

Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited

By

Judith Freedman

Reprinted from British Tax Review
Issue 6, 2010

Sweet & Maxwell
100 Avenue Road
Swiss Cottage
London
NW3 3PF
(Law Publishers)

SWEET & MAXWELL

Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited

Judith Freedman*

Abstract

This article revisits the arguments made by John Avery Jones in 1996 for “less detailed legislation interpreted in accordance with principles.” His plea has been influential but perhaps not completely understood. Recent developments in the UK, particularly in the area of so-called “principles-based drafting” may not have assisted in promoting this cause. It is frequently argued that real improvements in tax law require a coherent underlying policy, not just drafting changes. Obviously, drafting techniques will not cure a poorly structured tax and so ideally the starting point would be improved policy. But we cannot afford to wait for a total policy overhaul. A different approach to the way we legislate could both improve the way we think about policy and result in better implementation, application and legitimacy in decision making. Principles-based drafting is not a solution to all ills. Nevertheless, it could offer one route, in appropriate cases, to improvement as well as, in other cases, highlighting the need for more fundamental reform. We should not give up this experiment simply because it has not yet delivered total success. No new drafting technique can deliver a perfect tax system, but it is worth persevering with principles-based legislation.

Introduction

There is an ongoing and long-standing debate about the best way to draft taxing statutes.¹ Recently the discussion has focused around so-called “principles-based legislation” (PBL). As is so often the case, Australia has been ahead of the UK in attempting to apply this methodology.² Arguably the applications of the methodology have not always been well chosen and they have been the subject of much criticism in both jurisdictions.³ In a recent article in this *Review*,⁴ Graeme Cooper, commenting on the Australian regime for the taxation of financial arrangements (TOFA), asked:

* Professor of Taxation Law, University of Oxford. The author would like to thank Geoffrey Loomer and John Vella, colleagues at the Oxford University Centre for Business Taxation, with whom she has worked on this general area but whose views she does not necessarily represent here and also Xunming Lim for research assistance.

¹ John Avery Jones pointed out in 1996, when this topic was also being discussed, that there is nothing new about this preoccupation—see John F. Avery Jones, “Tax Law: Rules or Principles?” [1996] BTR 580 and (1996) 17 *Fiscal Studies* 3 citing the Income Tax Codification Committee Report (1936) Cmd.5131. An early work on tax which foreshadows many of the later comments is S. Surrey, “Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail” (1969) 34 *Law and Contemporary Problems* 673. Many of these issues have also been discussed by The Renton Committee, *The Preparation of Legislation* (1975) Cmnd. 6033.

² G. Pinder, “The Coherent Principles Approach to Tax Law Design” [2005] *Treasury Economic Roundup* (Autumn) 75.

³ On the UK see for example D. Haworth, “Section 48 and Schedule 24: disguised interest” [2009] BTR 570; P. Williams, “Section 49 and Schedule 25: transfers of income streams” [2009] BTR 574; on Australia see Graeme S. Cooper, “Legislating Principles as a Remedy for Tax Complexity” [2010] BTR 334.

⁴ Cooper, above, fn.3, 359.

“It is one thing to argue that this experiment was found wanting. Does this mean that the entire experiment was flawed?”

This could be a general question posed on the purported use of PBL to date in both countries. Cooper’s answer is that the experience so far does not augur well for the future. This article considers whether we should give up on PBL now or keep trying. Indeed, the question arises whether we in the UK have actually tried it properly at all yet.

In order to answer these questions it is necessary first to consider what is meant by PBL and to recognise that one of the difficulties with this debate is that not everyone has the same notion of the implications of this term. Consideration of the various concepts put forward is the starting point for this article, which then turns to consider the different approaches that have been suggested, their pros and cons and some of the problems that have been experienced in attempts at application in the UK.

This is not simply a domestic topic, nor purely a tax topic. It raises fundamental questions about the interpretation of legislation, the separation of powers as between the legislature, the courts and the administration, and the level of detailed guidance required to satisfy basic requirements of the rule of law. Thus the issues to be discussed are pertinent to all tax systems and, as discussed briefly below, have been explored by many legal philosophers. It is also a debate which, like so many others, has been explored extensively by John Avery Jones. John’s work in this area has been a stimulus to both the academic study of the issue and its discussion in policy-making circles. On a personal note, John’s work was a major factor in leading the author to consider the issue in her inaugural lecture, later published in this *Review*.⁵ It therefore seems an appropriate topic to revisit for this special collection in John’s honour.

An important theme to be considered in relation to PBL is that of the changing judicial approach to tax law. Indeed, this was where John Avery Jones began his exploration in his seminal Institute for Fiscal Studies Annual Lecture in 1996.⁶ The lecture was given at a time when both the Tax Law Review Committee of the Institute for Fiscal Studies (TLRC)⁷ and the Inland Revenue (as it then was) had issued reports on simplifying and improving tax legislation.⁸ It was also a time at which the decisions of the European Court of Justice (ECJ)⁹ were becoming increasingly significant, and the resulting transplantation of ideas from other legal systems to the UK was speeding up. It is in that context that John made his comments and suggestions. He was developing the idea, put forward by Leonard Beighton in this *Review*,¹⁰ that the UK courts would have to move in the direction of applying principles due to the influence of European Community (now European Union (EU)) Law.

⁵ J. Freedman, “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle” [2004] BTR 332.

⁶ Avery Jones, above, fn. 1.

⁷ Tax Law Reform Committee (TLRC), *Interim Report on Tax Legislation* (1995) IFS. Available for download at: <http://www.ifs.org.uk/publications/1913> [Accessed November 19, 2010]; TLRC, *Final Report on Tax Legislation*, (1996) IFS. Available for download at: <http://www.ifs.org.uk/publications/1911> [Accessed November 19, 2010].

⁸ *The Path to Tax Simplification* (1995), Inland Revenue.

⁹ Now called the Court of Justice following the Treaty of Lisbon 2009 but still referred to as the ECJ in this article for ease of reference.

¹⁰ L. Beighton, “The Finance Bill Process: Scope for Reform” [1995] BTR 33.

That influence from EU law is continuing to increase and make real inroads into the way in which our judiciary reacts to issues and in particular to the interpretation of legislation.¹¹ In addition, the UK judiciary now works frequently with the Human Rights Act 1998, passed to give effect to the European Convention on Human Rights. This requires the courts to interpret legislation so as to give effect to the Convention as far as possible and therefore has required the judges to work with principles, a challenge with which they have shown themselves well equipped to deal.¹² The external influences on UK law experienced over the past few years may make this an area where the Australian and the UK experience are beginning to diverge, despite the common origins of the UK and Australian systems.

Principles and purposes—sorting out the terminology

The first task of this article is to attempt some clarification of the terminology in this context. Confusion of the terminology has also led to lack of conceptual clarity. In his 1996 lecture, John contrasted rules and principles and drew on the work of the legal theorist Dworkin in support. Dworkin's work was merely a starting point for the idea and, as we shall see, it may be that it is not as helpful as it at first appears since, although the distinction is one that has some appeal, it also takes us into the deep water of legal theory. Dworkin has been widely criticised for the distinction and has modified his own ideas since first writing about them.¹³ This may not be of all that much importance in relation to the debate in the tax context, although we shall return to these issues of legal theory briefly below. First, though, it is worth examining what John was actually proposing.

