Humpty Dumpty’s guide to tax law: Rules, principles and certainty in taxation

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A B S T R A C T
Tax systems are, most commonly, rules-based. This gives the impression of technorationality in the interpretation of the numbers from which tax bills are derived. In fact, uncertainty and complexity in tax rules are seen as promoting tax avoidance behaviour, as avoiders exploit this complexity. Some authors have advocated that this can be combated by replacing rules-based tax legislation with principles-based legislation, giving tax authorities and the courts the power to interpret legislation purposively.

This paper demonstrates by reference to a number of UK tax cases that rules-based legislation already embodies the hidden operation of state power as judges have considerable discretion in the interpretation of rules. The paper goes on to argue that principles-based legislation would further empower the state vis-à-vis the citizen. While this might be intuitively appealing to the vast majority of taxpayers not engaged in tax avoidance, it brings with it the hidden danger of a fundamental alteration of the balance of power between the state and all citizens, and should therefore be treated with caution.

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1. Introduction

“When I use a word” said Humpty Dumpty in a rather scornful tone “it means precisely what I want it to mean, neither more nor less.” (Carroll, 1871)

Carroll was poking fun at pretension, but Humpty Dumpty’s words could equally apply to judges and tax lawyers, who spend their days arguing over the meaning of words in legislation and of numbers in accounts and tax calculations. UK tax law is a set of highly specific and complex rules. Yet, despite this, the plethora of UK tax cases each year demonstrates that the application of the law is not certain in all situations. Successful tax avoidance (defined by James, 1998 as ‘the rearrangement of a person’s affairs, within the law, so as to reduce tax liability’) involves finding and exploiting such ambiguities in tax rules. In attempting to combat such schemes, legislators reactively enact specific anti-avoidance legislation, spawning new complexity and ambiguity. This in turn is exploited by new avoidance schemes. Such cycles could, in theory, continue indefinitely.

It has been suggested that an alternative approach to anti-avoidance legislation is needed to cut through this vicious circle. Braithwaite (2002) advocates a shift away from specific rules to a more principles-based approach in which the legislation would be interpreted purposively. Such legislation would contain less detail and judges would be given a greater degree of discretion to interpret it in accordance with clearly stated principles. In the UK, Freedman (2004) has advocated the introduction of a general anti-avoidance principle (GANTIP), arguing that it would bring greater certainty into the UK.

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tax system by allowing the tax authorities to disallow tax avoidance schemes perceived as involving artificial structures and transactions without giving precise reasons.

The paper argues that uncertainty arises in rules-based systems owing to the uncertainty of language itself. This uncertainty makes the calculation of tax liabilities ambiguous and thus helps constitute a contested terrain between taxpayers and the state, with the amounts payable by one to the other at the heart of the dispute. Specific cases born of such uncertainty are sometimes adjudicated by the courts, allowing judges to exercise considerable discretion in adjudicating rules. The paper utilises such cases as a means of examining the exercise of such discretionary power, which often remains hidden (Lukes, 2005) because rules are assumed to be technocratic and rational. The paper argues further that, despite their limitations, rules give taxpayers some degree of protection against the exercise of capricious power by the state. If UK tax laws were re-drafted using a principles-based approach then this would further increase judges’ discretionary power, leading to the risk that this protection would be eroded, which would constitute a shift of power from the taxpayer to the state.

This paper contributes to the emergent body of critical tax research by problematising and exploring the operation of power and has five sections. Section 2 explicates the philosophical distinction between rules and principles and argues that both embody the operation of discretionary power. Section 3 discusses six tax cases which provide empirical evidence of the exercise of judicial power in deciding contentious issues in a rules-based system. These cases reveal something of the subjective nature of such exercises of power, despite the presence of clear rules. Section 4 discusses the possible implications of a shift to a principles-based approach to drafting legislation, including the introduction of a GANTIP. Using the Human Rights Act 1998 as an example of principles-based legislation, the paper demonstrates how such approaches may further increase judicial discretion, shifting power from the individual to the state. This is followed by some conclusions.

2. The nature of rules and principles

In order to compare the operation of power in rules-based and principles-based systems it is first necessary to understand rules and principles and differentiate between them. Dworkin (1977) draws a clear distinction between the two. He argues that rules are prescriptive: if a rule covers the facts of a particular case, the rule prescribes the outcome. In contrast, principles provide reasonings which point in a particular direction, but do not determine a given outcome.

Dworkin (1977) further argues that while rules should not conflict with each other, principles may. If two or more rules apply to a particular case, but each specifies a different outcome, there is an irreconcilable conflict, since it is impossible to conform to one rule without simultaneously breaking one or more other rules. Where principles conflict there is no such problem, as principles merely provide guidance rather than prescribing outcomes and it may be necessary to assign each principle a weighting in order to reach a decision. The relative weighting of principles need not be the same in all circumstances. Different decisions therefore may be reached in similar situations because the relevant principles have been assigned a different weighting in each case.

Such an approach implies that rules will produce certainty and principles permit the exercise of subjective discretion, but Braithwaite (2002) argues, perhaps counter-intuitively, that principles-based regulatory regimes may provide greater certainty than rules-based approaches in complex and dynamic situations. Rules can only provide a basis for a decision if the facts of the particular case fit the criteria for applying a particular rule. In complex situations this is likely to generate a plethora of rules designed to cover particular circumstances. These rules may conflict, necessitating a choice between rules and, hence, uncertainty of outcomes.

