2010 EATLP Congress, Leuven
27-29 May 2010

Retroactivity of tax legislation

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This volume of the EATLP Congress Reports is financially sponsored by the IBFD which also acts as the distributor.

ISBN 978-90-816475-0-2

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3.8.1. Introduction

The practice of retroactive tax legislation in Germany is considerably influenced by extensive case law provided by the German Constitutional Court. Since the first decisions on retroactivity in the 1960s tax legislation has been the main area in which this court practice has developed.

For almost 50 years the Constitutional Court practice on retroactive tax legislation has been quite steady. However, very recently the Court significantly changed its approach to retrospectivity. In three judgments of 7 July 2010 the Court strengthened the position of the taxpayer[1]. Due to several requests for constitutional review of German fiscal courts and some constitutional complaints by individual taxpayers the judges at the Constitutional Court also granted protection against changes which are considered to have only retrospective effect. This new development is not yet reflected in the academic debate, yet will probably affect it to a considerable extent.

3.8.2. Terminology in Germany

3.8.2.1. Distinction between retroactivity and retrospectivity

Based on the case law of the Constitutional Court, the prevailing German doctrine sharply distinguishes between retroactivity and retrospectivity as two quite differently conceived categories[2]. In terms of terminology, retroactivity is called "real' or 'true' retroactivity ('*echte Rückwirkung*' or '*Rückbewirkung von Rechtsfolgen*'[3]); retrospectivity is called 'pseudo' retroactivity (*unechte Rückwirkung*, '*tatbestandliche Rückanknüpfung*'[4]).

A statute is considered to have retroactive effect when it applies to transactions/cases which have been closed before promulgation of the new law. In this case the new statute alters legal effects produced prior to its existence. In contrast to this, retrospectivity exists if

1. Judgment of the Federal Constitutional Court (Bundesverfassungsgericht, BVerfG), reference number 2 BvL 14/02 of 7 July 2010, www.bverfg.de/entscheidungen/ls20100707_2bvl001402.html; reference number 2 BvL 1/03 of 7 July 2010, www.bverfg.de/entscheidungen/ls20100707_2bvl000103.html; reference number 2 BvR 748/05 of 7 July 2010, www.bverfg.de/entscheidungen/rs20100707_2bvr074805.html.
2. Since judgment of the Federal Constitutional Court (Bundesverfassungsgericht, BVerfG) of 31 May 1960, Decisions of the Constitutional Court (Entscheidungen des Bundesverfassungsgerichts, *BVerfGE*) 11, at p. 139 (145-146).
3. This terminology is used since judgment of the Federal Constitutional Court of 14 May 1986, *BVerfGE* 72, at p. 200 (242), by the Second Senate of the Federal Constitutional Court, but does not have a different meaning.
4. Terminology of the Second Senate of the Federal Constitutional Court (see supra footnote 3).

the new statute applies to transactions/economic activities which have begun in the past but are not yet concluded[5].

In the past the attribution to one of the two categories was of eminent importance, because it pre-determined the outcome whether the statute was held to be unconstitutional or not (see in detail below section 3.8.4.2). That was because the Constitutional Court classifies retroactive laws in principle as prohibited, whereas laws with only retrospective effect are in general permitted. There were only a very few judgments where in the case of mere retrospectivity the Constitutional Court nevertheless held a law unconstitutional for the reason of violation of the appellant's legitimate trust in the continuity of legislation. But these cases had been decided in other fields, not in tax law. Up to 2010 there was not a single case of a solely retrospective tax statute being abrogated by the Constitutional Court. This situation changed due to three judgments of 7 July 2010. Here, the Constitutional Court acknowledged for the first time that under certain conditions the taxpayer's confidence needs to be protected against mere retrospective changes of the tax law as well and abrogated on these grounds several retrospective changes (see in detail below section 3.8.4.2).

The tax literature is divided; some authors promote a uniform concept of retroactivity[6] mainly to avoid the pre-determination which is the result of the sharp line drawn between (true) retroactivity and retrospectivity (pseudo retroactivity) by the Constitutional Court. However, most authors want to adhere to the distinction[7], even though many criticize the outcome of court practice in cases of retrospectivity. But the fear is that if the distinction between (true) retroactivity and retrospectivity (pseudo retroactivity) is given up, one could no longer rely on the relatively predictable results of the ban of (true) retroactivity as a general principle.

The ultimate problem is to determine the moment the transaction/taxable activity is closed, so amendments/new tax obligations after this date have to be considered retroactive. The difficulties can be illustrated by the reform of the capital gains taxation in Germany in 1999[8], which led to several requests for constitutional review[9] and constitutional complaints, which were decided on 7 July 2010[10].

With Tax Relief Act 1999/2000/2002 (Steuerentlastungsgesetz) the legislator extended the deadline in which capital gains from real estate sales are taxed from two to ten years. The bill was adopted in parliament on 4 March 1999, and published on 31 March

5. E.g. judgments of the Federal Constitutional Court of 31 May 1960, *BVerfGE* 11, at p. 139 (146); of 19 July 1967, *BVerfGE* 22, at p. 241 (248); of 20 June 1978, *BVerfGE* 48, at p. 403 (415).
6. E.g. Dieter Birk, 'Steuerrecht und Verfassungsrecht – Eine Analyse ausgewählter Entscheidungen des Bundesverfassungsgerichts und des Bundesfinanzhofs zu verfassungsrechtlichen Grenzen der Besteuerung', *Die Verwaltung* (DV), Vol. 35, p. 91 ff, at pp. 109, 111; Joachim Lang, 'Verfassungsrechtliche Zulässigkeit rückwirkender Steuergesetze', *Die Wirtschaftsprüfung* (WPg.) (1998), pp. 163 ff.; Monika Jachmann, 'Zur verfassungsrechtlichen Zulässigkeit rückwirkender Steuergesetze', *Thüringer Verwaltungsblätter* (ThVBl.) (1999), pp. 269 ff.; Johanna Hey, *Steuerplanungssicherheit als Rechtsproblem* (Cologne: Dr. Otto Schmidt Verlag, 2002), at p. 247 and to other concepts in literature at pp. 233-239.
7. See e.g. Klaus-Dieter Drüen, 'Rechtsschutz gegen rückwirkende Gesetze – eine Zwischenbilanz', *Steuer und Wirtschaft* (StuW) (2006), at pp. 358-365; Roman Seer & Klaus Dieter Drüen, 'Der rückwirkende Steuerzugriff auf private Veräußerungsgewinne bei hergestellten Gebäuden auf dem verfassungsrechtlichen Prüfstand', *Finanzrundschau* (FR) (2006), at p. 661 (668).
8. By Tax Relief Act (Steuerentlastungsgesetz) 1999/2000/2002 of 24 March 1999, Federal Law Gazette I 1999, at p. 402.
9. Request of the Fiscal Court of Cologne of 25 July 2002, reference number 13 K 460/01, *Entscheidungen der Finanzgerichte* (*EFG*) 2002, at p. 1236; request of the Fiscal Court of Cologne of 24 August 2005, reference number 14 K 6187/04, www.fg-koeln.nrw.de; request of the Supreme Tax Court (Bundesfinanzhof) of 16 December 2003, reference number IX R 46/02, *Federal Tax Gazette II* 2004, at p. 284.
10. See footnote 1.