Proposals made by TLRC and John Avery Jones

The *Final Report of the TLRC on Tax Legislation*, upon which John Avery Jones was commenting in his 1996 lecture,¹⁴ proposed a potential long-term approach of primary fiscal legislation drafted in general principles to provide a framework around which necessary layers of detail could be added through secondary legislation. The idea was to create a new parliamentary committee so that the secondary legislation would receive better parliamentary scrutiny than is currently the case with statutory instruments. The aim was to reduce complexity and prolixity and also to limit opportunities for the use of the detailed legislation to create schemes which satisfy the detailed provisions but, arguably, not the original intention of the drafters. Given that the courts search for the intention of Parliament (which is not necessarily that of the policy makers, Ministers or drafters), this can result in successful tax-avoidance schemes using the rules themselves as

¹¹ See, for example, *Vodafone 2 v HMRC* [2009] EWCA Civ 446; [2009] STC 1480, although this decision has been criticised—for example, see G. Richards, “Arachchige, IDT and Vodafone too: interpretation of statute or judicial law-making?” [2010] BTR 38.

¹² See A. Kavanagh, “The Role of Parliamentary Intention in Adjudication under the Human Rights Act 1998” (2006) 26 OJLS 179, discussing *Ghaidan v Godin-Mendoza* [2004] UKHL 30; [2004] 2 AC 557.

¹³ The distinction was drawn by R. Dworkin in “The Model of Rules” (1967) 35 *University of Chicago Law Review* 25, though see now R. Dworkin, *Law's Empire* (Oxford: Hart Publishing, 1998) 413. Dworkin's theories in this area have been challenged by J. Raz and others. A particularly cogent criticism can be found in A. Marmor, “The Separation Thesis and the Limits of Interpretation” (1999) 12 *Can. J L & Juris* and see also A. Marmor, *Positive Law and Objective Values* (Oxford: OUP, 2001).

¹⁴ TLRC (1996), above, fn.7.

signposts as to how to achieve the effective avoidance, an activity dubbed as “creative compliance.”¹⁵

In his 1996 lecture,¹⁶ John Avery Jones rejected the TLRC suggestion, on the basis that the secondary legislation would proliferate (as it has done in the USA, which has a system that could be described in this way¹⁷) and the “current tax rule madness”¹⁸ would not abate. Instead he suggested his own two-tier system, based on European systems:

“At the top are more abstract principles corresponding to those found in the EC Treaty applying generally, and the more specific principles found in the preamble to Community legislation. The second level is the legislation itself which is interpreted with the aid of the higher level principles, as well as the explanatory memoranda. There is no third level of detailed legislation, but, of course, below the legislation is Revenue practice which is now published.”¹⁹

In his view, this would reduce the amount of detail necessary because the principles would give predictability and therefore give as much, or more, certainty as would great detail. In addition, John Avery Jones brushed aside concerns that this two-tier system, plus practice, would put greater emphasis on Revenue interpretation on the grounds, first, that this interpretation would have to be made in accordance with the stated principles, and, secondly, that the existence of the Revenue Adjudicator and the emergence of judicial review power would provide safeguards. Not everyone would be so sanguine about the use of Revenue practice and guidance to bridge the gap left by the removal of detail, and this is a matter to which we shall return later in this article.

What is clear from this description is that the type of principle being described by John Avery Jones is something that is external to the rules and that helps one to construe the rules. A principle, under his definition, is intended to be something higher level than just a vague or broad rule. These principles can have exceptions and conflict with one another whilst rules cannot do this—one rule must always take priority over another but principles can have different weights depending on the circumstances. These principles do not conflict with rules but assist in deciding what the rules mean in the first place. To those who argue that this will result in judge or administrator-made law, the response would be that there is no deficit of legitimacy. These principles provide answers which are derived by the courts and the revenue authorities from the legislature through their use of the principles and so are entirely in accordance with the requirement for tax law to derive from Parliament.²⁰

¹⁵ D. McBarnet and C. Whelan, “The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control” (1991) 54 MLR 848; J. Braithwaite, “Rules and Principles: A Theory of Legal Certainty” (2002) Aust J L Philosophy 47. See also the discussion in J. Black, *Rules and Regulators* (Oxford: Clarendon Press, 1997) 13.

¹⁶ Avery Jones, above, fn.1.

¹⁷ A system recommended by Surrey, above, fn.1, 709. In addition to this objection to this system in the USA, it is worth noting that the differences between the two political systems make the delegation of legislative power to the US Treasury Department more acceptable than a similar delegation to the UK Treasury or HMRC would be, since the USA is not a parliamentary system and has different lines of political responsibility from the UK.

¹⁸ Avery Jones, above, fn.1, 592.

¹⁹ Avery Jones, above, fn.1, 593.

²⁰ As declared in the 1688/1689 Bill of Rights, c.2 1 Will and Mar Sess 2, Art.4.

The examples John Avery Jones gives, taken from VAT, make clear his view of what principles are in this context. One of the cases he cites²¹ concerned compensation made to a farmer for giving an undertaking to discontinue milk production under a European Community scheme. It was argued that VAT was payable on this payment but in construing the applicable rules to the contrary the ECJ relied upon the principle in the First VAT Directive that “the common system of VAT involves the application to goods and services *of a general tax on consumption*.”²² This broad framework principle helped to explain the true meaning of the specific legislation in question.

Examples of higher level and more general EU principles are equality, proportionality, legal certainty and protection of legitimate expectations, fundamental rights and effectiveness. These have an interpretative function as well as being criteria for review of EU measures and, indirectly, of national measures.²³ Thus the principles shape EU law and, arguably, make it workable with much less detail than is contained in UK legislation.

The proposal made by John Avery Jones is contentious because it comes up against concerns about the relationship between the principles and the rules. If rules can be read subject to principles then, it is argued, this transfers power to the courts and administrators and creates a degree of uncertainty. The alternative view is that this is purely a question of using the principles as a guide to interpretation of the legislative intent. Thus it is not gap-filling but rather an aid to ensuring that there are no gaps. This is entirely different from HMRC or a judge filling in the gaps between detailed and supposedly comprehensive rules in a case. In a case of that kind, if there is a gap it is reasonable to suppose that parliamentary intention is unclear and so the judiciary has to make law. Where there is a principle, there is no gap.

The extent to which this argument is acceptable depends, to some extent, on the level of trust placed by the commentator in the ability and willingness of the administrative authority and the judiciary to apply the principles faithfully.²⁴ There may not be gaps but there is room for judgment, though no more and arguably less than under a system of detailed rules, which inevitably leave lacunae, it being impossible to cover every eventuality that might arise. There is disagreement about how well this kind of principle would work, but what it is intended to look like does seem reasonably clear.

Purposive interpretation

Some of the difficulties in this area, both conceptual and practical, have arisen because of confusion in the literature between PBL and purposive interpretation.

²¹ *Mohr v Finanzamt Bad Segeberg* (C-215/94) [1996] ECR I-959; [1996] STC 328.

²² Avery Jones, above, fn.1, 597.

