Taking a Fixed Tax Position in a Changing World – a personal perspective

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1. Introduction

Since the early 1990s the fundamentals of our tax law have remained relatively stable. We continue to have a tax system reliant on GST and income tax. Over this period, individual income tax has remained moderately progressive, compared with the pre-1984 tax scale. Capital gains remain untaxed and the corporate rate and imputation remain the same. There was a period of very radical tax reform from 1984 through to the early 1990s and since then a period of consolidation.

Nevertheless, we continue to have, on average, two substantial taxation bills introduced into Parliament each year. While the changes involved tend to be at a detailed level, they are nevertheless considerable. This means that tax practitioners operate in a world with ever changing rules, which is difficult for them.

It is certainly easier to base tax advice on a known quantity such as the law. Practitioners are trained in the interpretation of the law and various tax rules. This is their area of comfort. Consideration of how the rules might change and what impact that may have is speculation. It is outside the normal area of training for an accountant or a lawyer and draws more from the disciplines of politics and economics than from law or accountancy.

The issue posed by this paper is whether tax advice that does not take into account the prospect of legislative change is in fact adequate. My view is that it is not adequate and that advisors need to anticipate change. This might reduce the surprise some people seem to have when the law is changed and their transactions are affected by that change. If practitioners should be conscious of, and anticipate, legislative change, the second question is how to do so in a sensible and professional manner. As previously noted, this requires skills beyond those acquired through a study of accountancy and law. This paper aims to provide some thoughts and guidance on this point.

I offer my own personal perspective on this issue. I do so as a senior tax policy advisor to the New Zealand government. However, on issues such as retrospectivity and grandparenting the views expressed are my own, and may not in particular instances necessarily be those of the government or indeed officials. Nevertheless, as the examples given demonstrate, the views provided here do seem to be reflected in practice.

The paper first of all considers the case for certainty of tax law and whether certainty is always desirable. That section concludes that certainty in the tax area, as elsewhere, has benefits, but certainty can incur a considerable cost. As a result, one should not assume that tax law will be fixed. That being the case, the paper considers the various ways a client may be affected by tax law change. The first case is where the law changes prospectively but this affects the future tax position of a transaction already entered into. This, usually adverse, result can be offset by grandparenting provisions. But in what circumstances are grandparenting provisions likely and in what circumstances are they less likely? The impact on a client is greatest when a law change is retrospective. While the general position of governments has been to avoid retrospectivity, it can arise. When is this most likely? What protections are often given and in what circumstances? Finally, the paper considers the case of law changes being announced by Ministers with legislation to follow. In what circumstances is this most likely?

2. Certainty in tax law

Certainty in tax law can be justified on jurisprudential grounds as well as economic or policy grounds. This paper focuses on the latter. The jurisprudential arguments over certainty and its relationship to the rule of law have been extensively covered by the literature, and those interested should refer to that. It is briefly canvassed in section 4 of this paper.

From an economic or policy perspective, certainty is a benefit. Certainty reduces risk and risk is a cost. This can be illustrated by the example of an investor, who is interested in its after-tax rate of return. If the tax position is certain, an investment

will be undertaken up to the point that it meets the investor's required rate of return. If the tax law and, therefore, tax position is uncertain, the expected after-tax rate of return falls. That is because the probability of an unfavourable tax change must be factored into the expected rate of return. Since that means that some investment will not meet the required rate of return, the level of investment in the economy is reduced.

Another way of looking at this is that the evidence is overwhelming that a prerequisite for a highly performing economy is clear property rights. For example, it is difficult to gain the benefits of trade when it is unclear who owns tradeable items. A person's tax position may be seen as a property right that should be as clearly defined as possible.

While this seems clear, it does not necessarily lead to the conclusion that tax law should be certain and fixed for all time. Uncertainty incurs risk and thus costs, although the risk can itself be removed only at a cost. Take, for example, fluctuations in foreign currency pricing under our floating exchange rate. This imposes costs on business, being the costs of fully hedging positions, if indeed that is practical. Theoretically, the government could remove this cost by fixing the exchange rate, but that also has costs. A floating exchange rate absorbs the impact of external economic changes (such as changes in export and/or import prices). Under a fixed exchange rate that impact must be absorbed by wage and price levels or unemployment. Thus, various governments have concluded that although a floating exchange rate imposes costs on business, those costs are justified.