1999. Nevertheless, the extended holding period applied to all sales concluded after 31 December 1998.

One could argue that up to the moment of buying the property – let's say on 30 June 1995 – the taxpayer reckoned with the chance of selling the property any time after 30 June 1997 (after the two-year speculative holding period) without any fiscal consequences. That was possibly the reason why he decided to make a real estate investment. However, nobody would consider the taxable event at this moment as already fully closed.

So what is the critical date? After which point does the taxpayer deserve protection of his confidence in the existing legal situation? The moment when the former two-year holding period expired[11]? The moment he concluded the contract to sell the property? The moment he received the sales price from the buyer? Or the moment when the annual tax obligation of the tax period, in which he sold the property, arose (= the end of the fiscal year)?

In its judgment *2 BvL 14/02* of 7 July 2010[12] the Constitutional Court deemed the expiration of the two-year speculative holding period crucial. From this moment the taxpayer could expect that his position of being able to sell the property tax-free would be respected by the tax legislator.

3.8.2.2. The relevance of the tax period for the distinction between retroactivity and retrospectivity

In this context, one of the biggest controversies between the Constitutional Court and the tax literature as well as the fiscal courts is the relevance of the accrual of the tax obligation by the end of the year.

In as early as 1961 in one of its first judgments on retroactivity in tax law[13], the Constitutional Court invented a tax period-related concept for the distinction between retroactivity and retrospectivity (known as '*Veranlagungszeitraumrechtsprechung*'). Due to the fact that the tax obligation of all period-related taxes (especially personal/corporate income tax, value added tax) arises only at the end of the year, the Court concluded that a tax case is not closed until the end of the year, because the legal consequences are still open. Therefore, insofar as the new statute is promulgated before 31 December, it is considered to be only retrospective, even if it applies from 1 January of the current year. Only if the new law also claims application for previous years is it conceived to be retroactive.

In a leading decision of 14 May 1986[14] the Constitutional Court reaffirmed its case law. This was caused by a request for constitutional review of the Supreme Tax Court[15], which had challenged the formal view of the tax period-related distinction between retroactivity and retrospectivity.

German tax literature opposes this view almost unanimously (see below section 3.8.7). The main argument against the tax period-related distinction between retroactivity and retrospectivity is that the accrual of the tax obligation at the end of the year is of a merely technical character, but provides no insight as to whether the relevant taxable event had taken place before. The taxpayer deserves legal certainty about the tax consequences the moment he performs transactions (known as '*dispositionsbezogener Rückwirkungsbegriff*').

11. So Dieter Birk & Egmont Kulosa, 'Verfassungsrechtliche Aspekte des Steuerentlastungsgesetzes 1999/2000/2002', *Finanzrundschau* (FR) (1999), at p. 433 (438); contra, Supreme Tax Court of 16 December 2003 reference number IX R 46/02, Federal Tax Gazette II 2004, at p. 284.
12. See footnote 1.
13. Federal Constitutional Court Judgment of 19 December 1961, reference number 2 BvL 6/59, *BVerfGE* 13, p. 261.
14. Federal Constitutional Court Judgment of 14 May 1986, reference number 2 BvL 2/83, *BVerfGE* 72, p. 200.
15. Request of the Supreme Tax Court of 3 November 1982, reference number I R 3/79, *Federal Tax Gazette II* 1983, p. 259.

In its famous decision on the abolishment of tax subsidies for shipbuilding investments of 3 December 1997[16], the Constitutional Court accepted for the first time that there are transactions which are fully closed before the end of the fiscal year. However, it limited its decision to tax subsidies, holding that here the taxpayer in particular depends on the reliability of the tax legislation.

The German Supreme Tax Court, in line with the tax literature, held in a request for constitutional review of 2 August 2006 that this view also needs to be applied to regular tax provisions[17], with the only aim of producing revenue, because they often influence the behaviour of the taxpayer in the same way as tax incentives. Therefore, the taxpayer needs to know the tax consequences of his economic operations at the time he is undertaking them.

In its answer to this request the Constitutional Court did not alter its distinction between retroactivity and retrospectivity. In the judgments of 7 July 2010 the Court adhered to the tax period concept[18]. In the above example (see section 3.8.2.1) concerning the extension of the holding period for tax-free capital gains on real estate, it characterized the change as only being retrospective even to the extent it applied to transactions concluded between 1 January 1999, and 31 March 1999, the date of the promulgation of the Tax Relief Act 1999/2000/2002. However, at the same time – and this *is* a major change – the distinction between retroactivity and retrospectivity became less important because the Constitutional Court postulated protection against retrospective changes as well. Therefore, the tax period-concept probably will lose relevance.

It will be interesting to observe how this change in the Court's practice will affect the legislator's behaviour. In the past the German tax legislator made excessive use of the tax period concept. Very often tax statutes were enacted hastily at the end of December to allow them to enter into force for the whole fiscal year starting from 1 January. The legislator applied the period-related concept of the Constitutional Court even for inheritance tax, despite the fact that the inheritance tax claim accrues upon the event of the succession, and not only at the end of the year[19]. So far the legislator could feel safe in doing so, because changes within the tax period for the whole fiscal year always passed the review by the Constitutional Court without any special burden of justification. In the future, according to the judgments of 7 July 2010 the tax legislator needs to provide a special justification if he wants to apply a change retrospectively from 1 January if the law is enacted later in that particular year.

3.8.2.3. Interpretative statutes: legislative purpose of clarification

There is no special category of 'interpretative statutes' in German law-making. A technical term like 'interpretative statutes' is unknown.