²³ For further discussion of the role of EU general principles in the tax arena see R. de la Feria and S. Vogenauer (eds), *Prohibition of Abuse of Law: A New General Principle of EU Law?* (Oxford: Hart Publishing, forthcoming 2011), especially the chapter by P. Farmer, “Prohibition of Abuse of (European) Law: The Creation of a New General Principle of EU Law through Tax: A Response”.

²⁴ It has been pointed out, in connection with principles-based regulation, that there is a paradox here: principles-based regulation can give rise to a relationship of trust, but this relationship has to exist for principles-based regulation to be effective (J. Black, “Forms and Paradoxes of Principles-Based Regulation” (2008) *Capital Markets Law Journal* 425).

Purposive interpretation has been with us for some time. The Law Commission reported in 1969²⁵ that there was a tendency for UK judges to over-emphasise a narrow version of the literal rule, but since then the judges have embraced a “purposive” approach to the construction of statutes.²⁶ The reluctance to adopt such an approach in the tax area has often been noted but can be exaggerated.²⁷ Purposive interpretation has been applied in this area too where appropriate. So, for example, in *Luke v IRC*²⁸ as long ago as 1963 we find Lord Reid stating in an income tax case relating to benefits paid to a director, that, in that case:

“To apply the words literally is to defeat the obvious intention of the legislation and to produce a wholly unreasonable result. To achieve the obvious intention and produce a reasonable result we must do some violence to the words... It is only where the words are absolutely incapable of a construction which will accord with the apparent intention of the provision and will avoid a wholly unreasonable result, that the words of the enactment must prevail.”²⁹

Francis Bennion has described the process of purposive construction as one which gives effect to the legislative purpose by either:

- “a) following the literal meaning of the enactment where that meaning is in accordance with the legislative purpose”, or
- “b) applying a strained meaning where the literal meaning is not in accordance with the legislative purpose.”

He comments that:

“the purpose or object of Parliament in passing an Act (the legislative purpose) is to provide an appropriate *remedy* to serve as a cure for the *mischief* with which the Act deals. The legislative purpose of a particular enactment contained in the Act is to be arrived at accordingly. In particular, it is deemed to be to remedy the mischief to which *that enactment* is directed. The unit of inquiry is usually a single proposition (an ‘enactment’). As stated above, each enactment has its own limited purpose, to be understood within the larger purpose of the Act containing it.”³⁰

Cross on Statutory Interpretation explains that:

“The judge may look beyond the four corners of the statute to find a reason for giving a particular interpretation to its words and his role is one of active co-operation with the policy of the statute.”³¹

²⁵ Law Commission, *The Interpretation of Statutes*, Law Com. No.21 (Scottish Law Commission, No.11), para.80(c) cited in J. Bell and G. Engle, *Cross on Statutory Interpretation*, 3rd edn, (Lexis Nexis, 2004) 17.

²⁶ Bell and Engle, *Cross on Statutory Interpretation*, above, fn.25.

²⁷ Partly this reluctance to deviate from the literal has been a function of history as described by H.H. Monroe, *Intolerable Inquisition? Reflections on the Law of Tax* (London: Stevens & Sons, 1981). Partly it is the result of the complexity of the system, as discussed below.

²⁸ *Luke v IRC (Luke)* [1963] AC 557; 40 TC 630 (HL).

²⁹ *Luke*, above, fn.28, [1963] AC 577.

³⁰ F. Bennion, *Statutory Interpretation*, 5th edn, (London: LexisNexis, 2008) 944.

³¹ Bell and Engle, *Cross on Statutory Interpretation*, above, fn.25, 19.

Some discussions seem to assume that principles and purposive interpretation go hand in hand. It is true that the legislative purpose may be found in a principle,³² but a legislative purpose may be found in a variety of other places too. In fact if there is a legislative principle which governs the legislation in question there should be no need to resort to purposive interpretation, at least not that of the kind described by Bennion in his clause b) above. There is no need to strain the meaning of the legislation because the principle is part of the legislation being construed and assists in its interpretation. Thus PBL should *reduce* the need for judicial purposive construction of the kind that has to do violence to the statutory language because the principle is part of that statutory language. In this way, use of principles would increase and not decrease parliamentary control and would not make the exercise any less certain than it is now. It might possibly even be more certain.

Purpose clauses

The notion that a purpose may be found in a principle seems to have led some commentators to confuse PBL with what they call “purposive” legislation or to suggest that they might work well together. The problem may have begun with the suggestion of the TLRC that there might be a link between statements of purpose on the one hand and, on the other, general principles drafting, because statements of purpose would give courts greater confidence to adopt a purposive interpretation.³³ Pinder, in his article for the Australian Government Treasury, also associates PBL with what he calls “objects clauses”.³⁴ In his view, these should “explain both the broader purpose and policy intent behind the measure (the *why*) and the way the provisions achieve that broader purpose (the *how*)”. In a note in this *Review* in 2006, Brian Drummond expressed a concern that too much reliance might come to be placed on explanatory memoranda in complex areas such as life assurance. He considered that these memoranda cannot be said to represent the intention of Parliament in the way the statute itself does and so suggested that:

“achieving an appropriate degree of clarity and certainty in tax legislation would be a much more realistic possibility if that legislation was written (drafted) and read (interpreted) in a purposive way.”³⁵

In other words, the explanation should be contained in the legislation.

As Drummond points out himself in a subsequent note, however, a purpose clause contained within a provision is merely an express statement of legislative intention. It is not part of the operative provisions that charge to, or relieve from, tax. It exists purely to add background to the rules that follow.³⁶ If the provision is not operative, then its relationship with the detailed provisions that follow is very unclear. It is unlikely to be taken to override the clear words of an operative provision in the statute.³⁷ Most commentators are of the view that purpose statements

³² As John Avery Jones pointed out himself: above, fn.1, 593.

³³ TLRC *Final Report*, above, fn.7 [3.18]. The author was a member of the TLRC at the time this report was written (and still is) so accepts collective responsibility for this connection but considers it to be confusing in retrospect.

³⁴ Pinder, fn.2, above.

³⁵ B. Drummond, “A purposive approach to the drafting of tax legislation” [2006] BTR 669.

³⁶ B. Drummond and P. Marwood, “Purposive Drafting in the Finance Bill 2007” [2007] BTR 350.

³⁷ Bennion, *Statutory Interpretation*, above, fn.30, 734, citing a tax case, *Page (Inspector of Taxes) v Lowther* [1983] STC 799 (CA). In this case it was held that a purpose clause stating that the section in question was enacted to prevent

add little to the legislative process, given that they are qualified by the subsequent rules, which they either support or contradict.³⁸ A leading expert on drafting has commented that professional drafters dislike purpose clauses and consider that the operative provisions of the Act should be left to speak for themselves.³⁹

So, if a purpose clause contradicts a rule it seems from the case law that the express rule will prevail, whereas this should not be a problem in the case of a true principle that is itself part of the operative provisions. Where there is an operative principle as opposed to a purpose clause, the subsequent rule is a consequence of that principle and will be construed according to that principle. Therefore there should be no contradiction between the rule and the principle.

Nevertheless, despite the reservations expressed about purpose clauses, HMRC began to experiment with them. An interesting example was to be found in Schedule 13 to the Finance Act 2007, now contained in similar terms in section 542 of the Corporation Tax Act 2009 (CTA).

