

# 2002/03/12 - PL. ÚS 33/01: RETROACTIVITY

## HEADNOTES

Thus, if a certain model and manner of social thought and conduct has been consensually established in the value system and consciousness of society, which, for various reasons, e.g. as a result of the pressure from a certain political system, could not find normative expression, then the legal regulation of that conduct, containing retroactivity, remains fully in accordance with the principles of a democratic state based on the rule of law. In other words, it would, on the contrary, be inconsistent with the principles of justice if, in such cases, true retroactivity did not have its say. However, all this should all the more distinctively indicate that true retroactivity has no place in a state governed by the rule of law in situations where the legislature already could have had its “say” but did not do so.

Because, from a constitutional law standpoint, the legislature’s decision on the manner of resolving the overlapping in time of old and new legal regulations is not a matter of chance or arbitrariness, but is a matter of consideration of conflicting constitutional law principles, the Constitutional Court considered whether conditions exist for allowing an exception from the principle of forbidding true retroactivity, which would permit the constitutional admissibility of this legal norm. The framing of tax policy is a matter for the state, which determines what the tax burden on the taxpayer of a particular tax will be and how it will regulate his obligations in connection with verifying the correct assessment of tax. The Act on Income Taxes, in its original version of 1992, established the use of usual market prices in the event that negotiated prices differ from them and the difference is not satisfactorily documented, with this procedure to be used whenever there was interconnection by personnel or economic interconnection between the same legal entities or natural persons. Act No. 259/1994 Coll., in effect as of 1 January 1995, added to the Act on Income Taxes the obligation to satisfactorily document the difference between prices negotiated between entities connected economically or in personnel and prices negotiated between independent entities in ordinary business relationships under the same or similar conditions. This amendment narrowed the obligations of the taxpayer, who in future had to pay attention to satisfactory documentation of the price difference only in certain legal relationships foreseen by the law, and bore the consequences for any failure to fulfill this obligation in the form of a tax base adjustment by the tax administrator. Act No. 316/1996 Coll., in effect as of 1 January 1997, provided what was considered to be a price negotiated between independent persons in ordinary business relationships in setting the level of interest for loans, which did not expand the range of legal relationships subject to the law. Thus, until the amendment passed by Act No. 210/1997 Coll., the taxpayer could justifiably expect that in creating legal relationships he would have to document a price difference to the tax administrator and bear the consequences if he did not do so only with some of them, while with other legal relationships he would not be subject to this obligation. The Constitutional Court therefore believes that this case is a case of the taxpayer’s justified faith in the law, because in the legal situation at the time to which the retroactive norm applies, the taxpayer could not presume any flaw in his conduct and could not expect the

possibility of retroactive change. Although social relationships began to show signals that indicated the need for new legal regulation, which is the subject of the matter at hand, the legislature, in a democratic state, did nothing to limit disadvantageous effects earlier, i.e. by a regulation pro futuro. Thus, in this case conditions do not exist to accept an exception from the ban on true retroactivity, nor can the constitutional conflict be overcome through interpretation.

**CZECH REPUBLIC**  
**CONSTITUTIONAL COURT JUDGMENT**  
**JUDGMENT**

**IN THE NAME OF THE CZECH REPUBLIC**

The Plenum of the Constitutional Court decided on 12 March 2002 in the matter of a petition from the Ostrava Regional Court to annul the part of Art. III point 1 of Act No. 210/1997 Coll., which amends and supplements Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, identified by the number and punctuation “48,” with the participation of 1) the Chamber of Deputies of the Parliament of the CR and 2) the Senate of the Parliament of the CR as parties to the proceedings, with the consent of the parties to the proceedings without a hearing, as follows:

**Art. III point 1 of Act No. 210/1997 Coll., which amends and supplements Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, in the part identified by the number and punctuation “48,” is annulled as of the day this judgment is published in the Collection of Laws.**

**REASONING**

I.

