Retroactive Tax Legislation[1]

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This article discusses retroactive tax legislation, from the point of view of policy considerations, national positions, and international human rights law.[2] In particular, it focuses on retroactive tax legislation which overturns the result of a previously binding court decision, without preserving for the litigant in that case the beneficial outcome of that decision (in the terminology often used, without "grandfathering" that binding decision). The article is concerned only with adverse tax changes that impose a tax charge on a taxpayer when none previously existed, or increase the level of the tax charge from the level that previously existed.[3]

1. A note on terminology

At the outset, it may be helpful to make a terminological distinction between various phrases used in this article. "Retroactive legislation" refers to legislation which imposes a tax burden, or a higher tax burden, on income that has already been earned, or a gain that has already been realised, or an inheritance that has already been received (etc.). It is concerned with the scenario, therefore, where at the time that income was earned (etc.), there was no tax burden under the law at that time, or a lower tax burden, and the retroactive legislation imposes a burden or a higher one.

This may be contrasted with "retrospective legislation" which imposes a tax burden, or a higher tax burden, on future income (or gains, or inheritance ...) from a transaction which has already been completed. For example, suppose that a taxpayer has made contributions to a pension scheme on the basis of the law at the time that the contributions were made that he can receive a tax-free lump sum on retirement. The law is then changed to remove the possibility of receiving the tax-free lump sum. That would be retrospective tax legislation. The pension becomes

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payable after the law is changed, but the originating transaction was before the change in the law.

Finally, there is a category of legislation referred to sometimes as "petit retrospectivity"[4] where changes to the tax system are announced during the current tax year, while income is being earned. Thus, for example, the tax rate for a year may be announced only part way through that year.

2. Policy considerations

Both retroactivity and retrospectivity in tax legislation have negative policy implications.[5] They both undermine legal certainty in that they interfere with the predictability of legal outcomes. They both undermine legitimate expectations where the taxpayer has either anticipated a particular tax outcome for previously earned income, or, in the case of retrospective legislation, anticipates a particular future outcome.

In this context, the point might be made that neither retroactivity nor retrospectivity are so objectionable where the taxpayer, viewed realistically, had no legitimate expectation of the previous outcome. For example, a taxpayer who engages in abusive tax avoidance, particularly in circumstances where a government has already issued a warning that it may legislate against such avoidance retroactively or retrospectively, has no real complaint that his legitimate expectations have been defeated. Of course, this opens up a danger: revenue authorities may be inclined to find abusive tax avoidance where no one else would have seen it. Realistically, this argument can only be made where the avoidance was so abusive that no reasonable taxpayer, properly advised, could have had a legitimate expectation of enjoying the fruits of the avoidance.

Both retroactivity and retrospectivity undermine respect for the rule of law (of which legal certainty and the protection of legitimate expectations are manifestations). They undermine confidence in the reliability and the respect for the rule of law of the government concerned. Both can have a massive, negative impact on investor confidence in the country concerned. Economically, they can result in a significant risk premium for transactions involving that country: investors who fear that they may face a retroactive tax burden will seek to insure against it by building in an implicit premium in the return they expect from investments in that country.

While retrospectivity and retroactivity both have these negative policy ramifications, retroactivity goes further: retroactivity undermines the protection of property in that a taxpayer is required to pay more by way of taxes than was the case under the law at the time that he earned his income, realised his gain etc.

3. National positions

Because of the negative policy aspects of retrospectivity and retroactivity, there are a number of countries that impose a complete ban on retroactive tax legislation, normally in their constitutional laws. This is the position, for example, in Brazil, Greece, Mexico, Mozambique, Paraguay, Peru, Portugal, Romania, Russia, Slovenia and Venezuela.[6] There are also some countries that, whilst theoretically permitting retroactive tax legislation, in practice permit it so rarely that it is effectively banned: these countries include Hungary, Poland and Sweden. Finally, there are other countries that permit retroactive tax legislation, but only in specific situations and usually with particular safeguards. For example, it is the position that certain countries only permit retroactive tax legislation to counter abusive tax avoidance, or to reverse the result of a court decision where that decision was clearly contrary to previously understood legal norms. Even in these cases, the countries that permit retroactive tax legislation normally do so only where there is a strong public interest.