16. Judgment of the Federal Constitutional Court of 3 December 1997, reference number 2 BvR 882/97, *BVerfGE* 97, at p. 67; see for detailed reviews of this decision Johanna Hey, 'Die rückwirkende Abschaffung der Sonderabschreibung auf Schiffsbeteiligungen', *Betriebs-Berater* (BB) 1998, at p. 1444; Anna Leisner, 'Vertrauen in staatliches Handeln – ein unkalkulierbares Risiko?', *Steuer und Wirtschaft* (StuW) (1998), at p. 254; Rolf Schmidt, 'Abbau der einkommensteuerlichen Förderung von Handelsschiffen verfassungsgemäß', *Der Betrieb* (DB) (1998), at p. 1199.
17. Supreme Tax Court of 2 August 2006, reference number XI R 34/02, *Federal Tax Gazette II* 2006, at p. 887; as well Supreme Tax Court of 16 December 2003, reference number IX R 46/02, *Federal Tax Gazette II* 2004, at p. 284 (291 ff.).
18. See Judgment of the Federal Constitutional Court (Bundesverfassungsgericht, BVerfG), reference number 2 BvL 14/02 of 7 July 2010, http://www.bverfg.de/entscheidungen/ls20100707_2bvl001402.html, para. 62; see also the answer to the request of the Bundesfinanzhof of 2 August 2006, reference number 2 BvL 1/03 /footnote 1) para. 70.
19. Inheritance tax reform 1996 with Annual Tax Act 1996, *Federal Law Gazette I* 1997, at p. 378, adopted in parliament December 20, 1996; promulgated February 27, 1997, effective from January 1, 1996.

However, the legislator often claims that an amendment of an existing provision has the purpose of eradicating doubts about the correct interpretation of the legal wording ('*Klarstellungsinteresse*'). These 'clarification' provisions are often enacted with retroactivity, sometimes applicable to all pending cases (tax assessments which are not yet final and conclusive).

In general, these statutes have to be considered retroactive, when the new wording has to be applied earlier than entry into force[20]. Only in cases in which the 'clarification' statute would have an exclusively declaratory effect, could it be considered to be not retroactive, because it does not change the legal situation. Nonetheless, often these so-called clarifications in fact lead to a significant tightening of the prevailing legal situation.

In the legal history of an amendment one finds usually only a broad-brush indication of the legislative intent of 'clarification', which does not allow the distinction between an merely declaratory and a constitutive amendment. The identification of a merely interpretative statute is, of course, deeply intermingled with the dogmatic approach to the boundaries of interpretation of tax codes in the light of the principle of legality[21]. To be only interpretative the new law would need to stay within the constitutional limits of interpretation of the previous wording. It might deviate from the interpretation given by the Supreme Tax Court; nevertheless, still has to be compatible with the wording of the tax statute as it was so far. This is often questionable.

Furthermore, it is important to distinguish changes in tax statutes with the legislative intent of closing loopholes ('*Lückenfüllung*'). Here, the wording is too narrow, either because of a mistake of the legislator or because of new tax planning constructions which came up after implementation of the original statute. In this case the intended fiscal result cannot be reached by interpretation (of course, the problem is closely related to the controversy of the legitimacy and scope of 'economic interpretation' and analogy in tax law).

In both situations, the legitimacy of a retroactive entrance into force is not fully resolved. There are some decisions where the Constitutional Court accepted retroactive legislation if the existing law was unclear and confusing[22]. However, this exception to the ban of retroactivity dates back to the early period of court practice. It was developed to allow the legislator to overcome flaws of the legal system in the post-war situation[23]. In more recent decisions it has no longer been applied.

3.8.2.4. 'Validation Statutes' ('Nichtanwendungsgesetze')

Validation of the Supreme Tax Court's judicial decisions has become quite a frequent phenomenon[24]. Such *Nichtanwendungsgesetze* are often but not always enacted with retroactive effect. Especially if the legislator intends to overrule a change of the prevailing court practice the validation statute often is enacted with effect from the date of publication of the

20. On this see at length Johanna Hey, 'Vertrauen in das fehlerhafte Steuergesetz', *Deutsche Steuerjuristische Gesellschaft* (DStJG), Vol. 27 (2004), at p. 91.
21. See Frans Vanistendael in: Victor Thuronyi, ed., *Tax Law Design and Drafting*, Vol. 1 (Washington D.C.: International Monetary Fund, 1996) Chapter 2, at pp. 23-24 on the dogmatic approach to interpretation in Germany.
22. Judgment of the Federal Constitutional Court of May 4, 1960, reference number 1 BvL 17/57, *BVerfGE* 11, at p. 64 (72); of March 23, 1971, reference number 2 BvL 2/66, *BVerfGE* 30, at p. 367 (388); of January 17, 1979, reference number 1 BvR 446, 1174/77, *BVerfGE* 50, at p.177 (194).
23. See Gerhard Leibholz, Hans-Justus Rinck and Dieter Hesselberger, *Grundgesetz für die Bundesrepublik Deutschland* (Cologne: Dr. Otto Schmidt Verlag), Article 20 GG, marginal note 1637.
24. See also Wolfgang Spindler, *Liber amicorum for H. O. Solms* (Berlin: E. Schmidt Verlag, 2005) at p. 53; Wolfgang Spindler, 'Der Nichtanwendungserlass im Steuerrecht', *Deutsches Steuerrecht* (DStR) (2007), at pp. 1061-1066, president of the Supreme Tax Court, analyzing the increasing number of judicial decisions, most of them in favor of the taxpayer, which are overruled – either by a circular or by a tax statute.

Supreme Tax Court's new judgment. In this case, the validation statute is often initiated by a circular of the Ministry of Finance (known as '*Nichtanwendungserlass*'), stating that the new judgment will – except for the actual decided case – not be applied in general. This is done to prevent taxpayers from developing confidence in the new court practice.

In around 90% of the cases the validation will concern cases where the Supreme Tax Court has decided/changed its case law in favour of the taxpayer. This already gives evidence that validation legislation normally does not have the purpose of correcting a miscarriage of judgment, but is for mere fiscal reasons. This is important because it means that in most of the cases we are not dealing merely with a (different) interpretation of the prevailing statutes but with an aggravation.