On 11 October 2001 the Constitutional Court received a petition from the Ostrava Regional Court to annul Art. III point 1 of Act No. 210/1997 Coll., which amends and supplements Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, in the part identified by the number and punctuation “48,”.

The petition states that the Ostrava Regional Court, Panel 22 Ca, (the “petitioner”), is handling a complaint by P. P. against a decision by the Ostrava Financial Directorate which denied his appeal against a supplemental payment assessment by the Český Těšín Financial

Office on additional individual income tax for the tax period 1997. In May 1997 the plaintiff sold securities which were not publicly tradable at a loss of ca. CZK 10 million, and the tax administrator categorized the case as the conclusion of a trade between otherwise connected persons for purposes of lowering the tax base under § 23 para. 7 of Act No. 586/1992 Coll., on Income Taxes, as amended by of Act No. 210/1997 Coll. The petitioner believes that the part of Art. III. point 1 of Act No. 210/1997 Coll., identified by the number and punctuation “48,” is in conflict with Art. 1 of the Constitution of the Czech Republic (the “Constitution”) because it has retroactive effects.

Point 48 of Art. I of Act No. 210/1997 Coll. expanded the circle of specific business cases in which the tax administrator reviews negotiated prices. If the taxpayer does not satisfactorily document the difference between the price negotiated in such a case and the price which was negotiated in ordinary business relationships between independent persons connected otherwise than economically or by personnel, the tax administrator adjusts the taxpayer’s tax bases by the difference determined. Here the lack of a satisfactory explanation from the taxpayer leads to a change in the tax base and thus to a change in the amount of tax. Under Art. V, Act No. 210/1997 Coll. went into effect on 1 January 1998, but Art. III, point 1 of the Act states that Art. I points 33, 34, 48, 51, 52, 62 [applying only to § 24 para. 2 let. zf)], 69, 98 and 114 will already be applied for the tax period 1997.

According to the petitioner, the basic principles defining the category of a state based on the rule of law include the principle of protecting citizens’ confidence in the law and the related principle of a ban on the retroactivity of legal norms. Although the ban on retroactivity is expressly regulated in Art. 40 para. 6 of the Charter of Fundamental Rights and Freedoms (the “Charter”) only for the area of criminal law (under that provision the question whether an act is punishable is considered and punishment imposed under the law in effect at the time the act was committed, and a subsequent law is applied if it is more favorable for the perpetrator), the application of this ban for other areas of law must be drawn from Art. 1 of the Constitution. The accent laid on the ban on retroactivity for legal norms as one of the basic elements of a state based on the rule of law flows from the requirement for legal certainty. The ban on retroactivity consists in the principle that it is fundamentally impossible to judge, under current legal norms, human conduct, legal facts or legal relationships which occurred before the legal norm went into effect. The ban on retroactivity of legal norms is based on the principle that everyone must have an opportunity to know which conduct is forbidden, so that he can be called to account for violation of the ban. This ban is also related to the function of legal norms, which instruct persons subject to them how they are to act after the laws go into effect, and therefore are fundamentally in effect only in the future.

With reference to the Constitutional Court’s conclusions of law expressed in its case law on the question of retroactivity of a legal norm and the protection of acquired rights, the petitioner points to the fact that the application of point 48 in Art. I of Act No. 210/1997 Coll. already for the tax period 1997, although the Act went into effect only as of 1 January 1998, placed the taxpayer in a position where his previously legally faultless conduct is retroactively viewed more strictly, because business activities are subject to review by the tax administrator which, under the previous legal regulation, were not subject to such review. Thus, under the new legal norm, legal relationships are evaluated

which occurred before the norm went into effect, and this evaluation may have an unfavorable effect on the taxpayer's rights and obligations. In the period before 31 July 1997, when Act No. 210/1997 Coll. was passed, a person or entity could not predict, when entering business relationships, which facts would newly be legal facts decisive for his rights and obligations in the area of income tax, and thus did not have an opportunity to choose whether to undertake the possible risks related to these consequences. The new legal regulation, which changes the consequences of legal relationships which arose before the day when it went into effect, is thus a case of true retroactivity of a legal norm. Because this change retroactively worsens the taxpayer's legal position, it violates the principle of protection of acquired rights.

