfG 87, 153 of 25 September 1992 on the tax-free subsistence minimum, Dr. Gotthard Wöhrmann, "The federal constitutional court: an introduction", in *Law on the Federal Constitutional Court* (Inter Nationes, 1996), ed. by Sigrid Born, translated by Martin Fry. See also Ault (Ed), Rädler, Albert, "General Description: Germany", in *Comparative Income Taxation* (Kluwer, 1997), p.57. The basic exemption for personal income tax may not be lower that the minimum amount necessary for existence, which equals to the amount that is paid to the more vulnerable persons by the state welfare authorities.

[451] *Intersplav v Ukraine* (Application No. 803/02).

recognised the applicant's right. A general situation of abuse in cases of refund was not accepted as justification for the delays, "in the absence of any indication of the applicant's direct involvement in such abusive practices."[452] At stake was the "fair balance" between the demands of the public interest, particularly where there is a general situation of abuse, and the protection of the right to peaceful enjoyment of possessions. Again, the relevant circumstances of the case were taken into account on proportionality grounds, to limit the margin of discretion of States, which in principle is wide in implementing social and economic policies.

In *Bulves*[453] the issue was the right to deduct the VAT on inputs where the supplier delayed its compliance obligations on its outputs, which included the goods provided to the Applicant. The Court reiterated its case law on the public interest in preventing any fraudulent abuse of the tax system, and stated, "it may be reasonable for domestic legislation to require special diligence by VAT-registered persons in order to prevent such abuse."[454] The key fact that was taken into account was that by the time the right to deduction was denied to Bulves, its supplier had already complied with its VAT reporting obligations. This situation was peculiar, because it makes no sense and it is contradictory to any VAT system to deny the VAT input where the supplier has already paid over the VAT on its output. However, the Court made a more general statement on grounds of reasonableness and proportionality, which may cover other more usual situations of good faith of the taxpayer when claiming the right to deduct the VAT inputs:

> "Lastly, as regards efforts to curb fraudulent abuse of the VAT system of taxation, the Court accepts that when Contracting States possess information of such abuse by a specific individual or entity, they may take appropriate measures to prevent, stop or punish it. However, it considers that if the national authorities, in the absence of any indication of direct involvement by an individual or entity in

[452] Paragraph 38 of the judgment. See the same rationale in VAT cases decided by the ECJ in Chapter IV, section 7.3.

[453] *Bulves AD v Bulgaria* (Application No. 3991/03).

[454] Paragraph 65 of the judgment.

> fraudulent abuse of a VAT chain of supply, or knowledge thereof, nevertheless penalise the fully compliant recipient of a VAT-taxable supply for the actions or inactions of a supplier over which it has no control and in relation to which it has no means of monitoring or securing compliance, they are going beyond what is reasonable and are upsetting the fair balance that must be maintained between the demands of the general interest of the community and the requirements of the protection of the right of property."[455]

The Court largely accepts the justification of combating tax abuse, evasion and avoidance for any restriction on fundamental rights, but submit them to the test of proportionality coupled with reasonableness.[456] Whether this pervasive test is either strict or loose depends on the factual and legal circumstances of each case. Generally, where the taxpayer is in good faith and not taking unfair advantage of the tax system, the proportionality test is strict.

III.2.8. Conclusion

As the above sections demonstrate, the principle of proportionality is not only a key and pervasive principle of interpretation and adjudication of the European Convention on Human Rights, but may also be regarded as 'part and parcel of the rule of law.' It is applied as an overarching principle of interpretation and application to all other legal principles and rules at play, taking into account all the relevant circumstances of each individual case. It is a lively, flexible and essential aid to judicial review and to control the margin of appreciation of States regarding fiscal, social and economic measures that may interfere with fundamental rights. As demonstrated in some cases, the principle of proportionality may be undermined by a lack of justification or where a utilitarian view prevails over the liberal notion of individual rights, allowing "marginal" injustices in favour of certain public policies. This, however, does not detract from its importance and its desirable evolution as a neutral principle in search of fairness in all cases.

[455] Paragraph 70 of the judgment.

[456] See sections 2.6.a on tax avoidance and retrospective taxation, and 2.7.b on fiscal penalties.

It is also an optimizing principle[457] in its role of balancing and conciliating between other apparently competing or conflicting principles and rights to render them as effective[458] and compatible as possible. It lies at the heart of the concept of discrimination coupled with the notion of reasonableness as twin concepts, being applied not only to both implied and expressly limited rights, but also to absolute rights and positive and negative obligations of States within the Convention. It operates within the ambit of the facts, taking into account and fully assessing all relevant circumstances, as well as all other legal rules and principles; in other words therefore, it must work in practice and in law. One may fairly suggest that where there is no proportionality reasoning neither is there the substantive rule of law and justice with respect to the minimum common standards of human rights.

Taxation is clearly within the scope of the general law of the Convention, although it appears to me that the States have a broad margin of discretion in tax matters wider under the right to property than under the right to non-discrimination. The broader the margin of appreciation, the less strict the proportionality principle. The looser the proportionality test, the less the search for fairness in individual cases. There is a lack of transparency and justification in some cases, whereas in others a lack of consistency and predictability. In these cases there was just a rhetorical or really flawed application of proportionality coupled with reasonableness, because the principles and interests at stake were not properly and objectively balanced.

Excessive taxation may infringe the right to property based on the proportionality principle. The principle of ability to pay ("the financial condition") has been taken into account by the Court, but when applied to specific cases resulted in less individual fairness whilst more weight was given to policy considerations, as in the minimum wage taxation cases. With respect to the utilitarian or consequentialist

[457] Beatty (2004), supra, p.163. See also Schwarze (1992), supra, p.679.

[458] Steven Greer referred to the principle of proportionality as the alter ego of the principle of effective protection (2000), supra, p.20. See also the notion of effective remedy and proportionality under Article 13 in section 2.3.c.2 above.

view of the Court, some cases clearly demonstrate the prevalence of economic and utilitarian policies over 'marginal' cases of unfairness and injustice.[459]

The taxes that may be more easily caught by a specific prohibition of excessive taxation would be those on capital. However, indirect taxes (such as VAT and other similar taxes on consumption) may also be excessive, as the US Supreme Court has discussed in some cases. On the other hand, taxes on gains could also be regarded as excessive if other principles ought to be taken into account, such as the ability to pay, economic freedom to set up new or evolving business or charitable activities, access to markets on a level playing field of competition, reasonable savings for capital protection or future expenses and economic adversities. On the other hand, due regard should be given to financial and social conditions that may change and affect those in need of minimum financial support to survive, prosper and develop their own abilities.

The proportionality principle may work as a neutral instrument to enforce economic, social and fiscal policies. First, the purpose (ends) of legal rules must be identified objectively; and secondly, the relationship between ends and means is assessed by proportionality with no intrusion into their ends, unless they are not legitimate. Thus, the overall assessment must not be subjective, because of the objective purpose of the rule to be ascertained and the objective assessment of their means under the necessity test that is part of proportionality. Neutrality[460] is a relevant feature of the proportionality principle, besides its role in weighing and reconciling between apparently conflicting rules and principles. It has been suggested that proportionality, unlike the doctrine of margin of appreciation, "is generally regarded as a neutral or even a good tool."[461] On the other hand, the ultimate objective of fairness, which was the origin of the notions of equity, justice, equality, reasonableness and proportionality itself, should not be undermined by neutrality. Thus, neutrality cannot

[459] See cases particularly on discrimination on grounds of family relationship and minimum wage taxation, in sections 2.5.a and 2.7.c above.

[460] Generally, "neutral principles must be drawn from the constitutions and formulated in a way that allows them to be applied consistently", Beatty (2004), p.161. On proportionality and neutrality, see Beatty, idem, pp.161-4.

[461] Dembour, (2006), supra, p.90.

be an isolated or most important characteristic of proportionality, but must be seen within the general purpose of fairness.[462] Some derogations from or exceptions to general policies or rules required by the test of proportionality do not necessarily conflict with those policies, but function as an tool to make them as fair as possible. A clear illustration of this may be the two following cases, one positive and other negative. The positive is the *Van Raalte* case in which the Court extended a legitimate tax exemption for unmarried and childless women of 45 or over to men in the same situation.[463] By extending that exemption the Court did not go against the legitimate objective of the exemption (to avoid unfair emotional burden), but instead enforce it in other similar situations. The negative example is the *Lindsay* case in which the Court failed to extend the individual separate taxation of unmarried couples living together to the similar situation of married couples that were subject to the more burdensome joint taxation.[464] The Court also failed to take into account other Constitutional Courts´ decisions that were in favour of married couples and allowed what it itself referred to as marginal cases of injustice or unfairness.

However, from the evolving case law of the Court, it follows that proportionality has turned out to be a flexible and essential instrument to control any interference with fundamental rights regarding taxation, though its test is loosened or tightened depending on the justification and the legal and factual circumstances of each case. Furthermore, as an overarching principle, proportionality is the origin of other legal principles that may equally be regarded as part of the rule of law. For instance, in the *PM* case, the Court stick to the facts and closely scrutinised the tax discrimination between unmarried and married separated fathers, holding it unjustifiable, whereas failed to reverse the discrimination that was allowed in *Lindsay* between married and unmarried couples.[465] In another set of cases, the Court consistently and fairly assessed retrospective taxation to combat tax avoidance (*A, B, C, and D*; and *MA and Others* cases[466]), though decided against the taxpayers, whereas in my opinion it

[462] On fairness, see Chapter I, section 3, and the Conclusion, section 2.3.
[463] See section 2.5.b.
[464] See section 2.5.a.
[465] See section 2.5.a.
[466] See section 2.6.a.

applied a loosen test in the *Building Societies*[467] case to justify retrospective taxation to address very arguable technical mistakes of the previous legislation.

The following principles may be regarded as a corollary to other principles via application of the proportionality principle under the Convention. First, the principle of non-discrimination which cannot be assessed without the notion of reasonableness coupled with proportionality. Secondly, the principle of lawfulness that requires clarity and predictability and the obligation to provide legal advice in some cases. Thirdly, non-retrospective legislation, which may be justified by general interests such as combating artificial tax avoidance. Fourthly, prohibition of excessive taxation and the ability to pay ("financial condition") of individuals and legal entities. Fifthly, the principle of good faith that must be taken into consideration in cases of graver restrictions on the right to property (e.g. procedural measures to secure the payment of taxes) and combating artificial tax avoidance or abuse.

The next section will also illustrate the role of proportionality coupled with reasonableness as an essential principle of interpretation and application of the core rule of non-discrimination regarding international trade and its interaction with tax and non-tax rules and principles.

[467] See section 2.6.b.

III.3. The WTO – The Interaction between the Rules and Principles of International Free Trade, Taxation and the Role of the Proportionality Principle.

III.3.1. The core principle of non-discrimination within the WTO.

This section will analyse the role of proportionality coupled with reasonableness in assessing the relationship between ends and means, and balancing different interests, with particular regard to the objectives of international trade agreements. As with any other regulatory laws, tax policies and measures may affect trade. The section will also examine whether and to what extent the WTO agreements adopt a cost-benefit or proportionality analysis in a way that applies the tests of balance, necessity, and a 'less restrictive alternative' to determine the validity of regulatory and tax measures. The approach will then be compared with other jurisdictions in which the proportionality reasoning has been applied as an overarching principle of law, such as in the adjudication of fundamental rights and freedoms.

There is no written principle of proportionality within the WTO agreements, but there are some core rules regarding protectionism and discrimination; taken together with the balance of interests of different countries, these rules may be further assessed on proportionality and reasonableness grounds. Moreover, as the main objectives of the Marrakech Agreement[468] appear to be in conflict, they should be balanced against each other within the WTO framework using proportionality reasoning.[469] The preamble states that the legal role of the WTO is to give 'colour, texture and shading to the rights and obligations of Members under the *WTO Agreement*, generally, and under the GATT 1994, in particular.'[470] Indeed,

[468] According to the first two paragraphs of the WTO Preamble, objectives include: raising standards of living; ensuring full employment; ensuring growth of real income and effective demand; expanding the production of and trade in goods and services; allowing for the optimal use of the world's resources in accordance with the objective of sustainable development; protecting and preserving the environment; ensuring for developing countries a fair share in the growth in international trade.

[469] See Kennett, Maxine, Neumann, Jan and Turk, Elisabeth, "Second Guessing National Level Policy Choices: Necessity, Proportionality and Balance in the WTO Services Negotiations" (2003) Center for International Environmental Law, p.2.

[470] Appellate Body Report on *US – Shrimp* (WT/DS58/AB/R), paragraph 155.

proportionality may enhance these tasks in order to make WTO principles, rights and obligations as effective and compatible with each other as possible. Furthermore, the preamble points to some means for achieving the WTO objectives as being the desire of 'substantial reduction of tariffs and other barriers to trade', 'elimination of discriminatory treatment in international trade relations', preserving GATT's basic principles and furthering 'the objectives underlying this multilateral trading system'.[471] Proportionality may again be a relevant aid in scrutinising discriminatory measures in the light of the WTO's explicit and underlying objectives.

Proportionality and reasonableness may lie at the heart of the assessment as to whether GATT rules and principles are being infringed, particularly in cases of discrimination, as any restriction or regulation may also discriminate unfairly against cross border transactions. One of the main issues of international trade is liberalization against protectionism of any kind unless the latter may be justified under the exceptions provided by the WTO agreements. One of the most basic principles of multilateral trade and of the WTO has been non-discrimination. Even if one agrees with the 2005 WTO Report, which stated that non-discrimination has become the exception not the rule,[472] the role of proportionality may still be essential to justify discrimination by national measures or bilateral and regional preferential regimes.

The WTO rules dealing with protective measures may be construed according to the proportionality reasoning coupled with reasonableness; they are considered below.

First, Articles III of the GATT and XVII of the GATS (on national treatment of internal taxation and regulation) prohibit any direct or indirect discrimination that affords protection to domestic production. This national treatment operates in tandem with key Articles on justification for discrimination where it meets two consecutive

[471] Preamble, last three paragraphs.

[472] See 2005 WTO report *The Future of the WTO*, chaired by Peter Sutherland, its first director-general. More than half of the 300 deals notified to the WTO were created in the past decade and tend to undermine the non-discrimination rule, as bilateral and regional deals, by giving preferential access to some countries, which does not follow the most favourable nation principle under which Member Countries are supposed to extend to all other members their most favourable trade terms – the lowest tariffs and so forth (The Economist, January 22nd 2005, p.81).

tests: (a) general exceptions on public interest which must be necessary to their objectives, and which (b) must not be 'arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade', as provided respectively by the paragraphs and the chapeau of Article XX of the GATT:

> *" General Exceptions"*
>
> "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> (a) necessary to protect public morals;
>
> (b) necessary to protect human, animal or plant life or health;
>
> (c) relating to the importations or exportations of gold or silver;
>
> (d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, ...
>
> […]"[473]

Secondly, Articles VI on Anti-dumping and Countervailing Duties and XIV on Subsidies and the Agreement on Subsidies and Countervailing Measures (SCM),

[473] Article XIV, *caput* and its paragraphs, of the GATS has essentially the same wording as its equivalent quoted above, but expressly includes the two following exceptions regarding direct taxation:

> "....
>
> (d) inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members;
>
> (e) inconsistent with Article II, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound."

which prohibit any kind of financial incentives to domestic products with a detriment to imports, regulate the appropriateness of countermeasures.[474] However, this section will focus only on discrimination regarding international trade because this is the essential principle within the WTO agreements on which all the other rules and principles depend.

Indirect taxation may fall within the rules and principles of international trade, but may so direct taxes. Examples of direct tax measures were considered in *US - Tax Treatment for Foreign Sales Corporations*[475] and *Bovine Hides* (Argentinean advance tax on gains)[476]. In relation to services, Article XIV (d) and (e) of GATS provides explicit exceptions for the enforcement of direct taxes and double taxation conventions, but they are also submitted to its chapeau that prohibits 'arbitrary or unjustifiable discrimination between countries where like conditions prevail or a

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[474] See, inter alia, *US - Line Pipe* (WT/DS202/AB/R) in which the Appellate Body applied explicitly the principle of proportionality and stated in paragraph 259: "We note as well the customary international law rules on state responsibility, to which we also referred in *US — Cotton Yarn*. We recalled there that the rules of general international law on state responsibility require that countermeasures in response to breaches by States of their international obligations be proportionate to such breaches." See also Mitchell, Andrew D., "Proportionality and Remedies in WTO Disputes" (2007) EJIL Vol. 17 no.5; and Mavroidis, Petros C., "Remedies in the WTO Legal System: Between a Rock and a Hard Place" (2000) EJIL Vol. 11, no. 4, 763-813.

[475] (WT/DS108/AB/R). The Appellate Body made clear that Art III.4 (national treatment) may catch direct taxation rules that diferentiate between domestic and foreign products: "The Appellate Body upheld the Panel's finding that the so-called 'fair market value rule' under the ETI Act accorded less favourable treatment to imported products than to like US domestic products in violation of Art. III: 4 by providing a 'considerable impetus' to use domestic products over imported products for the tax benefit under the ETI Act". "Under the 'fair market value rule', any taxpayer that sought an exemption under the ETI Act had to ensure that in the manufacture of qualifying property, it did not 'use' imported input products, whose value comprised more than 50 per cent of the fair market value of the end-product" (summary of the case at www.wto.org/english/tratop_e/dispu_e/cases_e/ds108_e.htm (up-to-date at 24 February 2010, last visited 8 July 2010). The US did not justify that discrimination under the exceptions of Art XX of the GATT. On this case, see Van Thiel, Servaas, "General Report" in Lang, Michael, Herdin, Judith and Hofbauer, Ines (Eds), *WTO and Direct Taxation* (Kluwer, 2005), pp.26-28.

[476] *Argentina - Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, (WT/DS155/R, *Bovine Hides*). The Panel concluded at paragraph 11.161 that both advance payments of the VAT and the direct tax on gains were "internal tax measures applied to products" under Article III:2 of the GATT. Differently from the US in the *FSC* case (WT/DS108/AB/RW2), Argentina tried to justify the apparent differentiation between domestic and imported products based on the exceptions of Art XX of the GATT (see further on this case the next two sections, regarding the reasonableness and proportionality of the exceptions and the chapeau).

disguised restriction on trade in services.'[477] Thus, the importance of proportionality and reasonableness in assessing the discrimination under the chapeau may also affect direct taxation, including enforcement measures, double tax treaties regarding services[478] and principles of international tax law. Measures to combat tax evasion and avoidance[479] may be scrutinised under paragraph (d) and the chapeau of Article XX of the GATT and paragraphs (c) and (d) and the chapeau of Art XIV of the GATS. So do also other specific measures enforcing international principles, such as territoriality and worldwide taxation.[480]

Again proportionality in tandem with reasonableness as judge-made law principles must be analysed by means of WTO case law, mainly of the Appellate Body (AB), which is the final authority regarding the legal interpretation of WTO agreements.

III.3.2. National treatment principle and other GATT/GATS rules, non-discrimination, reasonableness and proportionality.

III.3.2.a. The principle of non-discrimination, its general assessment and the two-tier analysis of Articles XX (GATT) and XIV (GATS).

The pillars for promotion of free trade are the unconditional most-favoured-nation (MFN) obligation,[481] the national treatment obligation, binding commitments to reduce tariffs and the elimination of quotas on imports.[482] All these pillars are based

[477] For an overall view on direct taxation and WTO principles and rules, see Lang, Michael, Herdin, Judith and Hofbauer, Ines (Eds), *WTO and Direct Taxation* (Kluwer, 2005).

[478] See also Van Thiel, Servaas, "General Report", (2005), p.39.

[479] See *Bovine Hides* and *Dominican Republic - Measures Affecting the Importation and Internal Sale of Cigarettes* (WT/DS302/AB/R, *Dominican Republic – Cigarettes*).

[480] Those principles were taken into account in the above well-known *FSC* case regarding direct tax subsidies granted by the USA.

[481] Under Article I of the GATT, which provides the general MFN treatment, WTO members are immediately and unconditionally obliged to give to all trade partners the same favourable trade concession given to any other party to the agreement. A similar, immediate and unconditional right with respect to services and service suppliers is ensured by Article II (1) of the GATS.

[482] Choi, Won-Mog, *'Like Products' in International Trade Law, Towards a Consistent GATT/WTO Jurisprudence* (OUP, 2003), p.93.

on the non-discrimination principle[483] and national treatment; together these aim at equality of opportunity and avoidance of protectionism in the application of internal taxation and regulatory measures.[484] They have given rise to some of the most important and disputed issues according to WTO case law.[485]

Article XX of the GATT, which provides for general exceptions regarding discrimination, plays a key role within the whole agreement as it applies not only to Article III on equality of treatment between imports and domestic production but also to all its other Articles:

> "[T]he chapeau says that '*nothing in this Agreement* shall be construed to prevent the adoption or enforcement by any contracting party of measures ...' The exceptions listed in Article XX thus relate to all of the obligations under the *General Agreement*: the national treatment obligation and the most-favoured-nation obligation, of course, but others as well."[486]

The discrimination assessment is made first under one or more specific Article of the GATT or GATS, and then under, respectively, Articles XX or XIV on general

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[483] Idem.

[484] The Appellate Body (AB) Report on *Japan - Alcoholic Beverages II* (WT/DS8/AB/R) (p. 16) stated, "The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III 'is to ensure that internal measures not be applied to imported or domestic products so as to afford protection to domestic production' *(footnote original:* Panel Report on *US - Section 337*, para. 5.10). Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products" (*footnote original*: Panel Reports on *US - Superfund*, para. 5.1.9; and *Japan - Alcoholic Beverages II*, para. 5.5(b)).

485 Out of all WTO agreements on substantive, not procedural, provisions the GATT is still the most analysed by the Appellate Body decisions from 1996 to 2007 (Appellate Body Annual Report for 2007, WT/AB/9, p. 9, figure 3), and, under the GATT/GATS agreements, discrimination has not surprisingly been the most important issue at stake.

[486] Appellate Body Report on *US - Gasoline*, p. 24.

exceptions in a two-step assessment.[487] For example, if a measure fails to meet the requirements for the National Treatment Article,[488] which provides equality in the market, then it may be upheld by some of the exceptions and by the chapeau of Articles XX of the GATT or XIV of the GATS. The two-step assessment under Articles III and XX of the GATT (XVII and XIV for the GATS) includes a composite scrutiny of justification under the general exceptions Article, the so-called "two-tier analysis" as explained below.

The two-tier analysis under Article XX of the GATT requires the separate assessment of the necessity of measures aimed at ensuring a legitimate policy objective (general exceptions) subsequent to which, only where the disputed measure passes the necessity test, a second scrutiny must be made under the chapeau (heading or *caput*) of Article XX:[489]

> "In order that the justifying protection of Article XX may be extended to it, the measure at issue must not only come under one or another of the particular exceptions - paragraphs (a) to (j) - listed under Article XX; it must also satisfy the requirements imposed by the opening clauses of Article XX. The analysis is, in other words, two-tiered: first, provisional justification by reason of characterization of the measure under XX(g); second, further appraisal of the same measure under the introductory clauses of Article XX."[490]

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[487] See Ortino, Federico, "From 'Non-Discrimination' to 'Reasonableness': a Paradigm Shift in International Economic Law?" in *Jean Monnet Working Paper* (01/2005) and Verhoosel, Gaëtan, *National Treatment and WTO Dispute Settlement* (Hart Publishing, 2002), p.34.

[488] Article III provides National Treatment on Internal Taxation and Regulation, and essentially, the same National Treatment Clause is provided by Article XVII of the GATS.

[489] Although that does not mean that the Panel cannot assess the discrimination standard under the chapeau even where the discriminatory measure has failed to comply with the necessity test, since its analysis pursues an objective justification that may assist further the Appellate Body in its final decision, particularly regarding factual findings (*US Gambling*, WT/DS285/AB/R/Corr.1, paragraphs 343-4).

[490] Appellate Body Report on *US – Gasoline (WT/DS2/AB/R)*, p.22.

Both separate assessments involve a full scrutiny of discrimination, which together consider one legal issue in two stages, each of which may be assessed according to proportionality reasoning coupled with reasonableness. This is illustrated below.

III.3.2.b. The general exceptions, the wording 'necessary' as a requirement for non-discrimination and proportionality. The cost-benefit analysis and proportionality.

An initial parallel may be drawn between the European Convention on Human Rights and the GATT/GATS agreements regarding the term "*necessary"*. Whereas the ECHR took the view that *necessary* would be somewhere between *indispensable* and more flexible expressions such as *useful, ordinary, admissible, desirable* or *reasonable,*[491] the Appellate Body considered it closer to one of the poles. meaning *indispensable* rather than to the other pole, meaning *making a contribution to.*[492] "Such a contribution exists when there is a genuine relationship of ends and means between the objective pursued and the measure at issue."[493] Furthermore, the Appellate Body differentiated the requirements for permissible discriminations, linking all of them to the relationship between ends and means:

> "In enumerating the various categories of governmental acts, laws or regulations which WTO Members may carry out or promulgate in pursuit of differing legitimate state policies or interests outside the realm of trade liberalization, Article XX uses different terms in respect of different categories:
>
> 'necessary' - in paragraphs (a), (b) and (d); 'essential' - in paragraph (j); 'relating to' - in paragraphs (c), (e) and (g); 'for the protection of' - in paragraph (f); 'in pursuance of' - in paragraph (h); and 'involving' - in paragraph (i).

[491] See *Handyside* case on Chapter III, sections 2.3.b and 2.3.c.1.

[492] *Korea - Various Measures on Beef* Report (WT/DS161/AB/R), paras. 161-162 and 164.

[493] *Brazil – Measures Affecting Imports of Retreaded Tyres* (WT/DS332/AB/R), para 145.

> It does not seem reasonable to suppose that the WTO Members intended to require, in respect of each and every category, the same kind or degree of connection or relationship between the measure under appraisal and the state interest or policy sought to be promoted or realized."[494]

Thus, what may vary is the degree of the relationship between ends and means, which pervades the whole range of acceptable justifications for discrimination under the paragraphs of Article XX. In *US - Shrimps* the Appellate Body expressly construed the wording 'relating to' in paragraphs (c), (e) and (g) of Article XX as expressing a relationship between ends and means as well:

> "Focusing on the design of the measure here at stake, it appears to us that Section 609, *cum* implementing guidelines, is not ***disproportionately*** wide in its scope and reach in relation to the policy objective of protection and conservation of sea turtle species. ***The means are, in principle, reasonably related to the ends***. The means and ends relationship between Section 609 and the legitimate policy of conserving an exhaustible, and, in fact, endangered species, is observably a close and real one, a relationship that is every bit as substantial as that which we found in *United States - Gasoline* between the EPA baseline establishment rules and the conservation of clean air in the United States" (emphasis added).[495]

This clear demonstration of proportionality reasoning concerning the relationship between ends and means is followed by an analysis of less restrictive alternative measures, still within the requirement of necessity. The Appellate Body stated:

> "…… in order to determine whether a measure is 'necessary' within the meaning of Article XX(b) of the GATT 1994, a panel must consider the relevant factors, particularly the importance of the interests or values at stake, the extent of the contribution to the

[494] Appellate Body Report on *US - Gasoline*, p.17.

[495] Paragraph 141.

> achievement of the measure's objective, and its trade restrictiveness. If this analysis yields a preliminary conclusion that the measure is necessary, this result must be confirmed by comparing the measure with possible alternatives, which may be less trade restrictive while providing an equivalent contribution to the achievement of the objective. This comparison should be carried out in the light of the importance of the interests or values at stake.'"[496]

It is interesting to note that under paragraphs (g), (c) and (e), the reasonable alternative test is not applicable, since it is more appropriate to the requirement of necessity under paragraphs (a), (b), (d), which use the term 'necessary' and perhaps to paragraph (j), which uses the term 'essential'. Nevertheless, the most important point here is to observe how proportionality in different degrees resonates in all of them as general exceptions to discrimination, particularly the open-ended exceptions under paragraph (d) that may encompass any tax measures.

In a stamp tax case on cigarettes involving tax evasion and smuggling,[497] all the guidelines on the assessment of necessity were reiterated, on the basis of previous case law dealing with services (GATS), which adopted the same GATT principles:

> "In *US – Gambling*, the Appellate Body considered the 'necessity' test in the context of Article XIV of the *General Agreement on Trade in Services.* The Appellate Body confirmed that an assessment of the 'necessity' of a measure involves a weighing and balancing of 'the "relative importance" of the interests or values furthered by the challenged measure', along with other factors, which will usually include 'the contribution of the measure to the realization of the ends pursued by it [and] the restrictive impact of the measure on international commerce.'"[498]

[496] *Brazil – Measures Affecting Imports of Retreaded Tyres,* paragraph 178 (AB-2007-4).

[497] (*Dominican Republic-Cigarettes*)

[498] Appellate Body Report, *Dominican Republic – Cigarettes,* para 68, citing *US - Gambling*, para. 306.

In *Bovine Hides*[499] the withholding of VAT and a direct tax on Gains (GT) regarding imports were justified under paragraph (d), to counter tax evasion and avoidance. In this case, the Panel assessed the discriminatory nature of the higher withholding taxes (on VAT and GT)[500] on imports first under paragraph (d) of Article XX apparently applying a looser test of necessity. The Panel regarded the discriminatory measure in its general design and structure as more appropriate to tackle tax evasion than more drastic measures such as aggressive criminal prosecution of tax offenders, and accepted it under paragraph (d).[501] Nevertheless, under the chapeau of Article XX the disputed measure was more closely scrutinised and rejected by applying the test of necessity and proportionality.[502]

The timing of payment of a Selective Consumption Tax (which was payable earlier for imports) would have been an issue to be decided in *Dominican Republic-Cigarettes* similar to the issue in *Bovine Hides* of different tax rates, if the complainants had challenged it.[503] Had this issue been properly argued it was unlikely to have been upheld in line with the rationale of *Dominican Republic-Cigarettes* under either the necessity test of paragraph (d) of Article XX or the chapeau, as in *Bovine Hides*.

From the above tax cases it follows that in principle any tax discriminatory measure, including direct taxes and their measures of enforcement, may be caught by Article XX(d) and submitted to the two-tier justification. It also appears that the same rationale and proportionality scrutiny are applicable to tax measures as to any measure falling within the general policy exceptions that can hinder international trade.

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[499] *Argentina - Measures Affecting the Export of Bovine Hides and the Import of Finished Leather.*

[500] The system worked like a pre-payment of taxes on imports that would be charged in future transactions (re-sale) even for income purposes (GT tax on gains, IG *impuesto a las ganancias*). The higher rates on imported hides than on domestic ones might have been justified if there were a higher margin of profits on re-sale of imports.

[501] Paragraphs 11291-11308.

[502] See further analysis of this case under the chapeau, in the next section.

[503] The Appellate Body stated that the Panel could not decide the issue under the WTO procedural rules as it was not argued as a separate issue (*Dominican Republic-Cigarettes*, paragraphs 126-7).

Balancing the full purpose of the measure (whether the alternative measure would provide less protection) is another characteristic of proportionality reasoning applied to the requirement of *necessity*. At least three factors must be taken into account to ascertain the less restrictive available measure:

> i. 'the trade impact of the measure,
>
> ii. the importance of the interests protected by the measure,
>
> iii. the contribution of the measure to the realization of the end pursued.'[504]

These three factors must be submitted to a weighing and balancing process to determine the appropriateness of the disputed measure. Thus, it can be suggested that the balancing process permeates the whole analysis of necessity.[505] Summing up the nature of this process, the Appellate Body stated:

> "The weighing and balancing is a *holistic* operation that involves putting all the variables of the equation together and evaluating them in relation to each other after having examined them individually, in order to reach an overall judgement" (emphasis added).[506]

As the economic players are operating in a real world (as opposed to a theoretical one) the scrutiny of less restrictive measures must be as flexible as is appropriate to

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[504] *Dominican Republic – Cigarettes*, at para 70 citing also the rationale of *Korea – Various Measures on Beef* (para 164), *EC –Asbestos* (WT/DS135/AB/R) *and US – Gambling.*

[505] Pascal Lamy, Director-General of the WTO, pointed out the similarity between 'proportionality' and the 'necessity test' coupled with 'a new and additional balance test' ("The place of the WTO and its Law in the International Legal Order", 2006 EJIL 17, 969-984, p.979).

[506] *Brazil – Measures Affecting Imports of Retreaded Tyres*, paragraph 182. A holistic approach has been adopted by the Appellate Body regarding the interpretation of international treaties, as follows: "Interpretation pursuant to the customary rules codified in Article 31 of the Vienna Convention is ultimately a holistic exercise that should not be mechanically subdivided into rigid components" (*EC – Chicken Classification* (WT/DS269/AB/R WT/DS286/AB/R), paragraph 176), and for further material rightly supporting this approach rather than a sequencing and hierarchical one, see Qureshi, Asif H. *Interpreting WTO Agreements: Problems and Perspectives* (CUP, 2006), pp.122-3 particularly note 16.

changing and real circumstances,[507] which characterises again proportionality reasoning coupled with reasonableness in its search of fairness in each case. Thus, the States are required neither the most ideally less restrictive measure nor the most ideally consistent with the WTO principles.[508] In the tax stamp case discussed above, the Appellate Body reached a finding that,

> "…requiring that tax stamps be affixed in the Dominican Republic under the supervision of the tax authorities 'in and of itself, would not prevent the forgery of tax stamps, nor smuggling and tax evasion.' In this respect, the Panel indicated that other factors, such as security features incorporated into the tax stamps, or police controls on roads and at different commercial levels, would play a more important role in preventing forgery of tax stamps, tax evasion and smuggling of tobacco products."[509]

As a further illustration of the full assessment of proportionality in search of a rational justification - not only a theoretical one but also one that is practical, effective and reasonably enforceable - the Appellate Body applies the 'reasonably available' test to accept or reject the less restrictive alternative analysis:

> "[a]n alternative measure may be found not to be 'reasonably available' ... where it is merely theoretical in nature, for instance, where the responding Member is not capable of taking it, or where the

[507] 'WTO rules are reliable, comprehensible and enforceable. WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgments in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world' (*Japan - Taxes on Alcoholic Beverages* - AB-1996-2, last paragraph before the conclusions).

[508] The three factors pointed out above will determine "whether a WTO-consistent alternative measure which the Member concerned could reasonably be expected to employ is available, or whether a less WTO-inconsistent measure is reasonably available". See *Dominican Republic – Cigarettes*, at para 70).

[509] Idem, para 71.

> measure imposes an undue burden on that Member, such as prohibitive costs or substantial technical difficulties."[510]

This type of scrutiny may be regarded as a dynamic and comparative form of cost-benefit analysis. It takes into account the costs or technical difficulties of alternative measures, which must then be balanced with other factors such as trade impact, national policies and interests, and the degree of effectiveness. Whereas a static analysis merely juxtaposes the costs and benefits of a single rule, a more dynamic cost-benefit analysis compares the net benefits of multiple rules.[511] Thus, Trachtman suggested that proportionality "may become more like comparative cost-benefit analysis the more it evaluates various alternatives as part of its determination of whether the particular measure under scrutiny is proportional."[512]

The Appellate Body has consistently recognized the right of States to determine their own level of protection according to the analysis of reasonably available alternatives.[513] This was reiterated in *Dominican Republic-Cigarettes* in which 'a zero tolerance level of enforcement with regard to tax collection and the prevention of cigarette smuggling' were recognized as the desired level of protection.[514]

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[510] Appellate Body Report, *US – Gambling,* paragraph 308. Just 'administrative difficulties' are not sufficient in regarding an alternative measure as not reasonably available (Panel Report on *US - Gasoline*, paras. 6.26 and 6.28).

[511] Trachtman, Joel P. "Trade and … Problems, Cost-Benefit Analysis and Subsidiarity" (1998) EJIL 9, pp.36 and 70.

[512] Idem, p.76.

[513] In *US Gambling,* regarding services on morals' justification, the Appellate Body stated, "Moreover, a 'reasonably available' alternative measure must be a measure that would preserve for the responding Member its right to achieve its desired level of protection with respect to the objective pursued ... ." (paragraph 308).

[514] Paragraph 72. See the same reasoning regarding health purposes in EC Asbestos, paragraphs 168 and 174, and *Korea - Various Measures on Beef*, paras. 8.213 and 8.214. See also Regan, Donald H. "The meaning of 'necessary' in GATT Article XX and GATS Article XIV: the myth of cost–benefit balancing" (2007) W.T.R., 6(3), 347–369, at 350, citing *EC-Abestos, US-Gambling, Dominican Republic-Cigarettes,* and *Korean-Beef* as examples of cases in which the choice of members for their own level of protection is respected but with no assessment of the benefits of their objectives *vis a vis* their costs.

