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Retrospective tax legislation and the European Convention on Human Rights

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MA v Finland (Admissibility) (27793/95) (2003) 37 E.H.R.R. CD210 (ECHR)

THERE has been much discussion recently of the question whether retrospective[1] tax legislation is contrary to human rights. The introduction of the pre-owned assets regime by section 84 and Schedule 15 to the Finance Act 2004 has highlighted this issue.[2] The possibility, raised in the 2004 Pre-Budget Review, that retrospective legislation may be employed to combat tax avoidance schemes disclosed under the system of tax shelter reporting has added to the debate.[3] This note examines the jurisprudence of the European Commission of Human Rights[4] and the recent case law of the European Court of Human Rights on retrospective tax legislation, and considers the grounds on which such legislation might be challenged as incompatible with the European Convention on Human Rights.[5]

The Commission and Court have decided at least six cases on the compatibility of retrospective tax legislation with the Convention. The earliest case and the two most recent cases are the most illuminating. All of the six cases consider the compatibility of the retrospective legislation with Article 1 of the First Protocol to the European Convention, which guarantees the right to the peaceful enjoyment of possessions.[6] Article 1 provides as follows:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State 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."

Thus the second paragraph of Article 1 contains an express exception for laws to secure the payment of taxes. Since this is an exception to the general right of protection of possessions, it is clearly established that tax legislation may be scrutinised to ensure its compatibility with the Convention.[7] This scrutiny of tax legislation examines whether the law is incompatible with the Convention on grounds, for example, of lack of legal certainty, or that the legislation is disproportionate, or that it fails to reflect an adequate balance between the rights of the individual taxpayer and the general public interest.

The earliest of the six cases on retrospective tax legislation is a particularly clear one: *A, B, C and D v the United Kingdom.*[8] The four individuals concerned were solicitors practising in London. In March of 1977 they entered into partnership agreements with two companies and an individual engaged in the trade of dealing in commodity futures. The objective was to offset the trading loss in those trading partnerships against their earnings as solicitors.

In November 1977, the UK government announced its intention to legislate on commodity future trading, and in April 1978 the Government announced that the legislation would be retrospective. The legislation finally enacted was section 31 of the Finance Act 1978, which applied to any scheme or arrangement effected after April 6, 1976.[9]

The four solicitors complained that the retrospective application of the legislation denied them a deduction for losses when, under the legislation in force at the time they entered into the partnerships and at the time the losses arose, a deduction was permitted. They contended that this infringed Article 1 of the First Protocol.

The Commission of Human Rights first noted that the tax legislation under examination was in principle subject to supervision by the Convention organs to determine whether the legislation was necessary to achieve one of the permitted purposes mentioned in the first paragraph of Article1, and also to determine whether it was grossly disproportionate to its aim. The Commission concluded as follows:

"The applicants have complained that the general interest did not require s.31 to have a retrospective effect. However, the Commission notes that s.31 was enacted to counteract a specific form of tax avoidance, the effectiveness of which was already in doubt. It also notes that the applicants' tax liabilities for the relevant year had not been settled before s.31 was applied to them and especially that the applicants' claim relates to their entitlement to have an

artificial loss, incurred in a non-commercial venture, taken into account in reducing their existing tax liabilities which in themselves they did not dispute.
Taking these factors into account, together with the explanation which the United Kingdom Government provided when s.31 was enacted to the effect that retrospection was necessary if this form of avoidance was to be effectively prevented, the Commission concludes that the application of s.31 to the applicants was not excessive having regard to the provisions of Article 1 of the First Protocol of the Convention."[10]

Further on, the Commission continued as follows:

"The Commission has also considered whether there was a reasonable relationship of proportionality between the means employed and the aim sought to be realised by s.31. It notes that the applicants particularly stress the retrospective nature of s.31 in alleging that this provision was excessive.

The Commission recalls that retrospective civil legislation is not expressly prohibited by the provisions of the Convention. Nevertheless, it recognises that a retrospective provision imposing a tax liability or restricting the availability of tax relief must be regarded as more severe than a similar prospective provision especially by virtue of the uncertainty which it is bound to engender. Furthermore, although all tax legislation affects the interests of those thereby charged to tax, retrospective provisions prevent the reorganisation of the taxpayer's affairs to mitigate the new tax liability which remains possible in the case of prospective provisions.