Whether in these cases an exception to the ban on true retroactivity applies as well is not entirely clear. In a recent judgment of the Constitutional Court[25], it was argued that insofar as the Ministry of Finance announces immediately after publication of the new rule that the legislator will intervene, the taxpayer is not able to build up sufficient confidence in the new case law. Therefore, he does not need and cannot expect protection against retroactive validation.

The tax literature criticizes the practice of validation in general if it is done solely for revenue reasons[26]; it is even more opposed to the retroactive enactment of such legislation[27].

3.8.2.5. Relation between the date of publication and the date of entry into force

Conditio sine qua non for the entry into force of a statute is the publication in the Federal Law Gazette (see Article 82 para. 1 sentence 1 of the German Constitution). Without publication the law does not come into existence.

Hence, the date of effectiveness has to be distinguished from the date of publication. Normally statutes contain a special provision stipulating a date of effectiveness. It can be the date of publication. However, often this is a date in the future, such as 1 January of the following year, or 30 June, to create a clear and easy cut between the old and the new law. If this date of effectiveness is before the date of publication the law will be considered (truly) retroactive. Thus, in general the date of publication in the Federal Law Gazette marks the distinction between (true) retroactivity and retrospectivity.

But keep in mind that this general rule is derogated by the so far prevailing court practice of period-related distinction between retroactivity and retrospectivity in tax law (see above section 3.8.2). Accordingly, it does not even need a special provision to make the new statute applicable for the whole current fiscal year. It is sufficient to change the law by 31 December, because that means that the tax obligation will accrue as a result of the new law, according to the statutes in existence at the end of the tax period. To exclude transactions concluded before, the legislator would need to formulate transitional rules, saying e.g. that the new rule applies only for transactions after the date of adoption or the date of publication of the new law.

25. Judgment of the Federal Constitutional Court of May, 12, 2009, reference number 2 BvL 1/100, Vol.123, at p. 111 (May 12, 2009), reference number 2 BvL 1/00 and BFH/NV 2009, at p. 1382; also before Judgment of January 23, 1990, *BVerfGE* 81, at p. 228 (239).
26. See with many references Joachim Lang, in: Tipke/Lang, *Steuerrecht*, 20th ed. (Cologne: Dr. Otto Schmidt Verlag, 2010), § 5 marginal note 29-30.
27. E.g. Johanna Hey, *Steuerplanungssicherheit als Rechtsproblem*, (Cologne: Dr. Otto Schmidt Verlag, 2002), at pp. 327-329.

3.8.2.6. Concept of retrospectivity

Retrospectivity is a much more open concept than retroactivity. One could argue that almost every new statute affects economic activities which have been started in the past. The distinction between retrospectivity and mere future effects can again be illustrated by the recent reforms of capital gains taxation (see above section 3.8.1):

The 9th Senate of the Supreme Tax Court asked for constitutional review in a case where a taxpayer sold property only *after* publication of the extension of the holding period for tax-free capital gains by the Tax Relief Act 1999/2000/2002, although he knew that under the new law he was no longer able to sell the real estate without paying capital gains tax. However, the referring Senate argued that the new rule had retrospective effect, because it did not exclude property which was acquired before it came into force[28]. In weighing the interest of the legislator in changing the law against the taxpayer's interest in protection of his confidence the Supreme Tax Court gave priority to the latter.

The Constitutional Court (judgment *2 BvL 14/02*)[29] followed the request of the Supreme Tax Court because it did not consider the date of the sale of the property to be relevant, but the fact that the two-year holding period had expired before the law prolonged it to ten years. The requirement of the longer holding period to increases in value which had accrued before the new law was published was considered a violation of the taxpayer's legitimate expectations.

In contrast, the abolishment of the tax exemption for capital gains from shares by the Business Tax Reform Act 2008 was clearly not retrospective. The full taxation of capital gains had already been adopted on 14 August 2007[30], but is applicable only to capital gains from shares which have been *acquired* after 31 December 2008.

Less clear is whether the change from the old shareholder-related thin capitalization rule in sec. 8a of the Corporate Income Tax Act to the new general interest deduction ceiling has retrospective effect. It was also adopted by the Business Tax Reform Act 2008 of 14 August 2007 and applies – in case the fiscal year equals the calendar year[31] – to interest paid from 1 January 2008. Most authors argue that it has no retrospective effect, because it became effective only for future business expenses[32]. In contrast, one could consider it retrospective because it applies to existing loans, which often cannot be adjusted to the new fiscal situation quickly enough.

3.8.2.7. No categorical distinction between substantive and procedural statutes

In general, no distinction is made between the (retroactive) enforcement of substantive and procedural statutes. New procedural provisions principally apply also to pending cases, where the taxable event occurred in the past. However, unlike substantive statutes the tax period-related distinction between retroactivity and retrospectivity cannot be applied. Due

28. Request for constitutional review of 16 December 2003, reference number IX R 46/02, *Federal Tax Gazette II* 2004, pp. 284 ff. The taxpayer had bought the real estate in 1990, and sold it on 22 April 1999. That was three weeks after the legislator had promulgated the extention of the necessary holding period from two to ten years on 31 March 1999.
29. See footnote 1.
30. Business Tax Act Reform (Unternehmensteuerreformgesetz) 2008 v. 14. 8. 2007, *Federal Law Gazette I* 2007, at p. 1912.
31. If the fiscal year diverges from the calendar year, it applies already for all fiscal years beginning after 25 May 2007 (day of the adoption of the bill in parliament), and not ending before 1 January 2008 (Sec. 52 para. 12 d sentence 1 EStG). This is a quite common technique used for diverging fiscal years.
32. See e.g. Christian Hick, in: Herrmann/Heuer/Raupach, EStG/KStG-commentary, § 4h EStG Anm. J 07-3.

to the general principle that a law may not impose an impossible obligation, a new procedural statute cannot stipulate duties to cooperate with respect to the past.

3.8.3. Ex ante evaluation of retroactivity

3.8.3.1. Constitutional limitations to retroactivity of tax laws

Only for criminal laws does the German constitution contain an explicit *ex post facto* (Article 103 para. 2 of the German Constitution). It cannot be analogously applied to retroactive tax provisions[33].

In tax law the German Constitutional Court bases the principle of non-retroactivity on the rule of law (Article 20 para. 3 of the German Constitution). It derives from the rule of law the principle of legal certainty and the principle of protection of legitimate expectations (confidence principle, principle of public trust = '*Vertrauensschutzprinzip*'). For limitations on retrospectivity the Court also refers to the constitutional guarantees of personal freedoms as long as the ban of (true) retroactivity is based on the concept of the rule of law. The ability-to-pay principle is not used.