Schedule 13 contained the following purpose provision:

- 1—(1) The purpose of this Schedule is to secure that in the case of an arrangement—
- (a) which involves the sale of securities and the subsequent purchase of securities, and
 - (b) which equates, in substance, to a transaction for the lending of money at interest from or to a company (with the securities which were sold as collateral for the loan),
- the charge to corporation tax in that case in respect of chargeable gains reflects the fact that the arrangement equates, in substance, to such a transaction.
- (2) But this is not to be read as preventing the rules in this Schedule about corporation tax in respect of chargeable gains from having no effect in relation to debtor quasi-repos and creditor quasi-repos.

It is interesting that sub-paragraph 1(2) was considered necessary: it was probably not so, given that the subsequent express rules would have overridden the purpose provision, but there was an instant concern about uncertainty. The rewritten version in section 542 of the CTA 2009 has retained the purpose provision in sub-paragraph 1 intact and has retained and clarified the proviso. This purpose statement was welcomed at the time it was introduced,⁴⁰ apparently being seen as a way of cutting down the meaning of the subsequent, very wide provisions.⁴¹ Nevertheless, it was unfortunate that purpose clauses came to be associated in some minds with PBL, since later attempts to use purpose clauses in the Finance Bill 2009 were not so well received, as discussed below.

PBL and purpose clauses are two quite different concepts. There is no reason why they should work well together. In fact they have opposing objectives: the purpose clause is designed to aid

the avoidance of tax by persons concerned with land or the development of land was not sufficient to limit the operation of the section to transactions specifically designed to avoid tax.

³⁸Renton Committee, above, fn.1; *Making the Law: The Report of the Hansard Society Commission on the Legislative Process* (London: Hansard Society, 1993) 172–173.

³⁹Bennion, *Statutory Interpretation*, above, fn.30, 734–735.

⁴⁰Drummond and Marwood, above, fn.36.

⁴¹J. Gatehouse, “Sale and repurchase of securities — section 47 and Schedules 13 and 14” [2007] BTR 495.

purposive interpretation (though it may not even do that very well); whilst PBL is designed to eliminate the need for such interpretation.

Development of PBL—the coherent principles approach

A coherent exposition of a form of principles-based approach has been undertaken by Greg Pinder for the Australian Taxation Office (ATO).⁴² This is consistent with the ideas that John Avery Jones formulated, although it goes further and makes the principle a part of the framework or architecture of a specific piece of legislation, whereas John Avery Jones' principles are external to the statute. In this development, PBL becomes a completely new approach to drafting. This development of the concept is known as the “coherent principles approach”.

This form of principle is an *operative* high-level legislative provision.⁴³ It is a statement about the essence of all intended outcomes in a general field and not just a less-specific rule. It must therefore be comprehensive. It is sometimes called the cascade structure or pyramid, with the principle at the top and the rules then providing exceptions or sub-exceptions.⁴⁴ It can be seen that this is far from being a vague rule, or a purpose clause. It is a broad charging or relieving provision which will be cut down by the further provisions. The principle needs to capture the outcomes in a way that is “intuitive or obvious to someone who understands the law’s context”.⁴⁵ This results in the absence of any gap to be filled, since the principle provides the default position.

The objection to this will be that it switches the burden from the revenue authority, which must currently show that something is included in the charging provision, to the taxpayer, who must now show that a case is specifically excluded. This is true, but it is what is needed to deal with the drafting problems we experience currently in having to add on items that were omitted inadvertently. If the broad principle is one that has been agreed by Parliament, this does not represent an absence of parliamentary direction, as some have suggested, but rather an indication of parliamentary intention. The wide charging or relieving provision provides direction about how any second-tier rules should be interpreted by judicial decision based on the principles set out so that, if the principle is drafted correctly and the policy has been clearly thought through, the provision should not be over-inclusive. Those are difficult conditions to meet, however, so some mechanism will be needed to deal with over-inclusiveness in order to protect taxpayers under this shifted burden, but there are benefits in this approach for taxpayers too. Not only does under-inclusiveness result in constantly having to amend legislation, thus increasing complexity and detail, but it also results in uncertainty, since under the current UK system the gap might or might not be filled by some form of purposive construction, including the approach to statutory construction under the current interpretation of the *Ramsay* line of cases.⁴⁶ Even if the courts ultimately would not apply such an interpretation, the taxpayer might have to deal with a period

⁴² Pinder, above, fn.2.

⁴³ Pinder, above, fn.2; Krever, “Plain English drafting, Purposive drafting, Principle-based Drafting: Does Any of it Matter?” in J. Freedman (ed.) *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (hereafter *Beyond Boundaries*) (Oxford: Oxford University Centre for Business Taxation, 2008).

⁴⁴ Krever in *Beyond Boundaries*, above, fn.43.

⁴⁵ Pinder, above, fn.2.

⁴⁶ *WT Ramsay Ltd v IRC* [1982] AC 300; [1981] STC 174 (HL). On the current situation in respect of the so-called *Ramsay* doctrine see J. Freedman, “Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament” (2007) LQR 53.

of uncertainty whilst its interpretation is challenged by HMRC, and this may remain a genuinely grey area for many years. This uncertainty and proliferation of legislation helps no one.

Pinder recognises the need for taxpayer protection under the coherent principles approach and states that it may lead to a requirement for further guidance in some situations. Whilst it is possible that this is more necessary with a wide starting principle than with detailed legislation, we already have a considerable volume of guidance in the UK under our current system so this is not a phenomenon exclusive to the coherent principles approach. Arguably we already need a better framework for the management of HMRC guidance in any event,⁴⁷ given the uncertainties currently surrounding the degree to which guidance and other HMRC statements can be relied upon, and an improvement in this respect might make PBL more palatable and workable. It would be important to recognise, however, that under a coherent principles regime this would not be tantamount to giving HMRC the power to legislate, because the principles themselves would provide a justiciable framework for the guidance and so there may be less discretion for the revenue authorities, rather than more.

In Pinder's words, the process of using interpretive material is part of the unfolding of the principles:

“But it does not mean the ATO is inventing the law. In those cases, the Commissioner is explaining how he thinks the principles apply, not creating the principles themselves. The principles are enacted by Parliament and, like any legislation, impose limits on what interpretations can be drawn from them. In the final analysis, the judiciary will adjudicate on whether the Commissioner's interpretations are correct, in the same way as it already rules on the correctness of his interpretations of black-letter legislation.”⁴⁸

These arguments have many critics in Australia and in the UK.⁴⁹ One problem in Australia, as in the UK, is that the approach may have been utilised in areas for which it was not suited. Pinder is clear that the approach is best for measures that are “self-contained, rather than modifying existing black-letter law, and those that can be developed on a principled basis from their earliest stages.”⁵⁰ The example of successful PBL in the Pinder article is of a provision allowing employees with shares under an employee share scheme to continue to defer being taxed on the discount they got if the shares were issued even if their employer is taken over or restructures. The principle is a straightforward one which can easily be understood, and the legislation can be based on a desired outcome without having to detail the mechanism to be used to achieve that. This can be contrasted with later attempts to use PBL to deal with the difficult problem of defining the financial arrangements to be caught by certain taxing arrangements (TOFA). As Cooper states of this attempt, which he demonstrates to have been much more problematic:

⁴⁷ Currently there are many questions surrounding HMRC guidance and the extent to which the application of this is subject to judicial review and can be relied upon to give rise to a legitimate expectation. See for example, *R. (on the application of Davies) v HMRC*; *R. (on the application of Gaines-Cooper) v HMRC* [2010] EWCA Civ 83; [2010] STC 860; *Hanover Company Services Ltd v HMRC*, [2010] UKFTT 256 (TC).