In the same way, a tax law that is not fixed imposes costs by way of risks and uncertainty. However, a fixed tax law would impose costs. It would, for example, place all the burden for maintenance of the government's fiscal position on expenditure. It would also leave the government unable to alter the law to reflect changing views of equity, and it would provide no mechanism for countering the degradation of the tax base resulting from the activity of tax advisors or, for that matter, for correcting mistakes harmful to taxpayers.

There is no instance that I know of where tax law is fixed. We need to accept that tax law is forever changing, although we also need to bear in mind that any change needs to be justified because each change incurs a cost.

3. Prospective tax law changes and grandparenting

Given that tax law will change, it is important to consider how that will affect clients. I look first at the 'base case', where the law has changed, but prospectively. This means that the new law comes into place only for income derived or expenses incurred after date of enactment or some later date.

I call this the base case because it seems to be consistent with the view that laws should generally be prospective. In the sphere of criminal law, the principal that underlies non-retrospectively is relatively easy to describe. A prime purpose of criminal law is to modify behaviour. If I act in a way that is lawful but, retrospectively, and contrary to my expectations, the law is changed to make my actions unlawful, then I am subject to criminal sanctions, and the law cannot be said to be achieving its objective of modifying my behaviour. The law is then being misused. The costs of uncertainty are not outweighed by the benefits of the law change. Arguably there are exceptions to this, such as the Nuremburg Trials, but it is a useful guiding rule.

We use the same guiding rule in the tax area, but in the area of economic regulation (including tax) the issues are not as clear as in the criminal area. Where actions are motivated by economic costs and benefits, the law change alters the economic cost/benefit calculus. The mere fact that the law change takes effect prospectively does not protect people from the impact of that change.

Take the hypothetical example of the government taxing the capital gains of rentiers of housing accommodation. Even if the law took effect after enactment, an existing rentier would still face a tax on their capital gain, reducing the expected after-tax return from the transaction.

One approach to provide for this is grandparenting – not applying the law to transactions entered into before the proposal to change the law is announced. This will still not necessarily leave past actions unaffected by the change in the law. That is because the change in law can be capitalised into asset prices affecting all existing asset holders, including those who are grandparented.

Take again the example of a capital gains tax on rentiers. The immediate affect of such a tax is likely to be a reduction in the return on rental accommodation as an investment (assuming there is an expectation of capital gain built into the rental return). The reduction in the return from rental accommodation in the first instance could be expected to reduce the value of all rental accommodation assets. This, in turn, is likely to reduce investment in the rental area, leading to the reduction in the supply of rental accommodation. That reduction in the supply over time should result in an increase in rentals, assuming demand for accommodation is unchanged. The value of rental assets should then increase again but only back to its original level if the full burden of the tax is borne by those who are renting. The point is that even those who are grandparented and not taxed on the capital gain may be subjected to the effects of the tax through changes in asset prices. They still receive the benefit of a tax-free capital gain, but the capital gain may be lower.

Grandparenting is not therefore seen as appropriate with respect to broadly based tax changes affecting sectors of the economy where relative asset prices are changed. If sectors are to lose or gain tax concessions, the policy intent is to alter relative after-tax rates of return and thus asset prices. Grandparenting does not make sense in this context. Nor is grandparenting generally seen as appropriate where the protection afforded is likely to apply for long periods of time. While that can add certainty for protected taxpayers, the cost is ongoing inequities with a different tax treatment being applied to people undertaking the same activity. It is for that reason that officials did not recommend to the government that existing transactions be grandparented in the case of the proposed deferred deduction rules.

Instead, grandparenting is generally limited to transactions of a specific nature that can be expected to be completed in a relatively short time. In that case there is a close similarity with the transaction that has been completed before enactment and that

would thus not be affected by prospective legislation. In that case, the benefits of greater certainty in allowing contracts to be completed as contemplated by the parties, seems to outweigh the cost (mostly fiscal) of grandparenting.

A case in point was the change to the petroleum mining rules in the Taxation (Relief, Refunds and Miscellaneous Provisions) Bill enacted in 2002.

The amendment prevented the disposal of a petroleum mining entity giving rise to what amounted to double deductions. The fiscal implications were significant, and it was proposed that the measure apply to transactions entered into after the date of announcement. Given the fiscal risks, it would not have been feasible to propose such a measure with effect from a future date. Making it apply from announcement allowed for consultation through the select committee process. This proved worthwhile since it was at this stage that it became clear that an uncompleted transaction might be affected. The select committee agreed to make the measure effective from announcement but grandparented binding contracts entered into before the date of announcement. The distinction between a completed transaction and a binding contract entered into did not justify a different tax treatment. The benefit of people being able to enter specific transactions and being able to rely upon existing law governing those transactions justified grandparenting.