Braithwaite (2002) concludes that principles lead to greater certainty because they only provide guidance, allowing assessors to use their discretion in deciding which factors indicate compliance or non-compliance in any given situation. He supports this by a comparison of the assessment of nursing homes for the elderly. In Australia, they are assessed through broad standards based on principles such as ‘respecting the dignity of the residents’. In the US they are assessed through detailed rules, such as counting the number of residents attending various activities or the number of pictures on the walls of residents’ rooms. Braithwaite found that the use of broad standards led to greater consistency than detailed rules in the assessment of nursing homes.

This is, however, a very limited scenario: in the regulation of residential homes conflict between the rights of involved parties will not generally arise when assessing standards. In contrast, tax cases generally concern a conflict between the rights of two parties which result in (financial) winners and losers. Hence, the exercise of judgement comes down to the operation of power to the benefit of one party and the detriment of the other, as is demonstrated later.

Tax cases generally reach court only where rules provide only ambiguous outcomes, making judicial interpretation of legislation inevitable. Robertson (1998) suggests that in rules-based systems judges may reach their decisions by reasoning backwards: instead of the application of rules leading inexorably to a decision, the judges will reach a decision based on their own instincts and prejudices and then seek a legal rule which supports it.

In many cases, and the Law Lords admit this readily enough, they work ‘bottom-up’, from a basic instinct that the plaintiff or the defendant ought to win, to an argument that makes them a winner. (Robertson, 1998, p. 17)

Robertson (1998) cites evidence which demonstrates that, in cases heard by the House of Lords (which historically was effectively the UK’s supreme court), over 90 per cent of tax and criminal and over 80 per cent of public, constitutional and civil
cases could be correctly predicted by simply knowing which judges would hear the case. That the identity of judges hearing cases, which are likely to be among the most complex, provides such a strong prediction of the outcome indicates the extent to which decisions may be guided by judges’ personal attitudes, rather than strictly technical interpretative reasoning.

If, as Robertson (1998) argues, judges often argue ‘bottom-up’, relying on ‘basic instincts’, the question arises as to how subjective their instincts are. Braithwaite (2002) argues that judges’ instincts or intuitions are grounded in professional training, rather than personal values, but this begs the question of the extent to which professional training is itself subjectively grounded.

In the interpretation of case law, judges’ discretion lies in the extent to which they consider themselves bound by precedent. A judge may depart from the precedent of a higher court or court of the same level on a number of grounds, including where the judge considers that the precedent is no longer appropriate and where the facts of the case under consideration can be distinguished from the precedent. Zander (2004) argues that the relevant precedents are usually a mixed bag of decisions with different degrees of relevance to the case under consideration. Judges therefore have considerable discretion in deciding which precedents to give weight to. Furthermore, he argues that a court sometimes ‘distinguishes the indistinguishable’ (p. 275) in order to escape from an unwelcome precedent.

Judges might appear to have relatively little room for manoeuvre if they follow the literal rule of statutory interpretation, where judges assign words their normal meaning, even if the result seems to contradict the purpose of the legislation, or if the facts of a precedent seem to be identical to the case under consideration. However, when asked by Alice whether he could make words mean so many things, Humpty Dumpty replied ‘the question is... which is to be master – that’s all’ (Carroll, 1871). This raises the spectre of the power that judges have in assigning words their ‘ordinary’ meaning.

This discretion may be heightened under principles-based systems. Du Gay (2000) argues that the application of rules is characteristic of a bureaucratic ethos which gives citizens protection because bureaucracies aim to ensure consistency of treatment of citizens. In contrast to the bureaucratic ethos, the use of broad principles and increased administrative or judicial discretion is characteristic of a move away from a bureaucratic ethos towards the notion of treating all citizens in an ‘appropriate’ manner, where the definition of ‘appropriate’ can be highly subjective. This shift confers a large degree of discretion, and therefore power, on those who are responsible for making the decisions.

In sum, neither rules nor principles can be relied upon to be objective and value-free systems of decision-making. However, the appearance of objectivity may enhance the legitimacy of decision-making systems, effectively obscuring the operation of discretionary power. Lukes’s (2005) theories of power offer a useful lens through which to observe the operation of such power.

Lukes (2005) identifies three dimensions of power. The first dimension is overt: A has the power, in the form of legitimate authority or otherwise, to compel B to act in a certain way, which is not in B’s best interest and in which B would not act if that power did not exist. Examples of such power are authority conferred by law or seniority in an organization on the one hand, or torture, bullying or blackmail on the other. There is a very clear operation of power in courts as judges have the authority to affect people’s lives through the decisions that they reach. Such power is viewed as legitimate (in the form of respect for the law as personified by the corporeality of the judge) but, arguably, only so long as the process is perceived as rational and technocratic.

The operation of power can, however, often be more subtle. In Lukes’s second dimension of power, B ostensibly has a free choice of actions, but the range of options has been restricted by the power of A, so that B can, in practice, only exercise options which are not threatening to A. For instance, agendas may be organized in such a way that some things are simply ‘organized-off’ by virtue of the operation of A’s power. The very organization and operation of legal systems, with their rules of conduct and procedures, represents just such an operation of power.

In Lukes’s third dimension, A exercises power in a significantly more subtle way by shaping the thoughts, mores, norms and values of B to the extent that, while B ostensibly has free choice, the reality is that they believe that their interests are aligned with those of A and act accordingly. In this third dimension, the operation of power is at its most covert and, Lukes observes, power is most effective when it is least observable. It is also very difficult to observe and critique, since it is, by definition, ‘hidden’ and observable incidents are hard to discern. Moreover, a critique of such power requires the would-be observer to quit their own conditioning and to stand outside the dominant hegemony. Lukes (2005) argues that even where power is hidden, there exist windows of opportunity through which it becomes observable—small critical incidents that give insight. This poses methodological challenges—plainly the operation of such power would not be observable through data collection methods such as mass surveys.