3.8.3.2. Transition policy of the legislator

Within the constitutional margins the legislator is free in the design of the transition between old and new law. There are neither official nor unofficial guidelines on the transition policy. Surprisingly enough, the Ministry of Finance, who is drafting the tax bills in Germany, also does not apply a general guideline internally to the design of transitional law. Hence, it is decided case by case.

This lack of standardization creates a lack of certainty in itself, because the design of the transition from old to new law for the taxpayer is hard to predict.

The legislator normally, but not always, stays within the broad lines drawn by the Constitutional Court (see sections 3.8.2.1-4 and 3.8.4.2), especially by making use of the tax period-related distinction between principally allowed retrospectivity and in general forbidden retroactivity.

Retroactive effect is – as discussed above (see section 3.8.2.4) – regularly granted to 'validation statutes'.

Furthermore, the date of first application is very often – if not assigned to 1 January – accelerated from the date of publication to the date of the parliamentary decision (due to the case law of the German Constitutional Court, which allows the legislator to go back to the adoption of the bill in parliament even though it is considered to be a true retroactivity, see also below section 3.8.4.1). The reason for this common practice of retroactivity is to prevent taxpayers with the knowledge of the intended abolishment of a tax advantage trying to make extensive use of the (old) more favourable rule before the new statute actually comes into force (so-called 'announcement effects').

The *grandfathering policy* of the German tax legislator appears to be quite arbitrary. Only in some standard situations can recurring patterns be identified. For example, in the case of a change of amortization rules, acquisitions done in the past are normally excluded, whereby the cut-off date is often not the date of the publication of the new statute, but the adoption of the bill in parliament or even earlier (e.g. the date when the bill was proposed). Contrary to this, in the case of new restrictions to the offsetting losses, there is no pattern conceivable. In the majority of cases they apply also to losses which already occurred in the

33. Prevailing opinion, see e.g. Klaus Tipke, *Die Steuerrechtsordnung*, Vol. I, 2nd. ed., (Cologne: Dr. Otto Schmidt Verlag, 2000), at p. 147.

past, but sometimes loss-producing activities carried out before the new statute was adopted are excluded. The different treatment cannot be traced back to the legislative purpose, e.g. anti-abuse legislation.

In recent years a tendency to more generous grandfathering by the legislator is seen. This might be a reaction to the many requests for constitutional review by the Supreme Tax Court, calling for stricter standards than in the past. This can be proved again by the example of the reform of capital gains taxation in 1999 and 2009. Whilst the extension of the periods in which private capital gains are taxed in the Tax Relief Act 1999/2000/2002 has been granted without any grandfathering, even with real retroactivity (see above section 3.8.2.2), the abolishment of the tax-free capital gains from shares by the Business Tax Reform 2008 applies only to shares *acquired* after 31 December 2008. Shares acquired before this deadline will remain without any time limitation under the old regime, meaning that they can be sold tax exempt after a holding period of one year.

It will be interesting to observe if and how the judgments of 7 July 2010[34] change the legislator's transition policy. The Constitutional Court made it very clear that the tax legislator needs *special* reasons for retrospective legislation to overcome the taxpayer's confidence.

3.8.3.3. No ex ante control by an independent body

An *ex ante* evaluation of possible infringements of the Constitution by an independent body is unknown in Germany. The parliament can ask advice from its academic service (*Wissenschaftlicher Dienst des Bundestages*). However, this instrument is hardly ever used. Sometimes also the Federal Council (*Bundesrat*) issues a caveat regarding single provisions even though in the end it gives its required consent to the bill.

3.8.4. Use of retroactivity in legislative practice

3.8.4.1. The role of adoption of the bill in parliament

Very often the tax legislator provides retroactivity till the date of the adoption of the bill in parliament – regardless whether there has been a special press release making the parliamentary adoption public. Even though this practice is considered to be truly retroactive, the Constitutional Court considers it justified, without asking for special reasons of justification.

The rationale behind this court practice is that from the date of adoption of the new statute in parliament the taxpayer can no longer trust the continuity of the prevailing legal situation. In the general legal literature this exception to the principle of non-retroactivity is hardly questioned anymore.

Nonetheless, it is necessary to query this practice. Most tax statutes in Germany need the consent of the Federal Council; otherwise they fail. For this reason the adoption of a bill in parliament is only a first step. Especially if the political majorities in the Federal Parliament and the Federal Council are divergent it is doubtful whether the bill will be accepted and, if so, with which content. It can take weeks to some months until the fate of the bill is sealed. For the taxpayer this creates the unpleasant situation that he can neither trust in the still-prevailing legal norms nor in the announced changes.

For this reason the tax literature opposes the practice of retroactivity until the adoption of the bill in parliament. The main reason for this opposition is the special feature of a tax law, whereby the consent of the Federal Council is required in order for it to be

34. See footnote 1.

adopted[35]. This could lead to an approach where the tax legislator is allowed to go back to the date of the consent in the Federal Council.

The 11th Senate of the Supreme Tax Court in a request for constitutional review of 2 August 2006[36] challenged the Constitutional Court practice in an even more fundamental way. The requesting Senate insisted that the earliest constitutionally valid date for enforcement is the date of promulgation in the Federal Law Gazette. Deviation from this date would *always* require a *special* justification apart from the fact that the taxpayer might have previously gained knowledge from the adoption of the bill in parliament. The Senate emphasized the fact that formal publication of new statutes in the constitutionally provided organ of publication is a very important characteristic of a state under the rule of law. For good reasons the Constitution provides *only one* organ for publication as an essential requirement for a statute to come into existence. It is not reasonable to demand that the taxpayer to take note of an emerging new statute from other sources, which do not have the same reliability as the Federal Law Gazette.

In its answer to the request of the Supreme Tax Court the Constitutional Court[37] basically reiterated its position that the taxpayer's confidence in the prevailing legal situation is abating with the progress of the legislative procedure. Already after the tabling of a new bill the taxpayer needs to be aware of the change. The Constitutional Court refers to the taxpayer's responsibility to take precautions, e.g. to negotiate adjustment clauses. Furthermore, it can be required that the taxpayer take legal advice to shelter from negative effects of retrospective changes of the law.