One example of a country that permits retroactive tax legislation but only with specific safeguards is the United Kingdom. In 1978, during a debate on the Finance Bill, various limits on retroactive tax legislation were enunciated which became the "Rees Principles".[7] These were subsequently adopted as a policy base, and retroactive tax legislation was only permitted if it met these principles. The current coalition Government announced shortly after it came to power that it was putting these principles on a more formal basis. In March 2011 the Government adopted a "protocol" which applies to retroactive or retrospective tax announcements.[8] The conformity

of the Government's practice with this protocol is monitored by a committee of independent tax advisors, the Tax Professionals Forum.

In the United Kingdom, there have been eleven occasions when retroactive tax legislation has been enacted affecting the main direct taxes (income tax, capital gains tax and corporation tax) since 1945. These provisions were introduced to counter abusive tax avoidance schemes or to reverse previously unanticipated court decisions.

In France, retroactive tax legislation is in principle permitted, but subject to constitutional limitations based on Article 16 of the 1789 Declaration of the Rights of Man. In particular, retrospective legislation must be justified by an objective of sufficient general interest. The French Conseil Constitutionel is the guardian of the constitutional limits on retrospectivity.[9] It has stated as follows:-

> "If the legislator can modify a rule of law or validate an administrative act or private right retroactively, it is on condition of pursuing an objective of sufficient general interest and respecting final judgments and the principle of non-retroactivity of penalties and sanctions; that, moreover, the amended or validated act must not fail to have regard to any rule or constitutional principle, unless the general interest being pursued is itself of constitutional value; and, finally, that the scope of the modification or validation must be strictly defined."

Where retroactive legislation is proposed, previously decided cases that are final and binding (*décision passée en force de chose jugée*) are excluded from the scope of the retrospective legislation.

4. International human rights norms

There is no absolute ban under existing international human rights instruments on retrospective tax legislation. This may be contrasted with retrospective penal legislation, where human rights norms prohibit the retrospective imposition of criminal liability, or the retrospective imposition of a higher penalty than existed at the time of an offence. This is found in Article 7 of the European Convention on Human Rights (to which 47 European states are signatories), and also in Article 15 of the International Covenant on Civil and Political Rights (to which 167 states are signatories).

The ban on retrospective penal legislation has an impact in the tax field since there is a body of case law from human rights' tribunals that the imposition of substantial tax penalties (for, for example, incorrectly completing a tax return) constitutes a criminal offence for purposes of these instruments.[10] Thus the retroactive imposition of a substantial tax-geared penalty would be a breach of internationally accepted human rights norms.

The jurisprudence of the European Court of Human Rights records a number of attempts to challenge retroactive or retrospective tax legislation, generally on grounds that it conflicted with Article 1 of the First Protocol to the European Convention; that is, the right to enjoyment of possessions. Until relatively recently, such challenges were generally unsuccessful, though it is fair to point out that in most cases the legislation concerned sought to counter tax avoidance activities.[11] However, recent cases have, on occasion, found that retrospective tax law changes infringed Article 1. For example, in *Di Belmonte* v. *Italy*[12] a long delay in paying compensation for the expropriation of property had the result that the payment was subject to a tax which would not have been the case if it had been paid promptly. In those rather special circumstances, this retrospective application of the tax law was found to be a breach of the Article.[13]

Retroactive or retrospective tax legislation must be consistent with the provisions of Article 1 of the First Protocol. These provisions require that it must be "in accordance with the law", it must be "necessary in a democratic society", it must serve specific purposes (for example, the economic needs of the state), and it must not impose an individual and excessive burden on the taxpayer: to that extent, it must balance the rights of the taxpayer concerned with the interests of society. Any retroactive or retrospective tax legislation which fails to satisfy these requirements will be a breach of the Article and an unlawful misappropriation of property.

