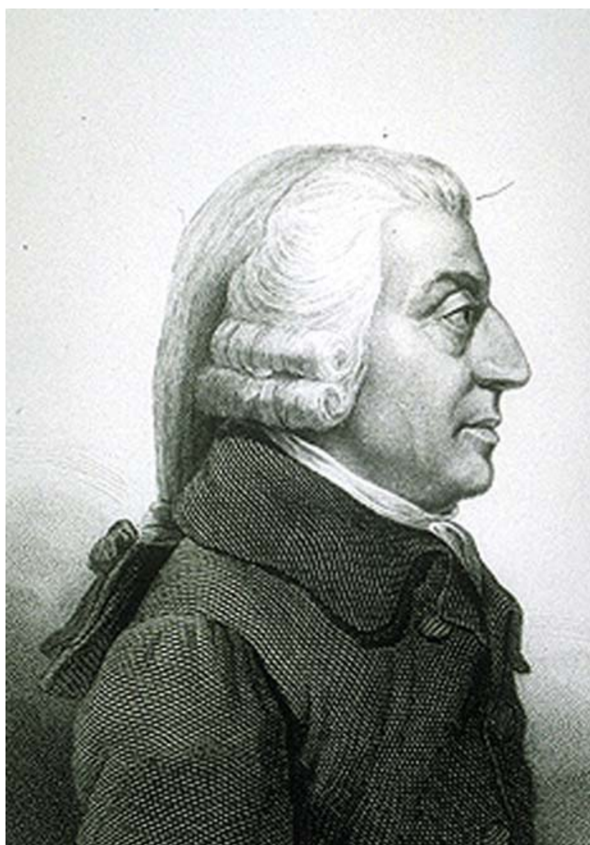

Retroactive, retrospective – or just retrograde

The issue of retrospection/retroaction has an international dimension, as *Maric Glaser* explains

In his comments on behalf of the CIOT on the 2008 Budget, Stephen Coleclough quoted Adam Smith's second tenet of taxation:

'The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person[1].'

Smith (pictured above) was so convinced of the need for certainty that he went on to say:

'The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality … is not near so great an evil as a very small degree of uncertainty.'

It must be remembered that Smith was in his later life a Commissioner of Customs.

More recently, Arden LJ also looked at the issue of legal certainty and commented:

'82 In my judgment, there is an objection in principle in this field of law to taxing transactions according to their economic reality. The economic reality of a transaction is antithetical to legal certainty. If VAT is payable according to economic reality, the seller will not know what VAT to account for, and the purchaser will not know what VAT to pay. The system for the collection of VAT would no longer be straightforward[2].'

It is axiomatic that if you enter into a transaction without knowing what tax you will pay or how it will be determined, there is an element of uncertainty. Both retrospection and retroaction cause uncertainty by altering the expected tax consequences of a past act.

The issue must be whether and in what circumstances the uncertainty thus caused can be the lesser of two evils.

The nature of retroaction and retrospection

The terms retroactive and retrospective are often used interchangeably to refer to any *ex post facto* legislation. Within the UK, the term retrospective has been widely but not universally used to refer to legislation that changes the consequences of a transaction that was completed in the past, while the term retroactive has been used to refer to legislation that attaches new consequences to acts that were commenced in the past but have not yet been closed[3].

The issue of retrospection/retroaction has an international dimension. In the *National and Provincial Building Society*[4] case, the European Court of Human Rights uses the terms retroactive and retrospective interchangeably. In a South African Constitutional Court case[5], Kentridge AJ commented that:

'A statute is said to be retroactive if it enacts that "as at a past date the law shall be taken to have been that which it was not," so as to invalidate what was previously valid, or vice versa.'

The term retroactive is referred to in the German constitution in similar terms[6], and Professor Jeremy Waldron BA, LLB, Otago; DPhil (Oxon), in commenting on New Zealand legislation[7] , says:

'Retroactive legislation is more radical. A retroactive law is one that operates on past events as though it were in force when the past event took place.'