The Commission notes however that in the present case when s.31 was enacted the Government of the United Kingdom expressed the view that the only way in which this particular form of artificial tax avoidance could be combatted effectively was by making s.31 retrospective. Bearing in mind the particularly artificial nature of the scheme and the secrecy in which it operated, the Commission concludes that the applicants have not shown that the aim of the legislation could have been achieved without retrospection and the Commission is accordingly satisfied that a reasonable degree of proportionality existed between the means employed and the aim sought to be achieved."(emphasis added)

The Commission concluded therefore that the retrospective tax legislation was not incompatible with the Convention.

In that case the Commission was clearly persuaded that the scheme was of an artificial nature, operated under circumstances of secrecy, and was convinced by the UK government that retrospective legislation was necessary to combat effectively the particular form of tax avoidance. The case clearly establishes that there is no absolute prohibition on retrospective tax legislation,[11] and indicates that it is unlikely that retrospective legislation, designed to counter an artificial tax avoidance scheme, would be held to be incompatible with the Convention.

The next three cases (in order of time), where retrospective tax legislation was considered, add relatively little.

In *Voggenberger Transport GmbH v Austria*[12] the taxpayer was assessed for road taxes for 1986, 1987 and 1988 without the benefit of a tax exemption, which was removed by legislation which entered into force on August 1, 1988 with retrospective effect. The Commission concluded that the legislation pursued a legitimate aim, and was not disproportionate. The Commission referred to the wide margin of appreciation which States enjoy with regard to the form and level of taxation. The Commission seems to have been particularly influenced by the fact that the company was aware that it had to pay road taxes in advance, and that these road taxes were subject to subsequent review. In that situation, the company had to take into account that the final amount of tax might be higher than its original estimate.

The case of *NAP Holdings UK Ltd v United Kingdom*[13] is an unusual one as the taxpayer was arguing that the legislation in question--section 115 of the Finance Act 1988, which reversed the effect of the *Westcott v Woolcombers Ltd* decision[14] --should have been introduced with retrospective effect. The Commission accepted that it was within the margin of appreciation of the UK government to decide that the amendment to the law (even though it returned to the law to what had always been thought to be the correct interpretation) should not be retrospective.

The *Building Societies* case[15] may also be regarded as a rather special set of circumstances. Following the successful litigation by the Woolwich Equitable Building Society,[16] the UK government passed retrospective legislation preventing any other building society from bringing a similar claim. On the assumption that other building societies might otherwise have had a "possession" (in the form of a right to claim restitution), the question arose whether the retrospective interference with that possession could be justified. The European Court noted[17] that tax legislation "must strike a 'fair balance' between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights … there must therefore be a reasonable relationship of proportionality between the means employed and the aims pursued." It also noted that in the area of taxation, states enjoy a wide margin of appreciation, and that the Court would respect the legislative assessment in such matters unless it was devoid of reasonable foundation. The Court concluded:

"There is in fact an obvious and compelling public interest to ensure that private entities do not enjoy the benefit of a windfall in a changeover to a new tax-payment regime and do not deny the Exchequer revenue simply on account of inadvertent defects in the enabling legislation …

Nor can the applicant societies maintain that the effect of the measure imposed an excessive and individual burden on them …"[18]

Again the *Building Societies* case may be regarded as a rather special instance of retrospective legislation.

The two most recent cases before the European Court are of much more general relevance. Both cases arise out of the same legislation in Finland. The second of the two cases--*S.B. and ors v Finland*[19] --simply followed the earlier case in its conclusion. The earlier case is *M.A. and 34 others v Finland.*[20]

These cases concerned a form of share incentive scheme operated in Finland by which directors and employees of companies were issued bond loans with warrants attached for the optional subscription for shares in the company. Provided that the subscription price was no lower than the fair market value when the loans were issued, there was no income tax charge on the issue of the loan or stock option. If the option were subsequently exercised, any gain on the disposal of the shares was taxable as a capital gain at the rate (in 1994) of 25 per cent.