Lukes’s (2005) multi-dimensional model of power can, I argue, shed considerable light on the operation of judicial power in tax systems. The first dimension of judicial power is where judges are simply believed to be interpreting the techno-rational rules of statute and case law in an objective manner. This accords with Braithwaite’s (2002) notions of interpretation. In the second dimension judges exercise considerable discretion through the organization of the decision-making system: for instance, the rules, as detailed by Zander (2004), relating to when judges may reject case law precedent allow a large degree of subjective judgement. In the third dimension the exercise of judicial discretion, and hence power, is unseen because there is a widespread acceptance or ‘buy-in’ by the population that the rules or principles are fair to them. For example, citizens might be persuaded that the flexibility given to the tax authorities and judges by principles-based legislation would only be used to counteract tax avoidance schemes of wealthy individuals and multinationals. While the exercise of judicial power in taxation has been analysed through the first and second dimensions, consideration of such power through the lens of the third dimension is significantly absent and forms the primary focus of this paper.
3. Rules and the operation of power

In this section I analyse the operation of judicial power under rules-based systems. As I am seeking to explicate the hidden operation of subjective power, I draw upon six legal cases that represent windows of opportunity through which such power can be seen. In these cases judges reached conclusions which appear surprising and at odds with established precedents and the interpretation of statute. I argue that these subjective interpretations reflect the hidden operation of judicial power.

3.1. Material bodies

In *Bourne v Norwich Crematorium* (1967) it was held that a commercially operated crematorium could not claim industrial buildings tax allowances. The allowance could be claimed in respect of a building, in which goods were subjected to a process and it was held that corpses were not to be considered as 'goods' or 'materials' and cremation was not a 'process'. Possibly the most important part of the judgement is the preamble to the judge's (Justice Stamp's) reasoning.

Having made his instinctive revulsion clear, he dismissed the arguments that a corpse was 'goods' and that cremation was a 'process' by arguing, in the manner of Humpty Dumpty, that legislation cannot be interpreted by simply assigning individual words their normal English meaning. Corpses may be seen as materials, in that they are items which are burnt in order to generate income for the crematorium, in much the same way as waste might be incinerated, however, the most important part of the judgement is that Justice Stamp did not, and did not need to, provide a robust argument why they should not be so regarded in order to reach his decision. It is hard to see how the judge reached this decision, which rejects a basic tenet of interpretation, other than to conclude that he instinctively could not stomach the inevitable conclusion of giving the words 'goods' and 'process' their normal meanings.

3.2. Wartime profit(eering)?

If the crematorium case could be dismissed as an isolated one, motivated by the squeamishness of a judge rather than any wider political motives, it would be a curiosity of no great importance, however, other cases have had wider significance. Examples of these can be found in cases involving excess profits duty (EPD). EPD was a tax imposed during World War I on wartime 'profiteering' and was payable, initially at 50 per cent and later at 80 per cent, on any trading profits in excess of a pre-war profit standard, calculated as the average of any two of the three accounting periods immediately preceding the start of the war. The rationale for the tax was summed up by Lord Hanworth in *Birt, Potter & Hughes v CIR* (1927) thus:

...it [EPD] was designed, as we all know, to try to secure to the Revenue a portion of the profits being made in the course of the War which were said to be enhanced by the circumstances of the War and, being so enhanced, to be beyond the sum which the subject was entitled to keep free of taxation, inasmuch as he ought not to be entitled to make a larger profit due to the misfortune of the nation at large in being at war.

This statement indicates that it was generally felt that the taxpayer had not only a legal duty, but also a moral, patriotic duty to pay tax in order to help the war effort rather than profit from the 'misfortune' of the nation.

It is interesting to look at whether decisions on EPD cases might have been influenced by this patriotic imperative. In *Hinshelwood (Thos.) & Co. Ltd v I.R. Commissioners* (1920) an agreement signed in 1913 provided that the managing directors, Mr. Beattie and Mr. Malone, should receive fixed salaries of approximately the same amount as they had previously received plus commission based on the company's profits. No commission was paid in the year ended 31 December 1913 due to the poor performance in that year.

The Inland Revenue Commissioners now say that they are entitled to issue an additional assessment in order to recover the amount of Excess Profits Duty which they failed to collect in respect of that omission to notice that there had been an increased payment to the managing directors in the two years under charge. In equity there would be no answer at all to that because the only result, except for a point I shall mention in a moment, would be that these payers of Excess Profits Duty would be allowed to *get off with* Excess Profits Duty on something like £10,000 or £11,000, which at 60 per cent, would be a very large sum. (p. 425) (emphasis added).

That is, the judge said simply that the taxpayers should pay the tax because it would be simply inequitable (in his view) for them not to do so. This is despite the fact that the agreement cannot be considered as tax avoidance, since, at the time
it was drawn up, the directors could not have known World War I was about to start and that EPD would be imposed. Lord Justice Clerk did not elaborate further on the reasons why it would be inequitable for the directors to obtain the deduction and it may well be that his sense of (in)equality was shaped by the patriotic duty to help the war effort by paying the EPD.

The case of Glenboig Union Fireclay v IRC (1921) is frequently quoted in technical books and manuals as being a leading case in establishing that compensation received in respect of the loss, or sterilisation, of profit-making apparatus is a capital receipt and therefore not taxable as trading income. From this description it might be assumed that the case was won by the taxpayer, but this is not so.

The appellant company owned and mined beds of fireclay, over part of which ran a railway line owned by the Caledonian Railway. The railway company paid the appellant company compensation of £15,316 in the year ended 31 August 1913 in return for it agreeing not to work the beds of fireclay close to the railway. The appellant company treated the compensation as a trading receipt in their accounts and accounted for income tax on it, but later, under the EPD regime, the tax authorities successfully contended that it should have been treated as a capital receipt and the income tax paid was refunded. This curious situation can only be presumed to have arisen because, due to the high rates of EPD and the fact that the pre-war profits standard was used to determine the level of EPD payable over a number of years, it was in the interests of the tax authorities to reduce the profits of the pre-war accounting periods in order to maximise EPD assessments.