⁴⁸ Pinder, above, fn.2.

⁴⁹ The criticisms are set out in Cooper, above, fn.3 at 345–346 especially. Some, though not all, of these criticisms relate to specific examples of drafting, however, which may be open to criticism because they are not good examples of PBL—see below—and so they may be exaggerated.

⁵⁰ Pinder, above, fn.2.

“One must wonder if any artificially constructed-and artificially constrained-regime could ever have been an appropriate place for enacting a principles-based definition.”⁵¹

This is not to say that the coherent principles approach cannot work, but only that it has not worked in every case, and that there may be areas of complexity and artificiality where it is not the best approach at all or perhaps is not the best approach until other difficulties have been resolved. If the attempt to draft in this way highlights the need to improve the underlying policy, then this is valuable, but only if heed is taken of the warning. Other problems are that the coherent principles approach is perceived as giving too much scope to judiciary and to administrators alike. There are concerns about separation of powers and about whether the judiciary will be prepared to give effect to general principles.⁵² In all these areas there are real issues to be addressed, and these will be discussed further below, but it must be remembered that the comparison is with our current system, which is also far from perfect in these respects. These problems may need to be tackled in any event and the use of PBL may assist in doing this by clarifying thinking about the problems and searching for acceptable solutions. Arguing that only perfect systems are worth consideration may inhibit the search for practical improvement.

PBL and tax avoidance

There is no inevitable link between PBL and specific anti-avoidance legislation. Indeed, this seems to be quite the wrong place to start. As explained above in connection with the Australian coherent principles approach, principles need to capture intended outcomes in a way that is intuitive to someone who understands the law’s context. Re-conceptualising a new area from scratch on a principles basis may well help to reduce the possibilities for artificial avoidance in the future, so there is a connection between PBL and prevention of avoidance in this sense, but it is a non sequitur to suppose that a specific artificial avoidance scheme designed to exploit previously existing detailed law can be tackled well by PBL. Partial replacement of legislation by PBL, while the underlying charging and relieving provisions remain in the old-style detail, is not going to be helpful because the underlying framework concepts will not be present and the principles will not be comprehensive or coherent.

As we shall see in discussing the UK examples below, the idea has developed within HMRC that PBL complements its anti-avoidance strategy. There is a belief, possibly well founded, that if the courts could see more clearly the principles behind the legislation their decisions would favour the HMRC more frequently.⁵³ This might be so, but it will only work if the specific anti-avoidance provisions are properly integrated into the old ones and this requires more than

⁵¹ Cooper, above, fn.3, 360.

⁵² D. Bentley, “Editorial: Tax Law Drafting: The Principled Method” (2004) 14 *Revenue Law Journal* 1 cited in Cooper, above, fn.3; Sir Anthony Mason, “Opening Address” ATAX 7th International Tax Administration Conference. Available at http://www.atax.unsw.edu.au/news/tadminconfApril06/7thTaxAdmConf_Opening_address.pdf [Accessed November 18, 2010]; W. Cole, “The ‘coherent’ or ‘general principles’ approach to drafting tax law: the concept and its use and utility in Australasia”, ATAX 7th International Tax Administration Conference (unpublished copy available from author).

⁵³ See the examples below and also Richard Thomas (then of HMRC), “Principles-based approach to financial products avoidance”, Presentation to Oxford University Centre for Business Taxation Summer Conference, June 2008 (unpublished, on file with author).

add-on PBL anti-avoidance provisions. Whole areas of law need to be reconsidered and redrafted for this to work.

Thus, for example, simply stating that legislation is looking to capture economic substance in a specific area will not be helpful unless it makes it very clear how this is to be interwoven with other legislation based on legal rather than economic concepts. The position with a general anti-avoidance principle (GANTIP) would be rather different because this would be a broad principle intended to underpin the entire tax system and would be a direction from the legislature to have regard to certain factors as being overriding if a particular set of factors was satisfied. This would still be an operative provision, and part of the architecture of the legislation, but it would come in at a higher level, closer to the general principles envisaged by John Avery Jones than to the coherent principles approach to drafting of which Pinder writes, which are fundamental to the delineation of the area concerned.

One of the major issues to be resolved with any general anti-avoidance provision, be it a rule or a principle, is its relationship with the underlying law.⁵⁴ That relationship would be made much easier if all the specific legislation were to be PBL legislation and indeed one might not need a GANTIP if *all* underlying legislation was drafted in a principles-based way, but since this is unlikely to occur for some time there is a case for this special kind of overarching GANTIP for the time being.⁵⁵ This is not, however, the real thrust of the PBL debate.

Further, there is nothing about PBL which makes it particularly well suited to the attachment of an unallowable purpose test. These tests, sometimes inaccurately known as motive tests,⁵⁶ relate to the taxpayer's reasons for acting as he did, either directly or indirectly, by looking at the purpose of the scheme entered into. This is not to be confused with either purposive construction or with purpose clauses in the statutes. This method of combating avoidance is increasingly frequently employed in anti-avoidance provisions in the UK. Arguably the proliferation of such clauses is a cause of complexity, uncertainty and the need for greater extra-statutory guidance. It may be that where there is a clear principle it is easier to specify whether the taxpayer's purpose is unallowable: the basic test in these cases is whether there is a commercial purpose or a tax-avoidance purpose and without knowing the objectives of the legislation it will be hard to judge this. This does relate, therefore, to having a clear underlying policy. If the legislation is properly delineated by the use of principles, however, it should be possible to eliminate or reduce the need for unallowable purpose provisions. The existence of a single overriding GANTIP might also reduce the need for such clauses. Thus, PBL legislation could help to reduce the need for these clauses or assist in making their scope clearer where they were used, but PBL and unallowable purpose clauses are not necessary or even natural partners.

⁵⁴ There is a massive literature on general anti-avoidance provisions elsewhere generally and on this point of meshing the principle with the underlying law in particular. For a starting point see Freedman, *Beyond Boundaries*, above, fn.43 and case notes on later developments in [2009] BTR 161–193.

⁵⁵ See further Freedman (2004), above, fn.5 and Freedman (2007), above, fn.46.

⁵⁶ For the difference between a purpose test and a motive test see HMRC, *Simplifying Unallowable Purpose Tests*, Discussion Document, July 31, 2009, [10040].