In the *M.A.* case, bond loans with warrants were issued on April 7, 1994. The attached right to subscribe for shares was exercisable between December 1, 1998 and January 31, 2000.

On September 16, 1994, the Finnish government introduced a bill proposing that the gains on the exercise of stock options would in future be subject to income tax (which in 1994 was subject to progressive rates up to 60 per cent): the original proposal was that the change would take effect with regard to the exercise of stock options from January 1, 1995.

Learning of this proposed change, the boards of directors of a number of companies (including that for which M.A. and his colleagues worked) decided to amend the terms of the grant of the bond loans to permit the holders to assign the warrants immediately. Thus M.A. and his colleagues no longer had to wait until December 1, 1998 before they could assign their options.

The fact that companies were accelerating the realisation of the value of the options became public knowledge. On November 3, 1994, the Finnish Parliament discussed whether the change to the legislation should be retrospective.

On November 7, 1994, M.A. and his 34 colleagues sold their warrants, realising substantial sums.

On December 9, 1994, the Finnish Parliament's Finance Committee recommended that the change to the legislation should be retrospective, and the proposed amendment to the legislation was adopted on November 21, 1994. The amendment provided that income tax treatment would apply to any stock option gains from December 1, 1995, as well as any gain after September 16, 1994 (that is, the date when the Bill was introduced) where the board of directors of the relevant company had given permission for an earlier exercise or assignment of the stock options.

The result of the change was that M.A. and the other applicants were subject to income tax at the highest tax bracket. As a consequence they were liable to pay in total in excess of 3.5m euros more in taxes than if the exercise of the options had been subject to capital gains treatment.

The applicants complained that the retrospective application of the income tax treatment interfered with their right to the enjoyment of their possessions and was incompatible with Article 1 of the First Protocol.

The Finnish Government first argued that the applicants did not have a "possession" as such, since they had no expectation that the tax treatment of the stock options would remain unchanged; this raised the issue whether there was a legitimate expectation that a particular (beneficial) tax treatment would continue to apply. The Government also sought to justify the retrospective legislation.

The Court's conclusions elide together somewhat the issue of whether there was a possession with the issue of justification. The Court's decision is difficult to summarise and bears quotation at some length:

"According to the Court's well-established case-law, an interference, including one resulting from a measure to secure payment of taxes, must strike a 'fair balance' between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights….

Furthermore, in determining whether this requirement has been met, it is recognised that a Contracting State, not least when framing and implementing policies in the area of taxation, enjoys a wide margin of appreciation and the Court will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation….

In the Court's view the changes in the tax legislation which took effect on 1 January 1995 as such certainly fall within this margin despite the fact that they applied, as from the above-mentioned date, even to existing stock option arrangements. Nor does the fact that the legislation applied retroactively in the applicants' case constitute per se a violation of Article 1 of Protocol No. 1, as *retrospective tax legislation is not as such prohibited by that provision.* The question to be answered is whether, in the applicants' specific circumstances, the retrospective application of the law imposed an unreasonable burden on them and thereby failed to strike a fair balance between the various interests involved." (emphasis added)

The Court then proceeded to consider whether the retrospective application of the change imposed an unreasonable burden on the taxpayers.

"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, 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'.[21] 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.

The Court notes that the alteration to the tax treatment of profits, made from appreciation of stock acquired under employer's stock options incentive programmes, was considered necessary from the angle of fiscal policy in the Bill issued in September 1994. The amendment was planned to be applied to existing stock option arrangements as from the beginning of 1995. This would have meant that only such existing stock options that could be exercised already in 1994 would have been left outside the application of the amendment. However, it appeared that some companies were planning to make arrangements to the effect that the stock options would be exercisable earlier than laid down in the original terms. Boards of Directors could also change the time of exercise by giving a collective permission to an earlier transfer without altering the original terms. The implementing provision of the 1994 Provision aimed at bringing these types of arrangements within the scope of the altered tax treatment. The retrospective effect was the Parliament's answer to the pre-emptive steps that had been taken in order to avoid the higher tax rate.