Furthermore, the second factor pointed out above (the importance of the interests protected by the measure) for assessing the necessity requirement apparently does not require a full evaluation of their benefits.[515] This approach may be contrary to a classical cost-benefit analysis,[516] which assesses the underlying objectives of a measure and its benefits to ascertain whether or not it is lawful. In other words, any alternative measure must achieve the same level of protection pursued by the disputed discriminatory measure, which cannot be challenged on grounds of excessive degrees of protection, unless caught by the chapeau on arbitrary discrimination (as will be discussed in the next section). Thus, proportionality encompassing the necessity test may be distinguished from a pure cost-benefit analysis by the margin of appreciation of States,[517] though nonetheless inherently applying a balancing process, which is also 'at the very heart of what proportionality is all about.'[518]

III.3.2.c. Chapeau of Articles XX and XIV: balance and non-abuse of rights, disguised restriction to international trade and arbitrary and unjustifiable discrimination.

It is worth noting that there are three cumulative standards of review over whether or not a measure satisfies a valid exception to discrimination under the chapeau of Articles XX (GATT) and XIV (GATS).[519] The first is characterised as arbitrary

515 See the appraisal of interests as an aid to ascertain the necessary requirement, discussed above in section 3.2.b: "the more vital or important [the] common interests or values' pursued, the easier it would be to accept as 'necessary' measures designed to achieve those ends" (AB Report *Dominican Republic -Cigarettes*, para 68, quoting *EC – Asbestos* para 172 and *Korea – Various Measures on Beef*, para. 162).

516 A cost-benefit analysis applying a balancing test "must stand ready to say of some measure that: (a) it achieves a legitimate local goal, and (b) there is no other less trade-restrictive way to achieve the same level of that goal, but (c) the measure is nonetheless illegal because the local benefits do not justify the trade costs" Regan, Donald H., (2007) at p.348.

517 See Regan, Ibidem, pp.352-3, 356-7; Trachtman (1998), p. 77.

518 Hilf, Meinhard and Puth, Sebastian, "The Principle of Proportionality on its Way into WTO/GATT Law", in Armin Von Bogdandy, Petros C. Mavroidis, Yves Mény, (Eds) *European Integration and International Co-Ordination*, (Kluwer Law International, 2002), 199-218, p.210.

519 Inter alia, see paragraph 150 of *US – Shrimps*. In *Brazil Retreaded Tyres* where the Appellate Body stated that the requirements of the chapeau are two fold, implying a closer relationship between arbitrary and unjustifiable discrimination, 'The chapeau's requirements are two-fold. First, a measure

discrimination, the second as unjustifiable discrimination, and the third as a disguised restriction on international trade. All of them are assessed on proportionality grounds, particularly in balancing the rights of Contracting Parties (as discussed below).

The interaction and the differentiation between the chapeau of Article XX and its paragraphs were explained in the discussion of the two-tier analysis.[520] They may be mentioned here again to demonstrate further their relevance regarding proportionality reasoning in practice and as a corollary of the doctrine of abuse of rights. In *US-Shrimp* the Appellate Body stated the following:

> "The general design of a measure, as distinguished from its application, is, however, to be examined in the course of determining whether that measure falls within one or another of the paragraphs of Article XX following the chapeau.
>
> …
>
> In *United States - Gasoline*, we stated that it is "important to underscore that the purpose and object of the introductory clauses of Article XX is generally the prevention of 'abuse of the exceptions of [Article XX]'." The Panel did not attempt to inquire into how the measure at stake was being applied in such a manner as to constitute abuse or misuse of a given kind of exception."[521]

As Hilf and Puth well captured it, the exceptions of "paragraphs (a) to (j) address the abstract measure, whereas the chapeau clause addresses the application of the

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provisionally justified under one of the paragraphs of Article XX must not be applied in a manner that would constitute "arbitrary or unjustifiable discrimination" between countries where the same conditions prevail. Secondly, this measure must not be applied in a manner that would constitute "a disguised restriction on international trade"' (paragraph 215). Ascertaining to some extent the vagueness of 'disguised restriction' in *US Gasoline* the Appellate Body stated that "considerations pertinent in deciding whether the application of a particular measure amounts to 'arbitrary or unjustifiable discrimination', may also be taken into account in determining the presence of a 'disguised restriction' on international trade" (at p.25).

[520] See the previous section 3.2.a.

[521] Paragraph 116.

abstract measure in the single case."[522] In other words, a measure can be justified in general ('in abstract') under the general exceptions but fail to pass the test of justification under the chapeau in practice in each case, particularly if there is abuse of the exceptions, taking into consideration the rights of other States.

From a literal reading of the chapeau one might draw the conclusion that it would either be similar to other non-discrimination Articles or have only the limited role of tackling absurd or irrational discrimination.[523] The Appellate Body stated, however, that this type of discrimination is distinct from that covered by other Articles:

> "[under the chapeau, first,] the application of the measure must result in *discrimination*. As we stated in *United States – Gasoline*, the nature and quality of this discrimination is different from the discrimination in the treatment of products which was already found to be inconsistent with one of the substantive obligations of the GATT 1994, such as Articles I, III or XI. Second, the discrimination must be *arbitrary* or *unjustifiable* in character."[524]

Furthermore, the Appellate Body adopted a purposive, contextual and logical interpretation when it recognised in a number of cases a broader and clearer role for the chapeau of Article XX:

> "[A] balance must be struck between the *right* of a Member to invoke an exception under Article XX and the *duty* of that same Member to respect the treaty rights of the other Members.
>
> The task of interpreting and applying the chapeau is, hence, essentially the delicate one of locating and marking out a line of equilibrium between the right of a Member to invoke an exception

[522] "The Principle of Proportionality on its Way into WTO/GATT Law", p.213.

[523] On irrational or absurd measure in the light of the reasonableness standard of review, see different and similar approaches, respectively, Chapters I, II.4 (The possible distinction between what is reasonable and what is non-arbitrary), III.2.2 (The meaning and ascertainment of reasonableness via proportionality reasoning), and IV.1 (Proportionality as a general principle of European Law).

[524] Appellate Body Report, *US – Shrimp*, para. 150.

> under Article XX and the rights of the other Members under varying substantive provisions (e.g., Article XI) of the GATT 1994, so that neither of the competing rights will cancel out the other and thereby distort and nullify or impair the balance of rights and obligations constructed by the Members themselves in that Agreement. The location of the line of equilibrium, as expressed in the chapeau, is not fixed and unchanging; the line moves as the kind and the shape of the measures at stake vary and as the facts making up specific cases differ."[525]

Thus, even after being regarded as proportionate to a legitimate policy, a measure may fail to pass the second test, which may also be described as a balancing test between the relevant measure and the rights of other Sates. If under the paragraphs of Article XX only the interests of the host State are taken into account (relevant policy and appropriate measure to achieve it), under the chapeau the interests of all other States must equally be taken into account, particularly the right not to be discriminated against.

Another difference between the discriminatory analysis under the chapeau and its paragraphs is the prima facie scrutiny in the former and its application in practice under the latter. However, one may still suggest that the same standard of discrimination applicable to the necessity test is required to pass the chapeau test. This line of reasoning would result in a mechanical application of the chapeau to a measure which has already been regarded as discriminatory under, for instance, Article III (national treatment), but necessary under any paragraph of Article XX. Thus, either the discriminatory measure would be necessary and then should always pass the chapeau test or it would always fail this second test for being unnecessarily discriminatory. This understanding would deprive the chapeau of any sound and effective meaning (*effect utile*).[526] Some examples can be helpful to clarify the lack of contradiction and the logical relationship between the two justifications.

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[525] Appellate Body Report on *US - Shrimp*, paragraphs. 156 and 159.

[526] "A fundamental tenet of treaty interpretation flowing from the general rule of interpretation set out in Article 31 is the principle of effectiveness (ut res magis valeat quam pereat). In United States - Standards for Reformulated and Conventional Gasoline, we noted that "[o]ne of the corollaries of the 'general rule of interpretation' in the Vienna Convention is that interpretation must give meaning and

In *US - Gasoline*, measures designed to protect 'clean air' were accepted under paragraph (g), but failed to pass the chapeau test for being in their application 'unjustifiable discrimination' and a 'disguised restriction on international trade' mainly because of:

> "… two omissions on the part of the United States: to explore adequately means, including in particular cooperation with the governments of Venezuela and Brazil, of mitigating the administrative problems relied on as justification by the United States for rejecting individual baselines for foreign refiners; and to count the costs for foreign refiners that would result from the imposition of statutory baselines." [527]

In *US - Shrimps* four reasons were given as support for regarding measures addressed to the protection of sea turtles first as unjustifiable discrimination under the chapeau, although they were justified under paragraph (g).[528] First, the application of guidelines on exceptions to the embargo of importing shrimps only accepted in practice the method applied in the US, not taking into account different conditions existing in other countries.[529] Second, the actual exclusion from the market of shrimps caught according to the US guidelines only because they had been 'caught in waters of countries that have not been certified by the United States' was another flaw in their application in practice which was hardly reconcilable with the policy

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effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility" (Appellate Body Report on *Japan - Taxes on Alcoholic Beverages*, p. 12). On the principle of effective interpretation, see further Qureshi, Asif H., *Interpreting WTO Agreements* (CUP, 2006), pp. 13, 110 and 163. On effectiveness of rights and proportionality, see the case law of the ECHR (Chapter III regarding the effectiveness of fundamental rights 'in practice and in law' and particularly section 2.3.c.2 on effective remedies, and sections 2.7.a and 2.7.b) and the ECJ (Chapter IV.8.5 on the principle of effectiveness).

[527] *US - Gasoline*, pp.28-29.

[528] See section 3.2.b above on the provisional justification of those measures under Article XX(g) to which proportionality is also applied as a requirement of proportionate relationship between ends and means.

[529] Paragraphs 162-4.

itself. [530] Third, the adoption of a unilateral measure only against some countries in lieu of promoting an international agreement on protection of migrant sea turtles was against other international agreements,[531] and discriminatory against those countries.[532] Two points are noteworthy here: a) other international agreements may justify or not discrimination under the chapeau,[533] and b) the argument of negotiation and conclusion of an agreement with some countries as being a clear "demonstration that an alternative course of action was reasonably open"[534] shows the application of the reasonably available alternative test in assessing discrimination under the chapeau. Fourth, the differences between countries concerning the US efforts to transfer technology and time concessions for adjustments were held unjustifiable.[535] Thus, under the first standard of discrimination the Appellate Body drew the following conclusion concerning all the foregoing differences:

> "*considered in their cumulative effect* … constitute '*unjustifiable* discrimination' between exporting countries desiring certification in

[530] Paragraph 165.

[531] Principle 12 of the Rio Declaration on Environment and Development, paragraph 2.22(i) of Agenda 21 Article 5 of the Convention on Biological Diversity, Annex I of the Convention on the Conservation of Migratory Species of Wild Animals (paragraphs 167-8).

[532] Paragraph 172.

[533] See also *Bovine Hides*, discussed below, in which an international agreement might justify discrimination under the chapeau.

[534] "Moreover, the Inter-American Convention emphasizes the continuing validity and significance of Article XI of the GATT 1994, and of the obligations of the *WTO Agreement* generally, in maintaining the balance of rights and obligations under the *WTO Agreement* among the signatories of that Convention. …. The Inter-American Convention thus provides convincing demonstration that an alternative course of action was reasonably open to the United States for securing the legitimate policy goal of its measure, a course of action other than the unilateral and non-consensual procedures of the import prohibition under Section 609" (paragraphs 170-1).

[535] Paragraphs 173-5. The AppellateBody gave due regard to the fact that the immediate enforcement of the protective measures to some countries was determined by judicial decision, by stating that "this does not relieve the United States of the legal consequences of the discriminatory impact of the decisions of that Court. The United States, like all other Members of the WTO and of the general community of states, bears responsibility for acts of all its departments of government, including its judiciary" (at paragraph 173). See a similar line of reasoning regarding judicial decisions of domestic courts concerning general principles of international public law in *US Gasoline*, p.28 and *Brazil Tyres*, paragraph 246.

> order to gain access to the United States shrimp market within the meaning of the chapeau of Article XX"[536] (emphasis added).

The Appellate Body also elaborated on the second standard of discrimination as 'arbitrary' in this decision. The two elements of arbitrariness were: a) 'the rigidity and inflexibility' of the regulatory programme that should be the same as the one in force in the US; and b) the lack of a due process in the certification procedure, such as no opportunity to counter-argue during the process, and 'no formal written, reasoned decision, whether of acceptance or rejection',[537] from which the AB came to the following conclusion:

> "…effectively, exporting Members applying for certification whose applications are rejected are denied basic fairness and due process, and are discriminated against, *vis-à-vis* those Members which are granted certification."[538]

The relationship between arbitrary and unjustifiable discrimination seems to be clear, particularly where the analysis of legitimate ends and appropriate means are ultimately in play in search of fairness. In other words, if States are supposed to be treated equally, any differentiation must be justified on reasonable and convincing grounds, mainly avoiding measures that not only restrict rights but also make less effective the legitimate policy pursued.

In *Brazil -Retreaded Tyres*[539] the justification for discrimination under the chapeau of Article XX was the protection of the environment which was the same justification as under paragraph (b). The question whether the discrimination under the chapeau is 'arbitrary or unjustifiable should be made in the light of the objective of the

[536] Paragraph 176.

[537] Paragraph 180.

[538] Paragraph 181. The Appellate Body also based its decision on Article X(3) of the GATT that requires due process for measures complying with the treaty; a fortiori measures that are exceptions to GATT rules and principles should also be subject to formal and substantive requirements of the due process.

[539] In this case, Brazil tried to justify imports of used tyres (environmental unfriendly goods) only from MERCOSUR stating that they were not substantial. See, on this case, Calster, Geert van, "Faites Vos Jeuxs Regulatory Autonomy and the World Trade Organisation after Brazil Tyres" (2008) JEL 20(1).

measure'[540] that in this case had been on environmental purposes under the necessity test. As a result, there may be a clear application of the same rationale for any discrimination, which requires a reasonable or logical relationship between ends and means that is an inherent feature of proportionality reasoning coupled with reasonableness. Moreover, demonstrating another possible correlation between the two different standards of discrimination, the Appellate Body held that under the chapeau a necessary measure would be unlawful "when the reasons given for this discrimination bear no rational connection to the objective falling within the purview of a paragraph of Article XX, or would go against that objective."[541] Thus, a discriminatory measure justified as necessary on environmental grounds under paragraph (b) of Article XX, must pass another test under the chapeau, which prohibits discrimination, in practice, grounded on baseless allegations or on an objective that is contrary to environmental protection. That is why a special treatment for Mercosur could not be upheld since it would harm the environment in the importing country.[542]

From this reasoning it follows that, although "the provisions of the chapeau cannot logically refer to the same standard(s) by which a violation of a substantive rule has been determined to have occurred"[543], there must be a logical relationship between them. As a matter of principle, the chapeau of Article XX does not allow a conflicting justification with a policy objective accepted to justify the general structure and design of a discriminatory measure under its paragraphs.

The rationale of discrimination under the chapeau may be similar to, different from or even opposed to policies expressly listed in paragraphs of Articles XX (GATT)

[540] Paragraph 227.

[541] Idem, ibidem paragraph 227.

[542] The Appellate Body stated at paragraph 246, "As we explained above, the analysis of whether the application of a measure results in arbitrary or unjustifiable discrimination should focus on the cause or rationale given for the discrimination. For Brazil, the fact that Brazilian retreaders are able to use imported casings is the result of the decisions of the Brazilian administrative authorities to comply with court injunctions. We observe that this explanation bears no relationship to the objective of the Import Ban-reducing exposure to the risks arising from the accumulation of waste tyres to the maximum extent possible. The imports of used tyres through court injunctions even go against the objective pursued by the Import Ban."

[543] *United States - Gasoline*, at p.23

and XIV (GATS) and in the open-ended policies under paragraphs (d) and (c), respectively. The reasoning of proportionality permeates the legal analysis of their similarities, differences, and (particularly where seemingly conflicting policies are at stake) its role of balancing and reconciliation is remarkable. Pascal Lamy highlighted the importance of this "form of 'balancing test' or 'proportionality test' between set of values, or between sets of rights and obligations."[544]

In the *Bovine Hides* case (discussed in the previous section concerning the necessity test), the withholding of VAT and Gains Tax on imports was justified under paragraph (d), to avoid tax evasion and avoidance.[545] However, they were not upheld under the chapeau of Article XX, as the taxes were higher than those on domestic products. The analysis of alternative reasonable measures was also made under the chapeau, such as equal withholding tax rates for imports and domestic goods or reimbursement of interests in compensation for the higher rates.[546] This analysis would be more appropriate to the necessity test and not to the standard of unjustifiable discrimination under the chapeau.[547] Nevertheless, there was in principle a more appropriate argument under the chapeau. Argentina alleged as justification for discrimination the Economic Policy Memorandum and a Technical Memorandum from the International Monetary Fund on tackling the relevant problem of tax avoidance and evasion particularly on the resale market. The Panel did not accept that reason because the commitment to the IMF neither provided for nor suggested those specific discriminatory measures.[548] Thus, apparently other

[544] "The Place of the WTO and its Law in the International Legal Order" (2006) EJIL 17, 969-984, p.980.

[545] See the previous section.

[546] Paragraphs 11325-11327 and 11329. The reimbursement of interests as an automatic compensation could be an appropriate alternative measure to combat tax avoidance or evasion of imports. If the tax paypayer simply evaded the tax in the domestic resale market, he would not be entitled to the reimbursement of higher taxation on imports. In other words, he would be ´encouraged´ not to evade the tax on resale of goods, because he could get a repayment or compensation for the higher tax rates paid at customs.

[547] By contrast, the Appellate Body made a more logical and principled analysis in *Dominican Republic - Cigarettes*, in which the stamp tax requirement failed to pass the necessity test as alternative measures were available with no further assessment under the chapeau whose analysis as a result was unnecessary (paragraph 74). See section 3.2.b above.

[548] Paragraph 11.328 .

international agreements could justify discrimination between countries, if necessary and reasonably justified on grounds of not being arbitrary or a disguised restriction to international trade.[549] Again, even under a different standard for assessing what is arbitrary or unjustifiable (perhaps because the former is more closely related to irrationality, capriciousness or unreasonableness and the latter to objective justification), proportionality is a relevant tool to ascertain their apparently broad and vague meaning. Likewise, the disguised restriction to trade may in the end be scrutinised on the same grounds: whether or not it is justified by an imperative purpose and is an adequate measure taking into consideration other principles, such as good faith and the interests of all other States.

As discussed in the previous section, for a measure to be necessary under the policy exceptions it must be less restrictive and reasonably available. This test also requires a balance in assessing the costs of those alternative measures and their benefits in relation to the degree of enforcement or protection desired by the State, but it goes no further. On the contrary, the chapeau has the different role in pushing the legal analysis towards the interests of other States. In other words, a restrictive measure would be actually proportionate only if it does not disproportionately affect the rights and interests of other States within international trade. That is why international agreements, which necessarily involve more than one country or international organizations, were taken into account to uphold or not discriminatory measures under the chapeau and not under the necessity test in the *US - Shrimps*, *Bovine Hides* and *Brazil - Tyres* cases. On the other hand, a type of necessity test may also be applied under the chapeau as occurred in *US - Shrimps*.[550] This may be because there has to be some logical connection between the policies for exceptions and the chapeau.[551]

[549] On the interaction of different international legal orders and the role of the WTO Appellate Body in applying all of them, Ibid, p.983. As well in *Brazil Tyres* the Panel indicated "that it was not suggesting that 'the invocation of any international agreement would be sufficient under any circumstances, in order to justify the existence of discrimination in the application of a measure under the chapeau of Article XX'" (paragraph 219).

[550] See *US Shrimps* analysed above in which a reasonable available alternative test was applied.

[551] See *US Gasoline* and *Brazil Tyres* discussed above.

Finally, it is worth analysing the relationship between proportionality and other general principles of international law, such as good faith, with respect to non-protectionism in international trade. The Appellate Body interpreted the chapeau not only according to but also as an expression of the general principle of good faith and the doctrine of abuse of rights:

> "The chapeau of Article XX is, in fact, but one expression of the principle of good faith. This principle, at once a general principle of law and a general principle of international law, controls the exercise of rights by states. One application of this general principle, the application widely known as the doctrine of *abus de droit*, prohibits the abusive exercise of a state's rights and enjoins that whenever the assertion of a right impinges on the field covered by [a] treaty obligation, it must be exercised bona fide, that is to say, ***reasonably***"[552] (emphasis added).

Again proportionality reasoning coupled with reasonableness (in its role of balancing different rights) is present, particularly where "in practice, the evaluation of reasonableness implies a due balancing of competing rights", which is "the basic idea of proportionality."[553] In the same vein, as the Appellate Body stated in an earlier case, the exceptions in the paragraphs "must be applied reasonably, with due regard both to the legal duties of the party claiming the exception and the legal rights of the

[552] *US - Shrimp*, paragraph 158. In this decision the Appellate Body also pointed out the competing rights between the States and the task under the chapeau to balance them: "The task of interpreting and applying the chapeau is, hence, essentially the delicate one of locating and marking out a line of equilibrium between the right of a Member to invoke an exception under Article XX and the rights of the other Members under varying substantive provisions (e.g., Article XI) of the GATT 1994, so that neither of the competing rights will cancel out the other and thereby distort and nullify or impair the balance of rights and obligations constructed by the Members themselves in that Agreement. The location of the line of equilibrium, as expressed in the chapeau, is not fixed and unchanging; the line moves as the kind and the shape of the measures at stake vary and as the facts making up specific cases differ" (paragraph 159).

[553] Hilf, Meinhard and Puth, Sebastian, "The Principle of Proportionality on its Way into WTO/GATT Law" (Kluwer Law International, 2002), p.213. On competing rights and the role of proportionality regarding fundamental rights, see Chapter IV, sections 2.3.c.3 and 2.7.b. On the law of balancing as a main characteristic of proportionality and reasonableness, see also Chapters I and II on the US.

other parties concerned."[554] Furthermore, in *US - Shrimps* the Appellate Body based its rationale for ascertaining the notion of *reasonable* exercise of rights on the general principles of international law, such as bona fides, fairness and equity in the light of the purpose of the competing rights.[555] Thus, the idea of *reasonable* application and exercise of rights appears to be closely linked with a proportionality balance between them under the chapeau as well.

In conclusion, the Appellate Body applies a complete test taking into consideration the purposive wording of the chapeau and the nature of the GATT and GATS treaties, which are more like law-making treaties (*traité-loi*) rather than simple contractual treaties (*traité-contrat*). As multilateral treaties based on good faith. The most-favoured nation principle encourages cooperation and avoids unilateralism (which is required for international tax issues, such as counteracting international tax avoidance and evasion, exchange of information, worldwide taxation, transfer pricing, and controlled foreign corporation taxation). With discrimination and necessity on one hand, and good faith, reasonableness and abuse of rights on the other, all inextricably entwined with proportionality and at the core of the GATT/GATS agreements, it may be argued that proportionality reasoning coupled with reasonableness is a key principle of interpretation and application of these agreements.

III.3.3. Contrast with other jurisdictions and conclusion.

[554] *US - Gasoline*, p.22. On the differentiation and interaction between proportionality and reasonableness standards, see Chapters I; II.2; IV, sections 2.1 and 2.2.

[555] At paragraph 158, footnote 156, the Appellate Body cited the following authorities: "B. Cheng, *General Principles of Law as applied by International Courts and Tribunals* (Stevens and Sons, Ltd., 1953), Chapter 4"; and "Jennings and Watts (eds.), *Oppenheim's International Law*, 9th ed, Vol. I (Longman's, 1992), pp. 407-410, *Border and Transborder Armed Actions Case*, (1988) I.C.J. Rep. 105; *Rights of Nationals of the United States in Morocco Case*, (1952) I.C.J. Rep. 176; *Anglo-Norwegian Fisheries Case*, (1951) I.C.J. Rep. 142." Particularly, a quotation of the former was worth mentioning: "A reasonable and bona fide exercise of a right in such a case is one which is *appropriate* and *necessary* for the purpose of the right (*i.e.*, in furtherance of the interests which the right is intended to protect). It should at the same time be *fair and equitable as between the parties* and not one which is calculated to procure for one of them an unfair advantage in the light of the obligation assumed. A reasonable exercise of the right is regarded as compatible with the obligation. But the exercise of the right in such a manner as to prejudice the interests of the other contracting party arising out of the treaty is unreasonable and is considered as inconsistent with the bona fide execution of the treaty obligation, and a breach of the treaty", p.125 (emphasis added in the Appellate Body decision at footnote 156).

Within the WTO agreements, the non-discrimination provision is a fundamental principle, and the jurisprudence of the Appellate Body largely applies the test of proportionality coupled with reasonableness, mainly in its aspects of necessity (reasonably available alternative measures) and balancing. It may also be right to suggest that in the WTO (GATT 1994) case law there is a dynamic or a more *holistic* approach to the issue of discrimination, under both the standard of the likeness of products between domestic and foreign goods,[556] and the two-tier test of discrimination (Article XX).

The ECJ has evolved mandatory requirements in the general interest, such as fiscal supervision, combating tax avoidance, tax coherence and allocation of taxing powers between Member States, to justify restrictions on fundamental freedoms; all are subjected to the proportionality test.[557] The WTO has recognised some tax restrictions on free trade, also based on proportionality reasoning, to accept discriminatory treatment on grounds of public policy under Article XX including combating tax evasion and avoidance (*Bovine Hides* and *Dominican Republic - Cigarettes* cases). It is worth noting the open-endedness, particularly of Article XX (d), concerning measures 'necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement', since compliance with any law or regulation might in principle justify restrictive trade measures.

Although as regards non-discrimination under the commerce clause in the US, the cost-benefit analysis may be more relevant, its similarity to proportionality reasoning is also clear given the factual circumstances and the interests at stake in each case.[558] Perhaps, the main difference between proportionality and cost-benefit analysis is that the former 'generally provides a margin of deference to the local regulation' and

[556] "In view of the objectives of avoiding protectionism, requiring equality of competitive conditions and protecting expectations of equal competitive relationships, we decline to take a static view of the term 'directly competitive or substitutable.'"(Appellate Body Report on *Korea - Alcoholic Beverages*, paragraph 120).

[557] See next Chapter.

[558] As Joel Trachtman pointed out "in the EU and the US contexts, terms like proportionality and balancing tests, and even cost-benefit analysis, are often used interchangeably" (p.77). See also Regan, (2007), pp.352-3.

focuses on 'proportionate costs and benefits instead of benefits in excess of costs.'[559] These differences may not be greater than their similarities, and may depend on how they are applied in practice and the relative importance of their labels in each case. In the ECHR the tool of proportionality as a trade-off is also clear, particularly where a utilitarian line of thought prevails, with a clear but controlled application of the margin of appreciation doctrine.

Proportionality reasoning might arguably be the same as that applied in EU Law to avoid double standards regarding restrictions on free trade, particularly on goods and services. The justifications on grounds of public policy and the general interest should be and have been assessed in terms of their legitimacy and fairness within an international context. In other words, it may not be fair if the EU applies a close scrutiny on proportionality grounds for a restriction to trade between Member States, whereas transactions with third countries would be subject to a more lenient test of proportionality under the WTO rules and principles against discrimination. On the other hand, developing and least-developed countries could be in a more continuously unfavourable position, if their products had to be scrutinised in a way that would hinder their access to the world market more than that of developed countries. Thus, their development could be harder in the realm of international trade, which is understood not only as free but also fair. Meanwhile, discrimination may be necessary to promote the main objectives of international trade liberalisation since free trade and competition are means and not ends in themselves.

The next chapter will illustrate the role of proportionality as an overarching principle of interpretation and application of other legal principles and rules in the conciliation and harmonization of objectives within EU law in tax matters.

[559] Idem, p. 74, citing the definition of Sunstein 'as requiring that aggregate social benefits are proportionate to the aggregate social costs', at note 178 (C.R. Sunstein, *After the Rights Revolution: Reconceiving the Regulatory State*, HUP, 1990, at 181).

IV. European Union Law (the European Court of Justice)

In contrast with all the other jurisdictions analysed in the previous Chapters, the proportionality concept appears to be slightly more pervasive and effective under the European Union system of jurisprudence. This Chapter will essentially analyse how the European Court of Justice (the Court) has been applying proportionality to tax matters.

First, after some comments on its nature and main characteristics as a general principle of EU law, proportionality will be considered with regard to the four fundamental freedoms of movement (of goods, persons, services, and capital), and also through the rule of reason. The European Court of Justice has decided that some differences between national tax systems are acceptable and others unacceptable under the fundamental freedoms enshrined in the TFEU,[560] and proportionality has been the most flexible and dynamic instrument for that determination.

Secondly, this Chapter will describe and make some comments on the importance of proportionality regarding the imperative requirements in the public interest in tax matters (effectiveness of fiscal supervision, coherence of the tax system, allocation of taxing powers between Member States, combating tax avoidance, including tax measures with environmental protection purposes).

Thirdly, it will analyse the Value Added Tax (VAT) case law to demonstrate how important is proportionality to determine and enforce its tax principles such as neutrality and abuse of rights within the internal market. Finally, it will examine proportionality as an overarching principle of law concerning retrospective legislation in its role of balancing other key principles of Community law such as legal certainty, legitimate expectation and the general interest.

[560] "So called *reasonable* national rules …. *could* be left to the discretion of Member States' national courts and their legal systems" in Swaine, Edward, "Subsidiarity and Self-Interest: Federalism at the European Court of Justice" (2000) Harv. I.L.J. 41, p.21-22. The role of proportionality can also be seen in justifications for compatibility of Double Taxation Conventions with EU Law, see O'Shea, Tom, *EU Tax Law and Double Tax Conventions*, (Avoir Fiscal Limited, London 2008), Chapter 3.

IV.1 Proportionality as a general principle of Community Law

Craig and De Burca emphasize that, "proportionality is now a well established principle of Community law" and "a version of the principle is now enshrined in Article 5 EC, which provides that action by the Community shall not go beyond what is necessary to achieve the objectives of the Treaty".[561] It is well accepted that proportionality may permeate all Articles of the Treaty and may assume different nuances depending on the subject matter of each case brought to the Court.[562] As a matter of principle, the European Court of Justice has been applying the proportionality notion in challenging EU and State actions, ascertaining their reasonableness and proportionality according to their purposes and to the objectives of the Treaty. Furthermore, proportionality has been a useful and vital instrument in balancing and determining the meaning of all principles, rights, fundamental freedoms, and objectives the Treaty explicitly or implicitly pursues.

Normally, there are three steps in order to determine whether a particular measure is proportionate or not:

(1) Whether the measure is suitable to achieve the desired end;
(2) Whether it is necessary to achieve the desired end;

[561] *EU Law – Text, Cases, and Materials* (OUP, 2003), p.372. Community has changed to Union since December 2009 and the expressions 'European Community law' and 'European Union law' are used interchangeably throughout the text. The legal basis of the principle of proportionality is the general principles of law like the rule of law itself, and that any limit to the freedom should not go beyond the degree necessary in the public interest, rather than specific articles of the Treaty (Jacobs and White, 2002, p.2; Tridimas, 1999, p.89; Emiliou, 1996, p.134-138).

[562] See Tridimas, p.103; Emiliou, p.134; and Craig and Burca, idem. See also Jürgen Schwarze, who demonstrated that the proportionality principle is "applicable in virtually every area of Community law as a criterion in the assessment of the legality of actions of the Community institutions and of national authorities, which has often had a decisive effect, in relation to both legislative and executive action." in *European Administrative Law* (Sweet and Maxwell, 1992) p.853, and Chapter 5 on the principle of proportionality.

(3) Whether the measure imposes a burden on the individual that is excessive in relation to the objective sought to be achieved (proportionality *stricto sensu*).[563]

In the words of the Court, the three-prong test of proportionality is quite clear:

> "It must be recalled that the principle of proportionality, which is one of the general principles of Community law, requires that measures adopted by Community institutions do not exceed the limits of what is appropriate and necessary in order to attain the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued."[564]

In other words, that test may require that a measure ought to be reasonably related to its objective, ought to be the least restrictive or the least burdensome or still the least intrusive means of obtaining the desired objective, and that its benefits ought not to outweigh its costs. The latter aspect appears to be the most relevant and it has been called "true proportionality".[565] Apparently, one requirement seems to be lacking in those three steps: the legitimacy of the objectives.[566] However, there is an alternative view according to which the determination whether the means and the ends

[563] Craig and De Burca, Ibidem, p.372. On the three steps of the principle and its closeness to the German concept of proportionality, see Emiliou, Ibidem, p.134, citing the *Fedesa* case analysed below in the topic related to the retrospective legislation (section 8 of this Chapter). See also Tridimas, Ibidem, (p.92) on the tri-partite test under which in practice there may be no distinction between the second and the third according to the cases decided by the Court.

[564] *United Kingdom v Commission* Case C-180/96 [1998] ECR I-2265, paragraph 96. See also the *Fedesa* case cited as authority on retrospective legislation, in section 8 below.

[565] Snell, Jukka, *Goods and Services in EC Law* (OUP, 2002), p.200.

[566] See Engel, Christoph, supra note 97, p.3. See also *Handyside* (ECHR, Chapter IV.2.2) on the requirement of a pressing social need and *Lindsay v Customs and Excise Commissioners* [2002] STC 588, in which the English Court of Appeal seems to have applied the four tests, in which the legitimacy of the objective would be a "pressing social need" whereas the others are suitability ("a way of achieving that end"), necessity ("no less intrusive way of achieving it"), and proportionality "*stricto sensu*" ("it does not involve an excessive interference with rights").

themselves are legitimate or not is prior to the proportionality test.[567] A better view would appear to be that the Court may scrutinize the legitimacy of the ends under the constitutionality test, and not necessarily under the proportionality test.[568] My view is that the analysis of whether the ends are legitimate or not is a logical, sensible and fair requirement to apply the test of proportionality coupled with reasonableness. There is no application of proportionality where the objective of the questioned measure is illegitimate, but this assessment of legitimacy must be made, or else proportionality coupled with reasonableness would turn into a formulaic process with no ultimate purpose of fairness.[569] For instance, the Court may strike down any measure that directly and clearly falls foul of the Treaty without further examination of its suitability, necessity, and intrusiveness, since the objective itself may be manifestly unlawful. It has been suggested that in practice the Court does not evaluate the objectives of the Member States' measures, provided that the purpose is

[567] See Messerschmidt, Klaus, "Efficiency and the Principle of Proportionality" available at <www.eurofaculty.lv/papers>, p.4. This author rightly points out that proportionality cannot be attributed to only one nation and illustrates the Supreme Court of Canada as having the following concept of proportionality, "The proportionality requirement has three aspects: (1) the existence of a rational connection between the impugned measure and the objective; (2) minimal impairment of the right or freedom, and (3) a proper balance between the effects of the limiting measures and the legislative objective." (*Regina v Butler* [1992] 1 S.C.R. 452, apud Messerschmidt, p.5). This decision was expressly referred to by the Constitutional Court of South Africa when the death penalty was regarded as unconstitutional under the test of proportionality (Jackson, Vicki C, and Tushnet, Mark, *Comparative Constitutional Law*, (Foundation Press, 1999), pp. 605-06). This may illustrate the borrowing of the proportionality principle as an unwritten principle of interpretation and application of other legal rules and principles from other constitutional and international courts.

[568] That seems to be summarized in particular cases decided by the Court, in which firstly it analyses the legitimacy of the objective of a measure under the imperative requirements in the general interest for justification of a restriction to the fundamental freedoms, such as tax avoidance, fiscal supervision, and tax coherence objectives; and secondly the same measure is scrutinized under the proportionality test. See, inter alia, *Gebhard* case C-55/94 [1995] ECR II-1135, *Bosman* Case C-415/93 ECR I-4921 in section 3 of this Chapter, and all tax cases regarding justification on those grounds.

