Retrospective Taxation
A discussion paper by the Chartered Institute of Taxation

1. Introduction and summary

1.1. This paper sets out the views of the Chartered Institute of Taxation (CIOT) on retrospective legislation, a topic that has always been of concern to the CIOT. However, we think it warrants particular consideration in the context of the 'Tax Policy Making: a new approach' paper published with the Emergency Budget in June 2010.

1.2. The most important feature of a tax system for all taxpayers, probably even more so than low taxes, is certainty. We are pleased to see that this is recognised in the Government's paper, which sets out that its aim is to have an approach to tax policy making that achieves a more predictable, stable and simple tax system.

1.3. We have become concerned about increasing use of retrospective action in the tax system. Retrospection is damaging to confidence in the tax system as it undermines the principles of stability and certainty. In an internationally competitive world, frequent retrospection reduces the attractiveness of the UK to potential inbound investors.

1.4. Under the principle of Parliamentary sovereignty, the Government in the UK can legislate retrospectively. It is in some respects constrained by its obligations under the European Convention of Human Rights and EU law. We accept that retrospective legislation is not prohibited by these obligations, provided the balance between the rights of individual taxpayers and the general public interest is maintained. However, the use of retrospective legislation will always damage the key principle of certainty in the UK tax system to some extent.

1.5. We do not say there is never a case for retrospection – indeed at times we will argue for it to correct an obvious anomaly that is harming taxpayers, such as with the recent changes to capital distributions treatment. However, it is something that should be used with extreme care and justified at length.

1.6. As a minimum, as part of its new approach to tax policy making, we think the Government should develop and adopt a clear statement of when, if at all, it sees retrospective legislation as appropriate. This statement should set out when retrospection will be used and its boundaries. We also suggest that Parliament needs to consider such boundaries with care; it

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should not simply be left to HMRC, for example. This is, we think, a key principle: that any use of retrospection needs to be justified properly in Parliament.

1.7. Such a statement should be part of the protocol mentioned at the last bullet point of paragraph 2.15 of the tax policy making paper. This says that the Government will look critically at the need to announce legislative changes taking immediate effect. Such announcements result in retrospective legislation and are discussed below. The opportunity should be taken to broaden this review and consider retrospection more generally.

1.8. This paper sets out some thoughts as to the different circumstances where the CIOT considers retrospective legislation may be acceptable and where it is not. It is not intended to be definitive; the whole subject is a very difficult one and we think that it is something that needs proper debate and, ideally, agreement between all involved in taxation policy. We have not found it an easy topic to address and some members will have reservations about what we are saying: for example, some will oppose all retrospection in principle.

2. Retrospective legislation – what is it?

2.1. At the start of this paper, we should set out what we mean by 'retrospective legislation'. There are broadly two ways in which tax legislation can act on past events, often referred to as "retrospective" and "retroactive".

2.2. ***Retrospective legislation:*** When we refer to retrospective legislation, we mean legislation that is retrospective in the full sense of the term, in that the legislation imposes (or increases) a tax charge on income earned, gains realised or transactions concluded at a time before the legislation was announced[1].

2.3. ***Retroactive legislation:*** The second way in which legislation can act 'in arrears' may be termed "quasi-retrospective legislation" or (more usually) "retroactive"[2]. Here 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 new, higher tax charge[3].

2.4. When examining case law, particularly EU case law, some care is needed because in some EU case law the term retroactive would be used with the meaning set out in paragraph 2.2 and the term retrospective would be used with the meaning set out in 2.3. In other words, in EU case law, the terms

[1] Taxation is, inevitably, seen as an imposition or even a punishment by many. So taking such action in a way that increases a tax bill for a previous year would be seen as something of a double punishment. A correction in favour of the taxpayer, as in para 1.5, would by contrast be seen as righting a 'wrong'.

[2] Sometimes referred to as 'the immediate application of the law'.

[3] The removal of tapering relief for CGT on business assets would be an example; another would be the withdrawal of industrial buildings allowances (IBAs).

are often given the opposite meaning to that generally used in the UK[4].

2.5 In passing, we note that under Scots law, there is a possibility of a document being rectified as a statutory remedy[5], rather than as an equitable remedy as under English law. This can have tax implications where errors in documents have unwanted tax consequences, because of the differing degree of retrospection that can apply to the remedy.