The petitioner states that in this case the new regulation is worded unambiguously and it can not be interpreted in a constitutional manner so that its consistency with the constitutional order can be ensured. Therefore, it proposes that the Constitutional Court make a judgment to annul Art. III, point 1 of Act No. 210/1997 Coll., which amends and supplements Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, in the part identified by the number and punctuation "48".

## II.

The Chamber of Deputies and the Senate of the Parliament of the CR, as parties to the proceedings, stated their positions on the proposal for a new legal regulation in accordance with § 69 of Act No. 182/1993 Coll., on the Constitutional Court.

## III.

The Constitutional Court, under § 68 para. 2 of Act No. 182/1993 Coll., on the Constitutional Court, proceeded to review whether Act No. 210/1997 Coll., which amended Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, was passed within the bounds of constitutionally prescribed jurisdiction and in a constitutionally prescribed manner and to review the contested provision itself. The Constitutional Court stated that the act was passed within the bounds of constitutionally prescribed jurisdiction and in a constitutionally prescribed manner.

## IV.

Provision of § 23 para. 7 of Act No. 586/1992 Coll., on Income Taxes was amended by Act No. 259/1994 Coll. and Act No. 316/1996 Coll., and before passage of the amendment in Act No. 210/1997 Coll. read: "If prices negotiated between persons connected economically or by personnel differ from prices which were negotiated between independent persons in ordinary business relationships under the same or similar conditions, and if this difference is not satisfactorily document, the tax administrator will adjust the taxpayer's tax base by the difference determined. For purposes of this provision, the price negotiated between independent persons in ordinary business

relationships when setting the interest rate on loans is considered to be interest of 140 % of the Czech National bank discount rate in effect at the time a contract is concluded. Persons are considered to be connected economically or by personnel if one person takes part directly or indirectly in the management, inspection or equity of the other person, or if the same legal entities or natural persons directly or indirectly take part in the management, inspection or equity of both persons or a related natural person. Taking part in inspection or equity means ownership of more than 25 % of the basic capital or holdings with voting rights. This provision does not apply to the provision by an employer, for compensation, of a room with necessary furnishings to a union organization for necessary operating activity.”

Point 48 Art. I of Act No. 210/1997 Coll. of 31 July 1997 added § 23 para. 7 of the Act on Income Taxes as follows: In § 23 para. 7, first sentence, after the words “by personnel” the words “or otherwise” are inserted. After the second sentence the following sentence is inserted: “This does not apply to cases where the creditor is a person with a registered address or home address abroad and the negotiated interest rate for a loan is less than 140 % of the Czech National Bank discount rate in effect at the time the contract is concluded.” After the words “a related person.” the following sentence is inserted: “Otherwise connected persons means persons who formed a business relationship primarily for the purpose of lowering a tax base or increasing a tax loss.” Subsequent amendments to the Act on Income Taxes did not affect § 23 para. 7.

Art. III Closing Provisions, point 1 of Act No. 210/1997 Coll. reads: “Art. I points 33, 34, 48, 51, 52, 62 [applying only to § 24 para. 2 let. zf)], 69, 98 and 114 shall apply for the tax period 1997.”

As stated above, the petitioner’s petition and arguments are not directed against amending the Act, but against the retroactivity of the closing provision, which causes a situation in which legal relationships arising before the day the Act becomes valid and in effect are subject to legal consequences established in a new legal regulation.