[569] The analysis of legitimacy of the ends is also extensively made by the ECHR sometimes explicitly as happened in the following cases: *Reiner* (Chapter III, section 2.5.c), *Darby* (Chapter III, section 2.5.c), and *M.A. and Others* (Chapter III, section 2.6.a). An implicit analysis of the legitimacy of the ends was made in *Van Raalte* (Chapter III, section 2.5.b), as the Court extended a (legitimate) tax exemption to a situation not set out in domestic law. If this tax exemption was not legitimate, and in my opinion it really was, it should be struck down and not extended to similar situations. See also the discussion on the margin of appreciation and the principle of proportionality within the ECHR (Chapter III, section 2.4.a).

not economic, but scrutinizes the suitability and necessity of the means employed, "thus flushing out protectionist measures" [570]

There is no proper definition of each of the above three steps of proportionality; and it has been suggested that proportionality remains a vague concept because ambiguity pervades the three constituent elements, and leads to uncertainty as to which interests have to be taken into account.[571] One may say that suitability, for example, falls somewhere between "indispensability" and "usefulness,"[572] but that relative indeterminacy is a constant of that principle that is inherently flexible, and whose role is also to balance opposite interests and apparently conflicting rules and principles.[573] In my opinion that flexibility of the standard of reasonableness, which pervades the three steps of proportionality, is important to reach fairness in all cases, particularly where a purposive and contextual construction should prevail over a literal interpretation of municipal and international law, paying due regard to all relevant facts. The principle of proportionality coupled with reasonableness must not be a mathematical formula, but it must be applied in a consistent and fair way taking into account and balancing all the principles at stake as well as all the objective factors.

It has been also suggested that the most striking point about the doctrine of proportionality is the great margin of discretion of the Court.[574] However, the greater the discretion may be, the higher the standard of consistency that must be demanded, since the fundamental role of proportionality has been to weigh different and apparently conflicting rules and principles in specific circumstances to reach a reasonable and balanced sense of fairness.

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[570] Snell (2002), p. 218. On the economic purpose prohibition, see *inter alia* the *Open Skies (Commission v United Kingdom of Great Britain and Northern Ireland)* Case C-466/98 [2002] ECR I-9427, paragraph 56.

[571] Gerven, Walter van, *The Effect of Proportionality on the Actions of Member States of the European Community: National Viewpoints from Continental Europe* (Hart, Oxford 1999), pp.39 and 60.

[572] See Jans, Jan H., "Proportionality Revisited" (2000) L.I.E.I. 27(3), p.245.

[573] On the differences and similarities between the principle of proportionality and the reasonableness standard of review and their interaction, see Chapter I, sections 1 and 2.

[574] Hartley, T.C. *The Foundations of European Community Law* (OUP, USA 2003), p.152.

Since the reception of proportionality from some national jurisdictions,[575] the Court has developed this concept in order to make the principles and fundamental rules enshrined in the European Community Treaty (ECT, or by its present name the Treaty on the Functioning of the European Union, TFEU, the Treaty) really effective, according to its economic and social objectives. This also has germane effects in the tax field, as discussed below.

[575] Both the EU principles of proportionality and the protection of legitimate expectations have been regarded as originally borrowed from the German legal order (Lenaerts, K., *Comparative Law and EC Law*, p.121). As analysed in Chapter II, the same notion of proportionality is seen in US jurisprudence, and other international jurisdictions, and has been argued to be a general principle of international public law and as a relevant rule of international law, within the meaning of Article 31(3)(c) of the Vienna Convention on the Law of the Treaties See Brownlie, Ian, *Principles of Public International Law* (OUP, 1990) at 626, apud Montini, Massimiliano, "The Nature and Function of the Necessity and Proportionality Principles in the Trade and Environment Context" [1997] RECIEL, vol. 6 (2), p.129.

IV.2. Proportionality, taxation, and the fundamental freedom of goods

IV.2.1. Custom duties (Articles 28-30 TFEU)

The Court in *Louloudakis*[576] gave a clear demonstration of how proportionality works, balancing apparently conflicting principles and deciding which circumstances must be taken into account in each case. In this case, the principle of proportionality was explicitly applied in order to determine the balance between the tax penalty and the gravity of the infringement, in the light of the freedom of movement of goods. The Court also stated that the good faith of the offender, and the difficulties raised by the determination of the applicable arrangements, ought to be taken into account. This was in contrast with the general principle of law under which everyone is presumed to know the law.

The facts and the legal issue were whether a means of transport temporarily imported by a Greek national married to an Italian national, and having family and business interests in both countries, was exempt from excise duties or not. The Court gave precedence to the principle of good faith over the principle according to which ignorance of the law is inexcusable. The purpose of the directive that granted exemption to vehicles temporarily imported was ascertained under the freedoms enshrined in the Treaty. From that perspective, the penalties were also considered disproportionate because they went beyond what was strictly necessary for the objectives pursued (requirements of enforcement and prevention of evasion) that may justify national legislation setting penalties at a certain level of severity. In conclusion, the Court said that even a particular circumstance such as the vehicle's age ought to be taken into account when fixing the penalty, because otherwise to fix the penalty only on the basis of cubic capacity could increase the duties, which might be as much as ten times the charges at issue. Proportionality was clearly applied in that case, not only for balancing two apparently conflicting principles but also for determining which particular circumstances ought to be taken into account.

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[576] Case C-262/99. See the opinion of Michael Dougan ("Remedies and Procedures for Enforcing EU Law", in *The evolution of EU Law*, edited by Paul Grainne and Grainne De Burca, Oxford, 2011, p. 426 note 97) on how the Court was simply applying in this case general principles of EU law. See also EC Tax Review 254 – 255, (Vol. 10, No. 4, 2001).

IV.2.2. Trade restrictions on imports and the rule of reason (Articles 34-30). Reasonableness, proportionality, and the origin of the overriding requirements in the public interest.

The basis of the rule of reason may demonstrate a close relationship between reasonableness and proportionality. It is generally accepted that in the well-known case *Cassis de Dijon* [577] the seeds of the rule of reason, which were sown in an earlier case (*Dassonville*),[578] came to fruition. As Jukka Snell pointed out, in *Dassonville* the Court "both gave a wide formulation to the scope of Article 28 (ex 30) EC and hinted at an exception for 'reasonable' rules."[579] A certificate of origin (from the British authorities) required by Belgian law was regarded as very difficult to obtain with respect to goods (Scotch whisky) already in free circulation in a third country (France). After having stated that the most important characteristic of measures equivalent to quantitative restrictions was their effects, the Court ruled as follows:

> "In the absence of Community system guaranteeing for consumers the authenticity of a product's designation of origin, if a Member State takes measures to prevent unfair practices in this connexion, it is however subject to the condition that these measures should be *reasonable* and that the means of proof required should not act as a hindrance to trade…"[580]

Under Belgian law, only direct importers would be able to meet that requirement, which might constitute an arbitrary discrimination or a disguised restriction on trade. In conclusion, the Court held that requirement unreasonable pursuant to the fundamental freedom of movement of goods, taking into account that indirect

[577] *Rewe Zentral AG* Case C-120/78. See also Craig and De Burca (2003), pp.636-39; Emiliou (1996), pp. 232-39; and Tridimas (1999), pp.126-9.

[578] *Dassonville*, Case C-8/74 [1974] ECR-837, in which the Court stated that "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trader" are forbidden by Art. 28 (ex-30) on quantitative restrictions and measures having equivalent effect. See Terra, Ben and Wattel, Peter, *EU Tax Law* (Kluwer Law International, 2003) p.31; Craig and De Burca, Ibidem, p. 636; Emiliou, Ibidem , pp.230-1.

[579] *Goods and Services in EC Law*, p. 182. See also Craig and De Burca, Ibidem, p.617.

[580] Paragraph 6 of the judgment (emphasis added).

importers were not really in a situation to satisfy it "without facing serious difficulties."[581] As circumstances change and the notion of "reasonable" may be living and changeable as well, in a later decision the Court regarded as acceptable the requirement of a certificate of origin that had become easier to obtain, according to new information provided by the British and Belgian governments.[582] Furthermore, in that case the Court, after having referred to *Dassonville*, stated that the essential issue was whether the measures taken to ensure the authenticity of origin were unreasonable or not, that was, whether they were disproportionate or not in relation to that objective.[583] In other words, the Court ascertained the meaning of reasonable as being closely related to proportionate.

In contrast with *Dassonville*, in *Cassis* the Court dealt with a non-discriminatory rule. In the latter case, the Court declared invalid a German rule that required a minimum content of alcohol to certain alcoholic beverages under which a French liquer could not be commercialised in Germany. The relevant legal issue was that the rule was not discriminatory because it was also applied to domestic beverages and Article 28 EC (now Article 34 TFEU) in principle dealt with restrictive situations only on imports. The derogations from Article 34 TFEU (ex Article 28 EC) are in Article 36 TFEU (ex Article 30 EC), which allows Member States to discriminate against imports on grounds of public morality, public policy or public security, and other economic and social reasons.[584] Thus, the legal scenario was that non-discriminatory rules (restrictive on both domestic and imported goods) did not fall within Articles 28-30 EC. However, the Court stated that even non-discriminatory rules were covered by Article 28 EC in order to pursue the objectives of the Treaty (a

[581] Idem, paragraph 8.

[582] *Commission v Kingdom of Belgium* Case C-2/78 [1979] ECR-1761, paragraph 43.

[583] Idem, paragraph 38. On the role of proportionality in ascertaining reasonableness see also Chapters I, section 2; and III, section 2.2..

[584] Including expressly "the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; or the protection of industrial and commercial property" (Art. 36 of the Treaty on the Functioning of the European Union). On the extension of these explicit exceptions to services and other fundamental freedoms, which do not provide for the same but public policy, public health and public security, see next sections 3, 4 and 5. See also on similar justifications applied to goods and services, particularly on environmental protection, Snell (2002), p.185 (and n.99), and section 4 of this Chapter.

single market with no barriers on intra-community trade, among other social and economic objectives), and, as a consequence, restrictions on imports and exports should be read down as any restriction that may hinder community trade. Furthermore, in the same decision (*Cassis*) the Court established reasonable derogations from that new and creative construction of Article 28 EC, that is, the so-called imperative requirements[585] (relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer).[586] Thus, since *Cassis*, even non-discriminatory rules have been prohibited if they hinder trade in the Community and cannot be reasonably justified under the test of the imperative requirements.[587] The ideas of reasonableness and proportionality were clearly highlighted in that decision when the Court stated that, in order to protect the customers from being deceived – the alleged purpose of German law – some less restrictive means could be adopted. These included liquor labels simply demonstrating their alcoholic content and not the most restrictive measure of prohibiting the circulation of light alcoholic beverages, as this went against the fundamental freedom of movement of goods.

Although not so clear at the beginning, the further application of the overriding requirements has helped to make crystal clear the role of proportionality[588] and point out its difference from the notion of reasonable construction and ascertainment of legal rules and principles. It is also important to note that these imperative requirements were extended to the other fundamental freedoms (of movement of

[585] The notion of general interest that the imperative requirements pursue may be considered as synonymous with the notion of pressing social need for justification under a broad test of proportionality.

[586] The list of the heads of justification is already a long one and many examples can be found according to the developing cases of the Court (Snell, 2002, p.191-2).

[587] As Tridimas (1999) pointed out since "*Dassonville* and *Cassis de Dijon* liberated Article 28[30] from the notion of discrimination, the Court had no option but to rely on the principle of proportionality in order to draw the demarcation line between lawful and unlawful impediments to trade", p.128.

[588] In *Sandoz* Case C-174/82 [1983] ECR-2445, the Court had already ruled that the principle of proportionality is the basis of the last sentence of Art 30 EC "to attain the legitimate aim of protecting human health" (para. 18, apud Craig and De Burca, 2003, p.633). There would be no reason why the same principle should not underpin the imperative requirements as reasonable derogations from the public express exceptions.

persons and capital, and to provide services) with relevant tax consequences discussed in the following sections (IV.3, IV.4, IV.5 and IV.6).[589]

IV.2.3. The relationship between State aid and the freedom of movement of goods (Articles 34-36 rule of reason and 107 TFEU)

Under Articles 107-109 TFEU (ex Articles 87-89 EC) State aids are in principle contrary to the common market; however, there are some exceptions that may be lawful. Whereas that incompatibility does not have direct effect and are subjected to a *de minimis* rule, Article 34 TFEU (ex Article 28 EC) has such direct effect and is not submitted to the latter rule.[590] Although those differences are quite clear and settled, the Court applied the notion of proportionality in order to regard a particular measure as falling within either Art. 34 or Art. 107 TFEU (ex Art. 28 or Art. 87 EC). As decided in the *Iannelli* case, even though some measures form part of a system of aid, they may be considered as "not being necessary for the attainment of its object or for its proper functioning," and in this situation there are no reasons why other provisions of the Treaty should not be applied.[591]

In a specific tax case decided by the Court under Article 28 EC (Article 34 TFEU), an incentive given by French tax legislation to newspaper publishers was held invalid because there was no reasonable justification for having an equivalent effect to

[589] Luc Hinnekens argued that the Court has applied the rule of reason in a more restrictive way in the direct tax area ("European Court Goes for Robust Tax Principles for Treaty Freedoms. What about Reasonable Exceptions and Balances?" [2004] EC Tax Review, 2004, p.66). However, the point that should be made is that the public interest requirements are open ended and not limited in principle to fiscal supervision, tax coherence, environmental protection, tax avoidance, and balance in the allocation of taxing rights as further discussed on those sections, in which proportionality has been an essential tool for the enforcement of the fundamental freedoms, since same economic and legal principles underpin them.

[590] Oliver, Peter, *Free Movement of Goods in the EC* (Sweet and Maxwel, 2003), pp.99 and 107 (Cases 296 and 318/82, *Commission v Netherlands*, regarding State aid; and Cases 177-8/82 *Van de Haar* [1984] ECR 1795 regarding Art 28).

[591] Idem, p. 107, quoting *Iannelli* C-74/76 [1977] ECR-557. The Court ruled that Art 28 EC would apply to an "arrangement whereby aid is granted to traders who obtain supplies of imported products through a State agency but is withheld when the products are imported direct, if this distinction is not clearly necessary for attainment of the objective of the said aid or for its proper functioning" (idem, ibidem). See also Craig and De Burca (2003), p.1163, on this case regarding the relationship between State aid and the rule of reason.

quantitative import restrictions.[592] Besides the application of the relevant test of justification, that case is also interesting since a direct tax on profits was used as a means of indirectly restricting imports.[593] The incentive was that either any expenditure incurred for acquiring assets used for publishing would be a current allowance (not subjected to depreciation over a number of years), or any reserve for that purpose would be tax-free, under the proviso of it not benefiting in any respect any part of the publication being printed abroad. The French government also tried to defend the incentive under Article 87 EC (Article 107 TFEU), since it argued that the tax provision could not be separated from the general aid scheme for the newspaper industry. Here again proportionality was a useful instrument to balance both Articles (State aid permissible under some economic and social conditions and the prohibition of restrictive measures on imports), pointing out that they have a common objective, namely to ensure the free movement of goods, and that the "mere fact that a national measure may possibly be defined as aid within the meaning of Article 92 [now 87] is therefore not an adequate reason for exempting it from the prohibition contained in Article 30 [now 28]."[594]

It has been suggested that the relationship between Articles 34 and 107 TFEU is still in a situation of uncertainty.[595] However, one may consider that in the field of State aid and the common market, social, political, and economic factors are changeable and to some extent unpredictable, and that proportionality reasoning coupled with reasonableness may bring more certainty without eliminating some margin of discretion.[596]

In has also been submitted that proportionality is the most flexible instrument for determining the legality of restrictions on trade, and the same could be said with

[592] *Commission v France*, Case C-18/84. See comments on that case in Terra and Wattel (2003), pp. 34-5; and Craig and De Burca, Ibidem, pp.1163-4. See also Peter Oliver (2003), p.108.

[593] On the use of direct taxation to restrict imports, see also Chapter III.3 in the WTO context.

[594] Quoting the decision, Craig and De Burca, Ibidem n.533, p.1164.

[595] Oliver (2003), p.108.

[596] On the role of the rule of reason and proportionality to ascertain the state aid definition, see Eeckhout, Piet, and Biondi, Andrea, "State Aid and Obstacles to Trade", particularly pp. 114-15, in *The Law of State Aid in the European Union* (OUP, 2004).

regard to taxation. Although one may also accept that, in economic terms, proportionality may not necessarily be the most efficient because "it inserts a degree of uncertainty, encourages litigation, and, in that respect, it is liable to increase transaction costs".[597] However, it is also vital to remember that, in taxation, there are many principles and rules apparently conflicting and open, which need to be reconciled and ascertained by judicial decisions, and that may be a sensible cost for more consistency, fairness, and effectiveness of some principles that should not be simply aspirational. For example, if the Courts give more prevalence to objective justification under the full assessment of proportionality in tandem with reasonableness in search of fairness in every individual case, in detriment to a utilitarian view, more exceptions to general rules and more cases will have to be decided.[598] The problem with categorizations is that they may cause hardship in specific cases, and one of the roles of the Courts is to remedy these cases as well. For fairness not to be just an aspiration, but really enforceable, and not just theoretical, but effective in the real life for all cases, more litigation may be necessary.

IV.2.4. Domestic taxation and protective measures (Articles 110-113 TFEU). Discriminatory and non-discriminatory rules under the test of justification.

If the previous rules regarding the freedom of movement of goods deal with actual or potential cross border transactions only (Articles 28-30 on excise duties and Articles 34-36 TFEU on restrictive measures on imports and exports, providing the right of access to the market), Articles 110-113 of the Treaty on the Functioning of the European Union fill the gap that could exist for discrimination against the products of other Member States through internal taxation when those products would already be in a Member State (right of equality in the market). They prohibit internal taxation that either directly or indirectly discriminates against domestic and similar imports or that afford indirect protection to other products.[599] For the first set of rules, mainly

[597] Tridimas (1999), p.127.

[598] See the case *Burden and Burden* (at Chapter III, section 2.5.a), for instance, where the ECHR accepted the utilitarian argument to avoid more exceptions to the general rule, concerning inheritance tax that contained some special treatment for a special case (civil partnership), but not for the other at stake (elderly siblings living together).

[599] See Terra and Wattel (2003), p.30; and Craig and De Burca (2003), pp.593 and 607.

Articles 28-30, discrimination is not necessary, whereas for the second (Articles 110-113), direct or indirect discrimination is a requirement. This aspect may induce the view that, for "a restriction of *access to* the market place of a Member State" to be a breach of the freedoms, discrimination is not required, while, for "interference with *participation in* that market", discrimination is required.[600]

The above distinction is relevant in order to determine if a particular measure falls within either Article 34 or Article 110 TFEU, since for the former there is no need for discrimination, and it may cover tax rules as well. Proportionality once more may have an important role in that differentiation. Terra and Wattel give an example of a Danish tax that was imposed on the registration of both new cars and imported used cars. The Commission considered the tax on new imported cars so high that would be a protective measure under Article 110 TFEU (ex Article 90 EC),[601] but the Court also stated that Article 110 was inapplicable as there was no similar or competing domestic production (Denmark did not manufacture cars). However, Article 34 might apply since that high tax could restrict intra-Community trade, even if it was not discriminatory or protective given the absence of domestic production.

On the other hand, the concept of similarity itself is not defined and the Court has a substantive approach to ascertaining its meaning, taking into account the economic characteristics of each product and its relevance in the market, in the light of the fundamental freedom of movement of goods. If the products are similar, discrimination falls within Article 110(1) and the offending State has to equalize the taxes on domestic and imported products. If the products are not similar, but there is indirect protection of some of them, there will be breach of Article 110(2) and the protective effect has to be removed.

For example, there is a clear difference between wine and beer. However, in order to undertake a non-discriminatory tax treatment, the Court understood that the excessive English domestic tax on wines, when compared to that on beer, was in

[600] Ghosh, Julian, "The Jurisprudence of the European Court on Tax and the Fundamental Freedoms" (2000) C.T.R. Vol.3 (1), p.4.

[601] Terran and Wattel, *European Tax Law* (2003), p.10 on *Commission v Denmark* Case C-47/88 [1990] ECR I-4509.

breach of Article 110(2).[602] The beer was largely produced in England, while the wine was mainly imported. Such measure applied to softer wines represented an indirect protection of their products.

The Court used the same approach regarding whisky and liqueur fruit wine, in which case it decided that they are not similar but the different tax treatment may be caught by the prohibition of indirect protection.[603] Although whisky was taxed disproportionately heavily in comparison with the Danish liqueur, the relevant circumstance that was taken into account was that the former was taxed not alone in a separate category, but together with many other Danish spirits.[604]

In contrast with those cases mentioned, the Court apparently had difficulty in ascertaining with certainty the similarity between spirits from cereals and other spirits, and concluded that in those circumstances of doubt or contestation, Article 110(2) would be applicable.[605] Although it may be suggested that these cases may confuse the issues that could be subjected to the subjective impressions and tastes of the judges, the point is that the conclusion may have achieved some degree of certainty in an area itself uncertain, even after further economic and consumer research had been requested. Thus, in a case where there is a sound uncertainty on similarity, one may reasonably expect or predict that indirect protection may be caught by the second paragraph of Article 110.

In these sorts of cases, the Court's task consists in analysing not only the form but also the economic substance of a measure and its effects. This was also demonstrated

[602] *Commission v United Kingdom* Case C-170/78 [1983] ECR-2265. The internal market is one of the factors to influence consumer and has neither to crystallize given consumer habits nor to consolidate an advantage acquired by national industries (Tridimas, 1999, p.138).

[603] *John Walker v Ministeriet for Skatter*, Case C- 243/84 [1986] ECR-875. See Craig and De Burca (2003), p.602.

[604] See Farmer, Paul, and Lyal, Richard, *EC Tax Law* (OUP, 1994), p.74. In this case it was alleged that whisky for Scots and English people was the same as liqueur fruit wine was for the Danes, but the relevant comparison was made between domestic and imported alcoholic drinks as a whole.

[605] *Commission v France*, Case C-168/78 [1980] ECR-347. See Craig and De Burca (2003), p.600-1 and Emiliou (1996), p.151.

in *Commission v Belgium*,[606] in which the Court considered that the difference of 6% between the taxes on beer (a domestic Belgian product) and wine (mainly imported) was insufficient to characterize a discriminatory tax treatment. There was a substantial difference between the cost of the two products, and the relatively small difference of the tax rate could not be used and considered as a protection measure for Belgian beer producers.

One last case is worth mentioning because proportionality was again expressly applied to tax penalties, but now under Article 110.[607] In this case, Italian legislation that allowed for a penalty of imprisonment and confiscation in cases of importation was considered disproportionate, as comparable penalties were not provided in the case of tax offences on domestic transactions. Although some differences in penalties would be admissible, by virtue of different circumstances that concern both the constituent elements of the offence and the greater or lesser extent of the difficulty of discovering them, the difference was considered disproportionate in the light of the free movement of goods, under Article 110 of the Treaty.

It is thought that, according to the jurisprudence of the Court, a more stringent test of proportionality is required where the Treaty is in play, because its underlying objective is to promote an economic constitutional order rather than to facilitate free trade (like other agreements between the EU and third states).[608] On the other hand, the decisions of the Court may be open to criticism since it seems to have applied different tests of justifications regarding Art 110 (internal taxation on goods) and the other freedoms.[609] Whilst in the former the Court seemingly applied a more lenient test of justification and proportionality, in the latter the Court may have applied them in a stronger way. The Court seemed to be more stringent in reviewing the *similarity* of goods under Articles 90-93 EC (now Articles 110-113 TFEU) including even an economic analysis and thus not needing to apply a broader test of proportionality to

[606] Case C-356/85 [1987] ECR-3299. See Craig and De Burca (2003), p.605 and Terra and Wattel (2003), p.305.

[607] *Rainer Drexl* Case C-299/86. See Terra and Wattel (2003), p.11; Tridimas (1999), p.159; and Farmer and Lyal (1994), p.61.
[608] Tridimas, Ibidem, p.124.

[609] Wenneras, Pal, "The De Coster case: Reflections on Tax and Proportionality" (2002) L.I.E.I. 29(2), p.227. Further analysis on this issue, see the next sections, particularly 3, 4 and 5 of this Chapter.

enforce the protection against discrimination.[610] However, as discussed in the following sections, the objective reasons to justify different treatment either are the same or have a similar rationale to the imperative requirements (such as environmental taxation, tax coherence, allocation of taxing powers, fiscal supervision and tax avoidance).

[610] This view on being more stringent and broad on comparability analysis appears to contrast with the case law of the ECHR, which seems to be stricter in relation to proportionality but less strict in relation to comparable situations. On the fundamental role of proportionality regarding objective justification of 'discrimination' and 'distinction' in treatment, see the case law of the ECHR, Chapter III.2.3.a, as well as tax discrimination justified by general interest concerning international trade and the WTO (Chapter III.3).

IV.3. Free movement of persons, services and capital (proportionality as an explicit condition for any restrictive measure) and the overriding requirements.

In *Gebhard*,[611] the Court summarized the rule of reason, which had already been applied to the freedom of movement of goods, with regard to other fundamental freedoms (persons, services, and capital), and clearly stated that proportionality is an explicit requirement for any measure that, in the public interest, may affect those freedoms. It then stated:

> "It follows […] from the Court's case law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions:
>
> - they must be applied in a non-discriminatory manner;
> - they must be justified by imperative requirements in the general interest;
> - they must be suitable for securing the attainment of the objective which they pursue; and
> - they must not go beyond what is necessary in order to attain it."[612]

As the conditions are cumulative, it follows from that decision that if a restriction on establishment is discriminatory, then without further question it falls within the Treaty's prohibitions, and it may be possible to rely for justification only on the express derogations on the grounds of public policy, security, and health in Article 52 TFEU (ex Article 46 EC). In other words, any restrictions on the fundamental freedoms may be justified either under the Treaty's express exceptions[613] or under a

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[611] Case C-55/94. See Craig and De Burca (2003), p.785; Terra and Wattel (2003), p.33; and Ghosh (2000), p.4.

[612] *Gebhard*, paragraph 37. See also *Kraus* C-19/92 [1993] ECR I-1663, paragraph 32; *Centros* C-212/97 [1999] ECR I-1459, paragraph 34; and *Inspire Art* C-167/01 [2003] ECR I-10155, paragraph 133 among others.

[613] Article 36 TFEU (ex Article 30 EC) for the free movement of goods, Article 45 TFEU (ex Article 39 EC) for the free movement of workers, Articles 52 and 62 TFEU for the freedom of establishment and of services, and Article 65.1(a) [non-residents and residents may be treated differently for tax purposes] and Article 65.1(b) [public policy proviso], which applies to the free movement of capital and payments. See Ghosh, (2000) p.12.

broader and more open category of Court-developed exceptions (imperative requirements in the public interest),[614] according to the rule of reason.

That case is also relevant to tax matters and proportionality because direct discriminatory rules are almost automatically caught by the Articles that prohibit them, and the explicit exceptions on grounds of public policy, public security or public health, to which proportionality may also be applied, are unlikely to be relevant to taxation.[615] Thus, if a tax rule were discriminatory, it would be invalid without further examination of its necessity and proportionality.[616] On the other hand, indirectly discriminatory and even non-discriminatory tax rules may fall under the exception of public interest that includes, according to the Court case law, fiscal supervision, fiscal coherence, allocation of taxing powers, and prevention of tax avoidance, provided that they are suitable and do not go beyond what is necessary to achieve those objectives (proportionality test).

It was thought that the relevant articles related to the fundamental freedoms of persons, services, and capital might catch only discriminatory measures.[617] It was not then so clear whether the *Cassis de Dijon* rule of reason, regarding the movement of

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[614] See Craig and De Burca (2003), p.814. As already said, the Court also uses the terminology "overriding requirements in the general interest" as synonymous with imperative requirements.

[615] See Ghosh, (2000) p.12 (n.45) mentioning paragraph 28 of the Advocate-General Opinion in *ICI v Colmer* [1998] STC 874. The public policy derogation neither encompasses the protection of the social order nor of consumers (*Commission v Spain*, paragraphs 44-45, Case C-153/08 [2009] ECR-0000). As stated by the Court, the public policy exception that may allow discriminatory measures is also under the proportionality scrutiny (*Open skies*, Case C-466/98, paragraph 57). A clear example of the applicability of proportionality to the public derogations is *Campus Oil* case C-72/83 [1984] ECR-2727 with regard to public security (paragraph 37, apud Craig and De Burca, Ibidem, p.631). In *Commission v Spain*, the Court also stated that regarding "the objective of preventing money laundering and combating tax evasion, it is not necessary to determine whether that objective could fall within the definition of public policy," where the tax exemption only for national lotteries was discriminatory in nature and unjustifiable by being disproportionate to those objectives (Case C-153/08, paragraph 39).

[616] On a similar issue whether environmental protection falls within either Art. 36 or the developed imperative requirements, see the next section.

[617] See Terra and Wattel (2003), p.41, regarding persons and undertakings, and Tridimas (1999), p.78, regarding persons and services. See also Farmer and Lyal (1994), p.31, on *Commission v Greece* Case C-305/87 [1989] ECR-1476, in which the Court stated that the Articles regarding the fundamental freedoms specifically implemented Article 6 EC (now Article 18 TFEU) that prohibits discrimination on grounds of nationality.

goods (Article 34 TFEU), could also protect the other fundamental freedoms, even from *non-discriminatory* rules, that might hinder or simply make less attractive the exercise of those freedoms. Similarly, what was indicated regarding goods was that the emancipation of the freedoms "from the notion of discrimination elevated proportionality to the determining criterion of compatibility with Community law."[618]

From a systematic, logical and principled construction, one may agree that the Court illustrated "convergence and harmonization in the interpretation and application of the fundamental freedoms",[619] which should be similarly construed since the same principles underpin them.[620] On the other hand, it is suggested that the Court has not always been consistent in applying either the rule of reason (imperative requirements) or the Treaty's express derogations. This is because it apparently applied the former where there was clear discrimination, even though indirect (*Bachmann*[621]), and the latter only in other discriminatory situations (*Commission v France*,[622] *Avoir Fiscal* case, and *Royal Bank of Scotland*[623]).[624] However, there is an alternative view, with which I agree in part,[625] in the sense that the rule of reason is also applicable to indirect discrimination and not only to non-discriminatory rules, while the express derogations would be more appropriate to direct discrimination.[626]

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[618] Tridimas (1999), p.94.

[619] See Terra and Wattel (2003), p.41.

[620] See Craig and De Burca (2003), p.784. They rightly suggest that the Court in recent years has put less emphasis on discrimination and more on liberalization, at p.768.

[621] Case C-204/90 [1992] ECR I-249. In this case the Court indicated that covert (indirect) discrimination could be justified by imperative requirements (Farmer and Lyal, 1994 p.130).

[622]Case C-270/83 [1986] ECR-273.

[623] Case 311/97 [1999] ECR I-2651.

[624] See Terra and Wattel (2003), p.43. According to Farmer and Lyal (1994), p.331, the discrimination in the *Avoir Fiscal* case was direct and could not justify a derogation from Article 52 EC (now Article 49 TFEU).

[625] See my comment on the *Commission v Spain* case (C-153/08) below in this section.

[626] Ghosh, (2000) p.12. This author pointed out that in *Royal Bank of Scotland*, the Court said that there was direct discrimination, which means that there was automatic breach of the Treaty, since tax reasons did not fall within the express derogations of public policy.

The point in terms of consistency is relevant since the principle of proportionality is hopefully flexible, but it is not desirable that it leads to uncertainty and inconsistency. Craig and De Burca also pointed out that in *Bachmann*[627] and *Commission v Belgium*[628] the Court decided that the national rules held indirectly discriminatory could be justified under the imperative requirements test (cohesion of the tax system i.e. optional deduction of contributions and taxation of the pension retirement or, vice-versa, non deduction and later exemption, in which only contributions paid in Belgium could be deducted),[629] without the need for the state to invoke the special grounds of exception in Article 48(3) EC (now Article 54(3) TFEU).[630]

Still another view may be worth considering as simpler and less complicated than that taken by the Court for explaining and applying the overriding requirements. As Oliver pointed out, the more straightforward approach might have been to regard those public interests (fiscal supervision, fiscal coherence, tax avoidance, etc) "as covered by the public policy exception."[631] However, the Court had, at the time the rule of reason developed, a stricter view of the public policy derogation, which could hardly be expanded.[632] The main concern of the Court was to empower itself of the

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[627] Ibid.

[628] Case 300/90 [1992] ECR I-305.

[629] The Court stated that refusing deduction is a disproportionate measure to safeguard the effectiveness of fiscal supervision, but it could be acceptable under the criterion of fiscal cohesion. See Terra and Wattel (2003), p. 64, and the next section on further comments about *Bachmann.*

[630] *EU Law*, p.721. See also the point made in relation to *Bosman* on the range of justifications considered by the Court for the (arguably directly discriminatory) nationality restrictions (p.787, footnote 100). Terra and Wattel also mention that important decisions besides *Gebhard*, within the ambit of measures without distinction that may be acceptable if they pass the test of the rule of reason (pp. 41-2). In *Bosman* the proportionality test was applied in all its steps, including the acceptable legitimacy of the objectives of the UEFA rules (financial and competitive balance between clubs, supporting the search for talent and the training of young players, as imperative requirements in the public interest by being of 'sporting interest only'). The measure regarding the transfer fee, which was indistinctively applicable, failed, however, on grounds of adequacy and less intrusiveness (paragraph 14 of the judgment).

[631] Peter Oliver (2003), p.288.

[632] See *Segers* Case 79/85 [1986] ECR-2375, n. 130; *Donatella Calfa* Case C-348/96 [1999] ECR I-11 para. 21, and *Commission v Spain* case C- 114/97 [1998] ECR I-6717 para. 46, apud Snell, p.180, n. 71 (n. 205).

authority to strike down even non-discriminatory rules, which could hinder the exercise of the fundamental freedoms; but only those that were regarded as unreasonable under the imperative requirements coupled with the test of proportionality. Consequently, since then it has been thought that the most relevant distinction between the public express derogations and the imperative requirements "lies in their scope of application": whereas the latter would catch only "equally applicable measures," the former would catch "distinctly applicable rules."[633]

It has been pointed out that the Court has also applied the overriding requirements even to discriminatory measures.[634] From those cases, one may infer that where a clear distinction between direct and indirect discrimination may not be feasible, the Court may apply the imperative requirements, if there is a pressing social need to do so through a more or less stringent test of proportionality. The more uncertainty on the distinction between overt and covert discrimination – or even between distinctive and indistinctive rules – the more the need for a close proportionality test that may reduce or even eliminate the level of uncertainty for justification of apparently unreasonable measures.

My view on this issue is that the Court may implicitly apply the rule of reason to the prohibition on discrimination and its express exceptions on public policy, public security, and public health grounds. In other words, only "unreasonable" discrimination would fall within that prohibition and its derogations, so that any discriminatory measure - unrelated to public policy, health and security - that would not be allowed, if the proviso on discrimination were literally interpreted, would be permissible as long as being reasonable. Similar reasoning was made by the ECHR, the ICJ, and some domestic constitutional courts, such as the Supreme Court of the US, where they inserted the wording "unreasonable" in the prohibition on discrimination.[635] The difference here is that the rule of reason is applied to the

[633]Snell (2002), p.186. See also, on the strain of that distinction, Craig and De Burca (2003), p.660.

[634] Oliver (2003), p.218, and Craig and De Burca, Ibidem, p.634-5. See also *Bosman*, analysed above, *ICI v Colmer* as explained below, and the tax environmental cases in the next section.

[635] See Chapter I, section 2. See also the US Supreme Court cases *Quaker* and *Hoeper* (Chapter II.3); in the ICJ see *Minority Schools in Albania* case (Chapter III.2.3.a). Within the WTO all the explicit exceptions to the non-discrimination principle as well as the general prohibition on 'arbitrary or

exceptions to discrimination, but the rationale is the same as where it is applied to any rules regarding direct or indirect discrimination in search of fairness. Thus, discriminatory tax rules, which would be outside of the scope of the public policy, security, and health exceptions, and as result automatically banned, only if they were unreasonable, according the to the imperative requirements of general interest under the test of proportionality. However, this does not seem to be the view of the Court, which has been strict in accepting direct discrimination based on the imperative requirements other than the public proviso exceptions.[636]

One may agree that if even direct discrimination could be justifiable under the imperative requirements, and not under the public express derogations, there could be less inconsistency between the freedoms, since the most fundamental value would be to protect intra-Community trade and not necessarily only the prohibition of discrimination. In other words, a discriminatory measure might be justified under the broad notion of imperative requirements because what would underlie the prohibition of discrimination would be the notion of a single market and its corollary of exercising the four freedoms and other fundamental Union rights, which might not have been significantly hindered, depending on the circumstances of each case, and according to a particular pressing social need. Thus, the point may be that the same idea of justification should be applied to all freedoms. As Craig and De Burca appear to suggest, "the generic term 'objective justification'" may have different formal aspects or even names (mandatory requirements for goods, imperative requirements for workers and services), but essentially underlie the same principles and objectives of the Treaty.[637] Once again, the role of proportionality has been seen as an essential

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disguised discrimination' were construed in the light of the reasonableness standard and the proportionality reasoning (Chapter III.3.2.c).