The Court finds that the main aim of the retrospective implementing provision was to prevent stock option arrangements, which were originally planned to fall under the amended provision, from escaping it. It accepts that this aim was part of the aim of ensuring equal treatment of taxpayers, i.e. in this case equal treatment in comparison with those who did not bring forward the exercise date of the stock options. The Court considers that the assessment made by the legislature in this respect cannot be regarded as unreasonable.

As to the impact of the measure, the Court considers that the legislation was not such as to amount to confiscatory taxation or of such a nature as could deprive the legislation of its character as a tax law. Despite its important financial consequences for the applicants, the measure cannot be said to have imposed an excessive burden on them, taking into account the maximum percentage of the tax levy and the fact that the levy, which in part was a reflection of the very high general income level of the applicants, was based on real profits made from the sale of the stock options….

Taking into account the margin of appreciation which the States have in taxation matters, the Court considers therefore that the actions taken by the respondent State did not upset the balance which must be struck between the protection of the applicants' rights and the public interest in securing the payment of taxes.

It follows that this complaint is manifestly ill-founded and must be rejected in accordance with Article 35 §§ 3 and 4 of the Convention." (emphasis added)

This case illustrates neatly the European Court of Human Rights' approach to retrospective tax legislation. Such legislation is not *per se* an infringement of the Convention. However, it will be zealously scrutinised to ensure that it can be justified. The government concerned will need to show why the objective could only be attained by introducing retrospective provisions. The taxpayers affected must not suffer an unreasonable burden. It will be easier to justify retrospective legislation where the measures are aimed at combating an artificial tax avoidance scheme, or preventing the circumvention of tax measures (as in the *M.A.* case).

Some conclusions

One of the points which, as yet, is not well developed in the Strasbourg jurisprudence, is the issue whether a taxpayer has sufficient of a legitimate expectation with respect to taxation as to amount to a "possession" protected by Article 1 of the First Protocol. As the Court noted in the *M.A. v Finland* case, the taxpayers there did not have an expectation that the tax treatment of the gains on their stock options would remain the same until the time when they were originally permitted to exercise those options (between December 1, 1998 and January 31, 2000). However, the Court seems to prefer to act on the assumption that the taxpayers are protected by Article 1, but then to consider whether the retrospective operation of the legislation could be justified or not. If the retrospective legislation can be justified in any event, then it is not necessary to conclude finally on the issue whether the taxpayer has a "possession" which requires to be protected.

The cases are very clear that retrospective tax legislation is not, *per se,* a breach of the Convention. However, any such legislation is subject to scrutiny to ensure conformity with the Convention. In particular, it follows from the cases that there must be good reasons for the government concerned in introducing retrospective legislation, and those reasons must respect a fair balance between the interest of the taxpayer and the general interest of the community. The legislation must also not be disproportionate in the sense of imposing an excessive burden on the taxpayers to whom the legislation applies.

It seems clear from the *A, B, C and D* and *M.A.* cases that legislation which is designed to counter a particular tax avoidance arrangement will be very hard to challenge on grounds that it is unjustified. The comments of the Court in *M.A.,* to the effect that a retrospective application of the higher tax rate to "pure cases" (that is cases where the directors already had the right to exercise their stock options and did so before the change in the law), might be regarded as an unreasonable interference with expectations, provides the only glimmer of comfort to taxpayers. In other circumstances, it seems that it will be very hard to challenge retrospective tax legislation on grounds of incompatibility with the European Convention.

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1.The term "retrospective" rather than "retroactive" is preferred here. For an excellent general discussion of retrospective legislation, see Lord Rodger of Earlsferry, "A Time for Everything under the Law: Some Reflections on Retrospectivity" (2005) 121 LQR 57-59.It may be helpful to distinguish two types of retrospective legislation. The first type is retrospective in the full sense of the term in that the legislation imposes a tax charge on income earned, gains realised or transactions concluded at a time *before* the legislation was enacted and at a time when that income, gain or transaction would (under the legislation then in force) have escaped tax or been subject to a lower rate of tax.The second type may be termed "quasi-retrospective legislation" (sometimes referred to as "the immediate application of the law") where legislation imposes a tax charge on income arising or a gain realised *after* the date when the legislation enters into force, but that income or gain arises from transactions entered into (or at least commenced) before the legislation. An example would be where a particular investment is acquired because it is subject to an attractive tax regime; the law is subsequently changed so that the attractive elements of the tax regime are removed and future income or gains from the investment are more heavily taxed. In effect, the taxpayer is "locked in" to the higher tax charge. This distinction between retrospective legislation in the strict sense and quasi-retrospectivity is sometimes highlighted in European Community law. See T. Tridimas, *The General Principles of EC Law* (OUP, Oxford, 1999) at 180-182.