In order to reach their conclusion the judges distinguished the facts from cases such as Bwllfa & Merthyr Dare Steam Collieries (1891) Ltd v Pontypridd Waterworks Co. (1903) and Eden v North Eastern Railway Co. (1907), the material facts of both of which were identical to Glenboig Union Fireclay. These cases (which were, admittedly, not tax cases) held that compensation paid where a mining business is unable to exploit part of a mine or quarry should be calculated by reference to profits foregone. On that basis, the compensation should be treated as a trading receipt. Having cited these cases, the Lord Justice Clerk then stated that he did not accept that the compensation should be so treated in this case, but that the restriction on working certain areas of the beds of fireclay reduced the capital value of the beds and the compensation was received in respect of that diminution in value and the Lord President (Clyde) agreed with his colleague’s arguments.

This case therefore appears to support Zander’s arguments concerning the alacrity with which judges will distinguish the indistinguishable—comparisons with similar cases indicates that it is an outlier. Not only did the judges distinguish the facts from the two precedent cases cited, but also there have been a number of subsequent cases in which the facts have been distinguished from those of Glenboig Union Fireclay. For example, in Waterloo Main Colliery Co. Ltd v IRC (1947), which was a case involving Excess Profits Tax (EPT, the World War II equivalent of EPD), compensation paid when part of the colliery’s area was requisitioned by the Ministry of Works for opencast working was held to be a revenue receipt. The case was distinguished from Glenboig Union Fireclay on the grounds that the portion of the asset had not been sterilised, but had been worked by the Ministry of Works, although the result for the taxpayer was identical in both cases; they were unable to exploit that part of the asset and its value to them was thereby reduced. Furthermore, for the same reason as in Hinshelwood (Thos.) & Co. Ltd v I.R. Commissioners, the taxpayer in Glenboig Union Fireclay could not be accused of attempting to avoid EPD in 1913.

If it is difficult to reconcile the judges’ reasoning in either Glenboig or Hinshelwood their context must be borne in mind. Both cases enabled the tax authorities to levy additional EPD. Given Lord Hanworth’s statement of the rationale for the introduction of EPD it may well be that the cases were decided in a particular way because it was considered the taxpayer’s patriotic duty to pay the tax and that it would be iniquitous to permit them to profit from war. Having decided on the desired outcome, it may be that legal reasoning tweaked the rules in order to achieve this, discarding inconvenient precedents and creating new distinguishing precedents, which only serve to make the tax system more complex.

3.3. Watered down law?

Bourne, Glenboig and Hinshelwood suggest the ways in which judges have re-interpreted case law, but to what extent can judges similarly subjectively re-interpret statute? A number of cases have demonstrated that this is possible, although the legal reasoning needs to be rather more sophisticated.

The case of North of Scotland Hydro-Electric Board v IRC (1961) related to EPT. The Finance Act 1946 s.37 permitted businesses a ‘deferred repairs allowance’ in relation to expenditure on the repair or renewal of fixed assets which, but for wartime conditions, would have been incurred in 1946 or earlier years. This allowance could reduce the profits liable to EPT in the year to which the cost of the repairs, in the opinion of the Commissioners, was attributable ex post. It was, however, a condition that the business was being run by the same persons in the year in which the expenditure was eventually incurred and the year to which it was attributable. The North of Scotland Hydro-Electric Board was a statutory board set up on 1 April 1948 under the Electricity Act 1947, which nationalised the electricity companies. The tax authorities therefore contended that the Board did not qualify for this allowance, since it was the not the same person that was running the business in 1946 and earlier years.

On the face of it, the tax authority’s contention was irrefutable, but Crump (1961) argues that the judges constructed a statutory hypothesis to allow the taxpayer to win the case by construing the Electricity Act 1947 s.14 (which nationalised the private electricity companies) as overriding Finance Act 1946 s.37, even though there was no evidence that the legislation intended this. However, Crump notes that there were political reasons for finding in favour of the appellant company; if the tax authority’s argument had been upheld, the result would have been that a nationalised industry would have had to pay a higher amount of EPT than otherwise, which may have been an obstacle to further nationalisation—a key aspect of post-war
government policy. Members of the Conservative Party, the official Opposition, had suggested that nationalisation could be frustrated by companies liable to be nationalised including a clause in any contract that any rights or liabilities under the contract should be cancelled on nationalisation.

Similar cases can be found much more recently, albeit where the motive for the decisions has been very different. These are *Five Oaks Ltd v HM Revenue & Customs* (2006), heard in September 2006 and *Limitgood Ltd v HM Revenue & Customs* (2007) and *Prizedome v HM Revenue & Customs* (2007), heard in March 2007. The companies in the last two cases were part of the same group and the cases were heard together. Since the reasoning was similar in all three cases, only these latter two cases are discussed here.

*Limitgood Ltd* and *Prizedome Ltd* both concerned the use of capital loss ‘refresher’ schemes, which sought to circumvent the provisions of the *Taxation of Chargeable Gains Act 1992* (TCGA 1992) Sch. 7A (as inserted by *Finance Act 1993* Sch. 8) restricting the use by companies of pre-entry losses.1 *Limitgood* was heard by John Avery Jones sitting alone and he found for the tax authority by interpreting the provision in a purposive manner and the case was not appealed to the High Court. The latter case was heard by Avery Jones sitting with Theodore Wallace, who was the chair. Avery Jones again found for the tax authority, using a similar line of reasoning. However Wallace found for the taxpayer and, since as chair he had a casting vote, his view prevailed. The case was appealed to the High Court (*HM Revenue & Customs v Limitgood Ltd and Prizedome Ltd* (2008)), where it was heard by Justice Blackburne, who overturned the Special Commissioners’ decision, again taking a purposive view of the provisions, albeit using a different line of reasoning from Avery Jones.