3. Retrospective legislation: to correct anomalies

3.1. As mentioned in the introduction, there are situations where retrospective taxation can be used for the benefit of taxpayers[6]. There can be no objections to the use of retrospective taxation in circumstances where there is open discussion and agreement between HMRC and stakeholders that there is an anomaly in the legislation in need of correction.

3.2. The situation is more difficult where retrospective legislation may be beneficial to one group of taxpayers, but harmful to another. Following an announcement in January 2009, Finance Act 2009 made a change to the rules concerned payments of manufactured interest[7]. Although as a matter of principle, we disagreed with the retrospective nature of this legislation, we appreciated that this was a difficult area, where there was a widely (but not universally) held view as to how the legislation should apply which did not accord with the Court's decision in the *DCC Holdings* case. In our view, in these exceptional circumstances, neither taxpayers who have followed the letter of the law nor taxpayers who have followed the accepted practice should be penalised. In these circumstances, the retrospective legislation should have included an option for those who wished to do so to continue to rely on the original legislation instead (but would not permit someone to change their filing position in accordance with the now alternative treatment).

3.3. Another example of the difficult dividing line was the ministerial announcement on 9 February 2010 by the Rt Hon Stephen Timms MP, Financial Secretary to the Treasury, amending the tax rules relating to manufactured dividends. The new legislation applied from 1 October 2007. These changes were made to counteract some tax planning which we understand was being undertaken by one bank, based on a particular interpretation of the legislation. We accept that the retrospective changes made 'confirm[ed] the general understanding of the tax system'; that is most taxpayers were applying the legislation in a way consistent with the amended legislation.

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[4] See, for example, Case C441/08 (a Polish case dealing with raising of capital) and the rather better known (VAT) case of Marks & Spencer (Case C-309/08).

[5] See the Law Reform (Miscellaneous Provisions) Scotland Act 1985 ss8-9, which grants the Court power to rectify a document that fails to express the common intention of the parties. The statute makes it clear that the legal effect of such an order would be retroactive, unless the Court derogates from the rule.

[6] A very recent example of this is the proposed changes to the rules in Corporation Tax Act 2009, Schedule 9A which will be introduced by the third Finance Act of 2010. These changes are being introduced following recognition by practitioners and HMRC that the new rules in CTA 2009 did not properly reflect the law as it had previously been understood and applied.

[7] This followed the High Court decision in *DCC Holdings (UK) Ltd v HMRC* [2008] EWHC 2429.

3.4. However, once again, there was no universal agreement as to the application of the law. Accordingly, the retrospective legislation should have included suitable transitional provisions or an opt-out[8] for those who wanted one (possibly with some form of requirement to show that transactions undertaken had been in anticipation of the law being as it was, rather than allowing an unaware taxpayer to take advantage of something they had not anticipated).

3.5. The fundamental principle is that taxpayers should be taxed on the wording of the legislation in place at the time of their actions[9] and not what HMRC thinks it says, even if some taxpayers agree with HMRC's view. To do otherwise is to damage the fundamental principle of certainty, something that should be at a cornerstone of any tax system.

4. Changes by Ministerial Statement

4.1. It has become relatively common to announce changes to legislation, usually to counteract specific avoidance schemes, by a Ministerial Statement. Sometimes these are accompanied by legislation, usually stated as draft, intended as applicable from the date of the announcement. On the surface, this is not retrospection as it applies 'from today'. There is, though, a risk that it becomes retrospective at least in part as the legislation takes a while to be finalised and ends up applying more widely than initially envisaged.

4.2. As mentioned above, we welcome the intention (set out in the Tax Policy paper) to develop a clear protocol for the circumstances in which the Government would be willing to make such announcements.

4.3. We think that such announcements are entirely legitimate as a matter of principle but they must:

- be carefully targeted;
- give precise details of timings of the imposition or change;
- include sufficient detail so that taxpayers and advisers are in no doubt as to the target; and
- allow for discussion and debate to clarify the detail of the legislation.

The risk with such announcements is that they create uncertainty.

4.4. Ideally, draft legislation should be available from the applicable date, though we can understand that this is not always possible. There must in any event be an opportunity to consult on the detail of the draft legislation.