Grandparenting provisions are not always taxpayer-friendly. On some occasions it has been seen as justified to grandparent existing transactions and not give them the more favourable tax treatment open to new transactions. The argument is that the more favourable treatment incurs a fiscal cost in order to encourage a particular activity such as increased investment. Providing this to past transactions incurs the fiscal cost but, because the transactions have already taken place, there is no corresponding benefit. One example of this is the McLeod Review proposal to provide a lower tax rate for foreign direct investment after date of implementation but retain a higher rate for existing investment.

Another example of grandparenting that can be unfavourable to taxpayers is the depreciation rates. Our depreciation rates are set out in the table below.

DATE OF ASSET PURCHASED	DEPRECIATION RATES
1995/1996 and later	Generally economic rates plus 20 % uplift
1 April 1993 – 1994/5	Old schedule rates plus 25% uplift or economic rates and no uplift
16 December 1991 – 31 March 1993	Old schedule rates plus 25% uplift
15 December 1991 and earlier	Old schedule rates

This enormously complex grandparenting aimed to minimise the fiscal cost of more generous depreciation rates while being as fair as possible to different taxpayers in different positions.

4. Retrospective law changes

As previously noted, New Zealand governments have adopted a general policy of not enacting retrospective tax legislation. This is in accordance with long-standing constitutional and jurisprudential principles that retrospective legislation is unjust, and contrary to the rule of law and proper legislation. This general doctrine can be traced back to the statement by Thomas Hobbes in 1671:

> "No law made after a fact done, can make it a crime because a positive law cannot be taken notice of, before it be made, and therefore cannot be obligatory,"[1]

These views were echoed by Blackshore in his *Commentaries on the Laws of England.* This aversion to retrospectivity is expressed in many forms. The following are examples:

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[1] T Hobbes *Leviathan*, Cambridge University Press, Cambridge, 1904 at 212

(a) The common law presumption against interpreting statutes to have retrospective effect. An example is the following observation by Gault J in the New Zealand Court of Appeal.

"The principle against retrospective criminal liability and retrospective increased penalties is well established. The reasons for the principle in terms of prior direction or deterrence and the consequent possibility of knowing compliance, and justice, in not being subject to unknowable penalties are long established and impregnable."[2]

This common law presumption is reflected in section 7 of the Interpretation Act 1999, which states: "An enactment does not have retrospective effect."

(b) International instruments such as the Universal Declaration of Human Rights. [3]

(c) Constitutional instruments such as the Constitution of the United States of America. Article 1 (a) (3) of that Constitution states: "No bill of attainder or ex post facto law shall be passed."

(d) New Zealand statutes. Section 10A of the Crimes Act 1961 states that: "No person shall be liable in any criminal proceedings in respect of an act or omission by him, if at the time of the act or omission, the act or omission did not constitute an offence." Section 26 of the New Zealand Bill of Rights Act 1990 provides the same protection as the Crimes Act and section 25 (g) of the New Zealand Bill of Rights Act protects people from penalty increases prior to sentencing. Section 7 of the Act requires the Attorney General to report to Parliament any provision of a Bill that appears to be inconsistent with that Act.[4]

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[2] R v. Poumako [2000] 2 NZLR 695
[3] Article 11 (2)
[4] Standing Order 260 requires the Attorney General to report before the second reading is passed

The jurisprudential aversion to retrospectivity is thus entrenched in international and New Zealand law. It is to be noted, however, that with the exception of the general presumption against retrospectivty in the common law and the Interpretation Act 1999, this is normally limited to the area of retrospective criminal sanctions. For example, although the United States Constitution may have been open to a wider interpretation, the US Supreme Court has limited the prohibition on "ex post facto law" to criminal law.[5]

The general presumption against retrospectivity is nevertheless reflected in the general policy approach in the tax area because of its foundation in ideas of fairness, justice and the economic benefits flowing from operating under certain law.

It needs to be appreciated, however, that whereas the concept of criminal retrospectivity is relatively easy to define as set out by Hobbes in the seventeenth century, what is meant by retrospectivty in the tax and civil areas generally is not such a clear concept. For example, in a letter to the Finance and Expenditure Committee, dated 31 July 2001, on the Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Matters) Bill 2001 [6] officials identified three views on retrospectivity in jurisprudential literature. Retrospective legislation can be seen as:

(a) any change in the law, or
(b) any law that affects a prior action of a person, or
(c) any law that defeats the rational and legitimate expectation of those to whom the law applies.