PBL—not “light touch”

One further possible confusion about PBL needs to be dispelled. Principles-based *regulation* has become associated with light touch regulation, especially in the area of financial regulation and, given recent events, this now attracts a certain degree of suspicion and is unfashionable to say the least. One can see that high-level drafting and a move away from reliance on detailed prescriptive rules could work well in association with a form of regulation which delegates responsibilities to those being regulated, but this is not a necessary part of PBL in the area of taxation, although the relationship of trust that is important for light touch regulation is also a significant part of being able to manage the principles-based approach.⁵⁷

Principles and legal theorists

It was mentioned briefly above that John Avery Jones originally based his distinction between rules and principles on a version of Dworkin’s ideas.⁵⁸ Edwin Simpson has suggested that a principled approach to taxation is not truly Dworkonian,⁵⁹ and in a pure sense he is correct. Dworkin’s principles were not of the legislative variety, as has been discussed above, but were drawn from the practice of judges and lawyers and general considerations of justice and morality. This meant that a judge did not exercise discretion to fill a gap in the rules when he applied a principle. This explanation contrasted with that of the positivists, notably Hart,⁶⁰ who considered that judges were developing or modifying law when they had to find a solution which was not prescribed by the rules.⁶¹ The principles discussed above are therefore somewhat different from those Dworkin had in mind, but they take certain characteristics from the Dworkonian idea. Rather than creating uncertainty and giving the courts and administrators excessive discretion, the principles discussed by John Avery Jones and Pinder are intended to reduce that need for discretion. The coherent principles approach gives the courts the tools they need to find the answers provided by Parliament. If one has principles of this variety, then there is no need to enter the philosophical debate about the existence or otherwise of the unwritten Dworkonian principles, since the statute provides what is needed.

There is an enormous literature on the philosophical debates on rules and principles and many reject Dworkin’s distinctions,⁶² but the principles concept as tailored above is a valuable one in the tax context provided it is understood that we are using it as a starting point and nothing more.⁶³ In particular it is important to stress that the use of the principles concept here is not

⁵⁷ On the relationship between the different elements of principles-based regulation see J. Black, “Making a success of principles-based regulation” (2007) *Law and Financial Markets Review* 192.

⁵⁸ See fn.13 above and text thereto. Dworkin’s ideas developed over time and this describes his original concept—see Dworkin (1967 and 1998), above, fn.13.

⁵⁹ E. Simpson, “The Ramsay Principle: A Curious Incident of Judicial Reticence?” [2004] *BTR* 358, 374.

⁶⁰ H.L.A. Hart, *The Concept of Law* (Oxford: Clarendon Press, 1961).

⁶¹ For a brief and clear discussion of the positions taken by the leading protagonists in this debate see J. Penner, “Law and Adjudication: Dworkin’s Critique of Positivism” in J. Penner, D. Schiff and R. Nobles (eds), *Jurisprudence & Legal Theory* (Oxford: OUP, 2005).

⁶² See Braithwaite, above, fn.15, discussing J. Raz “Legal Principles and the Limits of the Law” (1972) 81 *Yale Law Journal* 823 and F. Schauer, “Prescriptions in Three Dimensions” (1977) 82 *Iowa Law Review* 914. For a comprehensive rejection of principles as defined by Dworkin, see Marmor (1999 and 2001), above, fn.13.

⁶³ Braithwaite states that this is a “philosophically abstruse debate” and simply chooses the definition given by J. Raz (above, fn.62) that “Rules prescribe relatively specific acts: principles prescribe highly unspecific actions”: J.

intended to imply any introduction of morality into tax law.⁶⁴ On the contrary, the principle is an expression of the scope that the legislature has decided to give to a charging provision or relief and, since it leaves no room for judicial law-making, it does not invite judgments based on morality. The debate at its most fundamental is how best to convey and give effect to the intention of Parliament.

This is, of course, another area where there has been a vast amount of writing that cannot be explored thoroughly here. One contributor to this debate, Andrei Marmor, who maintains that there is nothing more to principles as opposed to rules than the generality or vagueness of what they describe, is of the view that more often than not the law can be understood without the mediation of interpretation. His argument here is that language may be context dependent but that does not entail indeterminacy, that is, lack of certainty.⁶⁵ He illustrates this with an example of a meal ordered at a restaurant which illustrates well the problem of literal interpretation. When we order a meal, it is implicit that we expect it to be edible, of a reasonable size and satisfying certain other characteristics. If we start to add specific instructions, for example to make sure this has not got sauce on it, then a literally minded, or difficult, waiter might start to think that other things which had been implicit were no longer so because we had not specified them—so, for example, he may come back with a meal with no sauce, but only a minuscule portion. This is precisely what happens with tax law drafting at present, where the response is to add more and more conditions rather than rely on the meaning of the word “meal”. This does not happen in the restaurant example, according to Marmor, because of social pressures and tacit conventions but also because:

“As long as we are familiar with the context, the meaning of the sentences we use is determinate enough. Interpretation is required only where there is something, either in the context or the expression itself, which is not familiar, or otherwise not clear.”⁶⁶

This chimes with a statement by Pinder in his article on PBL that:

“When a principle works, it does so because the essence it captures appeals to readers at other than an abstract intellectual level; it *means* something to readers because it relates to their understanding of the real world.”⁶⁷

The principle should provide the context to which Marmor is referring: that is how it provides greater certainty than the alternative of detail. In some areas the context will be easily discernible and that may apply to some areas of tax law, but one major problem with using principles in the tax law area is that tax law is very abstract and may not always relate well to the real world. In some cases of this kind it may be that the policy of the tax law needs to be brought closer to the workings of the real world before a principle can be made workable, although it could be argued that what matters here is the “real world” of the tax community and that, provided there is a

Braithwaite, “Making Tax Law More Certain: A Theory” (2003) 31 *Australian Business Law Review* 72. Put very broadly, Raz believes that legal principles do not exclude discretion but guide its use.

⁶⁴ On tax and morality see Freedman, above, fn.5, 334.

⁶⁵ Marmor, above, fn.13 at 139.

⁶⁶ Marmor, above, fn.13, 137–139.

⁶⁷ Pinder, above, fn.2.

strong enough understanding of the context within that community,⁶⁸ the principle will work. This depends on whether tax legislation is considered to be addressing the world at large or only a specialist sub-group. This in turn may depend on the topic covered. If principles are to be used successfully to help provide context that reduces the need for reliance on administrative or judicial discretion, this may need to be done by building upon what Julia Black calls a “regulatory interpretive community”.⁶⁹

Principles in a modern tax context

To conclude this section of this article, the use of the terminology relating to rules and principles is contentious in legal theory and even in the tax debate has taken on different meanings. This article cannot, and does not seek to, resolve the debate about the distinctions or lack of them in a wider sense, but rather argues that a certain type of “principle” as defined here could be of value in improving the drafting of tax law. This type of principle is part of the fundamental architecture of the tax system. As Pinder explains, it is an operative provision that provides all the intended outcomes in a general field. It is not necessarily accompanied by a purpose clause or linked to anti-avoidance provisions. It appeals to the understanding of the taxpayer community of the way the tax system works. It must therefore link to the rest of the tax system and ideally will be used as an approach to drafting basic charging and relieving provisions. The nature of these provisions should be such that they reduce rather than increase the need for judicial gap-filling because the principles provide the legislative guidance from Parliament that produces answers based on that legislation. There is therefore less need for judicial and administrative discretion here than under detailed law, which can and does leave many gaps unfilled and no legislative guidance as to how to fill them.

PBL—the UK experience

The introduction to this article referred to Graeme Cooper’s comment that the PBL experiment in Australia has been found wanting. Most commentators would say the same about the UK experiments in this area so far. This may be because of the areas chosen. In both countries the technique has been attempted in the area of taxation of financial products, where the real-world context is far from obvious. Highly artificial constructs have led to technical law in the past and fertile ground for artificial avoidance schemes. It is easy to see why PBL might seem an attractive way to cut through some of these problems, but by associating PBL with a complex, non-intuitive and highly artificial area and with anti-avoidance legislation, HMRC have made this experiment difficult for themselves.