3.8.4.2. Retroactive application from first announcement

The legal relevance of media reports about amendments of tax laws is also a highly controversial topic in Germany. There is no standardized practice of publishing changes of the tax code ahead of the formal law-making procedure. Sometimes upcoming changes of the tax law will be announced by an official press release of the Cabinet or the Ministry of Finance. Besides official announcements, plans to abolish tax subsidies or to impose higher tax burdens are often communicated by private media even before the legislative procedure starts, just on the basis of rumours and 'insider' information.

According to the case law of the Constitutional Court, which does not differentiate between the quality of the announcement (official press release or any other kind of media coverage), announcements are relevant in order to prove whether the trust of the taxpayer in the existing law is reasonable or not. Thereby the Constitutional Court makes a distinction between merely retrospective laws and retroactive laws[38]. Whilst it considers press reports to weaken the trust of the taxpayer in retrospective statutes, it used to be permanent court practice that the earliest moment the taxpayer has to envisage a retroactive enforcement of a statute is the adoption of the bill in parliament (see above section 3.8.4.1). However, in its shipbuilding subsidy decision of December 1997 the Court[39] seems to modify its practice, holding that if there is a risk of harmful distortions because taxpayers make excessive use of a subsidy before its abolishment, then the legislator is justified in enacting the statute with retroactivity until the press release.

35. E.g. Wolfgang Hoffmann-Riem, 'Rückwirkende Besteuerung der Bodenveräußerungsgewinne von Landwirten', *Deutsches Steuerrecht* (DStR) (1971), at p. 3 (4).
36. Supreme Tax Court of 2 August 2006, reference number XI R 34/02, *Federal Tax Gazette II* 2006, at p. 887.
37. Judgment reference number 2 BvL 1/03 of 7 July 2010 (see footnote 1), para. 74.
38. See comprehensively Johanna Hey, *Steuerplanungssicherheit als Rechtsproblem*, (Cologne: Dr. Otto Schmidt Verlag, 2002), at pp. 319-326.
39. Judgment of the Federal Constitutional Court of 3 December 1997, reference number 2 BvR 882/97, *BVerfGE* 97, at p. 67 (81).

The decision on the abolishment of fiscal shipbuilding subsidies had an even more special twist, because the Court had to decide about a situation, where the Cabinet on 25 April 1996 had announced that the subsidy would be abolished for contracts concluded after 30 April 1996. In the end, the legislator went back to the date of the cabinet decision, excluding – contrary to his announcements – contracts concluded between 25 April and 30 April. This clearly contravened the principle of good faith. However, the Constitutional Court sustained the tax statute at issue, accepting the legislator's intent to stop the run in shipbuilding investment which had occurred after the announcement by not increasing the existing overcapacity of cargo ships.

3.8.4.3. Retroactivity and pending cases

If a statute is enacted with unlimited retroactivity, then it applies to any pending procedure. Pending cases are normally not excluded from the application of the new statute.

This problem in particular occurs in cases of validation legislation (see section 3.8.2.4), where the legislator overrules a favourable decision of the Supreme Tax Court. Taxpayers who expected the favourable decision and who undertook legal action in parallel cases will not be able to benefit from the favourable change in the case law, if it is immediately overruled with retroactivity[40].

3.8.4.4. Retroactivity in favour of the taxpayer

In principle, the legislator is free to grant retroactive effect to tax statutes which are favourable to taxpayers. On the one hand, there are no constitutional restrictions. On the other hand, favourable changes with retroactive effect are rather rare. One of the reasons for the retroactivity of a favourable change might be to make up for a long political debate or a protracted legislative procedure. For example, some of the tax reliefs implemented to help business enterprises in the ongoing financial crisis have been adopted with retroactive effect.

If it is unclear whether a change will affect the taxpayer's situation positively or negatively (*double-edged changes*), the legislator sometimes makes the new law eligible for a transitional period, to be applied also for the past.

3.8.5. Ex post evaluation of retroactivity

3.8.5.1. Control by the Constitutional Court

Germany has a very effective system of *ex-post* control of legislative acts in order to protect taxpayers against unconstitutional taxation.

The capacity to dismiss a tax statute for infringement of the Constitution is exclusively with the Federal Constitutional Court. But there are different ways to take a matter to the Constitutional Court. Every German Court can ask for constitutional review by the Constitutional Court if it has doubts whether the law in question for a certain case is compatible with the Constitution. Hence, the taxpayer can already ask for presentation to the Constitutional Court at the lower tax court. Recently tax courts have been very active in presenting issues of retroactivity/retrospectivity to the Constitutional Court.

40. See e.g. the legislative answer to a change if the Supreme Tax Court's practice on joint ventures for local business tax purposes, in detail Paul Kirchhof and Arndt Raupach, 'Die Unzulässigkeit einer rückwirkenden gesetzlichen Änderung der Mehrmütterorganschaft', *Der Betrieb* (DB), Beilage 1 No. 22, (2001), pp. 1-18.

However, in case neither the lower court nor the Supreme Tax Court has constitutional doubts, then – after exhaustion of the recourse to the regular courts – the taxpayer himself can file an individual constitutional complaint claiming that the retroactivity/retrospectivity infringes the rule of law or the principle of public trust.

3.8.5.2. Standards applied to retroactive/retrospective tax statutes by courts

The history of the control of retroactivity by the Constitutional Court and the tax courts can be roughly characterized as follows:

The court practice of the Constitutional Court has been quite stable for around 50 years, even though it has continually been subject to profound criticism not only in the legal literature but also from the tax courts. In the 1980s the Supreme Tax Court attempted by a preliminary ruling to change the reasoning of the Constitutional Court regarding the tax period-related distinction between retroactivity and retrospectivity (see section 3.8.2.2)[41] – without success[42]. For the next 20 years the tax courts were resigned and just accepted the case law of the Constitutional Court. Then, in its judgment of 3 December 1997 the Constitutional Court indicated a possible change of its prevailing practice. This decision was the starting point not only for a lively discussion in the tax literature, but also for numerous new requests for constitutional review by the tax courts, questioning many of the rules set up by the permanent practice of the Constitutional Court. The material the tax courts could present to the Constitutional Court was enormous because in the late 1990s the tax legislator had often adopted retroactive tax statutes.

Most of the recent requests for constitutional review and individual constitutional complaints were decided in the judgments of 7 July 2010[43]. These judgments are very multifarious. They basically confirmed the prevailing court practice on the distinction between retroactivity and retrospectivity, but caused a sensation by changing the appraisal of retrospectivity.