This means that it is difficult to base tax policy on the simple rule that tax legislation should never be retrospective. Even if the formulistic notion of retrospectivity is adopted so that no legislation should come into effect until after enactment, in practice this if often found not to be a guide to good policy.

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[5] Calder v Bul (1798) 3 US 385
[6] See Annex A

This is illustrated by the Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill 2003, currently before Parliament. The Bill has 133 clauses. Of these, 27 (mainly GST) commence after date of introduction. Another 27 (mainly relating trans-Tasman imputation) commence on 1 April 2003. The remaining 87 clauses apply from various dates back to 1 July 1994. There does seem to be a lot of retrospective change and the Bill does not seem to be highly out of line with what can be expected in a tax bill. A closer examination of the bill reveals that what at first sight may seen highly retrospective is not in fact unreasonable.

The trans-Tasman measures are retrospective to 1 April 2003 so as to align implementation dates to the imputation year and to similar measures enacted in Australia. Making the measures effective from 1 April 2004 might improve "purity" but at a cost of a year's deferral of the advantage to taxpayers of wider crediting for New Zealand tax paid by trans-Tasman companies.

The most retrospective measure in the Bill is clause 103. That clause is retrospective back to 1 July 1994. However, the change it effects seems innocuous. In defining "flat-owning or office-owning company" in the Goods and Services Tax Act 1985 the present Act refers to the Companies Amendment Act 1964. However, that Act was repealed in 1993 and the definition is now in the Land Transfer Act 1952. Clause 103 fixes up these cross-references so that sense can be made of the Act.

Two clauses in the Bill illustrate how retrospective changes can be either favourable or unfavourable to taxpayers.

Clause 75 is retrospective back to 1 April 1995. The clause clarifies that the Commissioner can give a valid notice to a taxpayer or agent by posting the notice to an address nominated by that taxpayer or agent rather than the person's physical address. The history of the proposal is to be found in the High Court case of *Hieber v CIR*.[7] That case and its background made it uncertain whether Inland Revenue notices can be posted to post boxes. If anything this provision is taxpayer-unfriendly and retrospective but it seems reasonable.

[7] (2002) 20 NZLR 17, 774

Clause 95 is retrospective back to 1 April 1998, but is taxpayer-friendly. It deals with the situation where, as a consequence of the attribution of a net loss by a loss attributing qualifying company and the subsequent disallowance of deductions to the company and, therefore, the shareholders as well, shortfall penalties are charged to both the company and the shareholders. The clause will allow the shareholder to apply for a reduction in the penalty when the shortfall penalty charged to the company has been paid in full.

I think these examples illustrate that, at least in the tax area, retrospective legislation (defined as legislation that comes into effect prior to enactment) can produce a fairer, more just and more economically efficient result than blind adherence to a principle on non-retrospectivity. Whether any particular measure or not should be retrospective needs to be determined after a careful consideration of the costs and benefits of alternative implementation dates.

Some concern has been expressed about this approach to retrospectivty. Jan James and Nick Bland of Simpson Grierson, Auckland have written:

> "This retreat to a cost-benefit assessment creates a risk that retrospective legislation will become a tool of fiscal management, ultimately undermining the integrity of the tax system and the legal system as a whole."[8]

However, as outlined in officials' letter to FEC of 31 July 2001 (Annex A), officials' approach to retrospectivity is more sophisticated than a simply fiscal calculus. In that letter it is stated that officials agree that retrospective legislation can undermine our constitution and economic structure. However, officials interpret retrospectivity not narrowly, simply as legislation with a pre-enactment effect, but more broadly, as legislation that is contrary to the national and legitimate expectations of people. Such an interpretation allows for the complex economic environment in which tax law operates.

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[8] New Zealand Law Journal, October 2001 James , J and Blank, N – "Tax Update" – at 363.

It is legislated changes in expectations that really matter, not just changes in the legal words. Protecting expectations is seen as the best way of balancing the social and economic benefits of legal certainty with the social and economic costs of living with fixed tax law.

To be protected, however expectations must be rational and legitimate. A person may honestly believe that tax rates should never be increased and may act on that basis. However, in our society that is not a reasonable or legitimate expectation. Business must operate in an environment of risk. This includes the risk of changing markets, price levels, foreign exchange rates and so on. Certain tax changes are within this ambit of risk that should be expected. Among these are changes in tax rates.