Under § 23 para. 7 of the Act on Income Taxes in the version before the amendment by Act No. 210/1997 Coll. the tax administrator could adjust the taxpayer’s tax base by the difference determined, if the prices negotiated between persons connected economically or by personnel differed from prices which were negotiated between independent persons in ordinary business relationships under the same or similar conditions, and if this difference was not satisfactorily documented. Under the new legal regulation, the tax administrator may also investigate a difference determined in prices which were negotiated not only between persons connected economically or by personnel, but also persons connected otherwise, and person connected otherwise are considered to include persons who formed a business relationship primarily for the purpose of reducing a tax base or increasing a tax loss. In the interest of limiting artificial tax reduction as a result of purpose-made business relationships, the tax advisor’s authority to retroactively inspect, investigate and punish this form of the taxpayer’s “commercial” conduct was expanded.

In its case law, the Constitutional Court of the CSFR discussed the ban on retroactivity in its judgment file no. Pl. US 78/92 (Collection of Decisions [and Judgments] of the Constitutional Court, 1992, no. 15), in which it stated that the principles of a state based on the rule of law require, in each possible case of retroactivity that it be expressly stated

in the Constitution or in a statute, with the aim of ruling out the possibility of retroactive interpretation of a statute, and also require that consequences tied to retroactivity be resolved in a statute so that acquired rights are properly protected. The Constitutional Court of the CR, in its judgment file no. IV. US 215/94 (US, vol. 3, no. 30) stated that the characteristics of a state governed by the rule of law inseparably include the principle of legal certainty and protection of the citizen's confidence in the law, and that this process includes the ban on the retroactivity of legal norms or their retroactive interpretation. The inadmissibility of retroactive effect of legal norms in the field of criminal law is expressly regulated in Art. 40 para. 6 of the Charter and Art. 7 of the Convention for the Protection of Human Rights and Fundamental Freedoms (the "Convention"); their application in other areas of law is derived from Art. 1 of the Constitution.

Legal theory and practice distinguish between true and apparent retroactivity. The substance of true retroactive effect is that it is possible, under a particular current legal norm, to judge legal facts or legal relationships which occurred before the legal norm went into effect, or the fact that the new legal norm can change the legal consequences which arose lawfully before the day when it went into effect. In apparent retroactivity, legal relationships which were valid when the old law was valid are governed by that law until the time when a new law goes into effect, but are then governed by that new law. The creation of legal relationships existing before a new legal regulation goes into effect and legal entitlements arising under them are governed by the original, annulled legal norm. Generally, in cases of overlap between the old and new legal norms, apparent retroactivity is applied.

Analysis of the principle of retroactivity is also contained in Constitutional Court judgment file no. Pl. US 21/96, published under no. 63/1997 Coll., in which the Constitutional Court considered the question of possible exception to the inadmissibility of retroactivity of legal norms. The judgment states that while apparent retroactivity is generally admissible, and is inadmissible only in exceptional cases, true retroactivity is, on the contrary, generally inadmissible, but there are strictly limited exceptions where it is admissible. To shed light on the question of when these exceptions to the ban on true retroactivity can be admitted, the Constitutional Court, with supporting citations from previous and current legal theory, stated: True retroactivity "can be justified at most in situations where the past legal obligation was previously already felt at least as a moral obligation" (A. Procházka, *The Retroactivity of Laws*. In: *Dictionary of Public Law*. Vol. III, Brno 1934, p. 800). This situation is also addressed and foreseen by the already cited article 7 of the Convention, which provides in paragraph 2 that ruling out the retroactive effect of criminal law norms "... does not prevent the conviction and punishment of a person for an action or failure to act which, at the time when it was committed, was punishable under general legal principles recognized by civilized nations." The cited judgment further states that we also find a similar opinion in current legal theory: "Generally, one can diverge from the ban on retroactivity only exceptionally, by an express positive provision. As is obvious from history, the reason for such steps was a situation where legal certainty would come into sharp conflict with social certainty and with legal consciousness, as was the case in the CSR in the case of retributive decrees. The retroactive effect of a law on civil law relationships could also be justified by public order (*ordre public*), primarily if absolutely mandatory regulations would be affected which had been issued as a result of a particular marginal situation of the transformation of valued in society." (L. Tichý, *On the*