[636] In the *Commission v Spain* case (C-153/08), in which tax exemption was restricted to winnings from lotteries and games of chance organized by certain national bodies and entities, the Court also stated that direct discrimination is scrutinised under the public proviso Articles, whereas indirect discrimination is tested according to the imperative requirements, but analysed the justification on some grounds (preventing money laundering and combating tax evasion) put forward by the Spanish government and rejected them on proportionality grounds (paragraph 39).

[637] Op. cit. p.815. See also Oliver, p.218. See again *Bosman* (n.74), in which the Court held that a requirement of 'sporting interest only' may justify both indistinctively applicable rules as imperative in the general interest and direct discriminatory rules under the test of objective justification. See also the tax cases in the next section.

element for EU legal reasoning, since "the notion of objective justification incorporates that of proportionality."[638]

A related issue is the meaning of public policy regarding taxation. As the approach of the Court seems to be living and changeable, Ghosh points out that where the Court in *Royal Bank of Scotland*[639] declared that "only an express derogating provision, such as Article 56…could render…discrimination compatible with Community law" (paragraph 32 of the Judgment), it was suggested that discrimination against the claimant was direct discrimination "but that the public proviso could, contrary to previous thinking, encompass tax considerations".[640] Also in *ICI v Colmer* the Court pondered that the tax discriminatory measure in issue (a consortium relief available only to companies controlling subsidiaries whose seats were in the national territory of a Member State) could not be justified by 'reduction of tax revenue,' whose ground of justification fell neither within Article 56 EC (now Article 63 TFEU) nor within the overriding requirements.[641] Thus, the need to avoid a reduction of tax revenue is not accepted for mere restrictions on fundamental freedoms.[642] However, that question still appears to be open, and the Court might conclude, depending on

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[638] Tridimas (1999), p.126.

[639] Case 311/97.

[640] Idem, p.25, n.75. The Court stated, in paragraph 33 of the judgment, "The Greek Government has not relied on any of the grounds referred to in Article 56 of the Treaty in order to justify the discrimination contained in the legislation in question." In the *Commission v Spain* case (C-153/08) the Court also stated that direct discrimination are scrutinised under the public proviso Articles, whereas indirect discrimination is tested according the imperative requirements, but analysed the justification on some grounds put forward by Spanish government and reject them on proportionality grounds.

[641] *ICI v Colmer* Case C-264/96 [1998] ECR I-4695, paragraph 28. In order to ascertain the comparability of situations between resident and non-resident companies, and whether or not there was justification for discrimination, the Court scrutinized other imperative requirements, particularly the one concerning tax avoidance (see section 6 of this Chapter). Regarding the similarity of justification for discriminatory and non-discriminatory tax measures see also the next section, on tax environmental protection, and the tax coherence justification, in section 5, particularly *Schumacker* C-279/93.

[642] See *inter alia* the following cases: *Cadbury Schweppes*, C-196/04 ECR I-7995, paragraph 49; and *Lasteyrie du Saillant*, C-09/02, paragraph 60. In cases of justification based on tax avoidance there is also a loss of revenue, but what is essentially involved is the lack of good faith of taxpayers implementing wholly artificial arrangements or not exercising a genuine commercial activity (see sections 6 and 7.2).

the particular circumstances of each case, potential erosion of fiscal systems would fall within either the public policy justification or the imperative requirements. To both of which the test of proportionality would be applicable in order to balance the apparently conflicting interests, yet without undermining the fundamental freedoms. In my opinion the mere reduction of tax revenue cannot solely and in its own right be a justification, unless temporarily and under exceptional circumstances, such as an extreme financial crisis. That is unlikely to happen, as other less drastic and more important justifications can be applied under the present imperative requirements or taken together with the erosion of the tax base.

IV.4. The interaction between environmental taxation and the fundamental freedoms. The role of proportionality in objective justification and in the scrutiny of protection of the environment as an overriding requirement in the general interest.

Even before Article 2 of the EC Treaty (replaced, in substance, by Article 3 TEU) expressly provided for a high level of protection of the environment as a Community task, the Court had already considered it one of its essential objectives.[643] As a consequence, either under Articles 110-113 (tax discriminatory and protective measures) or under Articles 34-36 TFEU (trade restrictions on imports), and still regarding other fundamental freedoms, environmental considerations may have been taken into account to justify any actually or potentially restrictive measure. That is what the Court has ruled in a number of cases in which the reasoning has been based on the proportionality test.[644]

Furthermore, Article 6 of the EC Treaty provided that "environmental protection requirements must be integrated into the definition and implementation of the Communities' activities and policies referred to in Article 3", like the abolition of obstacles to the fundamental freedoms (Art 3(1)(b) EC), and the prohibition of all measures having the equivalent effect of restrictions on import and export of goods between Member States (Art 3(1)(a) EC).[645] Pursuant to that express rule, which "is not merely programmatic; it imposes legal obligations,"[646] the role of proportionality may have become clearer and somehow stronger in environmental protection in contrast with the fundamental freedoms, since the main objectives of proportionality

[643] See *Commission v Kingdom of Denmark* Case 302/86, paragraph 8.

[644] Regarding Arts. 34-36 see the previous note and within an environmental tax policy see *Preussen Elektra* case C-379/98 [2001] ECR I-2099; concerning Art. 110 see *Commission v Italian Republic* Case C-21/79 [1980] ECR-1 and *Outokumpu Oy* Case C-213/96 [1998] ECR I-1777; and relating to services (Art. 49) see *De Coster* Case C-17/00 [2001] ECR I-09445.

[645] Craig and De Burca, *EU law* (2003), p.32. Art 11 TFEU has the same purpose of Art 6 EC, but with no specific reference to other Articles of the Treaty.

[646] Opinion of Advocate General Jacobs, paragraph 231, in *PreussenElektra* C-379/98.

are to balance different principles according to their purposes, reconcile apparently conflicting rules and principles, and scrutinize them under the requirements of necessity, suitability and less intrusiveness. The following cases may demonstrate that statement.

First, in terms of discrimination under Article 93 EC (now Article 113 TFEU), the Court accepted, in one of the leading cases regarding environmental justification, that tax advantages may be granted on ecological grounds, for example to encourage undertakings of recovery and re-use of used oils.[647] Having accepted ecological considerations as a justification, the Court analysed the issue concerning the different taxation between regenerated oils produced in Italy and regenerated oils from other Member States. The Italian government tried to justify the discrimination on practical grounds, since the impossibility to distinguish regenerated oils (more ecologically friendly product) from oils of primary distillation, would lead to tax evasion whenever those products were imported. The Court refused that argument, stating that importers could produce evidence that the oils were regenerated, like a certificate from the authorities in the exporting State. Moreover, the Court considered that a higher standard of proof was not necessary in order to eliminate the risk of tax evasion.[648] In other words, the Court established that less restrictive measures were available in order to make the different taxation on ecological grounds compatible with the fundamental freedom of goods under Art 90 of the Treaty (now Article 110 TFEU).

Similarly, in *Outokumpu Oy*,[649] whereas the Court reiterated its statement in the *Danish bottles* case, in which it blatantly applied the proportionality test,[650] and additionally mentioned Art 2 of the EC Treaty on environmental protection, it

[647] *Commission v Italian Republic* Case 21/79. See Craig and De Burca (2003), p.594.

[648] Paragraph 21.

[649] Case 213/96. See Terra and Wattel (2003), p.288-9.

[650] *Commission v Denmark* Case 302/86 [1988] ECR-4607. See on this case and proportionality, Langer, Jurian, and Wiers, Jochem, "Danish Bottles and Austrian Animal Transport: the Continuing Story of Free Movement, Environmental Protection and Proportionality" (2000) RECIEL 9(2), pp.188-92.

dismissed the reason submitted by Finland that practical difficulties could justify the application of internal taxation that discriminated against products from other Member States.[651] Although it was extremely difficult to determine precisely the electricity method of production (either nuclear or water power method and the raw materials used), the Court considered that Finnish legislation did not even give the importer the opportunity of demonstrating the method of production and eventually qualifying or not for the tax rate applicable to domestic electricity produced by the same method.[652] Again, in other words, the Court accepted the objective criteria for different tax rates on environmental grounds but did not accept the rough measure adopted, since there were less restrictive means available such as permitting some sort of evidence in order to demonstrate the method of production.

It is worth noting that the flat rate duty on imported electricity, whatever its method of production, was submitted as 'equitable' because it was not higher than the domestic highest rate. Thus, only in certain cases is that tax higher in comparison with the lowest duty charged on more environmentally friendly electricity. From a practical point of view and in terms of simplification, the flat rate might have been regarded as fair and reasonable to its aims on environmental considerations; it failed, however, on grounds of being the least restrictive measure in which proportionality plays a fundamental distinctive role from the mere notion of reasonableness or from a broad idea of equity in taxation.

Finally, it is interesting to note that in this case, similarly to the one previously analysed (Case 21/79), by balancing and contrasting the essential Community objective of environmental protection with the fundamental freedom of goods under Art 90 of the Treaty (Article 110 TFEU), through that disputed tax measure, one may achieve both objectives, because Finland "was left with the choice of either introducing a single (average) rate or of offering the importer the opportunity to demonstrate the method of production."[653]

[651] Case 213/96 paragraph 38.

[652] Idem, paragraph 39.

[653] Terra and Wattel (2003), p.289.

The above cases clearly illustrate that environmental grounds may justify different tax regimes provided that there is neither discrimination nor any other less intrusive means available. It is debatable whether environmental considerations may justify discriminatory measures.[654] Apparently not, but the Court has not clearly settled that issue yet, and maybe there will be no need to do that. The point again, as discussed in the previous section, would be that if only non-direct discriminatory measures might be justified under the imperative requirements, and the public policy, public security and public health exceptions might not encompass environmental protection, any direct discriminatory measure might not be justified on those grounds. On the other hand, under Article 30 EC (Article 36 TFEU) with regard to goods, if "the protection of health and life of humans, animals or plants" includes environmental purposes, as seems to be accepted in the *Aher-Waggon*[655] and *PreussenElektra*[656] cases, there might be some inconsistency in the application of the fundamental freedoms as a whole, since the underlying principles would be the same.[657] In my view this apparent inconsistency would be solved by the application of the rule of reason to the express exceptions on discrimination, so that only 'unreasonable' non-public health measures would fall within the prohibition on discrimination and its public proviso derogations, as explained in the previous section.[658] However, since environmental

[654] See Craig and De Burca (2003), p.634. They point out that there is no reason why Article 30 EC (Article 36 TFEU) should not include consumer protection and the environment (p.661). Further on this, see below *De Coster*, in which a discriminatory tax measure might have been justified as long as it had been proportionate to the objective of environmental protection.

[655] Case C-389/96 [1998] ECR I-4473, in which the Court stated that German restrictions on air traffic noises that affected more strictly, but temporarily, aircraft registered in other Member States were justified by considerations of public health and environmental protection, since they were proportionate to the objectives pursued and those objectives were not achievable by measures that were less restrictive of intra-Community trade (paragraphs 19-25).

[656] Case C-379/98, in which, apparently, discrimination was justified on environmental protection grounds within the express derogation of protecting the health and life of humans, animals and plants as provided in Article 30 of the Treaty (paragraph 75 of the judgment). On a seemingly contrary view, see Snell who points out that environmental protection is not found in Article 30 and that the Court "stretched the concept of health" (op. cit. p.180).

[657] As Oliver (2003) at p.218 pointed out, the grounds of justification set out in Article 30 EC (now Article 36 TFEU) are more numerous than Article 46(1) EC (now Article 52 TFEU), as a consequence, more convergence was needed. The Court then has also applied the imperative requirements even to discriminatory measures, such as in some tax cases as well (*Royal Bank of Scotland*, *ICI v Colmer*), as analysed in the previous section.

[658] See note 627.

considerations may serve essential and changeable objectives from time to time, a second best view may be that the protection of the environment may justify both discriminatory measures within the public health proviso and non-discriminatory (indistinctively applicable) rules or even indirectly discriminatory ones within the overriding requirements in the general interest, depending specifically on the legal and the factual circumstances of each case.

Whereas in *PreussenElektra*[659] an apparently discriminatory measure was justified on environmental grounds (to promote renewable energy sources) within also the public health express derogation, in the Danish bottles case (*Commission v Denmark*)[660] a clear, non-discriminatory rule was justified under the overriding requirement of the protection of environment. In this latter case, the *Cassis* list was once more extended to encompass environmental justification within the imperative requirement of the general interest.[661] Whatever the nature of a particular measure, whether distinctively applicable or not, there must be justification under the proportionality test.

On the other hand, in *De Coster*[662] the Court, apparently for the first time, accepted that environmental considerations might justify a discriminatory tax measure under the overriding requirements. Taking into account the role of proportionality and the conflicting interests at play, the main facts and findings of that case are the following. The inequality of treatment, within the freedom of services, was between cable and satellite broadcasting companies, since only the latter method of reception of television programmes was subjected to a tax on satellite dishes.[663] The

[659] Idem, in which was stated that the obligation on electricity suppliers to purchase electricity produced from renewable energy sources at minimum prices located within the respective supply area of each undertaking concerned, as an environmentally oriented tax policy, was "capable, at least potentially, of hindering intra-Community trade" (paragraph 71).

[660] Case 302/86.

[661] See Snell (2002), p.192, 206-7, and Craig and De Burca (2003), p.666-7.

[662] Case C-17/00.

[663] See an interesting analysis on how an indistinctly applicable tax on goods (internal taxation under Art. 90 EC – now 110 TFEU) may be regarded as breaching the Treaty under Art. 49 (Art. 56 TFEU) (services), in Wenneras, Pal, "The *De Coster* case: Reflections on Tax and Proportionality", L.I.E.I. (2002) 29(2), pp.219-230.

Commission had observed that, whilst broadcasters established in Belgian enjoyed unlimited access to cable distribution, others from some Member States did not.[664] A further factor of inequality was that most television broadcasting programmes from those Member States could only be received by satellite dishes, and a tax on them was likely to discourage the recipients in that region from seeking access to television programmes broadcast from abroad.[665] The Municipality of Watermael-Boitsforts, Belgian, had introduced a tax of five thousand francs per year on satellite dishes, regardless of size and frequency of use, preventing their uncontrolled proliferation, and preserving the "aesthetics of the urban environment."[666] The Court held that that protection of the quality of the environment could be achieved by other less restrictive measures available such as the regulation of the size of the dishes, their position, the way they are fixed or the use of communal dishes.[667]

The similarity with the previous cases is clear regarding the way the Court justifies discriminatory tax measures either under Article 90 EC (internal taxation, now Article 110 TFEU), as stated in *Commission v Italian Republic* (C-21/79) and in *Outokumpu Oy* (C-213/96) or under Article 49 EC (services, now Article 56 TFEU), as held in *De Coster* (C-17/00). The test of proportionality pursuant to ecological considerations has been applied either under the objective justification reasoning or under the seemingly more elaborate, but likewise open-ended, category of imperative requirements in the general interest in order to achieve similar protection of the fundamental freedoms.[668] *De Coster* is also worth noting since it may demonstrate the interaction between the overriding requirements of non-fiscal nature and specific tax measures, like the one questioned (a tax on satellite dishes) that was ultimately quashed only because it failed to comply with the proportionality principle.

[664] Paragraph 32 of the judgment.

[665] Idem, paragraph 33.

[666] Wenneras, op.cit., p.220.

[667] Paragraph 38.

[668] The intensiveness of the test of proportionality may minimize the apparently arbitrary result that Wenneras pointed out regarding the disparity between internal taxation on goods, which follows the test of non-discrimination, and internal taxation on the other freedoms, which follows the rule of obstacle to trade (op. cit. p.227).

IV.5. Proportionality and tax imperative requirements (fiscal coherence, effectiveness of fiscal supervision, balanced allocation of taxing powers and tax avoidance)

In *Cassis,*[669] there was a list of examples of what could be understood as being within the public interest: the effectiveness of fiscal supervision, the protection of public health, the fairness of consumer transactions, and the defence of the consumer. Therefore, the same open-texture or open-ended requirements may apply to persons, services, and capital, and the Court in taxation matters has developed other possible justifications such as integrity of the system (fiscal coherence), and the need to prevent abuse of law (tax avoidance), besides fiscal supervision, but all of them are subjected to a close scrutiny of proportionality. In tax matters, that list is not all-inclusive, and the Court may develop other justifications according to the public interest under the rule of reason.

Most cases analysed below deal with direct taxation, which falls within the competence of the Member States, but their fiscal sovereignty in this matter has been limited by the obligation to comply with EU law[670], particularly the fundamental freedoms. The Court balances the fiscal sovereignty in direct taxation with the obligations of non-discrimination against nationals of other Member States and of making the exercise of the fundamental freedoms tax neutral or not less attractive, according to the rule of reason and the test of justification (proportionality).

IV.5.1. The tax system coherence as a justification under the proportionality test.

In relation to fiscal coherence as an imperative requirement, the Court has not accepted simply potential, indirect, and sometimes-illogical links between a

[669] See this Chapter, section 2.2.

[670] Among other cases analysed below, see *Schumacker* (supra), paragraph 21; *Wielockx* case C-80/94 [1995] ECR I-2493, paragraph 16; *Gschwind* Case C-391/97 [1999] ECR I-5451, paragraph 20; *Verkooijen* Ccase C-35/98 [2000] ECR I-4071, paragraph 32; and *Barbier* (supra), paragraph 56.

restrictive tax rule and its justification. Whereas in *Bachmann*[671] the means used (non deduction of contributions to foreign insurers) was considered proportionate in order to make effective the option provided by the tax system, that is, (non) deduction – (non) taxation,[672] in *Asscher,*[673] the coherence of the tax system was not accepted because the Netherlands was making an unjustified link between taxation and social security contributions. In this latter case, the Court stated that the application of a higher tax rate on income did not provide any social security protection, and pursuant to Council Regulation No 1408/71 insurance is required in principle solely in the State of the employees' residence where they pursue part of their professional activity.[674] Furthermore, that higher tax rate could be regarded as very rough and disproportionate.[675] Indeed, in *Asscher* a fundamental question may arise about the nature of the fiscal systems pursuant to two kinds of fairness, which may have to be balanced via proportionality on a case-by-case basis. On one hand, the fundamental freedom of workers requires that they would not be worse off by moving from one state to another because that would be unfair; on the other, personal income tax and social security systems may interact and seek for fairness as well, in a sense of achieving a fair share within the European Union.[676]

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[671] Case 204/90. In *Bachmann* the Court stated that the cohesion could not be ensured by means of measures that were less restrictive according to the following considerations: an undertaking by an insurer could prove not to be enforceable in the other Member State for public policy reasons; the requirement of a deposit would not work because the additional expense would make it disinteresting for the insurer to maintain the contracts; the allocation of tax jurisdiction could only be reached by double tax treaties or by harmonization; and any other measure to guarantee the recovery of tax on payments made by foreign insurers would have consequences similar to those resulting from the non-deductibility of premiums (I-282 and 283 points 21 to 27), apud Van Thiel, Servaas (*EU Case Law on Income Tax*, IBFD, 2001, pp.234-5). See also Farmer and Lyal (1994), pp.327-8, Terra and Wattel (2003), pp.63-7, and Williams, David, *EC Tax Law* (Longman, 1998), pp.106-9.

[672] There is no good reason in principle why that option should not be regarded as logical and fair, because to tax both the contribution (non-deductible) and the benefit "would be excessive taxation", whereas to tax neither would be a "subsidy" (Williams, op.cit. pp.108, n. 55).

[673] *Asscher* Case C-107/94 [1996] ECR I-3089. The issue in this case was whether under the Treaty a Dutch national could be required to pay Dutch income tax at a higher rate on income accrued in the Netherlands, because he was not liable to social security contributions there, but in Belgium where he was a resident.

[674] Para. 60 of the decision. See also on the social security coordination, Williams (1998), p.112-4.

[675] Terra and Wattel (2003), p.58.

[676] Williams, op. cit. pp.114-8. That author suggested that the Court in those cases did not ask: "is this person paying more tax within the EU than someone who has not moved. They ask only: is this person paying more within this part of the EU?" (idem, pp.117-8).

Similarly, the Court held in *Wielockx*[677] that, under the proportionality test applied to fiscal coherence, the Dutch rule that allows only residents to deduct payments to a pension reserve is not justified because there are less restrictive means to achieving the objective (the correlation between deduction and taxation) such as taxation at source upon liquidation, since, unlike in *Bachmann*, the pension reserve was established in the Netherlands and was not outside its jurisdiction.[678]

The above-analysed cases concerned one of the main fiscal questions of personal income taxes in Europe: how to deal with pensions.[679] Since they are treated as deferred remuneration and workers can move and receive them in another country, proportionality has been a useful tool for searching for principles and fairness. First, the rule of reason taken together with proportionality was the legal tool to develop the tax coherence imperative requirement that in my view is fair in trying to make compatible national tax systems, including its relevant principles, with the fundamental freedoms.[680] Secondly, where the tax coherence appears to be just a formal and strict logical requirement, proportionality comes into play to assess national tax rules by balancing the fundamental freedoms with a fair share in the tax system of both host and origin countries. One may suggest that some decisions may help free movers to avoid responsibilities (a fair share in a tax system that interacts with a social security system),[681] but where there may be evidence of abuse of a

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[677] Case 80/94. See Van Thiel (2001), pp.333-81.

[678] Van Thiel, Ibidem, p.359. Even if a bilateral tax treaty provided that pensions received are only taxable in the resident country, and as a result the reserve would never be taxed in Netherlands, the deduction could not be denied because such imbalance would be contemplated by the treaty itself, which is generally used to secure fiscal cohesion, according to that decision. See Van Thiel, Idem, 359-60.

[679] Williams (1998), p.106.

[680] See also below in this section, the fair decision in the *Schumacker* case, in which the Court gave due regard to and enforced the ability to pay and worldwide taxation principles balanced with the fundamental freedom of workers in the EU.

[681] Idem, p.118.

fundamental freedom another imperative requirement, combating tax avoidance, may justify reasonable restrictions via the proportionality test as well.[682]

The argument of coherence of the tax system was also rejected in *Baars*[683] and *Verkooijen*[684], following from those authorities that establish "the link between tax deferral and later realization of the tax claim *within the same tax* and *with the same taxpayer*, or even within the same contract."[685] A *direct link* between deductibility and subsequent taxation was required in *Svensson and Gustavsson*,[686] in which a macro-economic link between tax expenditure and tax revenue (a subsidy for mortgages taken out only with a Luxembourg bank, whose profits made by issuing mortgages would finance that subsidy) was considered insufficient.[687]

Another interesting case is *Schumacker*,[688] in which the Court balanced the imperative requirement of tax coherence with a possible justification for discrimination. The issue was whether a resident of Belgian employed in Germany could benefit from the tax regime at source like residents, mainly in respect of the preferential rates for married couples (the "splitting tariff") and the annual adjustment for tax assessment purposes. Since Mr Schumacker was not resident in Germany, and consequently not subject to the worldwide income taxation (unlimited liability) there, he could not claim for personal allowances that were properly granted in the State of residence. The coherence of the tax system was accepted in principle to justify the different treatment between residents and non-residents, since according to international tax principles the overall taxation of taxpayers by taking into account their personal and family circumstances in order to determine their ability to pay is a

[682] See this Chapter, section 6.2.

[683] Case 251/98.

[684] Case 35/98.

[685] Terra and Wattel (2003), p.71.

[686] Case 484/93 [1995] ECR I-3955.

[687] Terra and Wattel, Ibidem, p.71.

[688] Case C-279/93.

matter for their State of residence.[689] In Mr. Schumacker's situation, however, as he obtained all or most of his income in the source State (Germany), and under Art 15 (1) of the Belgium-German Treaty, which followed the OECD Model and empowered the State of source to tax income from employment, he would not be taxed in Belgian, where otherwise his personal and family circumstances might have been taken into account. In principle, the difference in tax treatment between residents and non-residents was considered necessary and suitable to reconcile and enforce the principles of worldwide taxation (unlimited liability) and ability to pay. As the Court considered, neither of those principles would be enforced in Mr. Schumacker's case. Thus, the Court held that the rule was indirectly discriminatory and unjustifiable where the taxpayer's personal circumstances could not be taken into consideration neither in the State of his or her residence nor in the State of source (of employment).[690] Neither the justification on grounds of administrative difficulties in ascertaining non-resident income and personal circumstances, nor administrative simplification for annual adjustment of deductions,[691] were accepted under the objective criteria for discrimination between residents and non-residents, which follows the same reasoning as the proportionality test applied to the imperative requirements that may justify restrictions to the fundamental freedoms. The Court once again made a balanced decision taking into account the specific individual circumstance of the taxpayer. This could not be ignored under the principles of justice as fairness, and at the same time the Court made compatible the freedom of work and the relevant tax principles at stake as shown above.

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[689] Paragraphs 32, 33, and 40 of the judgment. On the splitting system for married couples, see also the decision of the German Constitutional Court, based on the balancing of different principles (ability to pay, family protection and effectiveness of tax rate progression via proportionality test (comparing some national jurisdictions and the ECHR (Chapter III.2.5.a) and the US (Chapter II.3).

[690] Germany has introduced new legislation that provided for the right to the splitting system and account of other family and personal circumstances on condition that either at least 90% of total income be taxed there or that income from exempt foreign sources does not exceed a certain ceiling. That legislation was held valid under the Treaty in *Gschwind* Case C-391/97, although the taxpayer could not have his personal circumstances taken into consideration in his State of residence (The Netherlands), since under the Dutch-German treaty on double taxation the income from Germany was exempt in the Netherlands. That situation was clearly unfair and disproportionate to the objectives of the bilateral treaty and to the ability to pay principle enforced in both countries, but the remedy should be to claim against the Netherlands. That happened in *F.W.L. de Groot* Case C-385/00 [2002] ECR I-11819.

[691] Case C-279/93, para. 43-5 and 51.

IV.5.2. The fiscal supervision requirement and the proportionality test.

Regarding the imperative requirement of fiscal supervision, in *Futura*[692] the Court also closely considered proportionality. In that case, Luxembourg required separate accounting in accordance with its domestic standards; these accounts should have been kept there during the year in which the loss was made for carry-over purposes by branches of foreign companies. As Terra and Wattel point out, the Court accepted that tax rules may limit loss compensation to losses economically connected to the Member State income ('fiscal territory principle'), and that evidence to safeguard that principle was necessary.[693] However, the Court stated that Luxembourg could not limit the means to showing evidence just to its domestic accounts held there in the year of loss following its own standards. Moreover, Luxembourg should also permit any other reliable evidence, which could be less restrictive, like evidence based on the French accounts (country of the head-office), adapted for Luxembourg tax purposes. It was irrelevant that resident companies also had to keep accounts there, because the requirement to keep double accounts according to different standards (France and Luxembourg) was hindering market access. In this case, the Court most closely scrutinised the means to achieve the legitimate objective of ascertaining clearly and precisely the losses actually incurred in Luxembourg.[694] First, the Court dismissed the apportionment requested by Futura. Since the profits could be accrued on that basis, there seemed to be no reason why the taxpayer should not apply the same method for losses. However, "given that the apportionment method involves inaccuracies," the Court stated that that method alone should not put a Member State under any obligation to accept it.[695] Secondly, the Court did not accept the Commission suggestion of referring to the accounts kept at the place of the taxpayer's seat. This method would be less restrictive than keeping a "proper account" in Luxembourg, but it was considered inappropriate because tax authorities

[692] Case 250/95 [1997] ECR I-2471. See Terra and Wattel (2003), pp.76-7; Craig and De Burca (2003), pp.794-5; and Ghosh (2000), p.9.

[693] Op.cit. p.77.

[694] Paragraph 39 of the judgment.

[695] Idem, paragraph 42.

would have to refer to accounts pursuant to the other Member States' rules, which would be contrary to the right of a Member State to provide its own rules on taxable income or losses.[696] Finally, the Court regarded as acceptable in a way less restrictive to both the tax authorities and the taxpayer, by weighing their interests and rights, any clear and precise demonstration of the amount of losses actually incurred in the State and under its substantive domestic rules governing the calculation of income and losses.[697]

Still with respect to the effectiveness of fiscal supervision, it is worth mentioning the *Baxter* case,[698] in which the principle of proportionality was again expressly applied. The Court stated that French tax legislation (that allowed a deduction from the Corporation tax for expenditure on research carried out only within its domestic jurisdiction) violated the fundamental freedom of establishment, and could not be justified under the overriding public interest of fiscal supervision. The French government submitted that this restriction was essential for the tax authorities to ascertain the nature and genuineness of the research expenditure incurred. Taking into account that in most cases foreign undertakings would have developed their research activities outside the territory of the levying State (indirect discrimination), and that other less restrictive measures would be available like the annual accounts and the consolidated accounts from which the tax authorities could proceed in their supervision of research expenditure, the Court regarded as unjustifiable the a priori prevention from providing relevant documentary evidence that expenditure had actually been incurred. Furthermore, as the Commission pointed out regarding the specific needs of fiscal supervision, "the competent authorities have the power to require production of supplementary information, subject to the principle of proportionality."[699] In other words, there were less restrictive means available to the tax authorities "to ascertain, clearly and precisely, the nature and genuineness of the research expenditure incurred in other Member States."[700] This case is closely related

[696] Idem, para. 32-4.

[697] Idem, para. 43.

[698] Case C-254/97 [1999] ECR I-4809. See also Jans, Jan H., "Proportionality Revisited", p.257.
[699] Paragraph 17 of *Baxter* decision.

[700] Idem, paragraph 20.

to *Amprafrance* in terms of fiscal supervision or practicability justification, although the main issue then was tax avoidance.[701] The imperative requirements may interact and the public authorities may submit two or more different justifications for the same measure.

As has been analysed, it is settled that any restrictive measure, even if non directly discriminatory, must comply with the requirements summarised in *Gebhard*, particularly proportionality (in its version of suitability, necessity and non-availability of less restrictive means to achieve the legitimate public interest in terms of environmental taxation, fiscal supervision, fiscal coherence, and tax avoidance, which are at times interwoven and not all-inclusive). This may be illustrated by another type of imperative requirement - the fair balance of taxing rights between Member States - that may also go in tandem with combating avoidance.

IV.5.3. The allocation of taxing powers between Member States, tax avoidance and proportionality.

In *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*,[702] the Court by its Grand Chamber created another type of imperative requirement in the general interest that may affect the exercise of fundamental freedoms, also subject to the test of proportionality.[703] This case dealt with UK group taxation relief according to which losses accrued by subsidiaries in the UK could be offset against profits of parent companies, whereas their foreign subsidiaries could not be part of the same tax group relief treatment. In this regard, setting up subsidiaries in other Member

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[701] Case C-177/99 [2000] ECR I-7013, in which it was discussed whether the denial of deducting VAT on accommodation, hospitality, food, and accommodation, was proportionate or not, even if they could be of genuine business nature. Further, on that case, see section 7.1 below.

[702] Case C-446/03 [2005] ECR I-10837.

[703] O'Shea, Tom, "Marks and Spencer v Halsey (HM Inspector of Taxes): Restriction, Justification and Proportionality" (2006) EC Tax Review, (15) pp.66-82; Lang, Michael: "The Marks & Spencer Case - The Open Issues Following the ECJ's Final Word" (2006) European Taxation 46(2), pp.54-67; Romano, Carlo, "Cross-border Deductions of Losses: Marks & Spencer and after" (2005) Rivista di diritto tributario internazionale nº III pp.173-189; Meussen, Gerard: "Cross-Border Loss Relief in the European Union following the Advocate General's Opinion in the Marks & Spencer Case" (2005) European Taxation 45(7), pp.282-286.

States could be less attractive than to set them up in the UK in situation of losses and taking risks. The UK government alleged that it did not tax the profits of foreign subsidiaries and consequently it should not be obliged to grant relief for their losses, and sought to justify the restriction on three grounds:

> "First, in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned. Second, if the losses were taken into consideration in the parent company's Member State they might well be taken into account twice. Third, and last, if the losses were not taken into account in the Member State in which the subsidiary is established there would be a risk of tax avoidance."[704]

The Court accepted the justification based on these three grounds taken together as legitimate objectives as "overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives."[705]

Regarding the first, the Court stated,

> "In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred."[706]

The Court then analysed if that tax restriction went beyond what was necessary to achieve its legitimate objectives, stating two conditions on grounds of

[704] Paragraph 43 of the judgment.

[705] Paragraph 51 of the judgment.

[706] Paragraphs 45-46. The other two justifications concerned tax avoidance and abuse were taken together in this case with the fair allocation of taxing rights. A similar tax avoidance and abuse of rights doctrine are considered as a separate imperative requirement in the next section.

proportionality.[707] Also based on proportionality the Court stated that, although less restrictive measures might be available, they would require tax harmonization regarding direct taxation, balancing the fiscal sovereignty of Member States and the exercise of fundamental freedoms.[708] One may suggest that the circumstances of terminal losses were very specific, a risk that is inherent to any economic activity, and the Court could have held that it was a problem for the host State to solve. However, the role of the Court is to reach fairness in each specific situation, and it would be unfair if the group relief taxation in the case of terminal losses were available only for those that did not exercised the fundamental freedom of establishment, making it less attractive, though only in this specific circumstance. Thus, in my opinion the decision in *Marks & Spencer* was right and fairly balanced, taking into account the objectives of tax avoidance, and the balanced allocation of taxing rights, and at same time optimizing the fundamental freedom of establishment in a situation of terminal losses. This role of balance is also inherent in the principle of proportionality (which the Court sometimes does not expressly mention because it is already implicit in its ruling).[709]

Also on grounds of the allocation of taxing rights between Member States, the Court in *N*[710] analysed another tax restriction and closely scrutinised it under the test of

[707] In order to offset the losses of foreign subsidiaries, the parent company has to demonstrate first, that "the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods", and secondly, that "there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party"(paragraph 55).

[708] See Opinion of Advocate General Poiares Maduro, paragraph 83, and paragraph 58 of the Court.

[709] See, for instance, the *Bachmann* and *Schumacker* cases (section 5.1), and *Outokumpu Oy* (section 4), where the Court did not mention the principle of proportionality, but applied its reasoning to assess discrimination or to accept or reject an imperative requirement in the general interest. See also some cases on tax abusive transactions, such as *Emsland-Starke* and *Barbier* (section 6.2), and *Halifax* (section 7.2), where the Court also applied the underlying reasoning of proportionality. Lastly, some examples of no express application of proportionality, though assessing retrospective measures under its test (balancing the legitimate expectation of those concerned and the public interest in retrospective legislation), can be found in *Racke* (section 8.2) and in *Gemeente Leusden* (section 8.4). In my opinion this lack of express reference to the principle of proportionality in some cases cannot be seen as a lack of justification, what really matters is the actual reasoning of the Court, with which one may disagree on basis of individual concept of fairness, or lack of consistency with previous similar cases, or still a lack of fair balance between the general interests of Member States and the fundamental freedoms.

[710] *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* Case C-470/04.

proportionality. The issue was the obligation of a tax declaration and guarantee to obtain a tax deferral on increases in the value of securities, when the taxpayer moved to another State.[711] The Court held both measures appropriate under the first prong of the test of proportionality (suitability to achieve the legitimate objectives of a fair allocation of the power to tax and to avoid double taxation).[712] Regarding the second prong of the proportionality principle (the necessity test), the Court held proportionate the requirement of a tax declaration but not the guarantee.[713]

The Court seems to adopt a minimum impairment approach, comparing the guarantee, which was regarded as excessive based on the availability of less restrictive measures, under the test of necessity and according to the importance of the objectives pursued:

> "On the other hand, the obligation to provide guarantees, necessary for the granting of a deferment of the tax normally due, whilst doubtless facilitating the collection of that tax from a foreign resident, goes beyond what is strictly necessary in order to ensure the functioning and effectiveness of such a tax system based on the principle of fiscal territoriality. There are methods less restrictive of fundamental freedoms."[714]

Lastly, regarding the third prong (the balance of all interests at stake) of the three-prong test of proportionality, the Court held that the failure to take into account any reductions in value at the time of transfer of residence would result in any administrative measure infringing the fundamental freedom at play:

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[711] This issue was similar to *De Lasteyrie du Saillant* (Case C-09/02) decided on grounds of tax avoidance and proportionality; see the next section.