The current tax bill illustrates the application of these guiding principles. It hardly seems a rational and legitimate expectation that you can avoid your tax liabilities by having notices sent to the address you nominated rather than your physical address. Clause 75 recognises this and is technically retrospective in effect. On the other hand, a person who invests in a loss attributing qualifying company can reasonably expect penalties if they take, say, an aggressive tax position. It is, however, reasonable to conclude that they would not expect a double layer of penalties. Clause 95 recognised this and proposes retrospectively to remove one level of penalty.

If it is accepted that it can be justified to have legislation with pre-enactment effect, the issue arises as to whether in such cases, other protections can be justified. The position adopted by officials is that this can be the case. Such protections may be termed carve-outs from pre-enactment effect.

Two forms of such carve-outs can be found in our tax legislation. The minimalistic form is a carve-out for judicial proceedings that have been instigated prior to introduction of the legislation. An example of this was the 1998 Taxation (Accrual Rules and Other Remedial Matters) Bill. In that case a taxpayer entered into a waiver of the time bar. The taxpayer later argued that the time bar waiver was invalid and any assessment was time barred. Clause 91 of the Bill clarified that time bar waivers were not invalid. However, prior to the legislation being introduced the taxpayer instigated judicial proceedings. In these circumstances the Select Committee

amended the Bill so as to carve-out from clause 91 proceedings that had been instigated. This was seen as reflecting the spirit of section 27 of the New Zealand Bill of Rights Act 1990. This provides that litigation against the Crown will be dealt with according to the law in the same way as civil proceedings between individuals. One difficulty with this approach is that judicial proceedings are merely one part of the tax disputes process and it could be argued that similar protection should be given to all phases of that disputes process.

Such protection is achieved by the more common form of carve-out, which is to exclude from legislation with pre-enactment effect those taxpayers who have previously adopted the position that the legislation overturns. This is usually evidenced by the fact that the taxpayer has filed a return on the basis of an interpretation of the law that is being overturned or issued a notice of proposed adjustment on that basis.

The rationale here is that taxpayers who enter a transaction and file a return on the basis of a certain interpretation of the law can be reasonably concluded to have acted on the rational and legitimate expectation that the law will not change. It has proved more difficult to apply this principle in the case of GST. That is because a refund for GST input credits can arguably be claimed up to eight years after the transaction has taken place. In other words the transaction can take place with the taxpayer having one expectation but being later able to claim refunds on the basis of a different interpretation of the law.

This situation arose with the Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill 2001. That bill retrospectively blocked GST refunds affecting inbound tour operators and educational institutes. For the reasons given above, the legislation did not change the law for those who had already received refunds but did so for others, including taxpayers who had lodged claims with Inland Revenue.

This is a limitation of the carve-out approach. Another limitation is that it can be seen as protecting those who take the most aggressive interpretation of the law. On the other hand it can be useful in differentiating between those who had a rational and

legitimate expectation of the law from those who stood to gain a windfall from a change in the generally accepted interpretation of the law.

5. Ministerial announcements

In some jurisdictions it is common for tax policy initiatives to be announced with legislative proposals following, sometimes years later. The eventual legislation can then be backdated to the date of announcement. As a result tax advisors are required to advise clients on the basis of Ministerial press statements. Obviously such statements are not written by legislative drafters and are aimed at the general rather than a technical audience. It must therefore be a daunting task to proffer technical advice on complex transactions on the basis of law conveyed through press statements.

New Zealand has not adopted this approach to tax policy. Under the generic tax policy process most policy measures advance through an extensive consultation phase before final Ministerial decisions are made. Further consultation on the form of the legislation is carried out through the parliamentary select committee process.

Inevitably there are times when a more rapid response is required than the normal generic tax policy process allows. For example, an avoidance opportunity is identified that cannot be the subject of consultation without alerting everyone to the opportunity and exposing the tax base to unacceptable risk. In such cases the normal response is to announce a proposed response quickly, followed by legislative details that are effective from date of announcement (with any appropriate grandparenting provisions). An example as the petroleum mining measures mentioned in section 3 above.

There have been two recent variations from this approach. The first of these was the statement by the Minister of Finance and Revenue, Hon Dr Michael Cullen, of 26 May 2003, that the law would be amended so that masthead transactions as contemplated by Fairfax would not have the beneficial tax effects they have under existing law. The second was the Minister's statement, of 6 August 2003, that the law

will be amended to ensure that tax is levied on New Zealanders investing in Australian unit trusts in a manner that might allow them to derive, in effect, tax-free New Zealand sourced income.