In a presentation at the Centre for Business Taxation in 2008 Richard Thomas, then of HMRC,⁷⁰ stated that PBL was being promoted by HMRC because “it complements the HMRC strategy of reducing avoidance opportunities” by making the principles and purpose of the legislation visible to the courts and also reducing the need to constantly update the legislation in an area of high avoidance activity.

⁶⁸ Marmor, above, fn.13, 141.

⁶⁹ See J. Black, above, fn.15, building on the ideas of S. Fish, *Doing What Comes Naturally* (Oxford: OUP, 1989).

⁷⁰ R. Thomas, above, fn.53.

Commencing the experiment with anti-avoidance legislation, however, has meant that HMRC, HM Treasury and the tax community have an over-restrictive view of this approach. If it is going to work, PBL needs to be applied across the board and not only to avoidance legislation, given that by definition the principle needs to be used as the basis for a comprehensive charging provision. If the legislator gets the principle right, anti-avoidance provisions such as unallowable purpose tests and safe-harbours for activity that does not amount to avoidance should not be needed.

Another aspect of the process in the UK examples to date has been extensive consultation—something that is normally welcomed as improving the chances of drafting good legislation. Whilst one would hesitate to discourage this, and there is a widespread view that the drafting of the legislation discussed below was improved by the consultation, there is a danger that consultees will seek to add detail back in if that is the style to which they are accustomed, thus undermining the entire approach. Moving to a new approach may require more leadership and willingness to stand out against the crowd, but if the crowd are saying the legislation will not work this will take a good deal of courage and conviction. A programme across an entire area that can be discussed and understood, rather than a piecemeal reform of a small part of the code where problems have previously been experienced, is likely to be necessary to achieve any real success.

In addition it will be important that there is an environment of trust between members of the tax community—taxpayers and revenue authorities—for PBL to succeed. This returns us to Black’s paradox, that principles-based regulation can give rise to a relationship of trust, but this relationship has to exist for principles-based regulation to be effective.⁷¹

The UK financial products experiment—disguised interest legislation

The Finance Act 2009 contains two examples of legislation which it was intended should utilise PBL. Both were in the area of financial product taxation. These attempts have been noted in detail in a previous issue of this *Review*.⁷² Here we shall look briefly at one of these provisions, that dealing with “disguised interest”.⁷³

The draft legislation⁷⁴ contained a purpose clause as follows:

“1. **Purpose of Schedule**

The purpose of this Schedule is to secure that (subject to exceptions, and except where double taxation would result) a return designed to be economically equivalent to interest is treated in the same way as interest for the purposes of corporation tax.”

The draft continued:

⁷¹ Black, above, fn.24.

⁷² Haworth; P. Williams, above, fn.3.

⁷³ Many representative bodies responded to the consultation at workshops and in writing, making these and other points. This discussion draws particularly on the unpublished response of the TLRC.

⁷⁴ HMRC Technical Note, *Principles-based approach to financial products avoidance: Disguised Interest* (February 2008). Available at: <http://www.hmrc.gov.uk/legislation/disguised-interest-main.htm> [Accessed November 25, 2010.]

“2 **Disguised interest to be treated as real interest for corporation tax purposes**

- (1) Where a company is party to an arrangement designed to produce a tax privileged investment return for the company, the return is to be treated for the purposes of corporation tax as a profit from a loan relationship of the company.”

“Tax privileged investment return” was then defined as a return which “equates, in substance, to a return on an investment ... at interest” and met some other conditions. Provisions were to be caught only if they were “designed” to produce such a return and for that there was a test of what was the main purpose or one of the main purposes of the arrangement.

Here we see all the difficulties discussed above being introduced. As explained, purpose clauses are problematic, as are those which examine the purpose of the taxpayer. We have both in this example. The differences between the wording of the purpose clause and the operative clause raised questions about whether the provisions conflicted. The central problem was, however, that clause 2 was not a scoping principle. Rather it was an attempt to introduce a substance over form rule in an area where the underlying law is not based on economic substance.⁷⁵ What was needed to achieve the kind of PBL outlined above was to go back to the overall scope of the definition of loan relationship and ensure that this was defined in principle-based terms. In other words interest needed to be defined in terms that would include so-called disguised interest in the first place and not as an add on. What this clause does instead is to attempt to superimpose a substance over form rule over a base rule that is not conceived in compatible terms. It then also needs several carve-outs, because it is not desired to impose a substance over form rule in every case, and one of those carve-outs is based on the purpose of the taxpayer (by looking at the purpose of the arrangement).

Following consultation, this provision was amended to remove the purpose clause and the drafting is much improved, but it is still not PBL in the sense of having a broad provision scoping all intended outcomes in a general field as envisaged in the coherent principles approach.⁷⁶ The final legislation continues to refer to a return which is economically equivalent to interest, but since the meaning of this is by no means intuitive, due to the fact that the concept of interest is itself highly artificial and does not have universally agreed essential characteristics, this term has had to be defined.⁷⁷ The pressure from consultees to do this was understandable given the background, but this then defeats the object of PBL and begins to be a definition which could provide material for creative compliance.⁷⁸

A carve-out for arrangements which have no tax-avoidance purpose is still necessary, because the principle is not in fact to tax everything that might be said to be economically equivalent to interest under the wide definition of interest. Whilst welcome to taxpayers as a way of escaping the provision, this adds complexity and uncertainty. These characteristics have come to be seen

⁷⁵ Indeed most economists would reject the idea of a debt/equity distinction as a basis for corporate taxation: see M. Devereux and A. Gerritsen, “The Tax Treatment of Debt and Equity” (publication forthcoming).

⁷⁶ The provision can now be found in the Corporation Tax Act 2009 (CTA 2009) s.486B.

⁷⁷ CTA 2009 s.486B(2).

⁷⁸ Lord Hoffmann has stated extra-judicially in “Tax Avoidance” [2005] BTR 197, 203 that “The Revenue appear to have no faith in the ability or willingness of the courts to recognise the economic effect beneath the varied forms.” It is not clear that he would consider that this new legislation shows sufficient faith.

as consequences of using PBL. In fact, for the reasons discussed, this is not PBL at all, and therefore not a good basis on which to judge this approach to drafting. The difficulty here is not with PBL but with the way in which it was sought to apply it, like a sticking plaster in a sore place rather than a tool of fundamental design. That is not the fault of the drafting method but of the way in which it is being misunderstood and applied.

Group Mismatch proposals

Unfortunately it seems that the lessons of this experience may not yet have been learned. One of the latest references to PBL in HMRC documentation is to be found in another paper on financial products avoidance, dealing with group mismatches.⁷⁹ The thrust of the document is that corporate groups should not be able to create tax losses where there is no economic loss by, for example, using different accounting practices within a group. The “principle” is said to be that these intra-group transactions should give rise to symmetrical tax treatment.⁸⁰ This seems reasonable enough, except that the paper commences by explaining that, although groups of companies frequently operate as single economic entities, without regard to the position of the individual companies that constitute the group, UK tax legislation often does not recognise the interdependence of a group’s activities, but charges companies within the group to corporation tax on the basis of their own economic and accounting profits.