This background is helpful for understanding differences between the court practice of the Constitutional Court and the tax courts, namely the Supreme Tax Court, though in the end only the court practice of the Constitutional Court is of interest, because the tax courts have no power to declare a retroactive tax statute invalid.

Because of the importance of the case law of the Constitutional Court as a guideline for legislative practice, most aspects have been discussed above. Here I will summarize them to give a compact overview:

Applying the described methods of distinction between retroactivity and retrospectivity (see above section 3.8.2.1 and 3.8.2.2) the Constitutional Court has held, in principle, that there is a ban of retroactivity, whilst retrospectivity – at least in the past – was generally accepted.

However, the principle of non-retroactivity does not apply absolutely, however, but allows important exceptions, which can basically be assigned to two underlying ideas:

a) A reasonable taxpayer cannot claim trust in the (still) prevailing legal situation. This is supposed to justify retroactive enactment
   - from the date of adoption of the bill in parliament (see discussion above section 3.8.4.1);
   - in the case of an evidentially unclear or unconstitutional legal situation.
   - This exception has hardly ever been used. It was invented to overcome the transitional period after the Second World War, thus in a situation where the legal system needed a full reorganization. The difficulty of this ground of justification is that the flaw in the law has to be evident for a 'normal' taxpayer.

b) The confidence in the prevailing legal situation has to be subordinated to the interest of the legislator to change the law retroactively. This applies if
   - the disadvantage the taxpayer suffers from the retroactive enactment is negligible.
   - this de minimis rule is merely an outcome of the principle of proportionality.
   - the legislator can claim overriding urgent/compelling public interest.

It is common understanding that mere public revenue interests are not sufficient to justify retroactive tax laws. Nevertheless, the reason of compelling public interest implies a wide latitude in argumentation. So far, the Constitutional Court has never used it as the only ground of justification, but has combined it with facts which shook the taxpayer's faith. This is particularly true of the legislative intent to combat announcement effects[44].

Retrospectivity is held unconstitutional only if the taxpayer can claim that his interest in continuity of the legal situation outweighs the public interest in changing the law. In the past, this requirement was very hard to meet, because the Constitutional Court in the balancing progress only took into consideration *the change as such*, and not a change with a sufficient grandfathering rule. In the judgments of 7 July 2010 the Constitutional Court sharpened the requirements for justification. As of now the legislator needs to prove a special urgency for the change to justify its application also to investments/economic activities started in the past. It is not enough that the change as such is justified (e.g. closing loopholes, abolishment of unjustified tax subsidies), but rather a special reason has to be provided why it has to be applied with retrospectivity. The breach of confidence must be *necessary* to foster the aim of the law. The mere aim to collect more revenue by application without grandfathering is not suitable to surmount the taxpayer's legitimate expectations. In the end there is an open process of the weighing of interests, but the legislator must observe the limits of reasonableness.

3.8.5.3. Test of retroactivity against Article 1 of the First Protocol to the European Convention of Human Rights (ECHR)

To my knowledge there has been no court decision where a retroactive statute has been tested against Article 1 of the First Protocol to the European Convention of Human Rights (ECHR).

3.8.5.4. Retroactivity of Acts of Parliament and subordinate legislation

The German Constitutional Court understands retroactivity mainly as a problem of the rule of law. The rule of law has two aspects, one of which is objective (the principle of legal certainty) and one expressing individual rights (the principle of public trust; confidence principle). The structure of the test against this principle of public trust is the following:

a) Sufficient basis for confidence
b) Confidence
c) Worthiness of being protected

Retroactive subordinate legislation would be tested in the same way as statutory tax laws. The taxpayer can claim to rely on subordinate legislation in the same way as on parliamentarian tax statutes.

41. Request of the Supreme Tax Court of 3 November 1982, reference number I R 3/79, *Federal Tax Gazette II* 1983, p. 259.
42. See rejection of the view of the Supreme Tax Court by the Federal Constitutional Court judgment of 14 May 1986, reference number 2 BvL 2/83, *BVerfGE* 72, p. 200.
43. See footnote 1.
44. See Judgment of the Federal Constitutional Court of 3 December 1997, reference number 2 BvR 882/97, *BVerfGE* 97, at p. 67 (81 ff.).

In contrast, resolutions of parliament as such have no immediate binding force on the taxpayer. Hence, they are not object of the protection of public trust. This causes the problem that the taxpayer – it is said to destroy his confidence in the still prevailing legal situation – cannot claim that he trusted in a resolution of parliament like the adoption of a bill as such if in the end the bill fails in the Federal Council.

3.8.5.5. Avoiding unconstitutional retroactivity by interpretation

Tax statutes have to be interpreted in conformity with the Constitution[45]. Not only the courts but also the tax authorities are required to interpret each statute in a way that avoids infringements of the constitutional principles of legal certainty and public trust. Constitutional interpretation has – in the margins of the wording – priority over the dismissal of a statute as unconstitutional. Hence, in the case law of the Supreme Tax Court transitional rules are interpreted in accordance to the principle of public trust.

3.8.5.6. Self-discipline of the legislator

Especially in the late 1990s the tax legislator pushed the limits set out by the Constitutional Court. He seemed to feel free to increase the tax burdens with retroactivity for the current fiscal year. This gave rise to numerous requests for constitutional review and constitutional complaints, which lead to the sharpening of the Constitutional Court's practice in its judgments of 7 July 2010.

On the other hand, there are fields where in the past the tax legislator was quite generous. This is particularly true for changes of depreciation rates or methods. Normally the new less favourable depreciation rule applies only to new acquisitions. Sometimes these transitional rules are in themselves retroactive in the sense that the deadline is a date before publication of the new depreciation rule, often the date of adoption in parliament, but they do not apply to assets acquired in previous years.

In contrast, if the tax legislator limits the fiscal effects of accruals it usually stipulates not only restrictions for the future set-up of accruals, but also requires the liquidation of accruals set-up in the past in the current or the following taxable years.

3.8.6. Retroactivity of Case Law

3.8.6.1. Transition practice of the Supreme Tax Court in cases of a change of the existing case law

Legitimacy versus necessity of transitional rules in the case of a change of the case law is a matter of quite some controversy in the academic literature[46].