Application in Time of the Amendment of the Civil Code, Lawyer, no. 12, 1984, p. 1102). The criterion for admissibility of exceptions to the principle of a ban on true retroactivity is the legislative principle of “protection of justified confidence in the permanence of the legal order” (A. Procházka, Principles of Intertemporal Law, Brno 1928, p. 111). Justified confidence can come into consideration if a subject of law must, or had to, expect retroactive regulation. An example of such a situation is the application of a legal norm which is in sharp conflict with fundamental, generally recognized principles of humanity and morals: “In our legal order we can justify, by reference to the previously dominant moral conviction, e.g. the retroactive effect of usury laws (see § 13 of Act No. 47/1881 Imperial Laws, § 10 Imperial Order no. 275/1914 Imperial Laws , § 105 III. partial amendment to the Civil Code).” (A. Procházka, Retroactivity of Laws. In: Dictionary of Public Law. Vol. III, Brno 1934, p. 800.)

For the sake of completeness, the Constitutional Court adds to the foregoing that the cited “principles recognized by civilized nations” can, in their aggregate, scarcely be understood to mean anything other than a system of values established in society. Values are of fundamental importance in society, and play an irreplaceable role, because it is only thanks to them that human society can not only exist, but communicate historically and socially. Without them, social development would fall apart into a mosaic of unrelated social events and social structures into non-communication social units. In the aggregate of all their individual forms, values thus create “the rules of the game”, the observance of which, although they always were and probably will be violated, always reveals itself again to human society as a basic condition for its existence and social development.

It is to this system of values that the legal system, containing ethical and legal norms, is connected. If values can be defined to mean models of social thought and action, characteristics, social conditions and events, and institutional forms whose common feature is their being applicable, subject to consent, for a certain aim and purpose, norms can be defined as rules, orders, prescriptions for a certain manner of social conduct, subject to and secured by sanctions, which is recognized or established to attain such an aim or purpose. Values share a common base with norms insofar as together with them they form a society’s value system and legal order, as its constituent, establishing and organizing principle. Within this value system and legal order, however, values and norms fulfill particular, often closely related but nevertheless mutually non-substitutable functions. Both, values and norms, are marked by a relationship to a particular goal or purpose, but it is only values which indicate a general historical and social direction, constitute the envisioned aim and the basic method of achieving it, while the direct implementation of the form of values is a matter for norms. However, despite this executive nature and the dependence on a given value system, the social function of norms can not be underestimated and connected only with the technical aspect of social events. It is norms that represent the instrument that makes possible not only the implementation of values, but also their verification; norms help to bring a value system to life, and the success or failure of this effort indicate its social utility and applicability. Because values are primarily models for social behavior, and as such appear as idealized types, they can hardly be translated into legal norms in their full breadth. A society which tried to enact everything in law would ultimately create an extensive vacuum between the claimed conduct and its possibilities, which would in the end be composed of simulative and fictitious elements.

The foregoing excursion about the system of values and legal order may help us to better understand issues relating to true retroactivity, whose admissibility, in view of the breadth of values, is projected into all areas of social relationships, particularly legal relationships. Thus, if a certain model and manner of social thought and conduct has been consensually established in the value system and consciousness of society, which, for various reasons, e.g. as a result of the pressure from a certain political system, could not find normative expression, then the legal regulation of that conduct, containing retroactivity, remains fully in accordance with the principles of a democratic state based on the rule of law. In other words, it would, on the contrary, be inconsistent with the principles of justice if, in such cases, true retroactivity did not have its say. However, all this should all the more distinctively indicate that true retroactivity has no place in a state governed by the rule of law in situations where the legislature already could have had its “say” but did not do so.