The company’s scheme contravened the intention of the Schedule, but, perhaps surprisingly, a straightforward reading of the legislation appeared to allow it to succeed. Avery Jones’s approach was far from straightforward. In a manner upon which Humpty Dumpty could not have improved he set up a tension between a real world and a deemed world which is not apparent from a straightforward reading. Once this tension is removed, his argument quickly unravels. Justice Blackburne construed para. 1(6) of the Schedule to apply only to losses incurred by Limitgood Ltd. and Prizedome Ltd. after they had been acquired by Grantchester Holdings group (there were none) on the grounds that, if para. 1(6) were to also apply to losses which were pre-entry losses to the Grantchester Holdings group, the paragraph would add nothing to the Schedule. Even with the benefit of reading the full opinion, Justice Blackburne’s reasoning appears to be obscure, but it enabled him to reach the desired conclusion.

This decision has been criticised by Murray (2008) who characterised the approach of Avery Jones and Justice Blackburne as

> step[ping] back from the statute, decid[ing] independently from the words of the statute what was Parliament’s purpose, then ignor[ing] certain inconvenient words or add[ing] in others, to give effect to that presumed purpose. (p. 123)

Murray cites Lord Justice Peter Gibson in *Frankland v CIR* (1997), who said that it was the function of the court to interpret the legislation and not to legislate in the guise of interpretation. Murray closes by observing that no tax avoidance scheme will, by definition, accord with the purpose of the statute and, if statutes are interpreted purposively, the taxpayer will never win a case. Nevertheless, Justice Blackburne’s decision has been upheld by Lord Mummery in the Court of Appeal in *Prizedome Ltd & Limitgood Ltd v The Commissioners of HM Revenue & Customs* (2009) and no appeal has been made to the Supreme Court, therefore this decision is now final. He did so on the grounds that the construction of the legislation argued by the taxpayers could not have been intended by Parliament and he could therefore only uphold such a construction if ‘compelled to do so by the language of the statute’ (p.10), which he felt unable to do.

An even more recent case is *HM Revenue & Customs v Grace* (2008), in which Justice Lewison, for the first time in over a hundred years, overturned the decision of a Special Commissioner2 on a question of residence. A decision on residence status was a finding of fact, rather than law, and Commissioners’ decisions could only be overturned on a finding of fact if the findings were considered so bizarre that no reasonable person could have reached them from the evidence available. It follows that Justice Lewison could not overturn the decision simply because he disagreed with it.

The judgement contains the following statement on the interpretation of *Income and Corporation Taxes Act 1988* (ICTA 1988) s.334 (the relevant section for the tax years in question). The section states that a taxpayer will still be resident in the UK ‘if he has left the United Kingdom for the purpose only of occasional residence abroad’. Justice Lewison considered that this section contained two tests: whether a taxpayer had ‘left’ the UK, and, if so, whether it was for the purpose of ‘occasional residence’.

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1 TCGA 1992 Sch. 7A (inserted by FA 1993s.88 and Sch. 8) sets out to prevent companies acquiring other companies in order to exploit either their realised or unrealised capital losses to shelter gains arising elsewhere in the group. If company A (a member of group X) were to acquire company B and B had at the date of acquisition an unrealised capital loss of £1m, Sch 7A prevents a company in group X from transferring an asset pregnant with gain, acquired before the date that company B joined the group, into B shortly before sale (which under TCGA 1992. 171 can be done without any tax consequences arising) and offsetting B’s loss of £1m against the gain arising on the sale of asset. Where, at the date of acquisition, B has an unrealised loss, i.e. holds an asset pregnant with loss, and that asset is subsequently sold at a loss, the loss must be time-apportioned between the pre-entry and post-entry portions and only the post-entry portion may be used to shelter gains arising elsewhere in the group.

2 The Commissioners for Taxes were the first tribunal for tax appeals in the UK, although this system changed in April 2009. While the majority of these were heard by the General Commissioners, who were untrained in tax matters, but were assisted by a trained Clerk, complex cases of a technical nature were heard by Special Commissioners, who were tax experts.
They've a temper, some of them—particularly verbs, they're the proudest which, is clearly intended to carry its normal English meaning; the actual legal test intended by legislators solely concerning only debate surrounding when the taxpayer leaves the UK is whether this occurs when the plane takes off or when it leaves is of the view that the word is not 'a term of the art' and should be given its normal English meaning. He observes that the word is not in inverted commas, and the relevant section does not give the word a special meaning, he is of the view that the word is not 'a term of the art' and should be given its normal English meaning. He observes that the only debate surrounding when the taxpayer leaves the UK is whether this occurs when the plane takes off or when it leaves British airspace. By placing the word 'left' in quotation marks Justice Lewison therefore created a legal test out of a word which, is clearly intended to carry its normal English meaning; the actual legal test intended by legislators solely concerning the phrase 'occasional residence'. In his interpretation of 'left' Justice Lewison is reminiscent of Humpty Dumpty, who said 'They've a temper, some of them—particularly verbs, they're the proudest... however I can manage the whole lot of them' (Carroll, 1871, Ch. 6). It was common ground that s.334 did not apply in this case and the remarks were obiter dicta (i.e. the remarks, although included in the opinion, did not form a necessary part of his decision), therefore Justice Lewison did not elaborate on what that test should be, but the remarks demonstrate the potential to create legal uncertainty out of a simple English word.