5. The failure to grandfather binding judgments

The remainder of this article focuses on a particular aspect of retroactive tax legislation: that is tax legislation which reverses the effect of a court decision, but fails to respect the successful litigant's victory in the courts. It addresses the situation, for example, where a taxpayer has challenged a tax liability and has successfully litigated to a binding judgment in its favour; the government concerned then introduces retroactive tax legislation which changes the law with retroactive effect, without grandfathering that particular taxpayer from the change in the law. In effect, the taxpayer is robbed of the results of its litigation victory.

State practice in virtually every state that permits retroactive tax legislation is to exclude decided cases from the effect of retroactivity. This is clearly the practice both in the United Kingdom and in France.

Here there are additional principles concerned above those that are engaged by the basic issues of retroactivity and retrospectivity. Failure to grandfather binding judgments undermines the right to a fair trial, totally negates respect for the rule of law, shows no respect for the independence of the judiciary, and infringes the right to enjoyment of possessions.

An interesting judgment in this context is the decision of the European Court of Human Rights of the 27 September, 2011 in the case of *Aguardino SRL* v. *Moldova*[14]. In that case the taxpayer argued that it was exempt from tax because it operated in a tax-free zone. The Moldovan revenue authorities assessed it to a liability of approximately €126,000 in VAT and imposed on it a fine slightly over €100,000. The taxpayer took the issue to litigation and in June 2002 the Moldovan Supreme Court upheld the taxpayer. More than three years later, the revenue authorities introduced before the Moldovan Parliament an "interpretative" change to the law which had retroactive effect and supported the view previously taken by them (and which they had lost in the courts). Following the adoption of this law, in November 2005 the Moldovan Supreme Court was asked to review its judgment and decided now against the taxpayer.

The European Court of Human Rights held that this course of conduct infringed the right of the taxpayer to a fair trial as guaranteed (with respect to its criminal head - because of the penalty) by Article 6 of the European Convention. On this point, the Court said as follows:-

> "[25] The right to a fair hearing before a Tribunal as guaranteed by Article 6(1) of the Convention must be interpreted in the light of the Preamble to the Convention, which, in its relevant part, declares the rule of law to be part of the common heritage of the Contracting States. One of the fundamental aspects of the rule of law is the principle of legal certainty, which requires, among other things, that where the courts have finally determined an issue their ruling should not be called into question...
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> [26] Legal certainty presupposes respect for the principle of *res judicata*... that is, the principle of the finality of judgments. This principle insists that no party is entitled to seek a review of a final and binding judgment merely for the purpose of obtaining a rehearing and a fresh determination of the case. Higher courts' power of review should be exercised to correct judicial errors and miscarriages of justice, but not to carry out a fresh examination."

The taxpayer had also alleged a breach of Article 1 of the First Protocol (the right to enjoyment of possessions). Again, the European Court decided in the taxpayer's favour as follows:-

> "[40] The Court considers that the applicant company had a 'possession' for the purposes of Article 1 of Protocol No.1, namely the amount of money which it had been absolved from paying to the Inspectorate by virtue of the Supreme Court's judgment of 19 June, 2002. Quashing such a judgment after it has become final and unappealable constitutes an interference with the judgment beneficiary's right to the peaceful enjoyment of that possession.... Even assuming that such an interference may be regarded as serving the public interest, the Court finds that it was not justified, as a fair balance

> was not preserved and the applicant company was required to bear an individual and excessive burden..."

The outcome of the case was the recognition of both a breach of Article 6 (the right to a fair trial) and of Article 1 of the First Protocol (the right to enjoyment of possessions). The point might be made that the International Covenant on Civil and Political Rights contains no right to enjoyment of possessions, but it does contain a right to a fair trial in Article 14. Thus, for those countries outside of the Council of Europe who are parties to the International Covenant, conduct such as this would constitute a breach of the right to a fair trial.