2.Though that legislation may be regarded as an example of quasi-retrospectivity. The income tax charge is imposed on property which has already been the subject matter of the avoidance transaction, but only for years from 2005-2006. The taxpayer is given the opportunity, of course, to unlock the tax charge by electing to suffer the potential inheritance tax charge. The Parliamentary Joint Committee on Human Rights concluded that the legislation did not present a danger

of infringement of Article 1 of the First Protocol--see *Twelfth Report of the Session 2003-04* (HMSO, HL Paper 93; HC 603) at 13-16.
3.Paymaster General's statement on Finance Bill measures appended to Inland Revenue, "Avoidance and employment-related securities-proposals to amend Part 7 of ITEPA 2003" Technical Note, Inland Revenue, December 2, 2004.
4.Prior to the coming into force of the Eleventh Protocol to the Convention, cases were considered by the Commission before proceeding to the Court; that Protocol provided for all cases to proceed directly to the Court.
5.This Note examines only the position of retrospective tax legislation under the European Convention on Human Rights. In particular, it does not consider the presumption against retrospective legislation under the common law (on which see F. Bennion, *Statutory Interpretation* (2nd ed., Butterworths, London, 1992) at 214-222. Nor does this Note consider the approach to retrospective legislation under European Community law, which is in many respects more developed and offers greater protection than under the European Convention on Human Rights. For the position under EC Law see Tridimas, n.1 at 170-185. There is an interesting interplay between the non-retrospective application of Community legislation and the European Convention on Human Rights in the decisions of the European Court of Human Rights in *S.A. Dangeville v France* (Application No.36677/97, judgment of April 16, 2002), *S.A. Cabinet Diot and S.A. Gras Savoye v France* (Application Nos 492177/99 and 49218/99, judgment of July 22, 2003) and *Buffalo SRL (In Liquidation) v Italy* (Application No.38746/97, judgment of July 3, 2003).
6.Certain of the cases consider possible breaches of other Articles of the Convention, such as the non-discrimination provision in Art.14. However, the essence of the challenge in each case is based on Art.1 of the First Protocol.
7.On this, see, for example, *Kaira v Finland* (Application No.27109/95).
8.Application No.8531/79, reported in (1981) 23 DR 203--these are the Decisions and Reports of the European Commission.
9.The European Commission's decision quotes from the Chancellor of the Exchequer's budget speech in 1978 as follows:"Lastly a word about tax avoidance. This has emerged recently in a new form which involves marketing a succession of highly artificial schemes--when one is detected, the next is immediately sold--and is accompanied by a level of secrecy which amounts almost to conspiracy to mislead. The time has come not only to stop the particular schemes we know about but to ensure that no schemes of a similar nature can be marketed in future." *Plus ça change, plus c'est la même chose.*
10.At 209.
11.It may be worth noting that there is a specific prohibition on retrospective criminal legislation--Art.7 of the Convention.
12.Application No.21294/93--this case is not available in print but can be obtained on the "Hudoc" website--*http://hudoc.echr.coe.int.*
13.Application No.27721/95, published in (1996) 22 EHRR--CD 114 (European Human Rights Report--Commission Digest).
14.[1986] STC 182.
15.Application Nos 21319/93, 21449/93 and 21675/93, reported in (1997) 25 EHRR 127.
16.[1990] STC 682, HL.
17.Para.80, 25 EHRR 127 at 171.
18.Para.81, see n.16 at 172.
19.Application No.30289/96, judgment of March 16, 2004.
20.Application No.27793/95, judgment of June 10, 2003.
21.*i.e.* cases where the board of directors had not changed the terms of the bond loans to allow for early assignment or exercise of the share options.
22.Q.C., Gray's Inn Tax Chambers.