These cases demonstrate that, even where law is drafted in the form of precise rules, it is still necessary to adjudicate the precise meaning of legislation in specific situations. This uncertainty confers discretion, and therefore power, on the judges who adjudicate the cases. In one sense this is the first dimension of power as described by Lukes (2005), since it is the exercise of power conferred by legitimate authority. However, it also illustrates the second dimension of power: the exercise of power masked by the impression that they are simply applying techno-rational rules or literal methods of statutory interpretation. Citizens may be less likely to hold judges accountable for their decisions, if they are unaware of their power to base these on personal, rather than legal, judgements.

4. Principles and power

The previous section has argued that it is quite possible for judges to interpret rules-based legislation subjectively and the question arises whether, as has been suggested by Avery Jones (1996) and Freedman (2004) moving to principles-based legislation would create greater certainty for both citizens and the state. The UK evidence on this is limited, as nearly all statute law is rules-based and the UK currently has little principles-based tax legislation. However, it is important to consider, a priori, what the effects of the introduction of such law might be on the power relationships between citizens and the state.

One of the few examples of principles-based legislation in the UK is the Human Rights Act 1998, which enshrines the European Convention on Human Rights of 1950 into UK law. While the principles themselves may be uncontroversial, they lack guidance on how they might be implemented in various situations and it is therefore left to the judge to establish the specific criteria for the decision in each particular case. There is no requirement that subsequent cases follow the same criteria, particularly since it will usually be possible to differentiate the facts of each case which could be used to justify reaching a different decision, if that is considered desirable or expedient. This discretion has the effect of shifting power from individuals to the state, since, if there are no defined criteria for making the decision, it is very difficult to argue that the decision is unreasonable. In contrast, it is quite possible that the recent High Court decisions discussed in the previous section, like many others, will be overturned in a higher court, because it is held that the judges erred in their interpretation of the law. While the discretion in interpreting rules can be disguised as techno-rational decisions, the discretion inherent in the interpretation of principles is more apparent and illustrates Lukes's (2005) third dimension of power. Individuals might be persuaded to accept this discretion if they can be convinced that it will only be exercised for their benefit, however, once this discretion exists, it might easily be used in ways that these same individuals might disapprove of. For instance, local councils now have surveillance powers designed to enable them to combat serious crime, but there has been recent controversy over their use for relatively trivial offences such as littering and dog-fouling (Guardian, 2009).

This discretion will be of particular importance where two or more principles conflict and a judge must decide which principle should be prioritised. Such a conflict arose in Mosley v News Group Newspapers Ltd (2008) EWHC 1777 (QB) (e.g. The Lawyer, 2008; Times, 2008), in which the judge, Justice Eady, awarded substantial libel damages to Max Mosley for stories concerning his private life printed in the News of the World newspaper. Justice Eady was widely criticised for using the Human Rights Act 1998 to create a privacy law through judicial ruling.

The judgement turned on a conflict between article 8 of the European Convention on Human Rights (as incorporated into the Human Rights Act 1998 Sch. 2) which guarantees the right to respect for private and family life and article 10, which guarantees the right to free expression. Conflict therefore arises since, in exercising its right to freedom of expression, Max Mosley felt that the News of the World had infringed his right to privacy. Similarly, by successfully asserting his right to privacy, the News of the World may feel that their right to free expression has been infringed. The fact that the way in which this, and other, conflicts may be resolved is subjective is demonstrated by The Lawyer (2008), which summarised the views of various eminent judges on the above issue. It considered that Mr Justice Eady, as demonstrated by the above decision, and Mr Justice Blackburne are strongly inclined to prioritise the individual's right of privacy, whereas Mr Justice Tugendhat is strongly inclined to favour the right of the press to free expression, as illustrated by his decision to allow the press to report details of the personal life of the Chelsea footballer and then England captain John Terry (Guardian 2010), while Mr Justice...
Lindsay sat in the middle of this spectrum. It is, therefore, quite possible that the case would have been decided differently if it had been heard by, for example, Mr. Justice Tugendhat.

If a similar principles-based approach were adopted in tax legislation, and in particular in the area of anti-avoidance legislation, the UK tax authorities and courts would be asked to consider whether a scheme was ‘artificial’ or ‘abusive’. Previously, tax avoidance was simply distinguished from tax evasion, the former being legal and the latter involving deception and dishonesty and, therefore, being illegal. The distinction has become blurred in recent years and the tax authorities have taken a more aggressive stance against tax avoidance. For example, James (1998) defines the term ‘avoiion’ (a portmanteau word derived from avoidance and evasion, which would, doubtless, have greatly appealed to Humpty Dumpty) as behaviour designed to reduce tax payments in areas where the law is unclear, which indicates that the distinction between avoidance and evasion need not always be clear. Relating this definition to the above terms, an ‘artificial’ scheme might involve transactions which generate a tax loss, but where no commercial loss has been suffered, and an ‘abusive’ scheme would comply with the letter of the law, but not with its spirit. The origins of this more aggressive approach can be seen in W.T. Ramsey Ltd v IRC (1981), in which a scheme to shelter a capital gain was held to be ineffective, even though none of the individual steps could be considered a sham, because the taxpayer’s financial position was essentially unchanged at the end of the scheme and the only purpose of the scheme was tax avoidance. This was developed in possibly the best known case, Furniss v Dawson (1984) in which the judge applied a ‘blue-pencil’ test, that is, if pre-ordained steps were inserted into a scheme purely for tax reasons, these steps could be ignored. The scope of this doctrine was limited by later cases such as Craven v White (1988), but the desire of the tax authorities to go beyond strict black-letter law in striking down tax avoidance schemes remains.