However, he goes on to say that terminology does not matter; so, to avoid confusion, I shall attempt in this article as far as is possible to avoid the use of definitions.

Article 7 of the European Convention on Human Rights (ECHR) provides that:

1 No one shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence under national or international law at the time when it was committed. Nor shall a heavier penalty be imposed than the one that was applicable at the time the criminal offence was committed.

It therefore limits both retroactive and retrospective criminal legislation, but not similar civil legislation. The principle that the law should state what is to happen in the future and not change the consequences of the past has frequently been restated, eg, Willis J in *Phillips v Eyre*[8] commented:

'Retrospective laws are … contrary to the

general principle that legislation by which the conduct of mankind is to be regulated ought, when introduced for the first time, to deal with future acts, and ought not to change the character of past transactions carried on upon the faith of the then existing law.'

Other commentators have been somewhat more robust in their dislike of legislation that alters the consequences of the past, eg: *'Retrospectivity is the handmaiden of incompetent or mischievous governments.'*[9].

It might also be argued that the need for any legislation that changes the past is a consequence of lazy drafting.

The UK Parliament Joint Committee on Human Rights (JCHR) Twelfth Report noted in its comments on the pre-owned assets legislation[10] that while states have a wide discretion under article 1 of Protocol 1 of the ECHR to impose taxes, the legislation must satisfy the principles of legal certainty and proportionality. The Committee then went on to note that:

'For an interference to be lawful under the second paragraph of Article 1 of Protocol No. 1, it must satisfy the qualitative requirements of accessibility and foreseeability: the law which imposes the tax must be published, intelligible and generally available in a form which enables the individual to organise their affairs knowing with reasonable certainty the consequences of acting in different ways.'

The Committee went on to comment however that the relevant legislation was not truly retrospective[11] since it only imposed a tax prospectively, ie, while acts going back up to 18 years were taken into account, a tax charge could only arise if there was also a future act to trigger the charge.

As stated by Howard Flight,[12] the then Shadow Chief Secretary to the Treasury, Economic Affairs, in the Finance Bill debate on pre-owned assets:

'..the main objection to the provision is that it is retrospective in principle, even if cleverly designed to be retroactive in method. It undermines the traditions of British tax law because the legitimate and reasonable expectations of taxpayers have been denied'.

However, whatever the theoretical arguments against retroactive and retrospective legislation, the fact remains that the principle of Parliamentary sovereignty makes it possible for Parliament to legislate in contravention of general principles of law and indeed contrary to international agreements such as the ECHR, albeit with consequences.

Further, both the European Court of Justice[13] and the European Court of Human Rights recognise that such legislation can be in the public interest, although in the former case it has recognised that there is a balancing act to be performed[14] between the legitimate expectations of the taxpayer and the needs of the state. This is considered later.

The elephant test

If Adam Smith saw certainty as of utmost importance, his modern-day counterparts do not appear to do so; although, in a written statement on 2 December 2004[15], the Paymaster General Dawn Primarolo at least saw fit to warn that retrospective[16] legislation would be used to counter avoidance in the employment law area.

Proponents of such legislation argue that is necessary to combat avoidance (at least where it is abusive). As to what is abusive avoidance, it is argued that it is like an elephant – everyone knows what it is but defining it is more difficult. A zoologist or lexicographer might not agree.

Indeed, the court in *Halifax*[17] appeared to have no difficulty in deciding that avoidance itself was not prohibited by European law. However, if a transaction was entered into for the purposes of gaining an advantage not contemplated by the relevant law, it was appropriate for the tax authorities to redefine the transaction so as to restore the position that would have pertained had the abusive transaction not been undertaken. While the *Halifax* principle relates to European Community law, it has its counterpart in UK law in the *Ramsay* principle. In both cases, what the relevant judgments contemplate is that the purpose of legislation will emerge from its drafting and context and that the legislation should be interpreted accordingly.

If legislation has to be interpreted to give effect to its intention, it becomes difficult to see how legislation that alters the consequences of a completed transaction is needed. How it can possibly be said that any legislation clarifies what was always the case. It can improve how it is said but should not alter its meaning.