This Moldovan case is not an isolated instance, though it reflects very nicely the issue of retroactive tax legislation. There is case law from the European Court of Human Rights finding a breach of the Convention where final and binding courts judgments were re-opened by subsequent legislative or administrative acts.[15]

Similarly, there is case law that there is a breach of the Convention where retroactive legislation fails to grandfather litigation which is in progress as the time of the amendments to the law, even if that litigation has not reached the stage of a binding and final judgment.[16]

It is interesting to note the terms under which the European Court phrased the judgment in the Moldovan case (quoted above). Respect for the rule of law is fundamental to all civilised societies. It is reflected in the Universal Declaration of Human Rights which declares the right to a fair trial and the freedom from arbitrary deprivation of property. A state that introduces retroactive tax legislation and fails to grandfather existing, binding court decisions fundamentally undermines the respect for the rule of law.

6. Concluding comments

The themes of this article can be summarised in a number of points.

Retroactive or retrospective tax legislation, if permitted under the law of a country, is not *per se* a breach of international human rights norms but it needs to be justified as a matter of law. It damages legal certainty and legitimate expectations, it damages the reputation of the country concerned, and has a negative impact on investors' expectations.

The retroactive imposition of substantial tax-related fines is a clear breach of human rights norms under both the European Convention and the International Covenant.

Retroactive tax legislation which fails to grandfather final and binding court decisions is a clear breach of human rights norms: it infringes the right to a fair trial and the right to enjoyment of possessions, or the freedom from arbitrary misappropriation. It is a failure to respect the rule of law, and therefore contrary to the principles of law recognised by all civilised nations. It undermines confidence in a nation's judiciary and in the entire legal and political system of the country concerned.

1. This is the written-up text of a speech delivered (by Skype) at the IFA Mauritius conference on the 10 May, 2012.
2. It should be stressed that this article is written entirely from a personal view point, and does not reflect in any way the views of any client of mine or of any organisation with which I am associated.
3. It is not unusual for countries to adopt retroactive tax law changes where, for example, a court case produces a result contrary to the previously understood position and would have an adverse impact on other taxpayers. These beneficial changes are not discussed here. Also, technical corrections of errors in tax legislation may sometimes be retroactive; those changes are also not discussed here.

4. It is understood that this term is used in France.
5. For a broad discussion of retrospectivity *see* C. Sampford, *Retrospectivity and the Rule of Law* (Oxford, 2006)
6. *See* V. Thuronyi, *Comparative Tax Law* (Kluwer, 2003), p. 76-81, esp. p. 81, fn. 80. There may be other countries that ban retroactive tax legislation but whose position has not been identified.
7. *See* Hansard, Commons, Standing Committee A, 6th June, 1978, cols. 698 to 754.
8. *See Tackling Tax Avoidance* (HMRC, March 2011); the protocol is entitled "Protocol on unscheduled announcement of changes to tax law"
9. *See* : http://www.conseil-constitutionnel.fr/conseil-constitutionnel/root/bank_mm/anglais/en201078qpc.pdf
10. In the context of the European Court on Human Rights see the line of cases from *Bendenoun* v. *France* (Application No.12547/86) through to *Jussila* v. *Finland* (Application No.73053/01).
11. *See*, for example, *ABCD* v. *the UK* (Application No.8531/79), *MA* v. *Finland* (Application No.27793/95), and *SB* v. *Finland* (Application No.30289/96).
12. Application No.72638/01.
13. *See* also the merits decision in the *Yukos* case (Application No.14902/04) which is currently still pending before the European Court.
14. Application No.7359/06.
15. *See Stere* v. *Romania* (25632/02); Stingaciu and *Tudor* v. *Romania* (21351/03); *Blidaru* v. *Romania* (8695/02); *SC Pilot Service SA Constant* v. *Romania* (1477/02); *Dragu* v. *Romania* (11947/06); *Ciul* v. *Romania* (7644/04); *Lefter Nita* v. *Romania* (9410/04).
16. *Zielinski, Pradal and Gonzalez* v. *France*(24846/94); *Arras* v. *Italy* (17972/07); *Agrati* v. *Italy* (43549/08).