[712] Paragraphs 42 and 47 of the judgment.

[713] Idem, paragraph 49.

[714] Idem, paragraph 51. Among other less restrictive measures the Court referred to the Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, as amended by Council Directive 2004/106/EC of 16 November 2004, that allows a Member State to request from the competent authorities of another Member State all the information enabling it to ascertain the correct amount of income tax (paragraph 52).

> "Finally, in order to be regarded in this context as proportionate to the objective pursued, such a system for recovering tax on the income from securities would have to take full account of reductions in value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State."[715]

Sometimes the overriding requirement of a balanced allocation of taxing rights between Member States may work only where there is another justification for a restriction to the fundamental freedoms, as the Court stated in *Rewe Zentralfinanz.*[716] The German tax rule at stake only allowed the deduction of a reduced book value in respect of shareholdings in domestic subsidiaries. The German government reasoning in this case was similar to the UK's in *Marks & Spencer*, by alleging that profits and losses were two sides of the same coin, and as profits of foreign subsidiaries were not taxed, their losses should not be taken into account. The Court refused this justification by holding that the restriction was not addressed to tackle tax avoidance, unlike in *Marks & Spencer*.[717]

On the other hand, the tax avoidance requirement in tandem with the fair allocation of taxing rights differs from the autonomous tax avoidance requirement discussed in the next section. Whereas the former allows Member States to tackle any abusive transaction, in which there may be some business purposes other than tax mitigation, the latter encompass only wholly artificial arrangements. The Court made this clear in *Société de Gestion Industrielle SA (SGI),*[718] in which Belgian transfer pricing rules that applied an arm's length standard were upheld to protect a fair allocation of taxing rights. These transfer pricing rules did not address only wholly artificial prices. The role of proportionality is not only present in taking together and balance

[715] Idem, paragraph 54.

[716] Case C-347/04 [2007] ECR I-2647.

[717] Idem, paragraphs 41 and 52.

[718] Case C-311/08 [2010] ECR-0000. See O'Shea, Tom, "ECJ Upholds Belgian Transfer Pricing Regime", Worldwide Tax Daily 2010 WTD 19-1.

that requirement with a broad notion of avoidance,[719] but also in the scrutiny of the specific measures to secure arm's length prices between related parties in cross-border transactions.[720]

These above cases demonstrate how proportionality reasoning might be the determining factor in the recognition of new imperative tax requirements. My view is that under the rule of reason whose underpinning is equity or fairness, the proportionality principle is an important requirement to assess more objectively all measures that pursue general public interest that is undefined. Thus, where there is some uncertainty (the definition of general public interest), proportionality comes into play to bring more clarity and certainty, particularly under its necessity test and the overall interests at stake (not only the public interest), what is a fair balance between equity (rule of reason)[721] and legal certainty. The second and third prongs of the proportionality test were applied to assess the restrictions in order to make the fundamental freedoms as compatible as possible with the overriding requirement of a balanced allocation of taxing rights between different States. As discussed in *Marks & Spencer, Rewe Zentralfinanz* and *SGI*, the allocation of taxing rights may be in tandem with combating avoidance. This last requirement as a separate standard from the allocation of taxing rights and its close relationship to the general principle of good faith and abuse of rights and proportionality will be analysed in the next section.

[719] Paragraph 66 of the judgment in an implicit way.

[720] The Court first stated that the taxpayer must be "given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction"; and secondly, "where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence" (paragraphs 71-72 of the judgment).

[721] On the equity grounds of the rule of reason, see Chapters I, section 1; and IV, sections 2.2 and 9.

IV.6. Proportionality, abuse of rights and tax avoidance.

IV.6.1. The importance of addressing tax avoidance and the role of proportionality

Before analysing some cases on this topic, it is worth making some general comments on tax avoidance and some underlying principles that may justify specific or general rules addressed to that question.

Tax avoidance is challenging and the issues raised by general or specific anti-avoidance rules may "go to the foundations of a country's tax system."[722] Taxpayers have the right to legitimately organize their activities and business in the most suitable way, including a tax viewpoint. This is perfectly lawful behaviour and a customary doctrine recognized by many countries.[723]

Starting from the pure liberalism point of view, "a radical separation of legal form and economic substance … [is required, and] … laws must be addressed to the generality of legal subjects, without distinction as to their social or economic position."[724] This theory is considered untenable, due to its extreme inequalities at a socio-political level. Consequently, pure liberalism has given way to "welfare liberalism", establishing an adequate and substantive social basis and providing conditions that allow formal equality to be performed.[725] Thus, interventionist forms supplant the liberal forms of regulation.

Although equality, ability to pay, fairness, and the concept of abuse of rights may support the adoption of general or even specific anti-avoidance provisions, these rules may damage the requirements of certainty, predictability, and protection of fundamental freedoms, which are essential elements in a liberal system. However, Picciotto again highlights that this assertion unrealistically assumes that formal rules

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[722] Arnold, Brian J. "The Canadian General Anti-Avoidance Rule", in *Tax Avoidance and the Rule of Law*, (IBFD, 1997), p.243.

[723] See Vanistendael, Frans, "Judicial Interpretation and the Role of Anti-Abuse Provisions." (IBFD, 1997), p. 132.

[724] Piccioto, Sol, (W&D, London 1992), p.79

[725] Idem, p.81.

can be defined by referring them to completely factual conditions, or objectively ascertainable circumstances. The resort to less precise standards is often made in private law ("good-faith", "foreseeability", "reasonableness" etc.).[726] Similarly, it is reasonable to affirm that tax laws based only on specific and formal rules tend to be amended often; to the extent that they could be considered a battlefield between taxpayers and the Treasury. The optimal relationship between tax authorities and taxpayers should be fair play, capable of providing reasonable certainty, stability and predictability - the main objectives of those who support and defend liberal formalism as well. Thus, reasonable general or specific anti-avoidance rules may provide a fair relationship between taxpayers and fiscal authorities, avoiding abuse from both sides. Another great advantage of anti-avoidance rules, depending on how they are provided and enforced, is that they give opportunities to find principles of taxation and grant them "a vital function in the interpretation of tax legislation".[727]

A different perspective over tax avoidance matters considers the creation of legislative uncertainty as an essential weapon to control situations that would not be acceptable from the point of view of justice. Moreover, such situations would not be acceptable from the standpoint of the treatment of equivalent economic situations and of tax collection itself. "However, discretion and uncertainty are not necessary companions. Indeed, the exercise of discretion is how you offer certainty where legal definition cannot."[728] For instance, in terms of anti-avoidance measures, they may be specific or general. In this latter case, some discretion is necessarily left to fiscal authorities and judges to consider whether there is, in each case, a business purpose other than artificially avoiding taxes. In my view, the revenue discretion is more appropriate where necessary to ascertain objective factors and legal issues regarding tax avoidance; however, it must be submitted to judicial review. The broader the discretion the closer the scrutiny may be necessary to avoid subjectivism, bias, arbitrariness, and a lack of sound commercial reality, particularly when dealing with business purpose requirement. Thus, the tax assessment founded on tax avoidance must observe the fundamental rights that require no excessive burden of proof and

[726] Ibidem, p.87.

[727] Roxan, Ian, "General Anti-Avoidance Rule in Action" [1998] B.T.R. 140 at 146.

[728] Gammie, Malcolm. "Tax Avoidance and the Rule of Law", in Cooper, Graeme S. ed., *Tax Avoidance and the Rule of Law* (IBFD, 1997), p.215.

fair rebuttal, no interference with the taxpayers´ right to manage their own business (except where artificial arrangements are made solely for tax purposes), no excessive penalties or guarantees, no restrictions to carry economic activities while tax assessment is under way, independent commissioners and judges, and other rights, such as an overall fair assessment that is part and parcel of due process and the rule of law. As part of the assessment on tax avoidance, the role of proportionality coupled with reasonableness is to ascertain as fair and objectively as possible the legal issues and relevant facts with their open-ended circumstances, such as business purpose, abuse of rights, or valid economic reasons.[729]

It is also essential to mention the fundamental role the principle of proportionality coupled with reasonableness may have in balancing all tax principles that justify tackling tax avoidance, mainly equity and the doctrine of abuse of rights, against other relevant principles, such as good faith, legal certainty, and predictability. All of them are important and none of them should be absolute or exclusive. First, general or specific anti-avoidance rules should be suitable for the attainment of the desired objective (to avoid artificialities and abuses, for example); second, the necessity of the measure in a sense that it is the least restrictive of individual freedoms that could be adopted; and third, the requirement of the proportionality of the measure to the restrictions involved (balancing).

Having considered some issues regarding tax avoidance rules[730] and proportionality, this section will analyse how the European Court of Justice has developed and applied them in the light of the fundamental freedoms and other general principles of EU law, such as the general principles of good faith and abuse of rights,[731] through the principle of proportionality coupled with reasonableness.

[729] See the following sections 6.2, 6.3, and 7.2.

[730] On European tax avoidance, see also Weber, Dennis, *Tax Avoidance and the EC Treaty Freedoms* (Kluwer Law International, 2005).

[731] See, on the general doctrine of abuse of rights within the EU, Schammo, Pierre, **"**Arbitrage and Abuse of Rights in the EC Legal System" (2008) ELJ, 14(3), pp.351–376; and De La Feria, Rita, "Prohibition of Abuse of (Community) Law: the Creation of a New General Principle of EC Law Through Tax" (2008) CML Rev 45, pp.395-441; and specifically dealing with two main tax cases, Vanistendael, Frans, "*Halifax* and *Cadbury Schwepps*: One Single European Theory of Abuse on Tax Law?" (2006) EC T.R. 15(4), pp. 192-95. See also *Kofoed* (Case C-321/05 [2007] ECR I-5795, at

IV.6.2. Development of a general anti-avoidance rule in direct taxation and the doctrine of abuse of rights.

The first landmark case in which tax avoidance was put forward as justification for discrimination was *Commission v France* (*Avoir Fiscal*).[732] Though the essential issue in this case was not tax avoidance, as explained below, France tried to convince the Court to accept a discrimination against branches on that ground, and the first thoughts of the Court on this topic are worth discussing here. Under French tax legislation only resident shareholders had the right to a credit against their personal or corporate income tax for the corporate tax charged on the profits out of which a dividend was paid. In this case, French branches of German insurers were denied the tax credit, since branches have no separate legal existence and therefore could not have their residence in France, even though they were subject to tax on their branch profits. France argued that the foreign shareholders had the option of setting up subsidiaries instead, but the Court did not accept this argument based on the then Article 52 EC (now Article 49 TFEU) that provides for the choice of the legal form to be adopted in order to exercise the freedom of establishment. Consequently, that fiscal rule restricted a fundamental freedom using the legal criterion of residence. Moreover, as the rationale for the tax credit for shareholders was to avoid economic double taxation, and since the branches were taxable on their attributable profits, the same reason was present for them to claim the tax credit. The Court also rejected the other argument of combating tax avoidance that France presented, in a sense that there could be an abuse of the utilization of branches by foreign companies, and that only bilateral treaties should grant the credit. The Court responded on the basis that a fundamental freedom could not be conditional on bilateral negotiations with Member States. The Court finally gave no further consideration to the specific abusive purpose.[733]

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paragraph 38), analysed below, in which the ECJ expressly stated that the prohibition of abuse of rights is a 'general Community law principle'.

[732] Case 270/83. See Terra and Wattel (2003), pp.78-80; Ghosh (2000), p.28; Craig and De Burca (2003), p.792; Farmer and Lyal (1994), pp.313-5; and Van Thiel (2001), pp.137-68.

[733] See paragraph 25 of the judgment. Van Thiel mentions an obiter dictum in which the Court indicated that the tax avoidance submissions were little convincing (op.cit. p.147).

As Terra and Wattel point out, there was no reference to the rule of reason and the overriding requirements in the *Avoir Fiscal* case.[734] The Court simply stated that the Article does not permit any derogation on that ground. It may be suggested that the allegation of potential avoidance was not regarded as serious, or there was no risk of abuse whatsoever. It was possibly regarded as implicit that the public policy exception did not encompass tax considerations.[735]

Similar to the requirements of fiscal coherence and fiscal supervision, the Court has accepted a tax avoidance imperative requirement by applying the test of proportionality to assess measures addressed to abusive situations. In two landmark cases related to direct taxation, the Grand Chamber developed the principles applied to the doctrine of abuse of tax law or tax avoidance.

In *ICI v Colmer* [736], the Court held that a tax rule under which parent companies could offset losses from their subsidiaries only if the majority of them were bodies' corporate resident in the UK (consortium relief) was incompatible with the freedom of establishment. Pondering the justification based on the risk of tax avoidance, the Court stated:

> "…. the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax

[734] Op. cit. p.80.

[735] According to Farmer and Lyal (1994) (op.cit. p.331) the discrimination in that case was direct and could not justify a derogation from Article 52 (now 43). On this issue, see also sections 2 and 3 of this Chapter. If a discrimination involves the "residence" of companies criterion in other Member States, it may be better regarded as an indirect discrimination, which might be seen as direct where branches are subject to the branch profits tax.

[736] Case 264/96.

avoidance, since that company will in any event be subject to the tax legislation of the State of establishment."[737]

In *Cadbury Schweppes,*[738] the Grand Chamber closely scrutinised under the test of proportionality the UK Controlled Foreign Company (CFC) legislation that was designed to tax foreign profits of subsidiaries set up in lower tax jurisdictions. The UK CFC rules provided for an exception where the parent company could demonstrate that its main purpose or one of its main purposes was not tax motivated. The Court in principle accepted the legitimate purpose of tackling tax avoidance, but rejected the specific CFC rules, as they did not provide for an exception for genuine and not wholly artificial transactions, even if they were tax driven.[739] In other words, the legislation in principle went beyond what was necessary to counteract only abusive transactions (wholly artificial and not genuine). The means to achieve this objective were reasonably available and provided by the exchange of information and mutual assistance between national tax administrations by the competent authorities of the Member States in the field of direct taxation and by the Double Tax Convention between the United Kingdom and Ireland.[740] If a transaction is performed or a company is set up in another jurisdiction and its main purpose is to obtain a tax advantage, this must be genuine (not wholly artificial) to be valid for tax purposes. The way the Court found to make fiscal sovereignty in direct taxation compatible with the fundamental freedoms was to accept the combating of tax avoidance as a legitimate interest that may restrict the exercise of the freedom of

[737] Paragraph 26 of the judgment. That statement was reiterated in *Mettallgeselshaft* and *Hoesch,* Joined Cases 397/98 and 410/98 [2001] ECR I-1727, paragraph 57. See also Terra and Wattel (2003), p.81-83.

[738] Case C-196/04. See comments on this case inter alia, Simpson, Phillip, "*Cadbury Schweppes plc v Commissioners of Inland Revenue*: the ECJ Sets Strict Test for CFC Legislation" [2006] B.T.R. 6, 677; O'Shea, Tom, "The UK's CFC Rules and the Freedom of Establishment: Cadbury Schweppes plc and its IFSC Subsidiaries—Tax Avoidance or Tax Mitigation?" [2007) EC T.R. 13. More generally on CFC legislation and Community Law, see Lang, Michael, Aigner, Hans-Jörgen, Scheuerle, Ulrich, and Stefaner, Markus, (Eds), *CFC Legislation, Tax Treaties and EC Law* (Kluwer, 2004).

[739] The Court stated that it should be assessed if the CFC "physically exists in terms of premises, staff and equipment" (paragraph 67). The Court also illustrated (at paragraph 68) situations that would be abusive, such as the cases of a 'letterbox' or 'front' subsidiary (see *Eurofood IFSC* Case C-341/04 [2006] ECR I-3813, paragraphs 34 and 35).

[740] Paragraph 71 of the judgment.

establishment, but only where the specific anti-avoidance rule targets wholly artificial arrangements subject to the proportionality test.[741]

Another case that is worth discussing under tax avoidance, abuse and the proportionality test in direct taxation is *Lankhorst-Hohorst.*[742] This concerned German thin capitalization rules, under which interest paid by a resident subsidiary to its parent company (resident abroad or not) might be considered for fiscal purposes as a hidden dividend. The objective of that legislation was to avoid the abuse of a reasonable debt-equity ratio, as tax advantages are provided by the deduction of interest whereas dividends are not deductible. There may be also an advantage in relation to different rates of withholding tax on dividends and interest. Thus, the parent company could always opt for a loan instead of capital contribution for exclusive tax purposes if there were no specific anti-avoidance legislation. The problem with the German rule was that, although it provided for an exception under which if the subsidiary could also have obtained the loan from a third party under identical terms (*arm's length*) then the thin capitalization rule would not apply, this derogation could not be applied in *Lankhorst*, since it was over-indebted and unable to provide security in order to obtain a similar loan from a third party.[743] Moreover, the subsidiary justified the loan from its parent company in order to reduce the interest charged on bank loans and proved that its losses in the relevant years exceeded the interest paid. The Court cited *ICI v Colmer* and noted that the German legislation at issue did not have the aim of preventing "wholly artificial arrangements", since it applied to any situation in which the parent company had its seat outside Germany.[744] There are good grounds for saying that there was no abuse in a sense of artificial transactions without any commercial reasons. Accordingly, the restrictive measure went further than was necessary to prevent tax advantages

[741] For indirect taxation purposes, the Court seems to allow further requirements such as that the main purpose of a series of transactions is not tax motivated, but also submits them to the test of proportionality, as happened in *Halifax* and *Part Service*. See section 7.2 below.

[742] Case 324/00 [2002] ECR I-225. See Airs, Graham, "Lankhorst-Hohorst GmbH: Thin Capitalisation Rules and the EC Treaty" [2003] B.T.R. 4, 268-275.

[743] Paragraph 12 of the judgment.

[744] Paragraph 37.

obtained from loans and not from share capital pursued with the objective of abusive tax avoidance. On the other hand, it has been suggested that even if national legislation were addressed to combat tax avoidance, the Court would not accept this justification where some tax is paid on interest somewhere in the Community.[745]

Furthermore, even if taxpayers make investments solely for tax reasons, such as avoiding registration duties and taking tax advantages of legal structures provided in other Member States, their freedom of movement or capital may not be restricted. This happened in *Barbier* where the Court stated the following:

> "… the tax consequences in respect of inheritance rights are among the considerations which a national of a Member State could reasonably take into account when deciding whether or not to make use of the freedom of movement provided for in the Treaty." [746]

Another interesting case regarding tax avoidance, abuse and proportionality is *De Lasteyrie du Saillant*.[747] In this case, the Court first determined the objective of the French tax rule at stake, and asserted that avoidance is closely related to abuse in the sense of artificial transactions, by stating that French taxation regarding securities was,

> "… not specifically designed to exclude from a tax advantage *purely artificial arrangements* aimed at circumventing French tax law, but is aimed generally at any situation in which a taxpayer with substantial

[745] Airs, Graham, Ibidem, op. cit. p.272. Subsequently, the ECJ applied similar reasoning in cases involving thin capitalization rules, testing these rules under its tax avoidance approach and the principle of proportionality, such as *Test Claimants in Thin Cap Group Litigation* (case C-524/04 [2007] ECR I-2107) and *NV Lammers & Van Cleeff* (C-105/07 [2008] ECR I-173). See also O'Shea, Tom, "News Analysis: ECJ Overturns Belgian Thin Cap Rules" (Tax Notes International, March 10, 2008) p. 837.

[746] Case C-364/01, paragraphs 71 and 75. On *Barbier*, see O'Shea, Tom, "Accessing EU Tax Advantages" (2009) International Tax Report, p.7.

[747] Case C-9/02.

> holdings in a company subject to corporation tax transfers his tax residence outside France for any reason whatever."[748]

Secondly, the Court applied the proportionality principle by holding that the French tax rule could not, 'without greatly *exceeding what is necessary in order to achieve the aim which it pursues'*, assume 'an intention to circumvent French tax law on the part of every taxpayer who transfers his tax domicile outside France.'[749] The Court went on to give examples of less restrictive measures[750] relating them again to the principle of good faith:

> "As the Advocate General has pointed out in paragraph 64 of his Opinion, the French authorities could, for example, provide for the taxation of taxpayers returning to France after realising their increases in value during a relatively brief stay in another Member State, which would avoid affecting the position of taxpayers having no aim other than the bona fide exercise of their freedom of establishment in another Member State.[751]

From these authorities I conclude that, in principle, only abuse in the sense of wholly artificial transactions may fall within the requirements of prevention of tax avoidance, and that "tax jurisdiction shopping" is legitimate in an internal market.[752] The Court appeared to follow in direct taxation the doctrine of business purpose so as to avoid only transactions that are solely tax motivated.[753]

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[748] Paragraph 50 of the judgment.

[749] Idem, paragraph 52.

[750] The measures imposed on taxpayers who wished to move outside France were regarded as strict conditions, such as the obligation to make a declaration within the prescribed period, to designate a representative established in France and set up guarantees sufficient to ensure recovery of the tax on securities held there whose capital gains were not realised yet (paragraphs 47 and 56).

[751] Idem, paragraph 54.

[752] Terra and Wattel (2003), p.81.

[753] That view is slightly different from the notion of valid economic reasons provided by the Merger Directive, as will be seen below in *Leur-Bloem* and *Kofoed*, and within the VAT context in *Halifax* (section 7.2).

Another relevant case for the discussion of abuse is *Centros.*[754] This case concerned the use of a legal form in the UK expressly to circumvent Danish minimum capital contribution requirements. First, the Court stated that the fact that a "company does not conduct any business in the Member State in which it has its registered office and pursues its activities only in the Member State where its branch is established is not sufficient to prove the existence of abuse or fraudulent conduct.[755] As the justification based on abuse failed, the Court then considered the objectives of avoidance of fraud and protection of creditors under the proportionality test, explicitly stating that there were other ways less restrictive to the freedom of establishment, such as "making it possible in law for public creditors to obtain the necessary guarantees."[756]

The Court reiterated the notion of abuse in *Inspire Art*, stating,

> "….. that the fact that the company was formed in a particular Member State for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State."[757]

Thus, in contrast with the notion of abuse for tax avoidance, only if the company registered in a Member State were fraudulent - or not genuine as being wholly artificial - might the other Member State restrict its freedom of establishment. However, as a matter of company law, if a Member State allowed a letterbox company to have legal personality and registration of its seat with little or no physical presence - even with no or little staff and premises - the other Member State

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[754] Case 212/97.

[755] Paragraph 29.

[756] Paragraph 37 of the judgment. See also Craig and de Burca (2003), pp.796-8; and Werlauff, Erik, "The Consequences of the *Centros* Decision: Ends and Means in the Protection of Public Interests" (2000) European Taxation, pp.542-545.

[757] Case C-167/01, paragraph 96.

could do little to restrict the right to set up branches or subsidiaries in its territory.[758] Again, in *Inspire Art*, the justification of abuse did not prevail and the Court went on to consider other overriding requirements in the public interest based on proportionality as regards possible justification on grounds of:

> "... protection of fairness in business dealings and the efficiency of tax inspections, it is clear that neither the Chamber of Commerce nor the Netherlands Government has adduced any evidence to prove that the measure in question satisfies the criteria of efficacy, proportionality and non-discrimination mentioned in paragraph 132 above."[759]

The clearer the situation of abuse, the easier it is to be caught, as was demonstrated in *Emsland-Starke*.[760] In this case, goods were exported to a third State outside the Community and subsequently were re-imported. The apparent fiscal advantage was that the export repayments under EC Regulation 2730/79 were higher than the customs duties paid on import. The Court held that situation to be an abuse of EU law. Generally, a situation of abuse occurs where there is an artificial creation ("subjective element") and the purpose of a rule is not achieved ("objective element")[761]; in this case, persons may not benefit from Community rights, but any denial of benefits may not go beyond what is strictly necessary in order to either avoid or reverse the consequences of the abuse (proportionality).[762]

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[758] In this sense, see *Barbier*, where under EU law the Court allowed individuals to make investments exploiting legal structures with apparently no economic substance and designed only to provide tax advantages in other Member States.

[759] Paragraph 140.

[760] Case 110/99 [2000] ECR I-11569.

[761] "A finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved.
It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it. The existence of that subjective element can be established, inter alia, by evidence of collusion between the Community exporter receiving the refunds and the importer of the goods in the non-member country" (*Emsland-Starke*, paragraphs 52-53).

[762] Terra and Wattel (2003), p.84.

IV.6.3. Specific tax avoidance rules and proportionality.

An interesting point related to specific anti-avoidance measures is how far the Court may apply the proportionality test for direct taxation purposes. The Merger Directive authorizes a Member State to refuse some of its provisions (like deferral of capital gains and fiscal reserves) if a cross-border operation (merger, division, transfer of assets or exchange of shares) appears to have no valid commercial reasons i.e. if it has tax avoidance as its principal objective.[763] There is no definition of valid commercial reasons, but the Merger Directive gives an example of what could be considered as such (restructuring or rationalization of the companies). However, even that example is given only as a presumption of the operation having no tax motivation as its principal purpose. Before any Court decision on this matter, Farmer presumed that proportionality would require that national provisions should not go further than is necessary and have the effect of disadvantaging genuine operations.[764]

This was what happened later in *Leur-Bloem.*[765] In that case, the Court explicitly applied the principle of proportionality, not only considering the objectives of that Directive but also determining some guidelines that should be applied to domestic procedures for ascertaining the open concept of valid commercial reasons.[766] That case concerned a Dutch tax rule that excluded some categories of operations from the tax advantage without examining the tax avoidance purpose. For example, the fact that the same person, who was the sole shareholder and director of the acquired company, stays in the same position in the acquiring company automatically prevented the fiscal regime provided for by that Directive. In the given example, it is clear that it would be more effective to consider it automatically excluded from the scope of the Directive in terms of fiscal supervision, simplification, economic costs, and even perhaps statistic probability of tax motivation of that transaction. However,

[763] Directive 90/334/EEC Article 11(1)(a).

[764] Op.cit. p.292.

[765] Case 28/95 [1997] ECR I-4161. See Terra and Wattel (2003), pp.392-8.

[766] Among those procedures the Court pointed out that competent national authorities must carry out a general examination in each particular case, and that such an examination must be subjected to judicial review (paragraph 7 of the summary of the judgment).

the point may not be that. The relevant point may be that the interpretation and application of legal rules and principles, which should be considered and interact with other fundamental principles and concepts, such as fairness, in each individual case, may obviously have its costs. The Court held those automatic exclusions invalid because they went further than was necessary for preventing tax avoidance and would undermine the aim of the Directive, which was to introduce neutral tax rules in terms of competition and prevent those cross border operations from being hindered by restrictive national tax provisions.[767] The role of proportionality may also be seen in clarifying what is vague or open-ended in search of the relevant objectives of rules and other principles in play:

> "In the absence of more detailed Community provisions concerning application of the presumption mentioned in Article 11(1)(a), it is for the Member States, observing the principle of proportionality, to determine the provisions needed for the purposes of applying this provision."[768]

On the other hand, as already discussed in the previous section (6.2), the arrangement of genuine business transactions in order to minimize taxes is not an abuse. That may be why the Court as a second statement in that case said that 'valid commercial reasons' "must be interpreted as involving more than the attainment of a purely fiscal advantage such as horizontal off-setting of losses."[769] It may be suggested that tax advantages are legitimate and can be pursued together with other more substantial economic objectives under the Merger Directive. Although the Court in *Kofoed* stated that the notion of 'valid economic reasons' reflects the general principle of abuse of rights in EU law, the Merger Directive requires more than the mere lack of wholly artificial arrangements.[770]

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[767] Paragraphs 7 of the summary and 44 of the judgment.

[768] Paragraph 43.

[769] Paragraph 8 of the judgment.

[770] *Kofoed* Case C-321/05, at paragraph 38.

The role of proportionality in balancing fiscal sovereignty and fundamental freedoms may have been essential to determine a different approach under the Merger Directive and for VAT purposes, from direct taxation that is not yet harmonized. Where a specific tax is not harmonized within the European Union, the Court may have found a minimum common ground for Member States that least impairs the balance between the *bona fide* exercise of fundamental freedoms and their fiscal sovereignty.[771] In other words, the Court did not adopt the concept of avoidance introduced by the Merger Directive (broader than mere artificial arrangements), because otherwise it would be excessively interfering with the fiscal sovereignty of Member States in direct taxation. It avoided that interference by applying the principle of proportionality.

In conclusion, one may infer that only artificial arrangements may be caught by the imperative requirement of tax avoidance under EU case law dealing with direct taxation. Furthermore, the notion of abuse of law is an important tool to limit the fundamental freedoms in the light of the general principle of good faith. Each restriction may be tested under the principle of proportionality in tandem with reasonableness. These balance their legitimate objectives in the public interests, such as combating tax avoidance in concert with the notions of abuse and good faith, and their intrusiveness to the fundamental freedoms. It also follows from these analysed decisions that anti-avoidance measures are always subject to a detailed test of proportionality under the fundamental freedoms and principles of EU law.[772] The principle of proportionality coupled with reasonableness not only created the overriding requirement of tax avoidance for any restriction to the fundamental freedoms, where not provided by secondary or primary legislation, but is also an essential tool to scrutinize any tax avoidance measure. It is right to conclude that there is a fairer and more balanced concept of tax avoidance when proportionality is in play.

[771] See also section 7.2 on *Halifax* and *Part Service* cases.

[772] Not only CFC and Transfer Pricing rules may be scrutinized by proportionality, but also any general or specific anti-avoidance tax rules that may affect the exercise of the fundamental freedoms within the EU, and the Court tends to enforce them as far as possible according to its settled evolving law.

IV.7. VAT principles and proportionality (neutrality and right to deduction balanced with fiscal supervision, simplification, tax evasion and tax avoidance)

The purpose for having a specific section in this thesis on Value Added Tax (VAT) is to show how proportionality may be useful to identify the fundamental principles of a particular tax and make them effective. One may suggest that VAT within the internal market is related to the fundamental freedoms of goods and services and could have been dealt with in the previous sections.[773] However, the main objective of this section could be missed or given too little attention. On the other hand, some similarities will be found between this and the previous sections, such as justification based on combating tax avoidance, abuse of rights, fiscal supervision and simplification for a restriction on neutrality and the right of deduction of input tax. Restrictions on a fundamental freedom in direct taxation are also based on fiscal supervision, tax avoidance, abuse of rights, and coherence of the tax system. Both set of justifications - for VAT and direct taxation - are underpinned by similar aims of a common market within the Community and must be construed and consistently applied. The role of proportionality may be to make those imperative requirements in the general interest more consistent and predictable, reaching a right balance between the fundamental freedoms and the fiscal interests of Member States.

Furthermore, the objective of this section is also to demonstrate that proportionality is an essential instrument of judicial review not only for restrictions on fundamental freedoms and Communities rights, but also for specific taxes, to which that test may be applied in a consistent way in concrete cases in the search for and the enforcement of fundamental tax principles, such as neutrality.

This section comprises three parts and a short conclusion on VAT principles and the role of proportionality. The first deals with substantive measures that may directly affect the right of deduction and the principle of neutrality; the second analyses the creation of a substantive rule of abuse of rights according to proportionality

[773] For an overview on the VAT within the European Community see Farmer and Lyal (1994), and Terra and Wattel (2003).

reasoning; and the third scrutinises procedural measures with similar objectives of simplification, fiscal supervision, avoidance and evasion that may indirectly but disproportionately affect the right of deduction and the principle of neutrality.

IV.7.1 Tax avoidance, tax evasion, simplification, neutrality and fairness (substantive measures).

The first set of cases to be considered relates to substantive rules regarding specific measures to be adopted for simplification, tax avoidance or evasion purposes, under Article 27 of the Sixth Directive (Art 395 of Directive 2006/112).[774] The first case to which the Court expressly applied the principle of proportionality was *Commission v Kingdom of Belgium* decided on 10 April 1984.[775] The Court held that any national derogating measures must be strictly interpreted and may not depart from the main basis for charging VAT as provided by Article 11 of the Sixth Directive, except within the limits strictly necessary for achieving the aims stated in Article 27 (tax simplification, anti-avoidance and anti-evasion), whose reasoning is governed by the proportionality test.

The Belgium government had introduced a VAT minimum basis on new cars according to a price catalogue with no regard to discounts or rebates, whereas under Art 11 of the Sixth Directive the taxable amount is composed of the consideration, which has been or is to be obtained having regard *inter alia* to price discounts and rebates allowed to the customer and accounted for at the time of the supply. The justification for that derogation was tax evasion and avoidance in the motor trade, particularly where sellers give "a false declaration of the price of new cars, especially when accepting used cars in part-exchange, and in buyers deducting unpaid input tax", under Article 27 of the Sixth Directive.[776] However, the Court refused that justification, since the Belgian legislation departed in a too general and systematic

[774] It appears not to be a coincidence that the Court was to some extent influenced by those requirements of fiscal simplification and tax avoidance or evasion in abusive transactions, where it dealt with the imperative requirements of the same nature regarding the justification for a restriction on the fundamental freedoms of movement of capital, persons, goods and services within the Community as discussed in the previous sections.

[775] Case C-324/82 [1984] ECR-1861, particularly paragraphs 29-32.

[776] Paragraphs 25 and 30 of the judgment.

way from Article 11 that had left no room for accounting price discounts and rebates. In this sense that legislation was considered disproportionate to its objective, and the price catalogue was not proved to be a necessary measure to achieve that aim.[777]

A more elaborate decision regarding the principle of neutrality and the right of deduction, under which VAT by its nature is not to be a cost component, is *Ampafrance.*[778] In that case, the Court explicitly applied the proportionality test to a substantive rule regarding tax deduction and according to the VAT fundamental principles. The legal issue in this case was whether Council Decision 89/487, based on Article 27 of the Sixth Directive, and which authorised the French Republic to apply a measure derogating from Article 17(6) of that Directive, would be invalid under the general principle of proportionality. The measure was introduced to deny traders the right to deduct VAT on expenditure in respect of accommodation, hospitality, food and entertainment for the benefit of persons not employed by them, which they could show to be of a strictly business nature. In principle, from a formalistic point of view, the Council Decision was legally based on the exceptions provided by the Sixth Directive that governs VAT principles and rules. However, the substantive issue was whether, on grounds of practicability (simplification) and prevention of tax avoidance, the specific measure was excessive, in contrast with fundamental principles like neutrality and the essential right of deduction.

The Court stated that, since the measure excluded all the expenditures mentioned as a matter of principle, and appropriate means less detrimental to the right of deduction could be provided or already existed in domestic law,[779] it was not a means

[777] Paragraph 32 of the judgment. Furthermore, the Commission had affirmed that the tax avoidance and evasion purposes could be achieved by less restrictive measures, "for example by carrying out cross-checks between stocks of cars, either new or accepted in part-exchange by dealers, and dealers' sales" (Paragraph 23).

[778] Joined cases C-177/99 and C-181/99. See case comment by Troyer, Ilse de, and others, "VAT – Art 17(6) of the Sixth Directive and Council Decision 89/487/EEC – Exclusion of the Right of Deduction – Expenditure in Respect of Accommodation, Food, Hospitality and Entertainment – Proportionality" (2001) EC T.R. (10)1, 45-6; and Dolton, Alan, "The Council, the Court and the Principle of Proportionality – Reflections on *Ampafrance*" (2000) De Voil Indirect Tax Intelligence 53, 7-12.

[779] For VAT purposes, the tax charged is only deductible if the inputs are necessary to the business (paragraph 47); and for corporation tax, expenditure in respect of accommodation, food, hospitality and entertainment of a business nature may be deduct from profits (paragraph 49). In both situations the fiscal authorities rely on documents and other evidence to verify the business nature of those expenses.

proportionate to the objectives of simplification or combating tax avoidance. Furthermore, it had a disproportionate effect on the purposes and principles of the Sixth Directive. Although the Court stated that it was not its role to comment on other appropriate measures available to tackle tax avoidance, two examples were mentioned: the introduction of a fixed amount to be deducted or a control similar to that provided for corporate tax.[780] Therefore, less restrictive measures could be to demand some documentation indicating the business purpose of the expenditure or to allow a fixed amount taking into account either the reasonable or the average costs of those expenses.[781]

Regarding the role of proportionality in balancing tax principles, such as tax avoidance on the one hand, and tax neutrality on the other, it may be suggested that the most fundamental principle of VAT is neutrality and not necessarily simplification or prevention of avoidance. These are legitimate objectives since they are the means to achieve that principal aim, but not an end in themselves. From a practical, anti-avoidance perspective, to deny those deductions might be more effective, but the effectiveness of the principle of neutrality must govern all the other rules.[782]

In contrast with *Ampafrance*, in which the refusal of the right of deduction on certain inputs for tax avoidance purposes was regarded as disproportionate in the light of the principle of neutrality, in *Sudholz*[783] the Court accepted the justification for a limitation on the right of deduction on grounds of tax avoidance and simplification. Whereas in *Ampafrance* there was no deduction at all for expenses that may be related to business and private purposes (food, accommodation, etc), in *Sudholz* the

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[780] Paragraph 62 of the judgment.