These instances should not be seen as a fundamental change in the way New Zealand tax policy is developed. They are in fact a product of the government's adherence to that process. In both cases the government faced a significant and growing, widely publicised degradation of the tax base by transactions that were clearly contrary to policy intent. In dealing with this situation in a responsible way the government faced the options of:

- an announcement followed by consultation leading to legislation, or
- early legislation without the opportunity for consultation, or
- consultations followed by retrospective legislation.

Any other options exposed the tax base to an unacceptable risk. The government chose the first of these options. In the future officials are likely to advise a similar course of action in similar circumstances. It is not expected, however, that this will result in a general move to legislation by press statement. The responses in these cases were specific to their circumstances.

6. The tax advisor as soothsayer

The life of a tax advisor would be easier if tax law never changed. Given the need for tax law to be adapted to changes in the economy and practice, that is not the case and is never likely to be. Moreover, for the reasons outlined above, an advisor cannot assume that all tax laws will be effective only from after date of enactment. Even if law changes have a post-enactment effect they can still impact on prior transactions.

Managing change and risks is an inherent part of operating any business. Along with changes in markets, prices, foreign exchange, regulations and so on, business do have to consider and manager the risk of tax law changes. It thus seems to be a key role of the professional tax advisor to assist business in this area.

The first issue that needs to be considered is whether aspects of the law affecting a client are likely to change. Overall, New Zealand has a very open tax policy process. Part of that is having a publicised and transparent work programme. The consultative process should ensure that the rationale for and direction of policy changes are known and understood. This gives a good basis for anticipating tax policy change.

Not all tax policy changes can be clearly signalled in advance. For some measures early signalling would defeat their objective of maintaining the tax base. An astute advisor should nevertheless be able to gauge the potential for legislative change by considering the extent to which a particular opportunity provided by current legislation is clearly contrary to the policy intent and the extent of the fiscal risk it poses. The fiscal risk is measured not just by the one transaction but by the ability of the transaction to be replicated in other cases. Hence the extent to which the opportunity is widely known is relevant.

The point here is that the tax policy work programme is full. New issues will be accorded high priority according to the extent to which measure support overall government policy (such as the growth and innovation framework) and the extent to which the measures are fiscally important. Any opportunity an advisor sees that is clearly contrary to policy intent and that has potential fiscal implications of more than, say, $50 million per annum is likely to be considered a very high priority by officials.

Of course officials can only recommend remedial legislation when they themselves know of opportunities. Over the last half dozen years we have added considerably to our ability to gather information from other areas of Inland Revenue and from other sources. For example, you can assume that any ruling application has been carefully considered for policy implications. As a rule it seems reasonable to assume that what is generally known in the professional community is also known to tax policy advisors.

If you consider that a law change is possible, the next issue is whether that change would be retrospective, grandparented and/or subject to a carve-out.

As a general rule the government will propose prospective legislation. Such legislation can, however, still affect existing transactions especially if there are no grandparenting provisions. Such provisions are normally proposed for short-term transactions where the distinction between an unaffected completed transaction and a transaction in the process of completion lacks substance.

As experience has demonstrated, governments cannot rigidly maintain a rule of prospective legislation only without producing results that undermine the objectives of fairness and economic efficiency. Legislation that has pre-enactment effect has been , and will undoubtedly remain, part of our process. First, there is the case where quick action is required but consultation is desirable. In such a case the law will often be effective from date of announcement. Beyond that, officials will recommend legislation with pre-enactment effect, when this seems to be the best way to maintain the rational and legitimate expectations of the operation of the law. That is so whether the retrospective legislation is taxpayer friendly or unfriendly. A carve-out from retrospectivity can be justified where this best targets the rational and legitimate expectations of a sector of taxpayers.

Finally, when considering grandparenting, retrospectivity or carve-outs, officials will be more inclined to recommend more generous treatment for taxpayers the less the change corrects something that is clearly contrary to policy intent.

ANNEX A

Officials' letter to FEC

31 July 2001

The Chair
Finance and Expenditure Committee
Parliament House
WELLINGTON

Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Matters) Bill – retrospectivity

1. At the Committee's meeting on 25 July, official advisors were requested to produce an outline of our views on retrospectivity for discussion at the Committee's meeting on 1 August. This is set out below. In short our views are that retrospective legislation is legally valid. However, retrospective legislation can undermine the rule of law and in doing so (especially in tax and commercial matters) can incur significant economic costs by undermining private property rights and thus creating investment uncertainty. Given these concerns it might be tempting to adopt a simplistic rule such as all retrospective legislation is repugnant. However, it can be shown that adopting such a rule can lead to inequities and the mischiefs such a rule aims to prevent. We agree that Parliament should only enact retrospective legislation with care and caution but as in many areas of public policy retrospective legislation can be justified where the benefits outweigh the costs. Parliament needs to consider whether the benefits of the proposed retrospective legislation outweigh the costs in this case.