Here lies the difficulty. The underlying principle of the base legislation is not one of symmetry. Once again the proposal is to add on a provision which achieves an end result based on substance, whereas the underlying tax law is not based on substance. The objection is to the ability to create tax losses where there is no economic loss, but it is possible to have an economic loss and no ability to claim a tax loss under the current tax system, because it is not based on viewing the group as an economic entity. To make this a coherent PBL system, the starting point should be to state that groups will be taxed as economic entities, if that is what is desired. But that is not the current position in UK tax law at present and so in fact the “principle” pursued here is an anti-avoidance one rather than a fundamental underlying principle. For this reason, the legislation is intended to apply only where securing the possible reduction in tax is fundamental to the arrangement being entered into, or the shape that it takes.

The HMRC paper argues that the proposal is what they call, alternatively, “generic”, “thematic” and “principles-based” legislation and that it “provides stronger and broader defences against innovative schemes because it is clear that they do not fall within the intentions of the legislation.”⁸¹ It is argued that this would allow for the repeal of specific traditional anti-avoidance legislation and that the early signs are that the PBL in the CTA 2009 discussed above is having some success because significant amounts of anti-avoidance legislation have been repealed and there have been no disclosures of schemes of the type the new legislation was intended to block. The paper admits it may be too early to assess this, but of course if it is true that this is effective anti-avoidance legislation and that it can reduce the need for specific anti-avoidance provisions

⁷⁹ HMRC Discussion Document, *Financial Products Avoidance: Group Mismatches*, March 24, 2010. Available at <http://www.hmrc.gov.uk/budget2010/march/jp-avoid-group-mis-0385.htm> [Accessed November 21, 2010] (*Group Mismatches*).

⁸⁰ *Group Mismatches*, above, fn.79, [22].

⁸¹ *Group Mismatches*, above, fn.79, paras 16–20.

this is to be welcomed. It may, however, be at the cost of some uncertainty and added complexity, whereas a true coherent principles approach would aim to achieve this in a more wide-ranging, sustainable way and with no unallowable purpose test.

This proposal can be contrasted with the Australian corporate consolidate regime described by Cooper.⁸² Although he is critical of what he calls “principle-creep”—that is that the Australian Tax Office has taken the principle too far—the system Cooper describes actually seems to be a real example of PBL and shows what it has to offer. In Cooper’s view, principle-creep is an inevitable response to such general drafting. If so, it is necessary to construct systems to contain that, but it does not necessarily mean that the experiment is a total failure.

Conclusion

Various benefits are claimed for the use of principles over rules. Whether principles can achieve these claimed advantages depends on what we mean by principles and how well this concept is applied. This article has defined principles in a particular way that is tailored to the tax debate on PBL. These principles are part of the fundamental architecture of the tax system. They are comprehensive statements about the essence of all outcomes in the general field. They are operative provisions from which exceptions can then be carved out if necessary. To work well they must define the whole field and not just deal with a small area. They are not only about countering tax avoidance, although they should ultimately assist with this. This type of principle would reduce the need for judicial and administrative gap-filling. It would provide legislative guidance from Parliament that produced answers based on that legislation. This would not undermine the intention of Parliament, but give it effect.

PBL of this type could bring shorter legislation, fewer opportunities for creative compliance and thus a reduced need for specific anti-avoidance provisions and amendments to meet attempted avoidance. Under this kind of PBL system, there should be less uncertainty than under our current system of detailed rules, which invites a search for gaps, because it should be more predictable, not less, how a court would answer any given question. That is not to say that there would be no uncertainty—we cannot expect any system to deliver total precision in every case in view of the complexity of the issues being dealt with.⁸³ There will not be total intuitive understanding or agreement on tax law concepts and there will always be attempts to exploit any potential uncertainty. The existing system, which responds to this by further detail, has created the need for a vast amount of extra-statutory guidance, as well as resulting in a volume of legislation that is itself a factor in creating uncertainty. It is hard to find the law, difficult to understand it when one has found it and often also problematic to predict how it will be interpreted by the judiciary and how far the courts will be prepared to look at context and construe purposively, since this depends upon how far they feel constrained by the detailed wording of the statute. PBL recognises that the legislature can make law by setting out frameworks which give the courts and the revenue authorities the tools they need to do their job. There should be less need for the exercise of unguided discretion under this system than where the detailed rules leave real gaps. That does

⁸² Cooper, above fn.3

⁸³ On the argument that some indeterminacy is an essential feature of law and that the important thing is that the law should provide a guide to the answers see T. Endicott, *Vagueness in Law* (Oxford: OUP, 2000).

not mean that extra-statutory guidance would not be needed, but the fact that the principles do lay out the framework in broad terms and will have to have been based on a discussion of the underlying policy should help to ensure that this guidance is properly framed and understood by the interpretative community. It should be easier to monitor and, if litigation does become necessary, also for the courts to interpret.

The task of using principles in order to legislate should help to focus legislators on the absence of clear underlying policy where that is the problem. As the discussion of group mismatches above shows, for example, HMRC's own discussion document acknowledges that the principle it wishes to apply does not in fact govern the entire area. Simply stating this forces recognition of the problem. In this way this approach could eventually improve the quality of the debate. This alone will be a major advantage of the approach.

Despite the claims made for PBL here, we have shown above, and Cooper has demonstrated in his discussion of the Australian experience, that the attempts to apply PBL so far have not been entirely successful. The question is whether these problems are inevitable or whether they are the result of using the new approach in the wrong areas and, perhaps, in too limited a way. Given that it is unrealistic to expect to rewrite all the tax legislation immediately using PBL, should we give up on the approach either for all time or until we can attempt radical and comprehensive reform? Does the fact that "principle-creep" has occurred mean that the approach should not be tried again?

It is suggested that we cannot afford to abandon this experiment just because it will not deliver perfection. In fact we have no choice but to continue with it. The current route of ever increasing amounts of detailed legislation cannot continue and we need to find ways to improve the situation. We should, however, step further back to find starting points for this work and integrate it with structural policy reform exercises. Basic charging provisions should be rewritten using PBL, rather than using this for small areas of tax-avoidance activity. For example, instead of looking only at group mismatches, we should be looking to apply PBL to group tax relief more generally. We also need to work on ways of ensuring that administrative interpretation of the PBL is kept within the confines of the principles and is subject to proper controls, by having consultations on these interpretations together with other ways of involving the tax community in developing them. This is not a problem unique to PBL, and methods for tackling this require further consideration however we legislate.

PBL requires great effort from the Revenue authorities and legislators and from the taxpayer community, which needs to resist the temptation to try to obtain elaboration that turns the PBL back into detailed provisions, as we have seen happening with the experiments in the UK so far. This will require a better choice of subject matter to ensure that the principles used are meaningful and mesh with existing legislation and underlying concepts. In due course the judiciary will also need to show understanding of what the experiment seeks to achieve. This is a great deal to expect. The attempt to use PBL will highlight many imperfections in our system, but recognising these difficulties may be a good route to improvement, although perfection is too much to expect. ⁴

⁴ Drafting; Legislation; Purpose clauses; Statutory interpretation; Tax avoidance; Tax principles