[781] This type of fixed amount was accepted by the Court in *Sudholz* (Case C-17/01 [2004] ECR I-4243) that appears to be inconsistent with *Ampafrance* as discussed below.

[782] The Court does not always hold that the least restrictive measure must be adopted, since sometimes the most effective is better than other less restrictive ones, according to their objectives (Emiliou, p. 134, mentioning *Fedesa* (Case 331/88 [1990] ECR I-4023), analysed in the next section).

[783] Case 17/01. See Case Comments: Swinkels, Joep, "Impact of Walter Sudholz on Special Measures" (2005) I.V.M. 16(1), 23-27 and Macnab, Andrew, "Mr Sudholz's VAT" (2004) Tax J., 745, 20-21.

deduction was limited to 50% of the VAT charged on a passenger car used partly for business and partly for private purposes. The relevant facts were that Mr Sudholz used his car 70% for business and only 30% for private purposes, and the 20% difference would be a cost that at the end should be passed on to the consumers as a component of the price of his services and not as a VAT charge. Since he was willing neither to bear that cost nor to pass it on to his clients, he brought an action against that German tax rule on grounds of the principle of neutrality and proportionality, as other measures less restrictive could be implemented for tax avoidance and simplification objectives without undermining the former principles. The German government had also been authorised by a Council Decision under Article 27 of the Sixth Directive to limit to 50% the right to deduct the VAT charged on cars with mixed use, unless their use for private purposes did not exceed 5% of their total use.[784] The justification for that restriction was based on grounds of tax avoidance, evasion and mainly simplification purposes, since the "difficulty of actually verifying the breakdown between business and private expenditure" was acknowledged, which may cause "tax evasion or abuse."[785] The Commission stated that, like in *Ampafrance*, since the taxpayer could prove the proportion of business use, there was no reason why the same view should not be taken in the light of the principles of neutrality and proportionality. The less restrictive measure for tax avoidance purpose could be to demand some evidence from the taxpayers; however, the Court considered that, in terms of simplification, that requirement would be useless since its objective was precisely to avoid an effective verification by checking documents and so on.[786] Furthermore, in *Ampafrance* there was not a flat rate in question, and the Court had given an illustration in that case of limiting deductions to a fixed exclusion.[787]

[784] Council Decision 2000/186, in particular Article 2 (OJ 2000 L 59, p.12).

[785] Paragraph 6 of the judgment, quoting the fifth recital in the preamble to Decision 2000/186.

[786] Even for simplification purposes, there was a justification on grounds that it would be difficult to know in advance the exact proportion between private and business use. Furthermore, it would be difficult to examine later on the actual use. One may suggest that more weight could be given to the information provided by the taxpayers supported by further evidence if necessary.

[787] Paragraph 62 of the judgment analysed above.

Having distinguished *Sudholz* from *Ampafrance*, the Court regarded the flat rate as reasonable, based on the following reasons: the accuracy of the average in itself was not challenged; there was a safe harbour of 5% for private use to which that average limit was not applicable; other Member States adopted the same average that, moreover, was put forward by the Commission in a proposal for a Council Directive amending Directive 77/388.[788]

Although convincing to some extent, this reasoning brings some concern regarding the notion of reasonableness, since the flat rate is irrebutable, and consequently it appears to be incompatible with other decisions of the Court (to be analysed in this section) in respect of some procedural measures and presumptions.[789] The average rate was not the less restrictive measure. However, paying due regard to simplification and undermining negligibly the neutrality principle, the more open and flexible notion of reasonableness prevailed over a stricter proportionality test in this case. Whereas in *Outokumpu Oy*,[790] a flat rate for less environmentally friendly products with respect to the taxation of electricity was considered disproportionate, since other measures less restrictive were available (such as to prove its origin, whether from renewable sources or not, although with some difficulty), in *Sudholz* the flat average deduction was treated as proportionate on grounds of simplification to avoid the difficulty of checking documents. In the latter case, that difficulty was accepted as justification for not having adopted less restrictive measures, while in the former that similar difficulty was not accepted to justify a restrictive flat rate. Nevertheless, in the *Outokumpu Oy* case there was also a relevant issue of discrimination on imports under Art 90 of the Treaty (now Article 110 TFEU), which was not in question in the *Sudholz* case. This demonstrates that the Court more closely scrutinises directly and indirectly discriminatory tax measures via proportionality reasoning than particular tax restrictions on VAT deductions that may have a minor impact within the common market. How much deeper the reasoning is

[788] Paragraphs 57-59 of the judgment.

[789] See *Baxter* case (C-254/97), regarding fiscal supervision and the freedom of establishment, which is analysed in section 5.2 above, and *Garage Molenheide BVBA* (C-286/94 [1997] ECR I-7281) as analysed below.

[790] Case 213/96 analysed in this Chapter section 4 on environmental taxation and proportionality.

may depend on whether the Court sticks to the facts of each case (as seems to be in the case for VAT) or decides the issues more broadly (as seems to be the case for the fundamental freedoms). In my view this different approach to legal issues under the proportionality test is satisfactory where the issues are different, as in the cases of tax discrimination on the one hand, and tax simplification on the other. This does not mean that for tax simplification purposes a looser test of proportionality may be always acceptable, as other interests and principles may come into play, such as consistency and the ultimate objective of fairness.

However, as the *Sudholz* decision could seem to be inconsistent with the previous cases on neutrality,[791] it was convenient and necessary to the Court to elaborate on its reasoning in search for consistency and predictability.[792] The Court stated that the impact on neutrality would be negligible, falling within the express permission provided by Art 27 of the Sixth Directive, because the deduction limit would not affect the level of prices and VAT payable in the Community, as the number of cases in which more tax is paid "is likely to correspond generally to the number of cases where less tax is paid."[793] The amount of tax that could not be deducted may not be negligible from an individual perspective, since the right of deduction is conferred on each taxpayer, as a way of neutralizing the VAT effect on the level of prices charged. Furthermore, the principle of proportionality as a tool for construction and application of general or specific rules and principles should pay due regard to individual cases and take into account all relevant circumstances of each case to achieve a desirable degree of fairness.[794] The Court tried to achieve that objective justification on neutrality in the following statement: "even in individual cases, the effects on VAT due at the final consumption stage will be limited, given that it is

[791] *Commission v Kingdom of Belgium* (Case C-324/82), *Skripalle* (Case C-63/96 [1997] ECR I-2847) *and Ampafrance* (Case C-177/99).

[792] As the Court stated in *Sudholz*, paragraph 34.

[793] Paragraph 68 of the judgment.

[794] In fairness, like Mr Sudholz, one may consider that it was not quite fair to have a restriction of nearly 30% on VAT deduction (from 70% to 50% of the total VAT charged on his car) where he could prove that his vehicle was used 70% for business purposes. However, more unfairly, one may suggest, it would be a retrospective restriction to the detriment of the taxpayer's legitimate expectations.

possible for the supplier to apportion the VAT to all the goods sold over the years for which he keeps his vehicle."[795]

IV.7.2. Abuse of rights as a general anti-avoidance rule within the VAT system and the proportionality principle.

The second set of cases concerns a substantive rule of the interpretation of VAT provisions and the qualification of transactions in the light of the doctrine of abuse of rights. This doctrine of abuse of law is analysed separately from the previous section on specific tax avoidance legislative measures, such as in the *Ampafrance* and *Sudholz* cases, for two reasons: first, it is a general anti-avoidance rule, and secondly it was developed by the Court based on VAT principles and the general doctrine of abuse of Community law.

The Grand Chamber in the landmark *Halifax*[796] case held that a series of transactions might be disregarded and the immediate VAT deduction of inputs denied if there was an abusive practice, for which two requirements were necessary:

> "first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage."[797]

Thus, the Court took into consideration the purposes of the tax provisions in play that cannot be distorted by implementation of inappropriate or abusive transactions with

[795] Paragraph 69 of the judgment.

[796] Case C-255/02.

[797] Paragraph 86. As the Court explained at paragraph 81, regarding the first element of abuse: "To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules."

no economic substance to obtain tax advantages.[798] The Court also reiterated its settled case law on the application of the proportionality test to scrutinise measures that address the issues of combating tax avoidance, evasion and fraud:

> "It is important, however, to note in that respect that the measures which the Member States may adopt under Article 22(8) of the Sixth Directive in order to ensure the correct levying and collection of the tax and for the prevention of fraud **must not go further than is necessary to attain such objectives**" (emphasis added).[799]

The issue of combating tax avoidance or abuse of tax law may require a balance between equity and social solidarity on the one hand, and legal certainty and the freedom to carry out a commercial activity on the other. This right includes tax considerations, as it is the settled case law of the Court:

> "Moreover, it is clear from the case-law that a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system. Where the taxable person chooses one of two transactions, the Sixth Directive does not require him to choose the one which involves paying the highest amount of VAT. On the contrary, as the Advocate General observed in point 85 of his Opinion, taxpayers may choose to structure their business so as to limit their tax liability."[800]

The proportionality principle coupled with reasonableness weighs those principles and rights in search for an optimal solution, which may be to avoid abuse of tax law

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[798] Whereas in *Starke* and *ICI* and other cases the Court referred only to the element of artificiality or wholly artificial arrangements (see the previous section 6), in *Halifax* it appears to have gone further by stating that it is sufficient that the requirement of lacking an essential economic objective other than a tax benefit for a series of transactions to be abusive. This was still made clearer in *Part Service*, in which the Court reiterated that there is abuse where the principal (not the sole) objective of a series of transactions is to pursue tax advantages against the purpose of the tax rules at stake.

[799] *Halifax*, paragraph 92. Art 22(8) is the current Art 273 of Directive 112 of 2006 that authorizes Member States to "impose other obligations which they deem necessary for the correct collection of the tax and for the prevention of evasion" under certain conditions of non-discrimination and restrictions on intra-Community trade.

[800] *Halifax*, paragraph 73.

and abuse of rights. Again, as open-ended concepts, the notion of abuse may be ascertained via proportionality in tandem with reasonableness within the context of a tax system and the factual circumstances of each case. Out of the different options to decide the *Halifax* case, it seems that the Court opted for the concept of the abuse of rights as the more appropriate measure, taking into consideration the particular VAT system and its neutrality within an internal market.[801]

The Court also in *Halifax* balanced the doctrine of abuse of law with the principle of legal certainty and lawfulness, by disallowing - differently from fraud[802] - the imposition of penalties in case of abuse:

> "…. a finding of abusive practice must not lead to a penalty, for which a clear and unambiguous legal basis would be necessary, but rather to an obligation to repay, simply as a consequence of that finding, which rendered undue all or part of the deductions of input VAT."[803]

Consequently, a surcharge as a penalty would be disproportionate where the tax authorities and the courts conclude that a series of transactions is abusive for a lack of essential commercial reasons other than tax considerations. Contrariwise, in cases of tax fraud or evasion, penalties may be not disproportionate, unless they are excessive to their objectives.[804] To apply penalties only to situations of fraud and evasion seems to be fair, as the notion of abuse in a tax context may be much vaguer and not easily ascertained. As the Court stated in *Halifax* and *Part Service*, not only the purpose of the tax provisions at stake must be identified, but also a number of objective economic factors must be ascertained. These may vary widely and be open-

[801] It may be right to suggest that at least four options existed: first, to leave the Member States to regulate the issue of tax avoidance as they deem fit; secondly, to deal with tax avoidance only under the provision that allows derogations from the VAT Directive for tax avoidance purposes; thirdly, to refuse any consideration of a general doctrine of abuse of tax law existent in some Member States; and fourthly to apply it as decided in *Halifax*. The first two options were connected and the Court seems to have opted by the most suitable measure balancing the interests of Member States, the right of taxpayers to plan and run their own business, the existent but to some extent incipient doctrine of abuse of Community law, and the VAT neutrality and its role within an internal market.

[802] See *Albert Collée* Case C-146/05 [2007] ECR I-7861, paragraph 40.

[803] Idem, paragraph 93.

[804] See section 2.1 above, *Louloudakis*, where even in a situation where penalties were legally provided, they may be inapplicable by being disproportionate.

ended, which may make their consideration and ascertainment more difficult to predict.[805]

Furthermore, proportionality in concert with reasonableness may play the role of weighing and contrasting all the relevant economic factors in the light of the tax rules and principles at stake. Frans Vanistendael may have well captured this point,

> "... the ECJ lists several criteria of economic, legal or personal nature to assess the substance of the transaction, which points to the essential purpose and implies a balancing judgment between several purposes against one another."[806]

To avoid the impression that the Court randomly applies tax principles or that they are chosen to base a decision previously made, it is important to point out and differentiate the guiding principles from those less important, particularly in the leading cases, such as in *Halifax*. My opinion is positive on this case, because the Court, by developing a doctrine of tax abuse (which by definition involves some uncertainty) within the VAT, gave some clarity on the governing principles of abuse: due regard to the principle of good faith, legal certainty on the right of taxpayers to "limit their tax liability" unless there is abuse, a prevalence of purposive over literal interpretation of tax law, and with the requirement of setting out the objective factors to be taken into account (to avoid subjectivism and arbitrariness). Furthermore, the Court disallowed the application of penalties in those situations, what is fair, given more protection in an area of some uncertainty about the outcome of the decisions of the courts on tax abuse, having balanced equity and certainty.

[805] The Court listed five economic objective factors in *Halifax* (paragraph 89), and six in *Part Service*, in which it added another task for the national court to assess "if, the contractual structure of the transaction notwithstanding, the evidence put before the court discloses the characteristics of a single transaction. In that context, it may find it necessary to extend its analysis by seeking evidence of indications of the existence of an abusive practice" (paragraphs 54-55).

[806] "Halifax and Cadbury Schweppes: one single European theory of abuse on tax law?" (2006) EC T.R. 15(4), p.193.

In conclusion, where there is a situation of abuse, the fiscal authorities must redefine the transactions "so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice."[807]

Seemingly, this notion of abuse is similar to abuse in direct tax cases, in which the principles of proportionality and reasonableness have a fundamental role as well. However, whereas the objective element of abuse in direct taxation is more focused on the artificiality of transactions, the abuse for VAT purposes encompasses not only wholly artificial arrangements but also transactions with the principal objective of tax avoidance. The Court apparently applied a more stringent test of abuse perhaps because VAT is more harmonized and must be applied harmoniously within the States, whereas in direct taxation States retain their fiscal sovereignty unless there is a disproportionate interference with the fundamental freedoms.

V.7.3. Fiscal supervision, fraud, neutrality, fairness and proportionality (procedural measures).

The third set of cases to be considered concerns procedural measures that may directly or indirectly restrain the right of deduction and the principle of neutrality. An example is *Garage Molenheide,* in which the Court discussed whether a Member State could apply preliminary measures to retain the refundable VAT credit balance.[808] The Sixth Directive regarding the right to VAT deductions entitles Member States either to give a refund or to carry the excess forward to the following period. However, that Directive does not expressly encompass preliminary measures such as those introduced by Belgian legislation: non-refund on grounds of tax evasion or the existence of a debt claimed by the tax authority and disputed by the taxpayer. After having made a general statement on proportionality grounds, the Court held:

[807] Paragraph 94.

[808] *Garage Molenheide* case (C-286/94). See Jacobs, Francis, "Recent Developments in the Principle of Proportionality in EC law" in Ellis, Evelyn (Ed), *The Principle of Proportionality in the Laws of Europe* (Hart Publishing, Oxford 1999), pp.16-19; and Schwarz, Jonathan, "Measures to Prevent VAT Evasion" (1998) W.T.R. 26, 28-29.

> "Accordingly, whilst it is legitimate for the measures adopted by the Member States to seek to preserve the rights of the Treasury as effectively as possible, **they must not go further than is necessary for that purpose**. They may not therefore be used in such a way that they would have the effect of systematically undermining the right to deduct VAT, which is a fundamental principle of the common system of VAT established by the relevant Community legislation."[809]

The Court gave an illustration that an irrebuttable presumption was excessive and went further than was necessary in order to recover the alleged tax debt, because a guarantee could be a sufficient measure to protect the interests of the fisc and would, at the same time, be less onerous for the taxpayer.[810] The nucleus of the decision, though, could be considered pertinent to the judicial remedies relating to suspension of tax claims. However, its implications are clearly related to tax rules and principles, and may defeat any particularly disproportionate rule.

The Court also expressly applied proportionality in another case, while interpreting the Eighth Directive, which requires a taxpayer who is not established in a Member State to present the original invoice for a VAT refund.[811] According to the Court, a literal and clear interpretation without exceptions would lead to the acceptance only of the original invoice. Nonetheless, the possibility of a Member State granting a refund in exceptional cases had to be considered. For instance, there may be cases in which the transactions were undeniably performed, and the taxpayer cannot be penalised for the loss of import invoices or documents, and in which there is no risk of new refund applications.[812] As a matter of principle, the requirement for the original invoice to obtain a VAT refund is reasonable and adequate, since it would be unnecessary only where there is no possibility of further applications for a refund

[809] Paragraphs 46-47 of the judgment.

[810] Paragraphs 53-57 of the judgment.

[811] *Societe generale des grandes sources d'eaux minerals financaires v Bundesamt fur Finanzen* case C-361/96 [1988] ECR I-3495

[812] Paragraph 15 of the judgment.

regarding the same tax paid. Again, the proportionality test played the role of weighing apparently conflicting principles in the light of the specific circumstances of the case: on the one hand, equity and neutrality, on the other the speed of refunding process, certainty and simplification.[813] As the Court decided that the exclusion of a refund in those circumstances was not necessary to prevent fraud or tax evasion according to the proportionality principle,[814] one may suggest that in this case justice as individual fairness prevailed over justice as administrative convenience and order. This would be unsatisfactory according to a utilitarian view of proportionality that allows marginal cases of injustice; however, in my conception of fairness that was the right outcome.[815] Furthermore, the application of proportionality in this case did not undermine the objectives of preventing fraud or tax evasion, which may also fall within the overriding requirements related to the fundamental freedoms.

One last set of cases, in which the proportionality principle coupled with the standard of reasonableness played an essential role, dealt with the so-called 'carrousel fraud.' In a number of cases,[816] the fraudulent scheme was the following. Company A exported goods to B, which went missing after having sold them at a lower price to C, which resold the same goods to company D making a profit until the goods were finally sold back to company A. As exports are tax exempt (the VAT must be paid on the subsequent transaction in the importing Member State), company A can claim the VAT refund on its inputs, without the prior requirement of company B having paid its VAT on the same goods when reselling them to other traders. The UK (among others) tried to refuse a VAT refund to company A for obvious reasons, alleging that denying the exemption or the refund was in accordance with the principles of proportionality and legal certainty. However, the Court did not agree with this argument, taking into consideration the good faith of the initial trader (company A)

[813] Paragraphs 16 and 19 of the judgment.

[814] Paragraph 30 of the judgment. See also with a similar line of reasoning the *Intersplav* and *Bulves* cases decided by the ECHR (Chapter IV, section 2.7.d).

[815] On the concept of fairness, see Chapter I, section 3.

[816] *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise* Joined Cases C-354/03, C-355/03 and C-484/03 [2006] ECR I-483.

as it had 'no knowledge and no means of knowledge' of the fraudulent scheme.[817] In the *Albert Collée* case, the Court balanced the lack of good faith of the taxpayer with the risk of a revenue loss to scrutinise the argument of proportionality put forward by the German tax authorities.[818] To deny "the status of exemption transaction solely on the ground that the evidence of such a supply was not produced in good time" was regarded as disproportionate even where there was no good faith, if there was no tax to be collected.

The Court made clear in *Federation of Technological Industries* the role of *reasonable* behaviour and *good faith* by explicitly submitting the joint tax liability between the seller and the buyer to the proportionality principle:

> "… a taxable person, to whom a supply of goods or services has been made and who knew, or had *reasonable* grounds to suspect, that some or all of the VAT payable in respect of that supply, or of any previous or subsequent supply, would go unpaid, may be made jointly and severally liable, with the person who is liable, for payment of that VAT. Such legislation must, however, comply with the general principles of law which form part of the Community legal order and which include, in particular, the principles of legal certainty and proportionality."[819]

The Court illustrated as *reasonable* of suspicion the situation where the price of goods was lower than the market price, but even in this circumstance, such a

[817] Paragraph 51 of the judgment.

[818] *Albert Collée* case C-146/05, paragraphs 27 in relation to proportionality and 35-36 regarding the good faith and loss of revenue. It is interesting to note that in this case, although the taxpayer was not acting in good faith, the correction of his mistake could not be denied, as there was no loss of tax revenue. By way of contrast, where the taxpayer did act in good faith, the Court found that it was not relevant if the correction of his/her mistake could cause a loss of revenue (*Karageorgou and Others* Joined Cases C-78/02 to C-80/02 [2003] ECR I-13295, paragraph 50).

[819] *Commissioners of Customs & Excise, Attorney General v Federation of Technological Industries and Others* case C-384/04 [2006] ECR I-4191 (paragraph 35).

presumption must be rebuttable.[820] Furthermore, the Court held that a system of strict liability, in which presumptions are formulated in a way as to make it excessively difficult to rebut them, would go "beyond what is necessary to preserve the public exchequer's rights."[821] From this case, it may be suggested that the proportionality principle may work in tandem with the open-ended reasonableness standard in two ways. First, where proportionality may appear too strict (against any presumption); the reasonableness standard makes it more flexible by allowing rebuttable presumptions. Second, where the examples of what may be reasonable appear to be too vague, with no limit (any presumption might be allowed) proportionality through its test of necessity (by going beyond what is necessary) may aid to set its boundaries. In my opinion this ascertainment of what is reasonable through proportionality, and vice-versa to give more flexibility to proportionality, is another characteristic that shows how they work in tandem to reach a fairer decision. To disallow the joint liability would undermine the public interest in making easier to collect tax in suspicious cases of evasion, whereas allowing in all situations a joint liability would harm taxpayers in good faith. A utilitarian view of proportionality coupled with reasonableness would have favoured the joint tax liability as a matter of principle, though it would have allowed marginal cases of injustice.[822]

Again as an important requirement in applying the proportionality principle as to whether fiscal measures are fair and appropriate to tackle fraud, avoidance, evasion, the Court gives great regard to the good faith of taxpayers, as held in *Teleos*:

> "Accordingly, the fact that the supplier acted in good faith, that he took every reasonable measure in his power and that his participation in

[820] The Court stated that the taxpayer could prove "that the low price payable for the goods was attributable to circumstances unconnected with failure to pay VAT" (paragraph 31 of the judgment).

[821] Paragraph 32 of the judgment.

[822] See on the ascertainment of the reasonableness standard via proportionality, Chapters I, section 2, and note 60; III, section 2.2; and IV, section 2.2. See also in the same line against a utilitarian application of proportionality, this section above, the cases *Societe generale des grandes sources d'eaux minerals financaires* (C-361/96).

> fraud is excluded are important points in deciding whether that supplier can be obliged to account for the VAT after the event."[823]

This concludes the section on procedural measures that are closely scrutinised according to the principle of proportionality coupled with reasonableness. The discussion shows that the Court balances not only tax principles such as neutrality and the right to deduction or exemption, but also other general principles of law such as the good faith of taxpayers in each case, against the public interest to tackle evasion and fraud.

IV.7.4. Conclusions on VAT principles and proportionality.

This section demonstrates that the Court has also applied implicitly or explicitly the test of proportionality in order to accept the justification of fiscal supervision, tax simplification, fraud and tax avoidance, within the ambit of a specific tax, depending on particular circumstances of each case in which the VAT fundamental principles had to be taken into account. Moreover, the Court created in *Halifax* the abuse of rights doctrine to be applied to the VAT system, according to the principle of proportionality in concert with reasonableness.

As already observed as a general principle of EU Law, the principle of proportionality is applicable not only to tax matters with regard to the fundamental freedoms, but also to specific taxes such as VAT, as the Court decided in all cases analysed in this section. This spells out that tax matters are not considered a separate body of rules and principles that would not fall within a system of law that encompasses other general legal principles, particularly proportionality, which is an essential tool for examining and enforcing tax rules and principles in as fair a way as possible. Conversely, one may suggest that proportionality is unnecessary to search for principles of specific taxes such as VAT while neutrality has been recognized and enforced as a fundamental principle, regardless of any proportionality reasoning.[824]

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[823] *The Queen, on the application of Teleos PLC and Others v Commissioners of Customs & Excise*, Case C-409/04 [2007] ECR I-7797, paragraph 66.

[824] As a matter of principle, neutrality has been found within the VAT Directives and developed by the case law, in which proportionality did have neither any explicit nor apparently implicit role. This can in a number of decisions on neutrality and the definition of economic activity, such as in the *Fini* case

However, even then the role of proportionality remains crucial for weighing and reconciling different tax principles in the search for consistency and fairness in specific circumstances. These principles include neutrality, the right of deduction and good faith on the one hand, and simplification, fiscal supervision, procedural measures for assessment and refund, tax evasion and tax avoidance on the other hand.

Overall, it may be additionally suggested that the principle of proportionality has a great regard for fairness, equity, good faith and consistency, as has been seen in the Court decisions. Where both fairness and consistency or either appears to be undermined (such as again in *Sudholz*), the Court has tended to stick more to the facts of the case to justify its reasoning in order to protect those objectives and the lively, flexible and changeable notion of reasonableness.

The next section will analyse the interaction between different principles of taxation (public interest in retrospective tax legislation, and also tax avoidance and simplification) in contrast with the protection of the legitimate expectation and the effectiveness of EU rights, and whether and why proportionality has a more stringent test or not.

(C-32/03 [2005] ECR I-1599, paragraph 25), in which was stated that "The common system of VAT consequently ensures complete neutrality of taxation of all economic activities", and also Terra and Wattel (2003), pp.271-273. However, from the cases analysed in this section one may deduce that proportionality mostly enforces neutrality and to a minor extent undermines it, demonstrating that neutrality is not as complete and absolute as seems to be stated in the above *dictum* in *Fini*, taking into account other general and specific tax principles and rules.

IV.8. Retrospective tax legislation, legitimate expectation, and proportionality

IV.8.1. The principles of legal certainty and its corollaries of legitimate expectation and non-retrospective legislation. Types of retrospective measures and the principle of proportionality.

This section will illustrate how the Court has inferred the unwritten principle of non-retrospective taxation from some general principles of EU Law, like legal certainty and legitimate expectation, via the proportionality principle coupled with reasonableness. In other words, it will be clearly demonstrated not only that "there is a close link between the principle of proportionality and non-retroactivity",[825] but also the extent to which the proportionality reasoning, whether express or not, has established limits to retrospective taxation in accordance with the principles of legal certainty and legitimate expectation.

Depending on the public interest at play, which may be regarded as a pressing social need to justify a retrospective measure, the Court may accept such a measure in exceptional circumstances in a way that individuals affected could not have had any reasonable protection based on their legitimate expectation. However, with regard to the protection of non-retroactivity of legislation imposing a heavier burden there has not been any precedent yet upholding this, unless the legitimate expectation can be regarded as protected under national rules with respect to tax avoidance, and sufficient warning has been given to the taxpayers that new legislation could be enforced retrospectively to the date when that intention was made public.[826] On the other hand, where not dealing with such circumstances, the Court has invalidated retrospective tax measures in concrete cases based on the general principles of law

[825] Emiliou, (1996), p.144. On the close relationship between legitimate expectation and reasonableness, see also Hartley, (2003), p.149. The first point to be considered to establish the meaning for an expectation to be legitimate is whether or not it is reasonable in a sense that "a prudent man" (as either a taxpayer, or a consumer, or a trader, or an individual exercising any Treaty right) "would have had the expectation" (ibidem).

[826] See the joined cases *Leusden* and *Groep* (C-487/01 and C-7/02 [2004] ECR I-5337) and *Goed Wonen* C-376/02 [2005] ECR I-3445 (Grand Chamber).

such as: the rule of law, legitimate expectation, and legal certainty.[827] The instrument applied by the Court in all these cases was once again the test of proportionality, balancing conflicting interests. In terms of retroactivity as a whole, the Court weighs the alleged public interest as a justification against the legitimate expectations of the parties that are affected, discussing in each case which of them takes priority over the other. That means the measure or rule in question must be justified as a matter of necessity, proportional to its objectives, contrasting or balancing the public interest with the legitimate or reasonable expectations of taxpayers.

Two types or degrees of retrospective measures may be distinguished: the first may be called true or actual retroactivity, according to which the transaction or act performed under the revoked law is complete, whereas the second type may be regarded as apparent or quasi-retroactive, under which the transaction that falls within the new law is not complete yet.[828] The former appears to be more unfair and harder to justify, whereas the latter may be justified more easily provided that the legitimate expectation of individuals and legal persons may not be unreasonably affected. A case that has not been tested yet in Court is whether or not a true or actual retrospective measure may be justified for anti-avoidance tax purposes under the principle of proportionality. The least intrusive measure may not be retrospective legislation, because there may be other available measures like the abuse of rights doctrine to catch wholly artificial past transactions that have circumvented European

[827] Jürgen Schwarze captures the point regarding the origin of the principles of legal certainty and the protection of legitimate expectations correctly stating that they are "merely general maxims derived from the notion that the Community is based on the rule of law…" (*European Administrative Law*, 1992, p.867). As there are other principles that may run counter to those of legal certainty and the protection of legitimate expectation, "the right balance will need to be struck" (ibidem, and Chapter 6 on legal certainty and the protection of legitimate expectations). There, the role of proportionality comes into play. See also *Schlossstrass*e, Case C- 396/98 as analysed below.

[828] See Hartley (2003), p.147. See the same distinction under German Constitutional Law: proper or typical retroactivity and improper or atypical retroactivity, Tipke, Klaus, "La Retroattivita in Diritto Tributario", *in Trattato di Diritto Tributario* (Cedam, Padova 1994) pp.437-447; Schwarze (1992), p.1120; and Thuronyi (2003), pp.79-80. Actual retroactivity, where the law changes previously determined taxes, and *de facto* retroactive application. The latter is equivalent to the atypical or quasi-retroactivity, which allows the Parliament to be more flexible with a broader margin of discretion. Within the same context and meaning, see also the distinction between actual and apparent retrospective legislation in Craig and De Burca (2003), pp.380 and 382.

law. If there is a tax loophole or lacuna, the better way to fill it may be via new prospective legislation.[829]

Another form of retrospective legislation involves procedural rules that provide conditions for the recovery of undue charges. New legislation may establish shorter limitation periods for future claims or any other rule that may be more stringent than those in force when the payment was made or when the Court held some fiscal charge to be invalid. New limitation periods may be similar not only to actual retroactivity (as they may affect to some extent an earlier undue payment regarding a complete transaction, that may be not recoverable any longer), but also to apparently retrospective measures as they may just affect future payments, where transitional arrangements are provided to protect the legitimate expectations of those concerned.[830]

In comparing criminal law and tax law in respect of the principle of non-retroactivity, it is worth noting that the principle of non-retroactivity in criminal law is expressly stated, is common to all European legal systems, and is protected as a fundamental right under Article 7 of the European Convention on Human Rights.[831] In contrast, there is no specific article that provides for protection against more burdensome, retrospective tax legislation in any European Treaty. Thus, from a literal approach there might not be a similar protection against retrospective taxes, since reasonable taxation is not regarded as a penalty or a sanction.[832]

Nevertheless, there are some other principles that favour that protection in contrast with others that appear to justify retrospective measures; here, proportionality may

[829] See this section, item 4.

[830] This issue is particularly discussed in item 5 of this section.

[831] See *Regina v Kent Kirk* Case C-63/83 [1984] ECR-2689, paragraph 21, apud Craig and De Burca (2003), pp.381-382.

[832] Essentially a criminal fine involves, as a tax on a course of conduct does not, "an offence or breach of duty in the form of a violation of a rule set up to guide the conduct of ordinary citizens" (Hart, H.L.A., *The Concept of Law*, 1961, p.39). Whereas the incidence of tax is not a sanction in civilized societies, the economic natural role of taxation also differs from criminal law, since not only because the former may provide for an equitable redistribution of income and wealth, but also for the appropriate allocation of economic resources and economic stabilization (James and Nobes, *The Economics of Taxation*, Financial Times-Prentice Hall, New York 2000, pp. 7-10).

come into play to weigh all of them. Furthermore, this principle may not represent a mere consolidation of rules and principles of each Member State, because to some extent the Court may have gone further than some national jurisdictions, even in comparison with the European Court of Human Rights in terms of individual protection.[833]

The following cases will be separately analysed according to their justifications, and will point out the role of proportionality in construing the principle of non-retrospective taxation, starting with some non-tax cases.

IV.8.2. Proportionality, legitimate expectation and retrospective legislation in general.

In the landmark case of *Racke*[834], the Court enunciated the principle of non-retroactivity in light of the purpose of the retrospective measure and the protection of legitimate expectations as follows:

> "Although in general the principle of legal certainty precludes a Community measure from taking effect from a point in time before its publication, it may exceptionally be otherwise where the purpose to be achieved so demands and where the legitimate expectations of those concerned are duly respected."[835]

In that case, the Commission had altered the monetary compensation for a product using a regulation that provided for its application fourteen days before its publication. The Court stated that for the compensation to be effective, it had to take effect from the events that created it, and therefore new amounts could be applicable

[833] For an overview on other jurisdictions see Thuronyi, (2003), p.76-82 on non-retroactivity. See also McGuigan, Catherine, and Ross, Howard, "Tax and Retrospective Legislation" (1997) Tax J. 407, 11-16. On the European Court of Human Rights case law, see Baker, Philip, "Retrospective Tax Legislation and the European Convention on Human Rights" [2005] B.T.R. 1, 1-9, and Chapter IV.2.6.

[834] Case C-98/78. See Craig and De Burca (2003), p.380; and Tridimas (1999), p.170.

[835] Paragraph 20 of the judgment (Case C-98/78). See Craig and De Burca, idem pp.380-1; and Emiliou (1996), p.145.

"to facts and events which occurred shortly before the publication of the regulation fixing them in the Official Journal".[836] Regarding the legitimate expectations of those concerned, the Court said that it was inherent for monetary compensation purposes that "traders must expect any appreciable change in the monetary situation possibly to entail the extension of the system" to new goods and new amounts, taking into account also that the Commission had adopted "special measures for them to be brought to the attention of the various sectors of industry concerned."[837]

A case, in which the Court for the first time expressly applied the principle of proportionality in its clear three steps, is *Fedesa*.[838] The legal issue in this case was the validity of a retrospective Directive adopted at the beginning of March, which was to be applied from the first of January of that same year. There was a temporary legal vacuum because an earlier Directive had been annulled on the grounds of procedural defects. Since the substance of the matter was agricultural protection (hormone substances for animals), the Court stated that the traders could not have had a reasonable expectation of the law changing only because of a lack of scientifically conclusive findings concerning their dangers. The Court considered valid that retrospective measure, indicating that in matters of public health proportionality is laxly applied.[839] In order to justify retroactivity in those particular circumstances, the principle of proportionality was applied through its three elements (necessity, suitability, and non-availability of less restrictive measures).

The examples in the commerce and public policy fields are very fertile; and the fundamental principles were also applied to tax matters, as is shown in the following cases, in which the Court weighed on the one hand public interest as a justification for retrospective taxation (either to tackle tax avoidance and abusive transactions or to close loopholes), and on the other hand the legitimate expectation of taxpayers, via proportionality.

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[836] Case C-98/78, paragraph 20. See Emiliou, idem p.145.

[837] Case C- 98/78, paragraph 20.

[838] Case C-331/88.

[839] Tridimas (1999), p.102-3. See also Craig and De Burca (2003), pp.376-377 and 382.

IV.8.3. Actual retrospective taxation and legitimate expectation. Simplification as a justification.