2. This note first outlines what is being proposed in terms of retrospectivity. It then summarises what seem to be the key arguments of the Chen, Palmer and Partners' opinion (attached to the Ernst Young submission) and considers those arguments in the context of the proposed legislation.

What is proposed

3. Since May 1999 the legislation has been clear that GST is levied on supplies to non-residents where the benefit of that supply will be enjoyed in New Zealand. Examples are supplies to a non-resident parent of education for a New Zealand student and supplies to a non-resident tourist operator for hotel and other services to a tourist in New Zealand. Background papers released to the Committee make it clear that this was always the policy intent of GST since its introduction in 1986. Evidence to the Committee suggests that this was generally accepted to be the position by tax advisors and the private sector with respect to foreign students and tourists. That is why GST was paid in those cases in most instances. However, in 1995 the Court of Appeal reached a decision on advertising expenditure and this was interpreted as creating doubt as to whether foreign students and tourists supplies were liable to GST. Refund applications for foreign tourist supplies were first known to be received by Inland Revenue in 1998 and for tourists in late 1999.

4. The proposed legislation applies the legislative amendment made in 1999 back to 1986 when GST was introduced for taxpayers seeking to change a position in an earlier return. This retrospective legislative change would not apply to those who have received refunds or those who may have previously not paid GST (zero-rated) on their supplies. Such taxpayers will be subject to the law as it already stands. Inland Revenue's view of the law as applied to specific arrangements entered into by taxpayers is that this would mean that refunds paid on student fees would still be valid but that tourist operators who have received refunds or who have zero-rated supplies will still be required to pay GST. The latter issue may result in litigation whether or not the proposed legislation is enacted.

The Chen, Palmer and Partners' Opinion

5. The opinion defines retrospective legislation as "legislation which changes the law relating to a situation backwards in time from the time the legislation is enacted

by Parliament' (para 1). It agrees that such legislation is lawful (para 5) but argues that it is "repugnant to the rule of law" (para 51) that requires "certainty, generality and equality". Certainty means that the law should be "prospective, open and clear" (para 16) while generality and equality mean that the law should treat like people alike. The argument here may be summarised as contrasting two forms of state. Under the rule of law people cannot have their property or liberty challenged otherwise than in accordance with known rules. The alternative is arbitrary and capricious administration under which neither liberty nor property is secure. In New Zealand the rule of law is a fundamental aspect of our constitution. We would add that it underpins not only our constitution but also our economic structure since the certainty of property rights created by the rule of law is essential for investment and economic activity.

6. This leads Chen and Palmer to the conclusion that retrospective legislation is "seldom justified" – para 5 and 19. The use of the term "seldom justified" suggests that Chen and Palmer agree that retrospective legislation is sometimes justified although they do not expand on the circumstances where this might be the case.

7. Officials agree with the constitutional and economic importance of maintaining the rule of law as outlined by Chen and Palmer. We also agree that retrospective legislation can undermine this and thus requires careful consideration and justification. However, it is clear that retrospective legislation can be justified in some circumstances. The issue is whether this is such a case.

What is retrospectivity and is it ever justified?

8. The need to examine proposed retrospective legislation according to its effects rather than condemn all legislation that can be labeled as retrospective is demonstrated by the jurisprudential debate as to what is meant by retrospective legislation. The literature points out considerable difficulties with the Chen and Palmer definition that turns on whether the legislation operates before enacted. It has been pointed out that in a sense no legislation is backward looking in this way in that all legislation operates prospectively. It will be applied by a court (or a punishment

given) at a future date, not a past date. On the other hand, if retrospective legislation is seen as legislation that affects or varies any extant right or obligation, then most legislation will be retrospective in that the variation of rights and obligations is what legislation is about. This leads to the view that the rule of law requires clear and unambiguous laws, that are known to everyone, that are uniformly applied and that never change. While this may be a rule of law ideal, it is clearly impractical and profoundly undemocratic. For one thing it requires that no new laws ever be enacted. Interestingly, this is the view of G de Q Walker who is quoted with approval by Chen and Palmer.