As adjectives, ‘abusive’ and ‘artificial’ recall Humpty Dumpty’s assertion that, whereas verbs had a temper, he could do anything with adjectives (Carroll, 1871). If principles-based legislation gives the tax authority broad discretion, in the same way as the decision in Mosley v News of the World (2008) depended on the way an individual judge prioritised the two conflicting principles, the decision whether to overturn an earlier decision may depend on whether the subjective interpretation of ‘abusive’ or ‘artificial’ by the judges corresponds to the interpretation by the tax official or the lower court. The courts could take one of two approaches. They could refuse to intervene, except possibly in the most egregious cases, in which case there would be a substantial shift of power from the taxpayer to the tax authority, or they could intervene and overrule the decisions of the tax authorities and, by doing so, create guidelines which would develop into judicial precedents. This could give the taxpayer greater certainty, but may defeat the objective of principles-based legislation.

It has been argued (e.g. by Avery Jones, 1996) that the application of principles-based legislation can be certain if the principles underlying the legislation are clearly set out. However, if there is no guidance as to the interpretation of these words or only general guidance of the sorts of features which an abusive or artificial scheme might contain, there will be a large amount of discretion which can be exercised by tax officials and courts in defining what these words mean in specific cases.

One of the few examples of principles-based legislation in the UK tax system is the Disclosure of Tax Avoidance Schemes introduced by the Finance Act 2004, under which taxpayers, or their agents, are obliged to give the UK tax authority advance notice of arrangements which enable, or might enable, any person to obtain a tax advantage, and the tax advantage is one of the main benefits which might be expected to arise from the arrangements (Finance Act 2004 s.306). David Hartnett, who at the time was Deputy Director of the Inland Revenue (the UK tax authority at the time, now HM Revenue & Customs), clarified the way in which these provisions were intended to operate (Hartnett, 2006). He said that it was not intended to ‘inhibit the giving of normal, plain vanilla advice’ and gave three specific examples of where the provisions might apply. These examples were not intended to be exhaustive and the criteria for the inclusion of other schemes within these rules remain uncertain.

A principles-based approach to the design of the legislation allows the tax authorities to respond more quickly to anti-avoidance schemes, but the trade-off is a transfer of power from the taxpayer to the state, since the terms in which the legislation is drafted make it more difficult to challenge an interpretation by the tax authorities or the courts. The result may be that taxpayers will not consider it worthwhile devising avoidance schemes, given the ease with which they could be struck down. In this respect, the power of principles-based legislation may be greatest if it is not invoked, but simply left as a bogeyman to scare taxpayers. Taxpayers would thereby be using the Foucauldian concept of ‘techniques of the self’, whereby they exercise self-discipline and regulate their own behaviour, without the need for overt state coercion and a shift to principles-based legislation would therefore be one of the techniques and structures of governmentality whereby taxpayers regulate their conduct in accordance with the wishes of the government (Foucault, 1978), Hartnett (2006) relates a conversation with a banker in which the banker hinted that his bank might give up aggressive tax planning due to the legislation, which Hartnett saw as an indication of its success (Oats and Salter, 2008).

While the cases discussed in the previous section have shown that it is possible to read a desired meaning even into detailed rules, the nature of rules does give some certainty, and therefore some protection to taxpayers. As previously argued, rules are characteristic of a bureaucratic ethos and this gives citizens protection because the principles upon which the ethos is founded, such as adherence to procedure and commitment to the purposes of the office, aim to ensure consistency in the way in which different citizens (or taxpayers in this case) are treated (Du Gay, 2000).

The experience of the General Anti-avoidance Rule (GAAR) in Australia, which gives the Australian Tax Office (ATO) wide discretion to disallow tax avoidance schemes based on a number of broad principles, might also suggest that principles-based legislation will not necessarily lead to greater certainty. Pickup (2008) refers to the ‘judicial castration’ of the GAAR’s predecessor, Income Tax Act (1936) s.260, whereby this section was contested in a succession of judicial cases and reduced to a set of rules. The GAAR was introduced in 1981 in order to ‘toughen’ this part of the code and this approach has been
supported by the judiciary, but Pickup argues that there is serious concern that legitimate business and personal transactions are being ‘wrongly’ caught by the rule and speculates that the courts may, in time, start to favour the taxpayer to a greater extent.

Evans (2008) argues that, while the Australian government is satisfied with the way that the GAAR has operated, there has been a cost. Despite the large number of adjudicated cases, a large number of issues remain unresolved and there is no greater certainty about whether the GAAR will apply in a particular case. Cashmere (2006) (cited in Evans, 2008 p. 40) echoes Murray (2008) when he argues that Part IVA:

is drafted so widely as to be capable of enabling the Commissioner of Taxation to annihilate any transaction which provides a tax advantage... [w]hile certainty relating to the application of legal principles (including tax principles) cannot be assumed, it is important that there be certainty relating to the principles which are to be applied. The High Court has yet to provide that certainty in relation to the interpretation of Part IVA

Freedman (2004) has advocated the introduction of non-binding rules, that is, rules which would be followed unless they produced an unreasonable or absurd result, combined with binding principles, which would override the rules when they produce such a result, and a General Anti-avoidance Principle (GANTIP), which would be similar to the GAAR in Australia. Logically, following Dworkin’s (1977) definition of a rule, a non-binding rule is a contradiction in terms and becomes no more than guidance as to the course of action which should normally be followed. Once again, the issue of power arises: who should decide when it is appropriate to override a rule and in what circumstances? The only specific example of an over-arching principle which Freedman proposes is the GANTIP, stating that the provision of certainty should not be its purpose, but rather it should help to shape the responsibility of the taxpayer. By referring to the notion of responsibility, Freedman is perhaps invoking the notions of Foucauldian self-discipline and governmentality. Freedman views a GANTIP as an ‘overlay’, that is it would give guidance in the interpretation of the law where there is uncertainty and would permit assumptions as to the intentions of Parliament in certain situations. While she admits that the boundaries would be fuzzy, she views this uncertainty as a lesser evil than the legal entrepreneurship or ‘hyperlexis’ which gives rise to complexity through the accretion of anti-avoidance legislation.