In *Schlossstrasse*,[840] the Court held invalid under the protection of legitimate expectations a VAT legislative amendment post-dating a supply of goods or services for letting operations, which had not yet commenced, and which pre-dated the start of those operations and, consequently, their tax assessment. The objective of the change was to limit the scope of the option regarding the taxation of the letting of land as an instrument of simplification and to counteract tax avoidance. Under previous legislation, the taxpayer had the right to choose between an exemption and the right to deduct the VAT, unless the entrepreneur proved that the land has not been used or was intended for different activities from the undertaking. The new law on the simplification of tax legislation only permitted the option (of exemption or deduction) if the use (or intended use) of the land were only for operations, which did not preclude the deduction of input tax. Thus, one of the objectives was to avoid the deduction for operations that could be exempt. The German tax authorities alleged that there was no retroactivity because only after the use of the property could there be a final assessment of the VAT due, although the legislation allowed for the deduction at the moment of the supply of goods and services. The Court rejected this argument, stating that the principles of legitimate expectations and of legal certainty precluded the retrospective revoking of that option, if the national court found that the intention to commence economic activities giving rise to taxable transactions was declared in good faith, and that this intention was supported by objective evidence, as provided for by the previous legislation. In other words, it was for the national court to consider whether there was abuse or not, but not to decide whether there was violation or not of the principles of legitimate expectation and proportionality, since this matter was already settled by the Court.

In the same line, the Court held in *Sudholz* that a retrospective tax measure must be scrutinised under the test of proportionality, in the sense that it must be "justified by the purpose which it seeks to achieve, and whether the legitimate expectations of

[840] Case C-396/98. See Case Comment by Troyer, Ilse de, and others "VAT – Art. 17 of the Sixth Directive – Deduction of Input VAT – Deduction Precluded by an Amendment to National Legislation Removing the Possibility of Opting for Taxation of the Letting of Immovable Property" (2000) EC T.R. 9(4), 257.

those concerned have been respected."[841] Although the term 'proportionality' was not explicitly mentioned, the role of proportionality reasoning is again the thrust of that decision, since not only had the necessity and suitability of the measure to be ascertained, but also the balance with other principles, such as legal certainty and legitimate expectation, had to be considered.

The legal issue in this case was whether Council Decision 2000/186, which was published on 4 March 2000, would be valid retrospectively from 1 April 1999, on request from the German authorities. The reason for this was the Commission's delay in processing the request submitted by the German State for derogating measures to be authorised under Article 27 of the Sixth Directive. The German government lodged its request on 11 November 1998, and introduced the derogating national measure on 24 March 1999 imposing a limit on the deduction of input VAT regarding cars purchased after 1 April 1999 for simplification purposes. While the Court said that Article 27 did not preclude the disputed Council Decision being adopted after the national derogating measure, it stated that its retrospective effect was contrary to the principle of the protection of legitimate expectation.[842] The reason for that conclusion was that there was no suggestion in the preamble of Decision 2000/186 why a retrospective derogation had been necessary, and the argument put forward by the German authorities when the national measure had been introduced - delays of the Commission in processing the requested derogating measure - did not justify the retroactivity of the Council Decision.[843] Whereas the Court seemed not to have taken a formalistic approach in stating that Article 27 allows a Council Decision being adopted later than a national derogating measure, any retrospective legislation may be closely scrutinised by the requirements of its necessity, transparency and significance, weighing different and apparently conflicting interests in play. Furthermore, the simplification requirement invoked as the main purpose for limiting the right of deduction in *Sudholz* appears to be no more

[841] Case C-17/01 (paragraph 35).

[842] Paragraphs 24 and 40-41 of the judgment.

[843] Paragraphs 36 and 42 of the judgment.

relevant than other requirements such as combating tax avoidance, abuse and evasion that were brought into play to justify actual and apparent retrospective taxation.[844]

IV.8.4. Retrospective taxation and justifications of combating tax avoidance, abuse and evasion. Actual and apparent retrospective taxation.

In *Gemeente Leusden* and *Holin Groep*[845] the Court held that taxpayers as a matter of principle cannot have a legitimate expectation against the revocation of a legal framework, which allows tax evasion, avoidance or abuse.[846] In respect of tax avoidance, although taxpayers cannot be censured for taking advantage of a specific provision, or a loophole or a lacuna in the legislation that may not be regarded as an abuse, its retrospective revocation as such cannot breach a legitimate expectation based on EU law, which can only protect against the lack of reasonable transitional arrangements for the implementation of a retrospective amendment.[847] The national legislation at stake in this case had amended the previous law to some extent retrospectively, and introduced compulsory exemption and consequently the withdrawal of the right of deduction, which resulted in an adjustment of deductions made over a number of years on immovable property acquired as capital goods to be let.

This case may give a clear example of quasi or apparent retrospective taxation,[848] as the legislative amendment in question "has effects on the future consequences" [849] of situations that arose while the previous rules were in force. The amending legislation introduced transitional provisions and the specific case was not covered because the amount of the rent was artificially low. It was a case of apparent retrospective

[844] See *Gemeente* and *Holin Groep,* Joined cases C-487/01 and 7/02, and *Stichting Goed Wonen,* Case C-376/02, analysed below.

[845] Ibid.

[846] In *Gemeente Leusden* and *Holin Groep,* paragraph 78, the Court reiterated its case law, particularly the landmark Case C-110/99, *Emsland-Starke*, . Regarding the revocation of administrative unlawful acts, "it may be necessary to balance the public interest in legality and the private interest in legal certainty" (Craig and De Burca, 2003, p.387).

[847] Paragraphs 77, 79 and 81 of the judgment.

[848] On the distinction between actual and apparent retrospective legislation, see above, section 8.1.

[849] Paragraph 45 of the judgment.

legislation due to the adjustments to be made for the future for those apparently abusive tax avoidance transactions. The Court applied the proportionality principle and concluded that it did not appear that the amending law ought to "be considered to have gone further than its objective required or to have breached a legitimate expectation of taxable persons."[850]

From the above cases, and reconciling *Schlossstrass*e and *Sudholz* with *Gemeente Leusden* and *Holin Groep*, it is right to conclude that where there is a completed transaction, although tax motivated but with no abuse,[851] retrospective taxation is not an appropriate measure to tackle tax avoidance because of the principles of legal certainty and protection of legitimate expectation. It may be otherwise in a situation of transactions not yet completed. Additionally, for transactions which have future consequences (e.g. deduction for VAT purposes spread over several years), there must be transitional arrangements to protect the principles of legal certainty and legitimate expectation, unless there is abuse.[852]

In my view, according to a more rigorous proportionality test, a better protection should be granted to VAT taxpayers: to guarantee the right of deduction for capital goods under the rules in force when the right itself arises, that is on their supply, for the following reasons. Since the taxpayer takes into account the tax costs of the supply, including consideration of the time over which the VAT on capital goods may be deducted, and the principle of neutrality requires that the final consumer bears VAT charged even on capital goods, that right of deduction could be neither revoked nor changed (e.g. extended from 5 to 10 years) in relation to transactions in course. Otherwise, either or both the legitimate expectation and the neutrality principles would be jeopardised.

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[850] Paragraph 80 of the judgment.

[851] In a situation where the taxpayer may choose between two ways to have a car for his business by either buying it or renting/leasing it, and the former is chosen just because he can deduct wholly once the tax charged on the acquisition and not only on the rental payments, there is no abuse, because he actually needs the car, the price is real, and in particular there is no intended equal tax treatment for both types of contracts.

[852] Actually, where there is abuse, there is no need for a retrospective legislative measure, since, as the Court has already repeatedly stated, "If the tax authorities were to conclude that the right to deduct has been exercised fraudulently or abusively, they would be entitled to demand, with retrospective effect, repayment of the amounts deducted" (*I/S Fini H v Skatteministeriet*, Case C-32/03, paragraph 33).

For abusive transactions, the more appropriate remedy is not, in my opinion, a retrospective legislative amendment, but simply disregarding them under the abuse of rights doctrine.[853] For tax motivated operations the more appropriate measure seems to be a prospective legislative amendment, without affecting transactions already performed and without detriment to the time over which the deduction may be made. An apparently retrospective measure may be necessary either to address some wholly artificial arrangements with no economic substance (different from tax motivation and abuse), or to fill a legislative lacuna or loophole, eliminating or changing the right of deduction for the future regarding a previous supply of capital goods.

In *Stichting Goed Wonen*,[854] the Grand Chamber seemed to have summarised the doctrine of proportionality between legitimate expectation and retrospective legislation as a measure to be justified on grounds of tax avoidance as a requirement in the general interest. The case dealt with a general scheme supposedly to a great extent practised in Netherlands, in which making a usufruct economically similar to a straightforward leasing would circumvent a disallowed deduction. Thus, an exempted transaction with no right of deduction (leasing) was avoided by the creation of a right *in rem* similar to the right of use derived from the leasing, in order to give rise to a right of deduction, in circumstances where the economic value of the right of usufruct was not at arm's length. The objective of the new legislation was clearly to tackle those tax motivated and seemly artificial transactions, in a retrospective way: the amending law came into force on 29 December 1995, but took effect as from 18:00 hours on 31 March 1995, the date and time the future law was made public by a press release.[855]

In principle the Court has exceptionally accepted a justification founded on the alleged concern that those contrived arrangements (rights *in rem* with no economic substance) would be performed on a large scale between the time of the press release

[853] See the previous note and *Halifax* case, section 7.2.

[854] Case C-376/02. See case comment by Carr, Frank, "Retrospective Legislation" (2005) Ir. T.R. 18(4), 340-341.

[855] Paragraph 8 of the judgment.

and the amending law coming in to force, as the prevention of those apparently artificial arrangements might be in the general interest.[856] Although the Court referred to the national court to finally decide the case, it again gave some guidelines regarding weighing the legitimate expectation and the tax avoidance requirement for a retrospective measure. The Court stated that an assessment of whether or not the risk of a large use of those contrived arrangements "was significant enough to justify the retrospective legislation" was necessary, and also whether or not the press releases of 31 March and 3 April 1995 were sufficiently clear for those concerned "to understand the consequences of the legislative amendment planned for the transactions they carry out."[857] It is still worth noting that in this case not only apparently retrospective taxation could be accepted (for adjustments after the date of entry into force of the amending law), but also actually or truly retrospective legislation, since the deductions that had been made from the press release to the date the new law came into force would be affected if there was tax avoidance with no economic substance.

This circumstance may be regarded as one step further than the previous cases, since from its conclusion may follow the lawfulness of actually retrospective taxation where the objective is to block tax avoidance with no economic substance, under the test of proportionality, but with a flexible requirement of some notice in advance to the taxpayers to satisfy the principle of legal certainty and legitimate expectation. In cases of non-completed transactions, which were performed before the press release, even in tax avoidance transactions with little or no economic substance at all, the better remedy may be to accept only the apparent or quasi retroactivity, affecting only the futures consequences like the deduction of adjustments over several years for capital goods, as discussed above.[858]

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[856] Paragraphs 38-39 of the judgment. Showing consistency, the Court in this case regarded tax avoidance as an overriding requirement in the general interest likely to justify a restriction on the principle of legitimate expectation, likewise in similar cases regarding restrictions on the fundamental freedoms (see particularly section 6.2 of this Chapter).

[857] Paragraphs 39 and 45 of the judgment.

[858] See above comments on *Gemeente Leusden* and *Holin Groep* (Joined cases C-487/01 and 7/02).

In conclusion, in my opinion retrospective legislation to tackle tax abusive transactions should not be allowed any more within the EU after the precedent of *Halifax*[859] on abuse of rights. At the time the Court decided the cases analysed in this section, the doctrine of tax abuse within the VAT was not developed yet, and under the test of proportionality the less intrusive measure is to tackle abuse in each case. Thus, all guarantees would be granted according to the doctrine of abuse, such as a proper assessment based on objective economic factors, no applications of penalties, and under the due process of law. Though Member States might consider retrospective legislation as a most efficient way to warn taxpayers about any abusive legal issue, this specific task could be left with the fiscal authorities through circulars and not through an Act of Parliament, which may cause more general uncertainty among taxpayers.

IV.8.5. Retrospective taxation and procedural rules regarding limitation periods – proportionality, legitimate expectation and the principle of effectiveness.

Member States have had different reactions to Court decisions that held national tax rules invalid under EU law. Some of them, like France, the United Kingdom, Italy and Belgium, have tried to limit the right to recover taxes or charges unduly paid under the justification of limiting the unexpected loss of revenue, without affecting substantially the public budget. They justified specific restrictions under the argument of legal certainty and reasonable response from the taxpayers in a sense that those affected were reasonably aware of undue charges that could be recovered. The Court has considered those restrictions under the general principles of EU law and has either accepted in principle reasonable measures or struck down some unreasonable restrictions on grounds of whether they rendered virtually impossible or excessively difficult the exercise of EU rights (*the principle of effectiveness*), and met the requirement of not being less favourable than those regulating domestic situations (*the principle of equivalence*).[860]

[859] See this Chapter, section 7.2.

[860] See, inter alia, *Rewe* Case C-33/76 [1976] ECR-1989, paragraph 5; *Denkavit* Case C-61/79 [1980] ECR-1205, paragraph 25; *Dilexport* Case C-343/96 [1999] ECR I-579, paragraph 25; *Metallgesellschaft and Others* Joined Cases C- 397/98 and C-410/98, paragraph 85; and *Marks & Spencer* Case C-62/00, paragraph 34. On limitation periods and the principles of equivalence,

The idea of reasonableness once again is taken into account to hold those measures valid or not, pursuant to the objectives of other principles such as effectiveness and equivalence. The role of proportionality reasoning appears to underlie the judgments of the Court in all those cases, not only in balancing apparently conflicting interests or principles (on the one hand the effectiveness of rights and equivalence, and on the other the public interest in legal certainty in limiting the period during which claims for recovery of undue charges may be made). Thus, the reasonableness of measures may be evaluated according to a broad standard balancing the wide discretion of the national legislature and the ultimate requirement of not making impossible in practice the exercise of the right of refund in case of an undue payment. Here again the role of proportionality reasoning is relevant to ascertain the degree of reasonableness that may be acceptable within the boundaries of discretion, even in determining that a transitional period of three months for new rules to come into force may not be appropriate while a six months period may be.[861] The requirements of equivalence and effectiveness are cumulative, but the latter may take precedence over the former either where national legislation may have no domestic procedural rules at all, or in a situation where some conditions laid down for internal matters and for EU law are the same, but make the refund excessively difficult. This occurred in some cases regarding first the reasonableness in principle of the limitation period of 3 years,[862] and secondly with respect to the burden of proof for the reimbursement of undue charges that have been passed on to consumers.[863] The Court seemed to be flexible given the differences among national jurisdictions regarding the statute of limitations, but appeared to have reconciled a variety of principles in play, and rejected clearly unfair rules such as those that provided for no recovery at all for

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effectiveness and proportionality, see Southern, David, "VAT, the Three Year Cap, Rules and Principles" (2004) VAT Int. 22(1), 2051-2054.

[861] Where the limitation period has been reduced from five to three years, the transitional period of 3 months was regarded as clearly insufficient (*Grunding Italiana*, Case C-255/00 [2002] ECR I-8003).

[862] The Court held that a three years limitation period reckoned from the date of the undue payment seemed to be reasonable in the following cases, inter alia, *Edis* Case C-231/96 [1998] ECR I-4951, paragraph 35, *SPAC* Case C-260/96 [1998] ECR I-4997, paragraph 19, *Aprile* Case C-228/96 [1998] ECR I-7141, also paragraph 19, and *Dilexport* Case C-343/96, paragraph 26.

[863] *Denkavit* C-61/79, paragraph 26; *Spa San Giorgio* Case C-199/82 [1983] ECR-3595, paragraph 18; and *Dilexport*, Case C-343/96, paragraph 48.

those who had not brought an action before the judicial decision that has held the tax or charge contrary to EU law.[864]

Regarding the second issue that the undue charges might have been passed on to third parties, the Court gave a number of reasons for not accepting that the burden of proof lay on the taxpayer based on other principles, rules and facts, which may be balanced with the unjust enrichment doctrine. These include free market competition, the difficulty of sometimes proving who actually bears the burden of fiscal charges, the unreasonable acceptance of only documentary proof, and the necessity of broad and flexible rules of evidence that may facilitate the exercise of the right of recovery and not make it nearly impossible in practice.[865] Overall, there is no right if there is no remedy or action to make it reasonably effective and enforceable.

[864] See *Barra* Case C-309/85 [1988] ECR-355 that dealt with the recovery of an environmental tax on cars held invalid in the *Humblot* Case C-112/84 [1985] ECR-1367, where a subsequent statute provided that only those who had brought action before the *Humblot* decision would be able to recover the discriminatory tax.

[865] See *Spa San Giorgio* Case C-199/82, paragraphs 14-16. Regarding the burden of proof the current understanding of the Court seems to be what was held in *Dilexport*: it is acceptable for the burden of proof to be laid down on the administrative authorities and not on the taxpayers, and unacceptable even a rebuttable presumption that charges unlawfully collected have been passed to third parties (paragraphs 44-54).

IV.9. Conclusion on the EU and some comparisons with other jurisdictions.

The open-ended, overriding requirements in the general interest (combating tax avoidance, tax simplification, fiscal supervision, coherence, and a balanced allocation of taxing powers) are balanced with other general or specific tax principles, such as legal certainty, predictability, legitimate expectation, neutrality, ability to pay, fairness, the fundamental rights and the fundamental freedoms, through proportionality reasoning.

The nature of the overriding requirements (whether relating to discrimination, or on a rule of reason and equitable basis, or regarding the residual competences of Member States, or related to a general principle of EU law) is debatable.[866] The most appropriate explanation for these overriding requirements seems to be mainly based on equity and the rule of reason, in which the proportionality test coupled with reasonableness, plays a fundamental role. Most significantly, proportionality remains a core tool and concept to achieve effectively the objectives of the Treaty and make all its principles and rules compatible with each other as far as possible. This principle may also affect the analysis of the means proposed for collection of revenue, such as retrospective taxation, environmental taxation, direct and indirect discriminatory tax rules, and even indistinctly applicable tax rules that may make less attractive or less effective the exercise of EU rights.

The public interest that may justify retrospective measures may encompass combating tax avoidance, the practicability and simplification of the tax system, but must be weighed against the protection of legitimate expectations, and the effectiveness of EU rights. Overall, the former has not generally taken precedence over the latter, except in exceptional circumstances. Most cases decided by the Court have dealt with indirect taxes; however, there would be no great surprise if the Court comes to decide whether a direct tax might be retrospective (as the European Court of Human Rights has done). In direct taxation the Court balances the fiscal sovereignty of Member States and the restrictions of fundamental freedoms that may result from tax measures. Any national direct tax that is retrospective should have a

[866] See Snell (2002), pp.193-4

legitimate objective and be weighed against the legitimate expectations of those concerned.

The legitimate expectation doctrine is also based on the reasonableness and reliance principles, which should guide the life of any society, even in a Union with different legal traditions, cultures and rules. The role of the proportionality principle has been shown to be pervasive, as it may be applied not only to the measures but also to the objectives themselves when applying the test of justification.

Within the VAT system, the role of proportionality is overwhelming, covering all types of rules, such as procedural and substantive measures that may directly or indirectly affect the right of deduction and the principle of neutrality. This may be one of the clearest illustrations how proportionality coupled with reasonableness functions as an analytical tool to assess the overall fairness of a particular tax. The ends of specific measures must be weighed against other objectives of the rule of law and general principles of law, such as good faith and the abuse of rights.

An interesting comparison may be made between the EU and the WTO in relation to non-discrimination and proportionality. Within the WTO agreements, the non-discrimination provision is also a fundamental principle and the jurisprudence of the Appellate Body largely applies the test of proportionality coupled with reasonableness, mainly in its aspects of necessity (reasonably available alternative measures) and balancing.[867]

One contrast between the ECJ and the Appellate Body of the WTO may be pointed out, however. This concerns non-discriminatory rules that may make the exercise of the fundamental freedoms within different States less attractive. The ECJ freed itself from discrimination to focus on restrictions essentially based on proportionality with regard to the fundamental freedoms; the WTO has still applied proportionality to assess whether or not domestic measures are discriminatory and justifiable. One might suggest that there would be some room for applying WTO rules even to indistinctively applicable measures (*per se* non-discriminatory), if they were inconsistent with international free trade either because of their manifest illegitimacy

[867] See on the WTO case law, Chapter III.3.2.

or their wholly disproportionate nature, with due regard to the competing interests at stake. Another contrast is that Articles 110-113 of the TFEU (ex Articles 90-93 of the EC Treaty) also prohibit internal discrimination between domestic and foreign goods similar to Article III of the GATT 1994, but whereas the former seems to be applied strictly with neither margin of discretion nor strict proportionality justification,[868] the latter is open to any exception for discrimination under Article XX (but in this case submitted to its two-tier scrutiny with proportionality reasoning).

Concerning these two possible approaches to proportionality - one more closely related to the justification for discrimination in the WTO and the other more broadly linked to indistinctively applicable rules in the EU – they may be justified by two distinct objectives: trade liberalisation in the former and market integration in the latter.[869] That is why one may agree with Mavroidis on the WTO being 'about non-discrimination, *not* about deregulation!',[870] if one takes into account the differences and similarities of objectives and scope between the WTO as a multilateral trade agreement and the EU as a community treaty pursuing an internal market and the fundamental freedoms of movement of capital, services, goods and workers.

In the US, similar proportionality reasoning is applied under the commerce clause focused on discrimination and non-protectionism.[871] A plausible explanation for a broad test of proportionality in the EU may be justified by the necessity of market

[868] See this Chapter, section 2.4. However, the ECJ appears to have adopted a broader approach on environmental grounds under Articles 90-93, but also applying an objective justification analysis based on proportionality (see section.4).

[869] Trade liberalisation is understood as 'a process aimed at reducing tariffs and quotas' among nations, and 'supported by MFN and national treatment obligations', and market integration as 'a process which, in addition to trade liberalisation, aims at the abolition of all obstacles, both at and behind the border, to freedom of movement for all factors' (Verhoosel, Gaëtan, *National Treatment and WTO Dispute Settlement*, Hart Publishing, 2002, pp.4-7 and note 9). See also Chapter III, section 3.3.

[870] Verhoosel, Ibidem, p.7, citing Mavroidis giving the opening lecture of the WTO Law at Columbia Law School in 1999.

[871] See Chapter II, sections 1.1 and 5; and Chapter III, section 3.2.

access rather than stability as it is in the US where "the focus is in reducing transaction costs" rather than access.[872]

Finally, in relation to other general principles of the rule of law, such as the principle of legal certainty, it can be said that proportionality has become an overarching and essential principle of interpretation and application of EU law as it is has for the European Convention of Human Rights. Overall, in search of consistency, predictability, efficiency and fairness, there may be no way of reaching them all with a reasonable balance between conflicting interests and principles as effectively as applying the proportionality principle coupled with reasonableness.

[872] Maduro (1998), p. 97.

Conclusion

1. Proportionality and Reasonableness as Overarching or General International Principles or Standards of Law.

Before any specific or general conclusion, it would be worth summing up a general description or definition of the principle of proportionality coupled with reasonableness according to the jurisprudence analysed in all previous Chapters. The generally accepted conception is that proportionality in tandem with reasonableness is a general principle of law for interpretation and application of other legal principles and rules, according to which principles must be balanced against each other, aiming at their optimization and conciliation. In addition, all measures pursuing legitimate objectives and policies must be proportionate to them (a reasonable relationship between ends and means) in a less intrusive way to those concerned. All reasonable measures must be suitable and necessary. This requirement of necessity may be called the 'less restrictive alternative test' that may also require the analysis of whether alternative measures are 'reasonably available'. Sometimes a more restrictive measure may be accepted, if it is more efficient according to its legitimate ends, because there must be also a balance between its disadvantages and the overall interests in play.[873]

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[873] The three-prong test of proportionality (suitability, necessity and balance) may encompass the analysis of the legitimacy of the ends pursued by specific or general measures. Examples of legitimate objectives would be fiscal supervision, tax coherence, combating tax avoidance, environmental protection, balanced allocation of tax jurisdiction, compliance with international agreements. See also Chapter I. The margin of discretion (or appreciation, or deference) doctrine has also a role to play in proportionality reasoning which may be the overarching principle of interpretation and adjudication (on the differences and interplay between margin of appreciation doctrine and proportionality, see Chapter III, section 2.4). Metaphorically, one may say that the margin of discretion would be the driver and proportionality in tandem with reasonableness the whole coach, not only its four wheels (four tests: suitability, necessity, disadvantages not being disproportionate to the aims pursued, and legitimacy of the ends), as the latter must govern the driver him or herself (the judicial, administrative or legislative authority). Sometimes, depending on the subject matter even when expressly applying the proportionality principle, the Courts give little or no deference to the margin of appreciation of States regarding for instance self-defence (see for example the ICJ Case Concerning Oil Platforms, *Islamic Republic of Iran v. United States of America*, Judgment of 6 November 2003, General List No. 90, paragraph 73, Chapter III.1), and apparently on sex discrimination (see Chapter III.2, section 5.b, on the European Court of Human Rights and similar contrast with other jurisdictions such as the US regarding the joint taxation of spouses).

The first conclusion that may be drawn is that the principle of proportionality in concert with the notion of reasonableness is a general principle of law recognized and applied in international and domestic constitutional courts. This research gave more weight to the analysis of international over national courts for three reasons. First, demonstrating how proportionality may be distinct from and work in tandem with reasonableness was easier via the analysis of the case law of international jurisdictions, since in some individual countries they may be interchangeable and their interaction is not clear. Secondly, international judges tend to apply legal methods of interpretation and application of law as generally accepted that might go beyond national borders. Thirdly, this thesis is on taxation and there appears to be great interaction in that context between international fundamental rights and international trade.[874] Consequently, proportionality coupled with reasonableness may also be regarded as a general principle of law under Art 38 of the Statute of the International Court of Justice.[875] Sometimes the test of proportionality in tandem with reasonableness seems to be applied as an overarching principle of law, particularly regarding international trade, fundamental rights and freedoms.[876] From this, it may follow that the principle of proportionality coupled with reasonableness is not only a general principle of European Law or Human Rights, but also a general

[874] For example, the WTO jurisprudence in this sense is quite important as 153 countries have joined that international organization and, if Russia for instance has not joined it yet, it is a party to the European Court of Human Rights, whose case law is compelling on proportionality. Many countries are not contracting parties to the European Convention on Human Rights, but it encompass over 50 countries and, if China for example is not one of its members or any other Convention on Human Rights, it joined the WTO where the seeds of proportionality, particularly regarding non-discrimination and protectionism, is well rooted.

[875] Art 38 of the Statute of the I.C.J. provides that the Court shall apply: "b. international custom, as evidence of a general practice accepted as law; c. the general principles of law recognized by civilized nations". Other general principles of international law such as equality of States, reciprocity, good faith, the legal validity of agreements, and the freedom of the seas, may be construed and applied according to the principle of proportionality in its role of weighing apparently conflicting interests and ascertaining and making them effective and as compatible as possible with each other. As Georges Abi-Saab pointed out "… there are certain general principles of international law, or of law *tout court*, without which it is impossible to imagine how any legal system can function – in other words, principles inherent in the concept of legal system itself – such as the principles of good faith and proportionality" in "The Appellate Body and treaty interpretation", p. 459 in Sacerdoti, Giorgio, Yanovibh, Alan and Bohanes, Jan, (Eds) *The WTO at Ten: The Contribution of the Dispute Settlement System* (CUP, 2006).

[876] See the overwhelming and compelling jurisprudence of the ECHR (Chapter III.2) and the European Court of Justice (Chapter IV) regarding fundamental rights and freedoms, as well as in the US (Chapter II) and other international courts such as the ICJ and the Appellate Body of the WTO (Chapter III, sections 1 and 3, respectively).

principle of international law and applied in many domestic jurisdictions as a general principle of law. It may be regarded as 'part and parcel' of the rule of law.[877] There may also be an international concept of proportionality different from the international concept of reasonableness; not only do international jurisdictions use them as two joint tools, but also some domestic jurisdictions generally use them interchangeably.

Proportionality and reasonableness may also interact where the law provides the notion of reasonableness as a standard (like reasonable expense, reasonable price, or reasonable tax rate[878]). In these cases, the proportionality principle may play a fundamental role in ascertaining the standard of reasonableness. As Sunstein pointed out the term 'reasonable' is vague because it needs "a great deal of specification to have meaning for particular cases,"[879] and proportionality may have this essential function.[880] It follows from this that the proportionality principle may work in tandem with the apparently more open-ended reasonableness standard. Moreover, where proportionality may again appear too rigid (against any presumption); the reasonableness standard makes it more flexible by allowing rebuttable presumptions.[881] Where what may be reasonable appears to be too vague, with no

[877] "The universal model of the rule of law would necessarily include a proportionality tool. Proportionality would be required for the rule of law theories that include a notion of individual rights and/or distributive equality to provide a mechanism to rationally limit government discretion" (Sullivan and Frase, 2009, p.175, and their reference to the formal and substantive theories of the rule of law). See also Tamanaha, Brian Z., *On the Rule of Law: History, Politics, Theory,* (CUP, 2004). See also Beatty, (2004).

[878] See the OECD Reports on harmful tax competition that seem to be in search of a reasonable level playing field among all countries and jurisdictions that does not undermine the fairness and integrity of each country's tax system. See also Chapters I.2, and II.6.

[879] *Legal Reasoning and Political Conflict* (OUP, 1996), p.124.

[880] As the European Court of Justice has done in a number of cases, particularly in *Dassonville* (C-8/74), and further in *Commission v Kingdom of Belgium*, Case C-2/78 (Chapter IV.2.2), as well as the ECHR in ascertaining the legal standard of reasonableness (Chapter III.2.2). See also the above cases of discrimination in taxation in the US, the ECHR, and the WTO, and the cases *Societe generale des grandes sources d'eaux minerals financaires v Bundesamt fur Finanzen* (C-361/96) and *Federation of Technological Industries* (C-384/04) on Chapter IV, section 7.3.

[881] The ECJ systematically repeals general irrebuttable presumptions of tax avoidance based on the proportionality test (*Leur-Bloem, Lankhorst, ICI* cases, at Chapter IV.6, and *Amprafrance* section 7.1). See also *Garage* in which an irrebuttable presumption of tax evasion was considered as disproportionate when the taxpayer has a tax claim against him or her (Chapter IV.7.3); and *Federation of Technological Industries* according to which a circumstance of suspicion of tax evasion must be rebuttable to be proportionate (Chapter IV.7.3). Whereas in *Fratrak* and *Balak* the ECHR

limit (any presumption might be allowed), proportionality through its test of necessity (not going beyond what is necessary) may aid to set its boundaries. Thus, it may be right to suggest that the better way to construe or ascertain the term *reasonable* seems to be through the proportionality test, as it appears that the better way for proportionality to remain flexible is by applying it through the more open-ended standard of reasonableness. The proportionality and reasonableness tests run in tandem, and the concept of proportionality may cohere with the notion of reasonableness, from which it cannot be separated, as if they both formed a double helix device in legal reasoning, making it hard sometimes for judges and interpreters to treat the two separately. Sometimes it may be required to have an overall picture or an holistic view of the test of proportionality in tandem with reasonableness as the interplay between light (more certainty and clarity) and shadow (more uncertainty and lack of clarity) is required to fairly reflect economic and dynamic reality, such as in cases of tax abusive transactions; however, there must be enough clarity to ascertain objectively the legal and factual issues.

The originality of this analysis may also lie not only in substantiating that conclusion with case law from international courts, but also in pointing out tax issues that arise from domestic and international trade rules and principles, and from fundamental freedoms and rights. In other words, this general conclusion has been demonstrated mainly from an analysis of tax cases. This also shows that fiscal sovereignty of States is limited by unwritten principles of law, such as the principle of proportionality coupled with reasonableness. For instance, the role of proportionality is also clear in balancing federal and state powers related to taxation, such as in the US,[882] as well as

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accepted a presumptive and irrebuttable minimum tax base as justified, in *Vastberga* concerning criminal law, only rebuttable presumptions were acceptable. The different approach between tax base and the imposition of penalties may be justified by public policy reasons and generally accepted canon according to which fair and reasonable taxation is neither a sanction nor in principle a restriction on fundamental rights (Chapter III.2.7.a).

[882] In my opinion proportionality coupled with reasonableness can be related to federalism in two ways. First, by balancing federal and state powers (see Sullivan, E. Thomas, and Frase, Richard, 2009, p.83; and Chapter II, section 1.1, particularly *McCulloch* case); secondly, by varying the degree of scrutiny according to the different powers at stake. For instance, where indirect discriminatory taxation affects a federal right, states have less leeway in comparison with situations of no involvement of a federal right other than discrimination itself, and the tax measure is more closely scrutinised (see Chapter II, section 3, the comparison of *Grosjean* with other cases). Also where state taxation is not discriminatory, but it can affect the federal power to regulate inter-state commerce, the scrutiny under the fair apportionment is not as strict as under the proportionality test (see Chapter II, section 5, *Barclays* case).

in making compatible fiscal sovereignty in direct taxation of the EU Member States with the fundamental freedoms.[883] Likewise regarding the compatibility of domestic legislation with international agreements, such as those within the WTO, proportionality coupled with reasonableness has a fundamental role to conciliate domestic interests and the international obligation of non-discrimination, so that tax powers cannot favour protectionism unless they pass a close scrutiny.[884] Lastly, proportionality coupled with reasonableness is an essential tool to strike "a fair balance between the public interest and the applicant's rights," regarding fundamental rights.[885]

In its own right, or as a fundamental principle of construction and application of other general and specific tax principles and rules, the principle of proportionality in tandem with reasonableness may be employed to resolve fundamental tax issues.

2. Fundamental Tax Issues and the Role of Proportionality and Reasonableness.

2.1. Equality, Non-Discrimination and International Tax Law

As discussed, the application of the principle of proportionality in tandem with reasonableness lies at the core of discrimination and equality, drawing the conclusion that where to some extent there is no proportionality and reasonableness there is no equality.[886] In addition, if "the concept of equality is a universal notion",[887] there

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[883] Though the EU is not a Federation, a parallel can be made between domestic taxation that affects the fundamental freedoms ("federal" union rights), which are scrutinised under the test of proportionality (Chapter IV, sections 2 to 6). Where domestic taxation is harmonized the scrutiny seems to be stricter (such as in the case of VAT, see Chapter IV, sections 7 and 8) than in the case of direct taxation where the power to regulate direct taxes was retained by Member States (see Chapter IV, sections 3 to 6 and 8).

[884] See Chapter III, section 3.

[885] Paragraph 141 of the judgment in *Reiner* (Chapter III, section 2.3.c.1). See in the same words also sections 2.3.a, and 2.5 (*Belgian linguistic* case); 2.5.a (*Johnston* case); 2.6.b (*Compania Naviera S.A.* case); 2.6.c (*Stran* case); 2.7.b (*Janosevic* case), 2.7.d (*Bulves* case), among other cases.

[886] On non-discrimination regarding international law, see inter alia, McKean, Warwick A., *Equality and Discrimination Under International Law* (OUP, 1983). This author concludes that non-discrimination is a general principle of law, or as others may prefer a general rule derived from the principle of equality, and if they are right as they are, there is no justification for discriminatory measures unless there is a reasonable relationship between legitimate aims and proportionate means. See also the relevant case law, mainly the landmark and leading decision of the ECHR in the *Belgian*

must be a minimum common denominator, in whose determination the legal standards of reasonableness and proportionality may have a relevant role. The extent to which this standard is used to assess the reasonableness of classifications or discrimination depends on the importance given to the values at stake according to cultural and legal traditions, and socio-economic circumstances in each case.

A clear illustration of this as well as the role of proportionality coupled with reasonableness is the case of joint taxation of married couples, as compared with unmarried couples in the same jurisdictions. Married couples have been submitted to a higher income tax rate by virtue of progressive taxation, which discourages marriage from a strict tax perspective. The US Supreme Court and the German Constitutional Court both scrutinized the joint taxation of spouses, but weighing different principles and constitutional values. The US Supreme Court held unlawful the mandatory joint taxation that discriminated against married couples, which pursued the objective of combating tax avoidance,[888] whereas the German Constitutional Court balanced the ability to pay principle in light of the equality of rights of the two sexes, the constitutional protection of the family, and the purpose of 'bringing the working wife back to the home.'[889] Differently from the above jurisdictions, the ECHR refused to recognize as comparable the situations of married and unmarried couples as cohabitees, although its jurisprudence seems to be evolving; and where there is discrimination the ECHR always applies the test of proportionality coupled with reasonableness.[890] What went wrong with the ECHR´s

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linguistic case (Chapter III, sections 2.3.a, and 2.5), the US Supreme Court (Chapter II, section 1), and the WTO (Chapter III.3).