4.5. There are wider changes that are announced by Ministerial statement – effectively the intention to make changes in an area, or change the tax system significantly. That should presage proper consultation and debate, under the sort of timetable set out in the Tax Policy Making document referred to above, and welcomed. However, this has not always happened: for example, the bank payroll tax announced in December 2009. This resulted in legislation still being formulated after the end of the chargeable period. That is simply not acceptable and must not be repeated.

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[8] It is noted that the change mentioned above to capital distributions includes such an opt-out.
[9] Determined if necessary by the Courts, of course.

4.6. In summary, we do not object to changes that are announced with immediate effect provided the announcement is sufficiently clear and comprehensive so users are clear as to its effect and that it is accompanied (or quickly followed) by draft legislation for consultation[10]. It is not acceptable to have changes that are effective, but in respect of which consultation and debate then takes place to clarify the detail of the policy and its broad application.

5. Retrospective legislation: a general prohibition

5.1. Outside of the two circumstances set out above, there should be a general presumption against retrospective legislation.

5.2. It is accepted that under the principle of Parliamentary sovereignty the Government in the UK can legislate retrospectively, provided it can satisfy the requirements of human rights legislation. Pragmatically, we accept that the Exchequer will not unilaterally preclude its ability to protect itself with retrospection when it detects what it considers to be unacceptable avoidance.

5.3. However, it is in this area that safeguards and agreements are needed as to when retrospection can possibly be used. Fundamentally, however much the tax authorities object to avoidance, it cannot be acceptable for retrospection to be used routinely when avoidance is detected; that would simply bring tax law in the UK into disrepute.

5.4. We would like to see the Government adopt a general principle that includes a presumption against retrospection. That said, this principle could set out certain very limited circumstances where the Government could make the argument that retrospection can be used because it is considered <u>necessary</u> (rather than desirable). Such limited circumstances might include the position where:

- the law turned out, for example due to a court case, to be very different from what everyone, including taxpayers expected – see section 3 above regarding correctly anomalies;
- an announcement is made with immediate effect, provided it is accompanied by clear and workable legislation; and
- the budgetary impact of not acting retrospectively would be crippling to the UK economy, say X% of GDP, or to avoid a financial crisis or damage to the UK's credit rating[11].

[10] The actions taken against 'employment loss' schemes in early 2009 are an interesting case study in how such Ministerial statements need to be effected. Statements on 12 January 2009 and 1 April 2009 led to what became sections 67 & 68 FA 2009, generally effective from 12 January 2009. The second statement was necessary to clarify/extend the target and led to accusations that as this now seemed to catch some actions that might not have seemed to be in the original ambit, it was retrospective action. We have some sympathy with this view but on balance feel that the further statement was justified and it was fairly clear that the original targeting should have been anticipated as including the sort of revised scheme then being attempted. However, at a minimum, it showed that the original statement was not as carefully made as it should have been and illustrated the need to take as much care with these statements as with legislation – especially of course if the draft legislation is not immediately available.

[11] There is a counter argument to this materiality point; if there is a large amount of tax at stake, affecting many taxpayers, that might suggest under fairness principles that no action is taken to disturb prior years.

5.5. A further issue that should be addressed is who has the responsibility for deciding that, in extremis, a retrospective measure should be introduced. Care should be taken to ensure that retrospective legislation does not become a safety net for badly drafted or ill thought through legislation. It should not be used in circumstances where taxpayers simply behave in a way that HMRC or the Government does not like or did not anticipate when the legislation was enacted. Nor should it routinely be used in circumstances where taxpayers win cases in the courts, either in respect of tax planning or otherwise.

5.6. In our ‘Making of Tax Law’ paper published in June 2010, we put forward the idea of a Parliamentary Joint Committee on Taxation, made up of a combination of MPs and Peers. A body such as a Joint Committee of the type we suggested should be responsible for scrutinising and approving any retrospective legislation.

6. Retrospective legislation: advance warnings

6.1. In December 2004, the Government made a statement regarding the possibility of retrospective taxation in relation to the avoidance of tax (including NICs) on pay, especially bonuses, commonly referred to as the Primarolo statement.

6.2. At the time, we were very concerned over the impact of this statement. It was clearly intended as a clear public warning that retrospective legislation may be used within a targeted, narrow area, i.e. the taxation of employment income; was it fair or legitimate? Was it precise in its targeting[12]? The Primarolo statement referred to concepts such as the “rewards from employment” and the need to pay “the right amount of tax”. We had particular concerns over the phrase “the right amount of tax” where this seemed to be HMRC’s interpretation and not the Courts’ interpretation of the legislation.