9. Even a less strict form of the definition of retrospective legislation has difficulties. For example, any law that affects a prior action of a person may be said to be retrospective. Retrospective legislation is then seen as legislation that alters the future legal consequences of past events. However, this would mean that tax rates could never change (up or down) because people are likely to have made decisions (such as how much education to invest in) based on existing tax rates. People are also likely to have entered transactions giving rise to future profits based on extant tax law and rates. It would under this definition be retrospective to ever change those.

10. A third definition of retrospectivity that attempts to avoid the above problems is that retrospective legislation is legislation that defeats the rational and legitimate expectations of those to whom the law applies. The analysis is that under the rule of law people should be able to rely upon the law (and not official whim) to guide them in their actions. The problem with such a definition is that it is not clear-cut. It relies upon a judgement as to what is a rational and legitimate expectation. It is difficult to argue that an expectation that tax rates will never alter falls into this category, although some people may base decisions on such an expectation. There is debate as to whether retrospective anti-avoidance law falls into this area. It is argued that changes to bring anti-avoidance activity into the tax net can guide people not to push the boundaries of tax law too far and that there should be no legitimate expectation that such activity should be protected.

11. While the last definition does suffer from this defect it does force the analysis to turn away from labels to the key issue which is whether what is being proposed is

good or bad policy. Officials agree that for constitutional and economic reasons the rational and legitimate expectations of people should not be overturned by new legislation lightly. However, there are cases where that can be justified in policy terms by wider benefits.

12. In this bill submitters have argued in favour of legislation retrospectively allowing corporate interest deductions and transfers of tax credits. It is argued that this is favourable to taxpayers and therefore an appropriate retrospective change. However, to the extent to which such a change would be of practical effect by way of relieving a tax liability that would otherwise exist, it would be favourable to the taxpayers receiving such a benefit but unfavourable to all other taxpayers who would have to make up any shortfall in tax revenue.

Application to the Bill

13. In our view all legislation that can be seen as having retrospective effect should be enacted only with caution. Not overturning the rational and legitimate expectations of those who have entered transactions at the time the transactions were entered into seems a useful guide. The principles were set out in one of our previous reports to the Committee that read as follows:

> "In general, retrospective tax legislation is and should be avoided. Retrospective changes to tax rules undermine perceptions of fairness of the tax system, and thus voluntary compliance, and have economic costs in that the effect of investment and other decisions become more uncertain. Nevertheless, it is recognised by the Legislative Advisory Council and others that in the tax area, as in other areas, these considerations need to be balanced against other policy concerns on a case by case basis. In some cases it can be fairer and add certainty for legislation to be retrospective. The classic example is the correction of an incorrect cross-reference.
>
> "Considering concerns in this balanced way can sometimes lead to the conclusion that significant changes to the law should be retrospective. For

example correcting major base maintenance concerns is often achieved by making remedial legislation effective from the date of announcement, which is generally the date of introduction of the bill. In such cases the reasoning is that people are given notice of the change and, therefore, should not rely on the law that it is proposed to change.

"On more rare occasions greater retrospectivity seems justified. This is where the policy intent of the legislation is seen as being clear but the legislation does not achieve it, and the result is a significant hole in the tax base or a significant unintended tax impost on taxpayers. A recent example was the retrospective repeal of duty on credit card transactions enacted as part of the Taxation (Remedial Provisions) Act 1998 (No 7). The rationale is that there is in such cases greater unfairness and uncertainty in not changing the law retrospectively than in doing so prospectively. When legislation has an adverse effect on taxpayers, the general practice has been to protect those who have relied on the law that is being retrospectively changed. The change in law is not applied to those who have demonstrated that they have relied on the old law by taking some action such as filing a return on that basis."

14. In most cases schools and tourist operators when they entered into supply transactions expected GST to be payable. This is clear from the Ernst Young submission. GST was paid and returns filed on that basis. The best evidence that people entered into transactions on the basis that no GST would be charged on supplies is that they filed GST returns on such a basis. In terms of the PricewaterhouseCoopers submission these are those that "acted bona fide on the basis that the supply was zero-rated". The proposal is to not change the law in those cases. Those who have zero-rated their supplies will be able to rely upon unchanged law in any dispute with IRD. In addition, any taxpayer that has already received a refund (whether or not IRD considers that they remain entitled to it) will be able to continue to rely on existing law.

15. The proposal thus seeks to protect from legislative change those that can be said to have a rational and legitimate expectation as to the law while still protecting

the revenue base from a potential cost of $150 million to $200 million of lost revenue should the proposal not proceed.

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