Legislation that takes into account the past but is essentially prospective is easier to justify, since what it amounts to is a government saying: 'We got the drafting wrong (or 'Our needs have changed'). We won't penalise people who have acted on the current wording but will get it right for the future.' This is no comfort for someone compelled for whatever commercial reason to enter into a subsequent transaction which triggers a charge that might not otherwise have risen.

The world of retroaction and retrospection

HMRC (and its predecessors) have had several forays into the world of retroaction and retrospection.

The *Woolwich*[18] case concerned legislation containing the words '… be deemed always to have had effect', ie, it altered the tax consequences of past transactions. The House of Lords found for the taxpayer. However, other financial institutions that followed the Woolwich had their appeals dismissed. They proceeded to the European Court of Human Rights[19], which held that:

'It must also be observed that the applicant societies in their efforts to frustrate the intention of Parliament were at all times aware of the probability that Parliament would equally attempt to frustrate those efforts …. They had engaged the will of the authorities in the tax sector, an area where recourse to retrospective legislation is not confined to the United Kingdom, and must have appreciated that the public interest considerations in placing the 1986 regulations on a secure legal footing would not be abandoned easily.'

The European Court of Human Rights therefore accepted that public interest considerations might justify legislation that deprives a taxpayer of rights he thought he had at the time he carried out the taxable event or events. It appears that in reaching its judgement, the Court considered that the taxpayers knew what was going to happen, so there was no real surprise.

In 1996, the government introduced legislation curtailing taxpayers' right to recover VAT paid in error more than three years back from the announcement. In one of the longer running battles between taxpayer and tax collector, the outcome was finally determined in this year's Budget (ie, nearly 12 years later) when HMRC (and the government) finally accepted that EU law did require transitional legislation, which has been introduced in Finance Bill 2008.

In *Marks and Spencer*[20], the European Court had concluded in relation to the 1988 legislation that:

'National legislation retroactively curtailing the period within which repayment may be sought of sums paid by way of VAT collected in breach of provisions with direct effect of Sixth Directive … such as those in Article 11A(1), is incompatible with the principles of effectiveness and of the protection of legitimate expectations.'

If that was not sufficient, the Court in *Grundig Italiana*[21] decided a few months later that:

'Community law precludes the retroactive application of a time-limit that is shorter and, as the case may be, more restrictive for the claimant than the period for initiating proceedings that was previously applicable to claims for the recovery of national taxes contrary to Community law where no adequate transitional period is provided during which claims relating to sums paid before the entry into force of the legislation introducing the new time-limit may still be brought within the old period.'

At the time of the judgments above (2002), it would have been relatively easy to make adequate provision for compliance with both judgments by introducing legislation providing for transitional arrangements. However, Customs & Excise (as they were then) sought to apply a short non-statutory transition, so the opportunity to bring an end to the issue was lost for another six years.

It is perhaps understandable that the Treasury might consider that if the taxpayer can go back 20 years, it should be able to do so as well, and this is what is contemplated by *Finance Act* 2008, s. 58. This section specifically provides that the changes within it are treated as always having had effect – back to 1987 when the original legislation was enacted.

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The explanatory notes to the Finance Bill explained the clause as follows:

'The above Acts already provide that, where UK residents are members of foreign partnerships nothing in any Double Taxation Treaty affects their liability to corporation tax, capital gains tax or income tax respectively. Clause 55 puts it beyond doubt that the legislation has always had that effect and that persons entitled to share in the profits of a partnership are members of that partnership.'

Budget Notice 66 also noted that the new clause simply clarified how the law should always have been interpreted. Thus, both the Budget Notice and the Explanatory Notes appear to admit that the legislation was never clear, otherwise there would be no need for clarification.