6.3. At the time, we sought to clarify the target, range and impact of the Primarolo statement but nevertheless it has caused uncertainty for arrangements at the margins. For instance, is a growth-share acceptable or unacceptable avoidance? What about a shared-ownership trust scheme? Or salary sacrifice arrangements? (We understand that serious consideration was given to legislating the recent rules preventing sacrifice of cash for canteen meals on a retrospective basis).[13]

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[12] We and others also had considerable concerns as to the legitimacy of this approach under human rights legislation. We understand the Government’s advice was that such a statement is acceptable under the HRA *provided* it is precisely targeted on a narrow area. We remain unconvinced as to how valid this is and at a minimum believe it is an area that needs to be explored and debated properly.

[13] The Primarolo statement has led to one piece of retrospective action to date: FA 2006 s92. This imposed an upfront (retrospective) income tax charge on share options granted by EBTs where the grant sought to accelerate a corporation tax deduction for employer contributions to the EBT. The advantage sought was in fact around corporation tax rather than income tax but the Government considered the Primarolo statement still applied and so retrospective legislation was imposed accordingly. This was despite an HMRC press release issued in July 2005 (following the case of Macdonald v Dextra) which acknowledged that the then existing legislation did permit a corporation tax deduction for an employer when emoluments were paid by trustees even if (as with the grant of share options) “there is no tax charge at the time that the payments are made by the trustees”.

6.4. In any event, the change of government has led to questions about the continuing applicability of the Primarolo statement. Nothing has yet been said on this by a Government Minister and so the position remains uncertain. This is unsatisfactory but it does provide an opportunity to take stock in the context of Government policy on retrospective legislation as a whole, and within the framework of the recent Government paper 'Tax Policy Making: a new approach' (see paragraph 1.1 above). We think this would be helpful, as it would mean that the same fundamental principles on retrospection are applied to the taxation of employment income as for other income and gains. In this regard, a protocol along the lines outlined at paragraph 5.4.may be appropriate.

6.5. We think that the Government should avoid making broadbrush "warning" statements in the future. The procedures set out in the Tax Policy Making document should help obviate the need for such actions that, as we say, create considerable uncertainty.

6.6. It is worth looking at the experience of the USA in this area. There are good and bad examples and the IRS has learnt from experience. The early foreign tax credit Notices in 1998 were vague and had to be withdrawn. The later Notice in 2007 on foreign tax generators was a model (largely) of how to go about it. The genus of transaction was identified, the policy objection was fully explained and the steps to counter it were fully set out. In our view, if the Government wished to adopt a principle that permits retrospective legislation following a fair warning to taxpayers, this is the minimum standard to which the taxpayer should be entitled. It will be observed that such action is in effect in line with our comments on what makes an acceptable Ministerial statement on specific action and in many ways demonstrates that another 'Primarolo statement' is unnecessary.

7. Retrospective taxation and avoidance

7.1. As this paper has stated, we believe there should be a general presumption against the use of retrospective legislation. We note that the tax policy making paper says that the Government will look at developing a "strategic approach to tax avoidance". We welcome this and suggest that the discussion on countering avoidance should include a discussion of the parameters of retrospective legislation, as it is in countering avoidance that retrospective legislation is most commonly used.

7.2. A great difficulty in the debate about tackling avoidance is defining what constitutes tax avoidance and, more to the point, unacceptable avoidance of a sort that might justify the use of retrospective action. Neither term has ever been defined successfully. In any event, even if it were possible to identify cases of "avoidance" which were obviously egregious, routinely tackling these by retrospective legislation does not justify the overall damage done to UK plc that arises from so doing.

7.3. Accordingly, we strongly disagree with any suggestion that the fact that the Government is counteracting perceived avoidance justifies a harsher treatment involving retrospective taxation. Although such action may appear to a Minister as a justified attack on a particular scheme, it is seen by outsiders, particularly overseas investors, as the Government changing the rules after the event and raises concerns that such action could happen anywhere.