[887] Schwarz, Jonathan, *Schwarz on Tax Treaties* (Wolters Kluwer, 2009), p.256.

[888] Regarding regulatory measures, through which the State might exercise its police power, the joint taxation of spouses would be lawful where a constitutional provision provided for a more favourable tax regime for single persons to the detriment of married couples, or another constitutional allowance for taxing the economic or social benefits of marriage, or if an earlier regime were still valid in which the wife did not have any right to her own income. In terms of tax avoidance, the measure could be regarded as excessive and as such disproportionate, since other measures would be available to control tax avoidance, taking into account the fiscal supervision to check if one and not the other spouse have actually accrued income. See Chapter II.3.

[889] 6 BVerfGE 55, decision of 17 January 1957, excerpted in Kommers, Donald, *The Constitutional Jurisprudence of the Federal Republic of Germany* (DUP, 1997), p.498. See also Chapter III.2.5.a.

[890] See the criticism of this decision that may not be controlling, in Chapter III.2.5.a, and on tax discrimination sections 2.3.a and 2.5.a,b, and c. Besides the U.S. and Germany, two other domestic

unfair decision on joint taxation of spouses was a formulaic approach to comparable situations, and the missing application of reasonableness in tandem with proportionality. Thus, it may be concluded that where equality and discrimination are at stake, the principle of proportionality coupled with reasonableness may be an analytical tool to ascertain their legitimacy and appropriateness.

Another side of the coin of tax discrimination is to use a tax measure as a requirement for exercising a fundamental right, such as the right to vote[891] and to move or change residence (exit taxes).[892] Arguably the same may be equally true of the right to change nationality or citizenship, which can be conditional on proportionate tax measures, such as the requirement of a minimum period of time for taking effect, or provisional measures to secure the payment of tax on potential gains previously crystallized to tackle tax avoidance.[893]

A clear similarity between the US, the EU, the ECHR[894] and the WTO regarding discrimination lies in the use of proportionality reasoning to justify reasonable and acceptable exceptions. In tax matters the proportionality principle coupled with the margin of appreciation doctrine is perhaps adequate to control discrimination, as well as measures to combat tax avoidance or tax evasion, fiscal supervision, simplification, allocation of tax jurisdiction, fiscal subsidies and enforcement of other non-tax policies, such as environmental and consumer protection, free and fair

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jurisdictions, Italy and Spain, applied the notion of a reasonable and objective test under the proportionality reasoning in balancing different principles in play to override that discrimination. Even the European Court of Justice in the *Schumacker* case took into consideration the legitimate aim of the split system for couples based on the ability to pay principle recognized as a fundamental principle of domestic and international law as opposed to joint taxation.

[891] In *Harper v. Virginia Board of Elections* [1966] 383 U.S. 663 the Supreme Court held unconstitutional the poll tax of US$ 1.50 charged on every individual to be entitled to vote (see Chapter II.3). On grounds of proportionality the ECHR decided in *Hirst v United Kingdom* (Application No. 74025/01, Judgment of the Grand Chamber of 06 October 2005) that a blanket and automatic ban on voting imposed on prisoners violates the right to vote under Article 3 of Protocol 1 of the ECHR. On this issue of implied limitations to some fundamental rights and proportionality, see also Chapter III, section 2.3.b.4.

[892] See cases regarding exit taxes in the European Union (*N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* Case C-470/04, Chapter IV.5.3, and *De Lasteyrie du Saillant*, Case C-9/02, Chapter IV.6. See also the ECHR (Chapter III, sections 2.5.c and 2.7.b, particularly the *Riener* case).

[893] See below particular conclusions on tax avoidance.

[894] Though the ECHR applies a wider margin of discretion than the other Courts, on direct discrimination it is strict particularly on sex grounds (Chapter III, sections 2.5.b).

trade. The cost-benefit analysis, contrariwise, may not be appropriate to control taxation given its greater intrusiveness in assessing the benefits of specific taxes to hold them lawful or not. This may be a task for the legislature of each jurisdiction with due regard to fundamental rights. In relation to cross-border trade in jurisdictions where the federal government may intervene such as in the U.S., the cost-benefit analysis has provided provisional and effective solutions by assessing state measures.[895] It seems reasonable to adopt a stricter scrutiny of a cost-benefit analysis, with no margin of discretion to states, since it is based on a principle that prohibits the state legislature from infringing the commerce clause in the US, under which the states only have residual powers and while the federal government does not legislate.[896]

Furthermore, it is right to suggest in my opinion that proportionality in tandem with reasonableness cannot be placed on a rank of equality with other principles and rules, since it is an overarching principle that may govern, construe, ascertain, and balance all the others as a tool of reconciliation and optimization. If "the method of eliciting general principles from hundred of cases sometimes make it difficult to see the wood for the trees",[897] the proportionality test coupled with reasonableness may make it easier to elicit those general principles not only from cases but also from statutory instruments, codes, constitutions and treaties.

2.2. The Abuse of Tax Law and Other International Tax Principles Developed via Proportionality and Reasonableness.

In its role of construing other principles and of eliciting or revealing new legal principles, the case law analysed is striking, where legitimate aims and adequacy between ends and means are scrutinised under the test of proportionality implicitly or explicitly coupled with reasonableness. Many other examples (besides the ascertainment of equality and non-discrimination) illustrate its creative and lively

[895] Even in the U.S. the Supreme Court restrains itself from scrutinising state taxes based on the cost-benefit analysis, rather preferring the reasoning of internal consistency instead, that is quite similar to proportionality reasoning with an implicit margin of discretion for State Legislatures (see Chapter II, sections 1.1 and 5).

[896] On the cost-benefit analysis see Chapters II, section 1.1; and III, section 3.2.b.

[897] Lacey, Nicola, *A life of H.L.A. Hart: the Nightmare and the Noble Dream* (OUP, 2004), p.213.

role. These include the case law on non-retrospective taxation,[898] the effectiveness principle,[899] legitimate expectation,[900] non-prohibitive or non-excessive taxation,[901] lawfulness principle (clarity and predictability),[902] limitation to fiscal penalties,[903] neutrality in taxation,[904] tax evasion and fraud,[905] fiscal supervision and tax simplification,[906] and tax avoidance and abuse of rights. Particularly, regarding tax avoidance and evasion, proportionality may have the role not only of developing a reasonable doctrine of abuse, having regard to other legal principles such as good faith and limitation of fundamental rights to property and freedom, but also of

[898] One of the examples analysed in depth in this thesis was the role of proportionality and reasonableness while ascertaining whether retrospective tax legislation is admissible or not, according to other principles of law that should be taken into account such as the reasonableness and predictability under the due process clause in the U.S.; the right to property and legal certainty according to the ECHR (Chapter III.2.6); and the rule of law, legal certainty and the legitimate expectation within EU law (Chapter IV, sections 8.1-8.3 and 8.5).

[899] See Chapter III, sections 2.3.c.2 (right to an effective remedy and effectiveness in practice and in law), 2.3.d (its role of optimization in making other principles as effective as possible); and Chapter IV sections 2.2 and 2.5 (effectiveness of fiscal supervision as an imperative requirement in the general interest to justify proportionate restrictions to the fundamental freedoms), and 8.5 (disproportionate procedural measures that make rights ineffective).

[900] See ECJ cases, Chapter IV, sections 8.1-8.3 and 8.5.

[901] See US and ECHR cases Chapters II, section 1.1, and III, sections 2.7.b) and c, and 2.8.

[902] See ECHR cases, Chapter III, section 2.7.a.

[903] See ECHR and ECJ cases, Chapters III, section 2.7.b; and IV section 2.1.

[904] The ECJ applied the test of proportionality in order to make effective the underlying principle of the Value Added Tax (neutrality) and to ascertain the right to deduction as an essential right in contrast with the objectives of tax simplification and fiscal supervision, sometimes intertwined with tax anti-avoidance (Chapter IV, sections 7.1 and 7.3). Regarding direct taxation the Court also in *Leur-Bloem* took into consideration the objective of tax neutrality by construing the Merger Directive and assessed restrictions on its application according to the test of proportionality (Chapter IV.6.3).

[905] See *Hentrich*, decided by the ECHR (Chapter III.2.7.b). See also *Federation of Technological Industries* and *Telios* on the joint tax liability to prevent tax fraud (Chapter IV.7.3).

[906] See in the ECHR *Darby* (Application No. 11581/85) regarding fiscal simplification as a justification for discrimination (Chapter III.2.5.d); and in the EU (Chapter IV) *Outokumpu Oy* on environmental taxation and simplification (section 4), *Schumacker* on administrative difficulties and simplification for justifying discrimination (section 5.1), *Futura* and *Baxter* on grounds of fiscal supervision (section 5.2).

assessing the tax consequences of abuse and evasion. Furthermore, specific measures may be assessed on proportionality and reasonableness grounds.[907]

From the application of the proportionality test coupled with reasonableness to tax avoidance, one may conclude that retrospective legislation may be appropriate to catch only wholly artificial transactions,[908] whereas it may be disproportionate to catch tax-driven transactions with genuine commercial purpose. It is also interesting to contrast this aim of combating tax avoidance with tax evasion,[909] since the latter seems to be more compelling to justify measures that may be more drastic. Retrospective legislation as a matter of principle is not necessary to counteract evasion, as there is no need of a new law but just the application of the previous law in force when the evasion occurred. Thus, any penalties provided by law and submitted to the test of proportionality would be enforced. In this sense, it is also possible to differentiate avoidance from evasion by their legal consequences. Whereas evasion may trigger penalties, avoidance may not do so, according to the principle of proportionality. Counteracting tax avoidance is a legitimate objective recognized by domestic and international jurisdictions, but anti-avoidance measures provided by law must be proportionate to that end. In other words, they must be suitable, necessary and balanced with other interests and principles at stake, such as the fundamental freedoms,[910] the fundamental rights,[911] and non-protectionism in international trade.[912]

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[907] See *Hoeper* in the US (Chapter II.3 on equality and taxation of spouses to avoid manipulation of attribution of income between the spouses); within the WTO, see *Bovine Hides* and *Dominican Republic - Cigarettes* cases on tax avoidance, evasion and proportionality (Chapter III.3.2.b and c); and within the ECJ among others the cases *ICI*, *Cadbury Schweppes*, *Emsland-Starke*, *Leur-Bloem,*and *Lankhorst-Hohorst* (Chapter IV, section 6); *Skripalle*, *Ampafrance* and *Sudholz* on substantive measures regarding tax avoidance (Chapter IV.7.1); *HE* case regarding procedural measures to tackle tax avoidance (Chapter IV.7.3).

[908] See in the US the cases *Milliken v. US, US v Carlton, Nichols v. Coolidge*, *Boldgett v. Holden*, and *Untermayer v. Anderson* (Chapter II.4); within the ECHR, *A., B., C. and D.* and *M.A. and Others* (Chapter III, section 2.6.c); and within the ECJ the joined cases *Gemeente* and *Holin Groep,* and *Stichting Goed Wonen* (Chapter IV.8.4).

[909] On an international distinction between tax avoidance and evasion, see Baker, Philip, "Tax Avoidance, Tax Mitigation and Tax Evasion" <www.taxbar.com/Articles> (last visited 8 July 2010).

[910] See Chapter IV, sections.6 and 7.2.

[911] Mainly the rights to property, non-discrimination, and freedom of movement within the ECHR. See Chapter IV, sections .2.4. *a* (family taxation), and *c* (discrimination on grounds of fiscal

Furthermore, in terms of tax policy the principle of proportionality in tandem with reasonableness may determine appropriate means to tackle avoidance, such as fixing limits to a general judge-made abuse of law doctrine, and assessing general and specific anti-avoidance rules either separately or concurrently.[913] Particularly regarding tax avoidance, it is debatable whether a system based on general principles rather than prescriptive rules may be more appropriate, depending on the legal traditions and constitutional systems of each jurisdiction. In my view a system with general principles, such as an objective abuse of rights doctrine (taking into account objective economic factors, the principle of good faith, no application of penalties, objective ascertainment of the purpose of the tax legislation at stake, and an overall fair assessment) is more appropriate to tackle tax avoidance, because it balances equity and legal certainty, whereas prescriptive rules favour legal certainty only or mostly. A combination of a general rule with prescriptive ones, for greater clarity and legal certainty, would be better depending again on what would be more appropriate to the legal systems of each jurisdiction. The principle of proportionality in concert with reasonableness may work well either within a system where detailed and prescriptive rules prevail over intellectually demanding general principles or otherwise. Overall, the proportionality test coupled with reasonableness may examine whether specific or general anti-avoidance measures taken together or not are suitable, necessary (do not go beyond what is necessary to tackle avoidance or abuse, as there may be less restrictive measures) and reasonably balanced and compatible with other relevant interests and principles at stake. These other relevant principles or rights that ought to be taken into account would be legal certainty, the right to property and the fundamental freedoms.

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residence), 2.6.b (retrospective taxation and avoidance), and 2.7.b (fiscal sanctions and freedom of movement).

[912] Tax avoidance may not justify disguised protectionism within the WTO agreements, particularly under Article XX of the GATT and Article XIV of the GATS to which the tests of reasonableness and proportionality are applied. See *Bovine Hides* and *Republic Dominican -Cigarettes* cases, at Chapter IV.3.2.*b* and *c.*

[913] See also on the challenges of tackling avoidance through rules or principles, Jones, John Avery, "Tax Law: Rules or Principles?" [1996] B.T.R., 6, 580.

In terms of policy and economics of taxation, taxes may be assessed on a number of grounds: how they affect incentives, how fair they are, how efficient to raise revenue, how they interact with other taxes within a system and how simple. These canons of taxation as identified by Adam Smith (equity, certainty, convenience, and economy) have to be balanced and reconciled. In addition, they may be separately tested on grounds of proportionality in tandem with reasonableness, for example where "enforcement and collection costs should be reasonably proportionate to the receipts."[914]

In summary, the role of proportionality in tandem with reasonableness is to construe, apply, enforce, develop, and sometimes elicit other rules and general principles of law as consistently and efficiently as possible. Thus, its role may not only be to avoid absurd or formulaic legal construction, but also to give life and useful meaning by achieving the worthwhile policy objectives underlying the law.

2.3. The Features of Proportionality (optimization, effectiveness and neutrality) and the Principle of Good Faith in Assessing Fair Taxation.

Furthermore, proportionality may be thought of as a vital method, not only to balance apparently conflicting principles, rules, and interests, but also to reconcile them in search for more fairness, consistency and effectiveness. This optimization[915] of principles can be said to be a primary function of proportionality in law. The maximum of fairness with the minimum of disorder would be an optimal situation and the dividing line between unfairness and order would depend on policy considerations and the role of the rule of law in society. The choice between fairness with disorder and unfairness with order may be a false dilemma, and the principle of proportionality may serve to enforce fairness with order.[916]

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[914] *International Tax Glossary*, IBFD, 4th Ed, p. 49. See enforcement and collection measures tested under the principle of proportionality at Chapters III, section 2.7.b (mainly the *Gasus, Lemoine, and Hentrich* cases) on the ECHR, and section 3.2.b on the WTO (*Argentina Hides* and *Dominican Republic-Cigarettes* cases), and IV on the ECJ, sections 5.2, 7.1 and 7.2 (see *Futura, Ampafrance, Garage* cases, among others).

[915] Beatty, (2004), p.163. See also Schwarze (1992), p.679. According to Robert Alexy proportionality reasoning in this aspect of weighing other principles expresses the idea of Pareto-optimality ("On the Structure of Legal Principles", *Ratio Juris*, 13/3, 2000, p.298). See also Chapter I.

[916] See inter alia *Garage* and *Sudholz* (Chapter IV. sections 7.1 and 7.3).

Another essential feature of the proportionality principle coupled with reasonableness is its operation 'in law and in practice' as well. Not only must the principle of effectiveness work in practice via proportionality and reasonableness, but so must any fundamental right or freedom.[917] Thus, the proportionality test coupled with reasonableness may not be a mere aspirational principle nor serve the purpose to interpret and apply other principles of law merely in a way that is aspirational and not effective, with practical and substantial consequences.

Still in its role of weighing principles among themselves, proportionality may be regarded as an overarching principle that demonstrates its sense of flexibility and fairness. In each case depending on its particular circumstances, proportionality may give precedence to an open principle such as *good faith* over an apparently rigid one that seems to have no exceptions, such as *everyone is presumed to know the law*, even in tax matters.[918] It may be suggested that such cases are exceptional and very rare, but the point is that proportionality may catch even those special cases where the usual methods of interpretation and construction might not achieve a fairer decision through a more sensible reasoning without undermining the consistency of legal systems. The case law on tax avoidance, fiscal supervision, evasion, fraud and some on retrospective taxation demonstrate great weight being given to the principle of good faith, when balancing other rights, interests and principles.[919]

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[917] See *inter alia* on the requirement of proportionality *in practice* the ECHR cases *Krasuski*, *Riener*, and *Volokhy* (Chapter III, sections 2.3.c.2, 2.7.b, 2.7.a), and the effectiveness principle mentioned above within the EU. As well the discriminatory analysis under the chapeau of Article XX of the WTO/GATT and its paragraphs requires the prima facie scrutiny in the former and its application "in practice" regarding the latter (Chapter III.3.2.c).

[918] See Chapter IV.2.1 (*Louloudakis*, Case 262/99).

[919] See the following cases explicitly decided on abuse, good faith and proportionality grounds *Intersplav* and *Bulves* regarding the right to tax refund decided by the ECHR (Chapter III.2.7.d); *De Lasteyrie du Saillant* (Chapter IV.6); *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise* (carrousel fraud cases) and *Federation of Technological Industries* and *Telios* regarding joint tax liability requiring reasonable behaviour, good faith and proportionality (Chapter IV.7.3); *Schlossstrasse* concerning retrospective taxation, legitimate expectation and good faith (Chapter IV.8.3); *US Shrimps* and *Bovine Hides* on the interpretation of the chapeau of Art XX of the GATT regarding the bona fide exercise of rights of States and its relationship with reasonableness and arbitrary or disguised protectionism (Chapter III.3.2).

The case law on good faith and taxation may reveal a moral dimension of proportionality coupled with reasonableness. One may highlight the difficulty in conceptualizing words like "reasonableness" or "rationality" because these expressions might go beyond legal matters. One distinction that may be drawn between reasonable and rational is the acceptability of a decision or a rule. An unreasonable decision may be more related to its unacceptability for being just unfair or for not having taken other principles into account rather than its lack of rationality or logic.[920]

One may also consider that these concepts may be founded on criteria that are more sociological than merely legal, namely, including economic, cultural and ethical aspects. As Sunstein pointed out, "some people think that conduct is reasonable if it passes a cost-benefit test;"[921] … or "compliance with community norms;" or still "respect for certain understandings of individual autonomy," asserting that "dictionaries cannot resolve this question."[922] Rawls' description of reasonable persons as free, equal, acting in cooperation with others[923] has also a moral element. Thus, unilateralism would not be reasonable, nor a lack of reciprocity in an international tax context. For example, where States adopt protectionist tax measures or have no regard to a fair allocation of taxing rights.[924]

The moral dimension of proportionality coupled with reasonableness may also be seen in the logical and moral opposition to the truism "the ends justify the means",

[920] One distinction that may be drawn between reasonable and rational is the acceptability of a decision or a rule. An unreasonable decision may be more related to its unacceptability for being just unfair or for not having taken other principles into account rather than its rationality or logic. On further differences between reasonable and rational see also Sen, Amartya, *The Idea of Justice* (HUP, 2009) pp.183 and 195.

[921] On the difference between the cost-benefit analysis and proportionality, see Chapter III.3.2.b.

[922] Sunstein, Cass R., *Legal Reasoning and Political Conflict*, pp.123-4.

[923] Sen, Amartya (2009), p.79.

[924] In this sense, both CFC and Transfer Pricing rules may be tested under the tests of reasonableness and proportionality regarding their purpose of tackling tax avoidance which should give some regard to the tax treatment of profits accruing in other jurisdictions. Sometimes even unilateral measures may be justified regardless of other States measures, such as an unilateral tax credit to avoid double taxation where worldwide taxation is in force in light of the capital export neutrality principle. Another example of a unilateral tax measure that may be justified would be the application of domestic anti-avoidance rule to avoid abuse of tax treaties by wholly artificial arrangements to exploit unintended double non-taxation.

because besides the legitimacy of the ends, the means must be proportionate, reasonably balanced, and fair to pass the test of justification. This aspect of fairness, the notion of reasonable person, and the principle of good faith in reasonableness and proportionality may also evoke the ancient Roman law according to which "*Iuris praecepta sunt haec: honeste vivere alterum non laedere, suum cuique tribuere.*"[925] Thus, it may be right to suggest that the principle of proportionality coupled with reasonableness would be a modern concretization and application of fundamental principles and rules of law also with a moral component. However, it may not be right to suggest that exploiting loopholes in the legislation for tax purposes would be immoral or morally wrong. The concept of morality may depend on a number of reasons and circumstances involving the consciousness of the individuals and in my opinion cannot be a legal standard by itself to define whether or not there is abuse for tax purposes. The legal concept of abuse of rights can be inspired or underpinned by moral elements likewise the principle of good faith, but it must be as objective as possible, because other fundamental tax principles must be taken into account, such as the legality or lawfulness principles and its corollaries of legal certainty and legitimate expectations. Thus, as stated in the previous section, the notion of tax abuse must be ascertainable by objective economic factors in line with the commercial reality, the principle of good faith, and the objective and logic purpose of the tax legislation at stake.

In an apparent contrast with that objective moral element, another characteristic of proportionality can be its neutrality,[926] as a neutral instrument to enforce economic, objective and fiscal policies. It has been suggested that proportionality, unlike the doctrine of margin of appreciation, "is generally regarded as a neutral or even a good tool."[927] On the other hand, its neutrality should not undermine the ultimate objective of fairness, which may have given origin to the notions of equity, justice, rule of reason, equality, reasonableness and proportionality itself. Thus, neutrality cannot be

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[925] Ulpian in his *Regole* (Digest. 1.1.10pr).

[926] Generally, "neutral principles must be drawn from the constitutions and formulated in a way that allows them to be applied consistently" (Beatty, 2004, p.161).

[927] Dembour (2006), p.90. See also on the utilitarian view over the notion of individual rights, Chapter III.2.8.

an isolated characteristic of proportionality, which may serve a utilitarian perspective on human rights or fundamental freedoms, but it must be seen within the general purpose of fairness.

With respect to the utilitarian or consequentialist view of the Courts, some cases clearly demonstrate the prevalence of economic and utilitarian policies over 'marginal' cases of unfairness and injustice.[928] In my opinion that is the main problem of the Courts, besides sometimes a lack of consistency and objective justification, particularly where a margin of appreciation (subjective) prevails over the proportionality test that is fairly objective when applied properly. All similar situations should lead the courts to refuse any unfairness, however trivial it may seem to society as a whole, because injustice in each particular case opposes fairness just as light opposes darkness, as equity opposes inequity, as equality opposes unreasonable discrimination. This being so, the more the principle of proportionality coupled with reasonableness in search of fairness is applied, the more justice as fairness there will be. This can be implemented not only in the field of human rights by giving more prevalence to the more objective reasoning of proportionality rather than the subjective margin of appreciation doctrine, but also by granting to every individual case the guarantee of a proper and balanced assessment. Above all the law is not only about rules, but fundamentally also principles and ultimately fairness. Efficiency is a relevant value but it should not supersede justice. Individual rights versus a utilitarian public interest may be at stake in cases decided by courts under the test of proportionality in tandem with reasonableness.

To avoid subjectivism and caprice in law and even more uncertainty and unfairness, the proportionality test in tandem with reasonableness must be as objective as

[928] See Chapter III particularly on discrimination on grounds of family relationship *Lindsay* and *Shackell* (section 2.5.a) and *Burden and Burden* (section 2.5.b), and the minimum wage taxation (*Fratrak* and *Balak* cases, section 2.7.c.). See also Chapter IV, *Sudholz* (section 7.1) in which a more open and flexible notion of reasonableness prevailed over a stricter proportionality test in contrast with *Ampafrance* (also section 7.1), and *Outokumpu Oy* (section 4). On the other hand, marginal cases of injustice were clearly disallowed against a utilitarian application of proportionality in the cases *Societe generale des grandes sources d'eaux minerals financaires* (C-361/96) and *Federation of Technological Industries* (C-384/04), on Chapter IV, section 7.3.

possible, particularly its objective necessity test[929], and giving due regard to all interests at stake. Nevertheless, it may not be desirable to systematize the proportionality concept to an extent that could stifle its content and flexibility. In other words the principle must be open to new economic and technological circumstances, new similar exceptions not set out in previous law, and new complex facts, so that it can serve as a legal tool to overturn previous case law or thinking without lacking consistency.[930] Also a mere formalistic approach may not be helpful, since that principle, for its own nature and purpose, should somehow be flexible to construe both apparently rigid and vague norms.

From the analysis of several jurisdictions it may be suggested that proportionality in concert with reasonableness is an open-ended concept and inherently flexible.[931] This does not mean that it tends to be ineffective and subjective. On the contrary, as demonstrated above, proportionality may act mainly as an essential instrument to identify fundamental principles of each system and make them really effective, such as the previous examples of equality and non-discrimination, measures to tackle avoidance and evasion, and other measures to secure an efficient and fair tax system.

2.4. Proportionality and Reasonableness as Applied to Double Taxation Conventions.

Another aspect of the contribution of this research to international law may be a conclusion concerning the application and interpretation of double tax conventions, for which proportionality in concert with reasonableness may have the role of an

[929] On the necessity test as part of proportionality, see the Conclusion, section 1, and some quite illustrative objective assessments, such as the *Handyside* case (Chapter III, sections 2.3.b and 2.3.c.1; *US – Gasoline* and *Dominican Republic Cigarettes* cases (Chapter III, section 3.2.b); *Futura*, *N*, and *De Lasteyrie du Saillant* cases (Chapter IV, respectively sections 5.2, 5.3, and 6.2).

[930] See, for example, the *Quill Corp* case overturning the *Bella Hess* case (internet sale development affecting the use tax, Chapter II, section 1.4); and the *Louloudakis* case that allowed an exception to the principle of law under which 'everyone is presumed to know the law'(Chapter IV, section 2.1).

[931] Interesting ways to further investigate the term ´reasonableness´, but not here as there is no space, would be a research of national tax legislation and how this term is interpreted and applied by tax authorities and judges, and how its use is analysed by tax scholars of each country.

overarching international tax principle.[932] As such and in its own right, it may be applied to a number of issues, such as the allocation of tax jurisdiction, balancing the ability to pay and benefit principles,[933] solving transfer pricing and other disagreements regarding treaty interpretation,[934] exchange of information between fiscal authorities and tax collection enforcement.[935] Particularly in transfer pricing rules under Art 9 of the OECD Model, a secondary adjustment may be a necessary and proportionate measure to be implemented by one of the Contracting Parties where the other applies the reasonable standard provided by the treaty to determine the profits in transactions performed between associated enterprises.[936]

Moreover, the standard of reasonableness permeates the OECD guidelines on transfer pricing, as well as the Code of Conduct of the European Commission, under which only reasonable requirements and documentation should be demanded from

[932] Concerning the precedence of Human Rights over Double Tax Conventions where Contracting States are signatories of Human Rights Conventions, see *Schwarz on Tax Treaties* (2009), p.84, and Baker, Phillip *Double Taxation Conventions* (Sweet & Maxwell, 2001) (R.I-1-8, Double taxation conventions and Human Rights). For those countries who are not yet signatories to Human Rights Conventions, their Constitution or a special Bill of Rights may enshrine fundamental rights which may prevail over DTCs. Thus, where proportionality and reasonableness are key principles to construe rights and obligations under domestic or international law they should also be applicable to DTCs when they interact with fundamental rights and freedoms.

[933] Regarding the same income, while developing countries tend to support the benefit principle that provides legal and economic basis for the source taxation, developed countries are inclined to sustain the ability to pay principle that is more related to the residence taxation. Those economic and legal principles like many others in the international tax arena have to be reconciled and arguably compromised to achieve a workable and acceptable fairness, not to hinder international trade and social and economic cooperation.

[934] See for example the suggestion made on Mutual Agreement Procedure under the principle of proportionality and its reasonable implementation by the *OECD Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes* (*Proposal 6: Suspension of collection of tax)* of 1 February 2006.

[935] Concerning the application of the rule of reason and the principle of proportionality to the exchange of information, see "Article 26 of the OECD Model in Light of the Right to Informational Self-Determination", by Prof. Dr Schaumburg, Harald, and Dr Schlossmacher, Stefan, in Tax Treaty Monitor, (IBFD, October 2000), pp.522-28.

[936] For example within the EU, the Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises is an attempt to reach a reasonable agreement between occasionally conflicting tax jurisdictions in which proportionality may have a relevant role to play in interpretation and effectiveness of international and domestic legal principles and interests.

taxpayers.[937] These reasonable requirements must be proportionate and not go beyond what is necessary to ascertain an arm's length or a reasonable profit in the general and specific economic circumstances of each taxpayer. In contrast with the actual economic profits that may be hard to reveal in the real world, to achieve simplification other measures might be introduced such as the profit split method. The U.S. worldwide unitary taxation rule was considered proportionate and reasonable in the U.S. but it had to be limited due to its international economic problems, which foreign investors regarded as unfair and disproportionate.[938] Thus, the tension continues between fair and real profit taxation (encompassing tax avoidance considerations), and simplification and efficiency that may be better solved under the test of proportionality coupled with reasonableness in a bilateral or multilateral forum.

There may be other international tax issues that can be resolved via proportionality in tandem with reasonableness, such as determining the compatibility of domestic anti-avoidance rules and principles with tax treaties, interpretation of limitation on benefits clauses (anti-avoidance), interaction between capital export and import neutrality and the credit and exemption systems, and non-discrimination. Particularly regarding tax avoidance and discrimination, under the WTO agreements there is specific provision regarding services and settled case law regarding goods, allowing discrimination on the basis of tax treaties or domestic rules founded on the justification of combating tax avoidance. However, this exception must pass a test of justification quite similar (one may say the same, regarding the role of balancing and abuse) to reasonableness and proportionality under the chapeau of Articles XX

[937] See for example the following suggestion, "not impose unreasonable compliance costs or administrative burden on enterprises in requesting documentation to be created or obtained" (*Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU***,** 07.11.2005, COM, 2005, 543, Art. 6a), among other express reasonable requirements and guidelines.

[938] See Chapter II.5, particularly the logical reasons given for the explanation of the internal and external consistency of the specific rules, based on the assumption that all jurisdictions together could not tax more than the entire corporate income, and that the factors used should reflect the way the income is generated. It is noteworthy that the discussion between the UK and the US concerning this state tax was regarded by Enzo Cannizzaro as an illustration of a normative standard of proportionality applied to diplomatic intercourse in taxation ("The Role of Proportionality in the Law of International Countermeasures" 2001 EJIL 12(5), p.902 and note 35).

(GATT) and XIV (GATS),[939] to avoid disguised discrimination. The same may be said regarding the non-discrimination article of DTCs, under which discrimination would be lawful, if justified by tax avoidance, evasion or other requirement in the public interest, such as an environmentally friendly tax policy, and through proportionate measures. In this sense, express provisions would not be necessary for excluding the benefit of non-discrimination in relation to any law designed to prevent the avoidance or evasion of taxes, such as the Article 25 of the UK-Australia Treaty, among others. However, it may be fair to consider that in the absence of a similar provision in a DTC (but taking into account other international tax principles, such as legal certainty, ability to pay and benefit principles, good faith, trade neutral allocation of tax jurisdiction, and reciprocity), tax avoidance that would justify discrimination could target only wholly artificial arrangements or sham transactions whose sole purpose was unintended abusive tax avoidance.[940] Furthermore, the interpretation and application of limitation on benefits (LOB articles) as anti-avoidance rules in light of the principle of proportionality coupled with reasonableness may be a corollary of their own nature according to the case law of domestic and international courts.

3. Costs and Benefits of Proportionality. International Tax Certainty and Fairness.

There may be some uncertainty where the courts accept the public interest to justify discrimination or restrictions on fundamental rights, fundamental freedoms and non-protectionism. However, the courts have explained on what grounds the open-texture public interest is acceptable (such as fiscal supervision, tax coherence, combating tax avoidance and tax evasion, simplification, the allocation of taxing rights, environmental purposes, a trade neutral allocation of tax jurisdiction, securing the payment of taxes, as examples) and submitted it to a close test of proportionality in tandem with reasonableness. This may prevent the abuse and indeterminacy of the

[939] See *Bovine Hides* and *Dominican Republic - Cigarettes* cases on tax avoidance, evasion and proportionality (Chapter III.3.2.c).

[940] On the apparently narrow interpretation of the DTC article on discrimination, see the case law analysed in Baker, Philip, *Double Taxation Conventions*, and a comparative approach between the non-discrimination DTC article, the case law of the ECJ and the Subsidies and Countervailing Measures Agreement (SCM) within the WTO, Friedlander, Lara, "The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties After GATT 1994" [2002] BTR 2, pp.71-118.

general interest justification on behalf of the rule of law, consistency, fairness, and accountability. This may also bring more determination to the somewhat abstract public interest and more certainty to taxation in terms of what could fall within that open-ended concept, exemplified (not all-inclusively) as imperative requirements in the general interest. This again results in more certainty within the application of those requirements. Nevertheless, certainty is just one of the many principles that have a relevant role in each legal system; it must be considered and contrasted with all other fundamental principles of each system as a whole, in search of consistency as well as fairness.

This leads to a final comment on the extension of judicial review and the increase of litigation as a possible disadvantage arising from the rule of reason and the necessary application of the principle of proportionality in tandem with reasonableness. Whereas proportionality may be proposed as the most flexible and perhaps most effective instrument to ascertain the validity and limits of legal principles and rules, it may not be the most efficient in economic terms. This is because it brings with it some degree of uncertainty, more litigation, and (in all likelihood) more transaction costs.[941] However, only new situations may be litigated so that there will be a temporary increase of litigation. Furthermore, it is important to note that in taxation there are many apparently conflicting principles and rules, which can also be vague. These need to be ascertained by administrative and judicial decisions, and under the fair objective assessment on proportionality grounds, particularly its necessity test, more certainty can be achieved. The costs involved in this process may be sensible for more fairness in each individual case, as well as for more effectiveness of some principles, which should not be merely empty words or only aspirational. Concerning judicial activism and a lack of predictability, the margin of appreciation or discretion doctrine may restrain the Courts from over-reaching themselves,[942] and the analysis of the case law may aid to give consistency and reasonably predict future cases.

[941] Tridimas (1999), p.127.

[942] On the margin of appreciation doctrine, which may allow some marginal injustices to occur for the sake of simplification and workability, inspired by some utilitarian thoughts, see Chapter III sections 2.4, 2.5.b (*Burden and Burden*), and 2.7.c (*Balaz* and *Fratrak*). See also Chapter IV.7.1. (*Sudholz*) and the first note of this conclusion.

From a pragmatic perspective, it would not be desirable to eliminate the principle of proportionality and reasonableness, since democratic States have accepted them as a tool in international and domestic law. This approach in international law may run against defenders of the Westphalian principle that state sovereignty trumps all; however, this principle seems to be unsound, particularly in relation to Human Rights, state responsibility, international trade, and tax matters.

Ultimately, the rule of law must have a guardian in giving a final decision, particularly in hard cases. The solution seems to be to give courts the necessary guarantees and obligations to be practical, consistent, and impartial, in order to apply the proportionality principle coupled with reasonableness. Additionally, as a necessary requirement of proportionality and reasonableness, the more reasoning and justification for relevant circumstances that should be taken into account (and irrelevant circumstances that should be ignored), the more consistency there should be in each system without undermining fairness. Its application has been evolving and widening in many jurisdictions; and it may be one of the greatest legacies from the 20th century in terms of a general principle of law, having originated from the rule of reason[943] as developed and applied by international and domestic courts.

[943] See Chapter I. Metaphorically one might suggest that the rule of reason and the standard of reasonableness may be not only a symbol of rationality and fairness, but in a certain way contain within themselves the principle of proportionality as a seed contains the tree, and a spring contains the river.

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Korea - Various Measures on Beef Report	WTO	WT/DS161/AB/R
US - Gambling	WTO	WT/DS285/AB/R/Corr.1
US - Line Pipe	WTO	WT/DS202/AB/R
US – Gasoline	WTO	WT/DS2/AB/R
US – Shrimp	WTO	WT/DS58/AB/R
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