Starting with these theoretical foundations in evaluation the present matter the Constitutional Court concluded that point 1 Art. III, referring to point 48 Art. I of Act No. 210/1997 Coll. has the effects of true retroactive effect.

Because, from a constitutional law standpoint, the legislature’s decision on the manner of resolving the overlapping in time of old and new legal regulations is not a matter of chance or arbitrariness, but is a matter of consideration of conflicting constitutional law principles, the Constitutional Court considered whether conditions exist for allowing an exception from the principle of forbidding true retroactivity, which would permit the constitutional admissibility of this legal norm. The framing of tax policy is a matter for the state, which determines what the tax burden on the taxpayer of a particular tax will be and how it will regulate his obligations in connection with verifying the correct assessment of tax. The Act on Income Taxes, in its original version of 1992, established the use of usual market prices in the event that negotiated prices differ from them and the difference is not satisfactorily documented, with this procedure to be used whenever there was interconnection by personal or economic interconnection between the same legal entities or natural persons. Act No. 259/1994 Coll., in effect as of 1 January 1995, added to the Act on Income Taxes the obligation to satisfactorily document the difference between prices negotiated between entities connected economically or in personnel and prices negotiated between independent entities in ordinary business relationships under the same or similar conditions. This amendment narrowed the obligations of the taxpayer, who in future had to pay attention to satisfactory documentation of the price difference only in certain legal relationships foreseen by the law, and bore the consequences for any failure to fulfill this obligation in the form of a tax base adjustment by the tax administrator. Act No. 316/1996 Coll., in effect as of 1 January 1997, provided what was considered to be a price negotiated between independent persons in ordinary business relationships in setting the level of interest for loans, which did not expand the range of legal relationships subject to the law. Thus, until the amendment passed by Act No. 210/1997 Coll., the taxpayer could justifiably expect that in creating legal relationships he would have to document a price difference to the tax administrator and bear the consequences if he did not do so only with some of them, while with other legal relationships he would not be subject to this obligation. The Constitutional Court therefore believes that this case is a case of the taxpayer’s justified faith in the law, because in the legal situation at the time to which the retroactive norm applies, the taxpayer could not presume any flaw in his conduct and could not expect the possibility of retroactive change.



Although social relationships began to show signals that indicated the need for new legal regulation, which is the subject of the matter at hand, the legislature, in a democratic state, did nothing to limit disadvantageous effects earlier, i.e. by a regulation pro futuro. Thus, in this case conditions do not exist to accept an exception from the ban on true retroactivity, nor can the constitutional conflict be overcome through interpretation. The argument of the Chamber of Deputies, that in this case the tax administrator surely also relied on § 23 para. 10 of the Act on Income Taxes, changes nothing about the above mentioned conclusion. Under this provision “The tax base is determined on the basis of accounting maintained according to a separate regulation 20), unless a separate regulation or this Act provides otherwise or unless the tax obligation is reduced by another method.” According to the footnote, the separate regulation means Act No. 563/1991 Coll., on Accounting, the Directive on the Chart of Accounts and Principles of Single Entry Accounting published in the Collection of Laws. The Constitutional Court considers § 23 para. 10 of the Act on Income Taxes to be incapable of justifying an exception to the ban on true retroactive effect of point 1 Art. III, referring to point 48 Art. I of Act No. 210/1997 Coll., and it found no other grounds for doing so.

For the above mentioned reasons the Constitutional Court granted the petition of the Ostrava Regional Court and, under § 70 para. 1 of Act No. 182/1993 Coll., on the Constitutional Court, annulled Art. III point 1 of Act No. 210/1997 Coll., which amends and supplements Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended by later regulations, in the part identified by the number and punctuation “48,” as of the day this judgment is published in the Collection of Laws.

**Decisions of the Constitutional Court can not be appealed.**

Brno, 12 March 2002