7.4. We strongly objected to the recent Finance Act 2008 section 58, which changed the application of a double tax treaty going back 20 years[14]. Taxpayers had no warning of the apparent need for the change to the law. Quite the reverse: the HMRC manual had referred to the sort of planning which was being attacked since 1997. Whatever the rights and wrongs of the scheme, taxpayers and advisers could surely be forgiven for assuming its use was accepted – or, at any rate, not seen as warranting tackling with any urgency. In particular, there was never any indication of a need to clarify – or change – the 1987 law.[15]

8. Retroactive legislation

8.1. A great deal of tax legislation is retroactive, in that changes to the tax system affect taxpayers as a result of actions they have previously taken. Examples include the recent changes to capital gains tax that will affect all those who bought assets prior to the changes, changes to capital allowances and, even, the withdrawal of the married couple's allowance.

8.2. We can have no objection to retroactive legislation in principle. Governments cannot guarantee the law will never change to affect the future and must be left free to do so. We would not suggest that Parliament should limit itself in relation to its decisions regarding rates of tax etc.

8.3. However, it would be useful for the Government expressly to recognise that even very simply tax changes can have a retroactive effect and to give some thought to the principle of legitimate expectation. We think this concept is reflected in the Tax Policy Making paper and the increased predictability of tax changes is to be welcomed in this regard.

8.4. This is particularly appropriate where taxpayers have been induced to act in a particular way, by being offered a tax incentive aimed at influencing their decision. That favourable regime or incentive should not be precipitately withdrawn. In making any tax policy or legislation, Government should ensure that there are proper transitional rules and appropriate periods to allow reorganisation of affairs. The changes to offshore trusts for non-domiciles in Finance Act 2008 Schedule 7 are an example of how legislation can be retroactive but with sensible transitional provisions which are contained in Part 2 of that Schedule. In contrast, it is very debateable whether the withdrawal of IBAs and related allowances gave a sufficient transitional period[16].

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[14] The legislation is currently being considered by the Courts in *Huitson v HMRC* [2010] EWHC 97. In our view the attack on the tax scheme undertaken by Robert Huitson, and other similar schemes, by retrospective legislation in this way was extreme and unjustified.

[15] For the avoidance of doubt, we had no objection to the change effected by s59 FA 2008, which blocked the effectiveness of the scheme prospectively: such action was only a surprise in that it had not happened already, given HMRC's knowledge of the arrangement.

[16] Given that investors in buildings did so in anticipation of a tax allowance for their costs over a 25-year period, to find these were withdrawn with only a four-year transition was harsh. We accept that the reduction in allowances 'paid' for a reduction in tax rates but that was uneven in its impact and did not compensate IBA-losers in full. We cannot argue that governments have to allow for as long a transition as 25 years, but this illustrates well how changes to the tax system must be made with extreme care when they have any sort of impact on the past, to avoid damaging investor confidence in the UK's system.

8.5. The CIOT welcomed the way that in the June Emergency Budget the changes to rates of allowances for plant and machinery were announced as taking effect from 2011 (though the exact timing of the changes could been given more prominence). This allows businesses to plan their capital expenditure accordingly. It was also a modest reduction in rates (and hence timing of allowances) for past expenditure, in contrast to the full withdrawal of industrial buildings allowances by Budget 2007.

8.6. Similarly, Finance Act 2004 (section 84 and Schedule 15) introduced rules relating to pre-owned assets, which operated in a retroactive way to charge income tax on arrangements already put in place placing capital assets out of the charge to IHT. Whilst we continue to have considerable concerns about the way these provisions operate, they did at least have some transitional arrangements with the "escape" provisions that allowed the taxpayer to elect irrevocably back into the IHT regime[17].

9. Change of stance by HMRC

9.1. There have been suggestions that retrospection (or retroaction) can also arise through a change of stance by HMRC on a matter[18]. This will inevitably be the case on occasions, though HMRC may well feel that they are simply setting out and applying the law as it has always been.

9.2. Clearly, it must be open to HMRC to publish revised guidance on an issue and, in doing so, point to a revised treatment. The key is surely:

- changes must be published openly;
- if they are significant, consultation or at least prior notice should occur; and
- the constraints on retrospection and retroaction in this paper need to be considered carefully and observed.

Taxpayers must be able to rely on the previous guidance for periods before any change is promulgated.

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[17] Though the transitional provisions had their own anomalies – for example a taxpayer who died suddenly could not have the election made by PRs.

[18] The current litigation around residence has been argued in the *Gaines-Cooper* case to arise from a change of practice by HMRC, though the decision in the Court of Appeal went against the taxpayer.

The Chartered Institute of Taxation

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