If taxpayers could be persuaded to not only acquiesce in, but actively to support measures such as principles-based drafting and interpretation or a GANTIP, because the terms in which it is phrased lead them to believe that it would only be used to target schemes of which they would disapprove, without giving any thought as to how the principle might be applied in practice, this would be an illustration of Lukes’s (2005) third dimension of power. How a GANTIP might be applied in practice is necessarily speculative, but a clue about the possible direction the tax authorities might take may be gleaned from the recent case Jones v Garrett (2007) UKHL35 (generally known as the Arctic Systems case after the name of the company used by the taxpayer, Mr. Jones). In this case the tax authorities sought to re-allocate dividends paid by the company to Mrs. Jones from her to Mr. Jones. The tax authorities won all the way up to the Court of Appeal, but the decision was overturned in favour of the taxpayer in the House of Lords. The tax authorities’ stance had attracted much adverse comment in the professional press (for example Truman, 2007) on the grounds that these arrangements were not tax avoidance, but merely sensible tax planning by ordinary taxpayers. The taxpayers eventually prevailed because the Law Lords held that the tax authorities had misinterpreted the law, but doubt arises whether they could have challenged the decision successfully if the tax authorities could have invoked a GANTIP, arguing that the arrangements were abusive or artificial.

This case suggests that, if the tax authorities had a GANTIP at their disposal, there is no guarantee that they would not seek to extend its use to the types of arrangements used by Mr. and Mrs. Jones. If they were to do so the attitude of the public towards a GANTIP might change. Admittedly, a GANTIP might have little effect on the majority of taxpayers, since the sorts of tax avoidance schemes which might be targeted by a GANTIP can often currently only succeed after a successful legal battle and are therefore only available to taxpayers with sufficient resources to pursue the matter (Mr. and Mrs. Jones’s costs were paid by the Professional Contractors’ Association, who were concerned about the possible effect of this case on their members, if the tax authorities had won). Taxpayers might therefore view this extension of power as a welcome attempt to ‘level the playing field’.

This section has argued that a move to a principles-based system risks transferring power from taxpayers to the state and that taxpayers should not blindly assume that the discretion will always be exercised for their benefit. While such an extension of state power occurs also in other contexts, this is often accompanied by a greater awareness of the possible power consequences. In the realm of tax, such principles-based legislation might be construed as only attacking tax abusers and therefore be of popular appeal, but the populace might not be aware of the wider potentialities of such legislation on their lives and tax affairs.

5. Conclusion

In this paper I have argued that uncertainty is inherent in both rules-based and principles-based methods of drafting tax legislation. Uncertainty is more apparent in principles-based legislation since principles only provide guidance which must be applied to specific situations. However, while rules may appear prescriptive, uncertainty also arises in rules-based legislation because the interpretation of legislation is a matter of the interpretation of words and uncertainty is a result of instances where their meaning in a particular context is considered to be ambiguous. Discussions of uncertainty have emphasised that uncertainty in the meaning of rules is exploited by taxpayers to avoid tax, but the belief that this could
be eliminated or reduced by adopting a principles-based approach to the drafting of tax legislation may well be misplaced. Where there is uncertainty, judges must adjudicate and, since the legislation has failed to provide a clear answer, they have discretion in the way the cases are adjudicated. This discretion gives judges power and the extent and nature of this power will depend on the amount of discretion which judges have, the extent to which this discretion is apparent and the extent to which others can be convinced that this discretion will be exercised for their benefit. While taxpayers may contrive uncertainty under a rules-based system in order to avoid tax, judges may also do so for reasons of personal sensibilities, or political motives, such as the patriotic duty to pay tax during wartime or to prevent tax avoidance. This power may be hidden if the impression is given that judgements are simply a matter of following techno-rational rules, but the simple knowledge and understanding that discretion exists and that the notion that rules operate in a prescriptive and techno-rational manner is an illusion can curb this power. Despite their limitations, the detailed nature of rules do give some degree of certainty since they give less room for interpretation than where judges are required to interpret broad principles. The consequence of this is that where judges use their discretion to interpret rules in a way which strains the meaning of the words, it is easier to rectify this by overturning the decision in a higher court because the detailed nature of rules means that the judges can rule that the lower court has interpreted the law wrongly.

A shift from a rules-based to principles-based legislation has the potential to shift of power from taxpayers to the state and it would be harder for taxpayers to challenge decisions made on the grounds that a scheme was, for example, deemed to be abusive or artificial, because the lack of clear criteria in interpreting these terms means that it is more difficult to rule that the interpretation by tax officials or the lower court was wrong or unreasonable. If this shift were to be portrayed as being necessary to combat tax avoidance, it might appear to be superficially attractive to the majority of taxpayers and garner their support. This power shift would therefore be hidden. Taxpayers may support the shift, just as long as they are convinced that the powers will only be used against those of whom they disapprove, but there is no guarantee that these powers will not be used in a manner which adversely affects themselves; Principles-based drafting is likely to change tax law fundamentally and it may be impossible to revert to the previous system; to return to Humpty Dumpty, when, in his nursery rhyme incarnation, he fell off the wall and ‘all the king’s horses and all the king’s men couldn’t put Humpty Dumpty back together again’.

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