This might be the reason why the practice of the Supreme Tax Court is not uniform at all:

- Sometimes the Supreme Tax Court itself formulates a transitional rule. This happened recently when the Grand Senate of the Supreme Tax Court changed its longstanding

45. See Klaus-Dieter Drüen, in: Tipke/Kruse, *Abgabenordung/Finanzgerichtsordnung* (Cologne: Dr. Otto Schmidt Verlag), § 4 AO marginal notes 238-239.
46. Pro see e.g. Johanna Hey, 'Schutz des Vertrauens in BFH-Rechtsprechung und Verwaltungspraxis', *Deutsches Steuerrecht* (DStR) (2004), at pp. 1897 ff; contra see Anna Leisner, 'Kontinuitätsgewähr in der Finanzrechtsprechung', *Deutsche Steuerjuristische Gesellschaft* (DStJG), Vol. 27 (2004), at p. 214; Michael Fischer, 'Rückwirkende Rechtsprechungsänderung im Steuerrecht', *Deutsches Steuerrecht* (DStR) (2008), at p. 697; on the whole Klaus-Dieter Drüen, in: Tipke/Kruse, *Abgabenordung/Finanzgerichtsordnung*, (Cologne: Dr. Otto Schmidt Verlag Cologne), § 4 AO marginal notes 116-118.

practice on the inheritability of loss carry-forwards for purposes of the personal income tax[47], but excluded transfers undertaken in the past regardless whether the tax procedures are still open. The Senate argued that also judiciary is bound by the rule of law. Despite the fact that judgments have no erga omnes effect, they also constitute the legal situation the taxpayer relies on. Literature reviews of this judgment were ambivalent[48]. The tax authorities followed the Supreme Tax Court and granted a transitional rule by a circular, even though the judgment of the Supreme Tax Court has no legally binding force except in the decided case.
- In other cases the Supreme Tax Court only suggests that the tax authorities should decide case by case to grant protection of the confidence, based on sec. 163, 227 of the General Tax Code (Abgabenordnung).
- In some cases the tax authorities grant protection of trust after a change of the case law of their own accord, no matter whether this issue was addressed or not by the Supreme Tax Court.
- Apart from the question of protection of confidence against retroactive application of a new rule the Supreme Tax Court also applies a principle of continuity of its case law[49]. The principle of continuity does not deal with the legal consequences of the abandonment of existing case law, but with the requirements for such abandonment. Substantial objective reasons are necessary to invent a new rule. However, the principle of continuity does not prevent changes in the case law, but only increases the burden of argumentation.

The Supreme Tax Court provides/initiates protection of confidence *only* if the new rule is unfavourable for the taxpayer.

In contrast, the Constitutional Court has a permanent practice of granting protection to the fisc's revenue interests. If it holds a statute unconstitutional in general, its decisions have *ex tunc* effect. The legislator is supposed to repair the legal situation from the beginning. However, in tax law the Constitutional Court very often deviates from this general rule in order to protect the national budget. For this purpose the Court grants its decisions only *ex nunc* effect, often even only pro future effect. This '*Unvereinbarkeitsrechtsprechung*' weakens the protection of taxpayers against unconstitutional taxation, and is rejected by the prevailing opinion in the tax literature[50].

3.8.7. Views in the literature

3.8.7.1. Main views in the literature

The tax literature promotes a principle of non-retroactivity. Most authors oppose the tax-period related distinction between retroactivity and retrospectivity[51]. There is broad support for the view of the Supreme Tax Court that the decisive moment has to be the closing of transactions by the taxpayer. This is the moment at which the taxpayer needs certainty about the tax consequences of his economic decisions. He is entitled to be protected against

47. Judgment of the Supreme Tax Court of 17 December 2007, reference number GrS 2/04, *Federal Tax Gazette II* 2008, p. 668.
48. Pro also referring to the US practice of prospective overruling Hans-Joachim Kanzler, "Vertrauensschutz oder Rückwirkungsverbot bei Rechtsprechungswandel im Steuerrecht – entschieden am Beispiel der Vererblichkeit des Verlustabzugs', *Finanzrundschau* (FR) (2008), at p. 465; contra see e.g. Michael Fischer, 'Rückwirkende Rechtsprechungsänderung im Steuerrecht', *Deutsches Steuerrecht* (DStR) (2008), at p. 697.
49. See with references of the case law and the discussion in the tax literature Klaus-Dieter Drüen, in: Tipke/Kruse, *Abgabenordung/Finanzgerichtsordnung*, (Cologne: Dr. Otto Schmidt Verlag), § 4 AO marginal notes 307-311.
50. See e.g. Roman Seer, in: Tipke/Lang, *Steuerrecht*, 20th ed., 2009, § 22 marginal no. 287.
51. See e.g. Joachim Lang, in: Tipke/Lang, *Steuerrecht*, 20th ed., 2009, § 4 marginal no. 177.

a later change of the legal consequences, especially when he is no longer able to adjust his behaviour to the new law.

Some authors promote a uniform concept of tax statutes which affect economic decisions made in the past (see also section 3.8.2.1). They argue that the sharp – nevertheless often arbitrary – line between retroactivity and retrospectivity hinders reasonable results especially for the latter group of merely retrospective changes in the legal situation. The worthiness of protection against retrospective tax legislation can be as high as in the case of a retroactive change. Hence, there is no categorical difference between retroactive and retrospective tax laws. It might only indicate different levels of intensity of the betrayal of the taxpayer's confidence. However, most authors want to stick to the bifurcated concept of retroactivity/retrospectivity, mainly because they fear that otherwise the – fairly effective – protection against retroactive changes could be jeopardized, but they call for a better protection against merely retrospective legislation as well.

Apart from these conceptual questions, the way the Constitutional Court applies the grounds of justification towards retroactive legislation is also the object of criticism.

3.8.7.2. Influence of the law and economics view

So far the law and economics view has had no impact on the jurisprudential debate in Germany. The reason for this could be that the whole debate in Germany is mainly driven by considerations of constitutional law, basically blind to the economic effects of retroactivity *vice versa* non-retroactivity.

The few protagonists of a greater freedom of the legislator to change tax statutes even retroactively or at least without grandfathering rules[52] base their point of view not on possible economic benefits, but on the democracy principle. They also fear a petrification of the law if the tax legislator were always obliged to provide grandfathering rules.

52. See e.g. Rainer Wernsmann, Grundfälle zur verfassungsrechtlichen Zulässigkeit rückwirkender Gesetze, *Juristische Schulung* (JuS) (2000), at pp. 39-43.

3.8.8. Annex I

Table 3-1. Changes of Tax Legislation: Constitutional Restrictions of Retroactivity