The approach of the European Court of Justice in the case of *Gemeente Leusden*[22] is worth noting. In that case, the Netherlands government withdrew the option to tax in certain cases. The effect of the legislation was that transactions that would have been taxable based on choices that taxpayers had already exercised would become exempt. That affected the right to recover VAT in relation to the properties. The European Court of Justice concluded that:

'Where a Member State withdraws the right …it must take account of the legitimate expectation of its taxable persons when determining the arrangements for implementing the legislative amendment.'

The Court also went on to say that:

'The repeal of legislation from which a taxable person has derived an advantage in paying less tax, without there being any abuse, cannot however, as such, breach a legitimate expectation based on Community law.'

Achieving a balance

It is difficult to see any real justification for legislation that alters the consequences of a transaction that has already been closed out. As noted, if the purpose of the law was clear, then altering the legislation adds nothing, since the existing legislation can be interpreted to give effect to the intention of the original legislation. Saying that new legislation clarifies what the law always said merely admits that the old legislation was deficient in the first place, and is an effective admission that the principles outlined in the JCHR Twelfth Report[23] referred to above were not met.

It is easier to justify changing the consequences of a transaction that has not yet been completed – provided that, as the Court in *Gemeente Leusden* concluded, there is respect for the legitimate expectations of those who entered into arrangements based on the law at the time and cannot exit them without significant consequences.

How to achieve that is the challenge, but perhaps at a time when the government is proposing to introduce a taxpayers' charter to protect taxpayers, one of the safeguards that should be provided is a guarantee that taxpayers will be protected from both retroactive and retrospective legislation, and that any such legislation will respect the legitimate expectations of taxpayers.

On 4 July this year, a memorial to the achievements of Adam Smith was erected in Parliament Square in Edinburgh. A better monument might be to recognise the value of his principles.

Maric Glaser is the CIOT technical director for VAT and indirect taxes. The views he expresses in this article are his own, and do not necessarily represent those of the CIOT

1. *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776
2. *Telewest Communications plc (1), Telewest (Publications) Limited (2) v Commissioners of Customs and Excise* [2005] EWCA Civ 102
3. See, however, *Wilson and others v Secretary of State for Trade and Industry* [2003] UKHL 40 – paragraph 187 in which Lord Rodger of Queensferry commented: 'Because such provisions do actually affect the position before the legislation came into force, they can conveniently be described as "retroactive" .'
4. Case of *The National & Provincial Building Society, The Leeds Permanent Building Society and The Yorkshire Building Society v The United Kingdom* (117/1996/736/933-935)
5. *(Case no CCT 8/95)*
6. Art 103(2) – An act may be punished only if it was defined by a law as a criminal offence before the act was committed.
7. Retroactive Law: How Dodgy was Duynhoven? The article can be found on the http://www.austlii.edu.au/nz website.
8. (1870) 6 QB 1, 23
9. Professor Jim Corkery – quoted in an article *Retro Active Tax Legislation: A 'Deaf Leopard' And His Spots* – Revenue Law Journal Volume 17, Issue 1 2007 (Bond University, Australia)
10. Twelfth Report – http://www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm
11. In this context – something that changes the tax consequences of something that has happened.
12. http://www.publications.parliament.uk/pa/cm200304/cmhansrd/vo040707/debtext/40707-15.htm
13. *National & Provincial Building Society and others v United Kingdom* (Case 117/1996/736/933-935)
14. For example in *Gemeente Leusden (C-487/01), Holin Groep BV cs (C-7/02) and Staatssecretaris van Financiën*
15. http://www.publications.parliament.uk/pa/cm200405/cmhansrd/vo041202/wmstext/41202m02.htm
16. Meaning legislation that does change the tax consequences of the past.
17. *Halifax plc and ors v Commissioners of Customs & Excise* (Case C-255/00)
18. *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1992] STC 657
19. *National & Provincial Building Society and others v United Kingdom* (Case 117/1996/736/933-935)
20. *Marks & Spencer plc and Commissioners of Customs & Excise* (Case C-62/00) – 11 July 2002
21. *Grundig Italiana SpA and Minstero delle Finanze* (Case C-255/00) – 24 September 2002
22. See footnote 8 above
23. See footnote 6 above.