

RESPONSIVE REGULATION, RISK AND RULES: APPLYING THE THEORY TO TAX PRACTICE

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I. INTRODUCTION

John Braithwaite's seminal work on responsive regulation¹ has been taken up and developed by tax authorities around the world.² It has had a major impact on methods of tax administration. The Braithwaite model, with its enforcement strategy and regulatory sanctions pyramid³, has much to offer in a tax context. This strategy works by relying on self-regulation or attempting to coax compliance by persuasion initially, which will work with the majority, and then moving on to greater levels of enforcement culminating in criminal penalties for the most

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¹ Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992); John Braithwaite, "The Essence of Responsive Regulation" (2011) 44:3 UBC L Rev [forthcoming] [Braithwaite, "Essence"]. See also John Braithwaite, *Markets in Vice, Markets in Virtue* (Oxford: Oxford University Press, 2005) [Braithwaite, *Markets*]; Valerie Braithwaite, ed, *Taxing Democracy: Understanding Tax Avoidance and Evasion* (Aldershot: Ashgate, 2003) [Braithwaite, *Democracy*] (applying these ideas in tax writings).

² Kristina Murphy, "Moving Forward Towards a More Effective Model of Regulatory Enforcement in the Australian Tax Office" [2004] British Tax Review 603.

³ This was introduced in John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (Albany: State University of New York Press, 1985) and then developed in Ayres & Braithwaite, *supra* note **Error! Bookmark not defined.**

recalcitrant minority at the tip of the pyramid.⁴ This approach has some limitations and difficulties, however, and its application in the tax world could be strengthened by recognition of its weaknesses and the implementation of action to address these problems.

Some critics argue that there is an inherent constitutional problem with responsive regulation.⁵ These concerns are of a general nature, but have particular strength in the tax field, in view of the constitutional and political sensitivity surrounding tax raising powers and as a result of the complexity and relative indeterminacy of tax law, which may make it more difficult than in other areas to assess what constitutes compliance in every case.⁶ To some extent the limitations relate to the way in which the model is applied, but there are also more fundamental objections that require examination. This article discusses two particular problems, together with possible responses, which could help to appease the critics of responsive regulation in the tax arena. Part II describes these problems and sets out the challenges posed by responsive regulation to tax administration. Part III discusses these issues further, in the context of changing relationships between revenue authorities and large businesses, using a case study based on the approach of Her Majesty's Revenue and Customs (HMRC) in the U.K. in this area. Part IV discusses the issues raised by the example in the context of some of the responsive regulation literature and Part V concludes by suggesting that the theory of responsive regulation has great value in tax administration but also the potential for misfiring in this area unless applied and used only where appropriate legal safeguards are provided. Legally enforceable safeguards are required to maintain the rule of law and provide a clear framework of objectives, due to the sensitivity of taxation and the complex relationship between citizen and taxpayer.

⁴ See especially Ayres & Braithwaite, *supra* note **Error! Bookmark not defined.** at 35–40.

⁵ See e.g. Jan Freigang, “Scrutiny: Is Responsive Regulation Compatible with the Rule of Law?” (2002) 8:4 *European Public Law* 463; Karen Yeung, *Securing compliance: a principled approach* (Oxford: Hart Publishing, 2004) at 170, 248.

⁶ See Mark Burton, “Responsive Regulation and the Uncertainty of Tax Law: Time to Reconsider the Commissioner’s Model of Cooperative Compliance?” (2007) 5:1 *eJournal of Tax Research* 71. Critics have made similar comments in connection with other areas of law, however, for example criminal law. See Andrew Ashworth, “Is the criminal law a lost cause?” (2000) 116 *Law Quarterly Review* 225.

The phrase “rule of law” is used here in its formal rather than its substantive sense to mean that government should govern by known rules and that the law must be capable of guiding the behaviour of its subjects.⁷ This is not inconsistent with a theoretical approach that rests upon mutual trust but can provide an appropriate background for a relationship of trust.

An adherence to the rule of law does not mean that we must stick to the old cat-and-mouse game of detailed legislation, which often provides opportunities for taxpayers and their advisers to find ways of subverting that very legislation—the game of “creative compliance”.⁸ The answer does not lie in rigid detailed legislation, literally interpreted; indeed, this is not the way most modern legal systems work, even in the tax area. It may be essential to leave some discretion in the hands of the tax authorities and the courts, but this must be bounded discretion. Building trust and involving interest groups in “regulatory conversations”⁹ are important parts of the answer, but in a tax context this must be supported by legal structures and be subject to administrative safeguards or it will not be perceived by taxpayers to be fair, in which case responsive regulation will fail.¹⁰

If tax law cannot be certain (and it is unlikely that it can be) then it must at least be ascertainable within an equitable system.¹¹ This may be better achieved through a system based on principles than on one

⁷ See Albert Venn Dicey, *Introduction to the Study of the Law of the Constitution* (London: Macmillan, 1885); Joseph Raz, *The Authority of Law: Essays on Law and Morality*, 2d ed (Oxford: Oxford University Press., 2009) at ch 11. See also Paul Craig, “Formal and substantive conceptions of the rule of law: an analytical framework” [1997] PL 467 (for further discussion and references).

⁸ See Doreen McBarnet & Christopher Whelan, “The elusive spirit of the law: formalism and the struggle for legal control” (1991) 54:6 Mod L Rev 848.

⁹ Julia Black, *Rules and Regulators* (Oxford: Clarendon Press, 1997) [Black, *Rules*]. See also John Braithwaite, “Rules and Principles: A Theory of Legal Certainty” (2002) 27 Australian Journal of Legal Philosophy 47 [Braithwaite, “Legal Certainty”] (developing the term in a tax context).

¹⁰ Valerie Braithwaite, “Dancing with Tax Authorities: Motivational Postures and Non-complaint Actions” in Braithwaite, *Democracy*, *supra* note **Error! Bookmark not defined.** [Braithwaite, “Dancing”] at 15.

¹¹ Timothy AO Endicott, *Vagueness in Law* (Oxford: Oxford University Press, 2000); Philip Pettit, *Republicanism: A Theory of Freedom and Government* (Oxford: Clarendon Press, 1997) at 176.

attempting the futile aim of achieving comprehensive rules.¹² The use of some discretion will always be necessary; the consequences for taxpayers who disagree with interpretations and applications made by revenue authorities need to be as limited as possible, transparent, and open to scrutiny and challenge.

II. TAX AND RESPONSIVE REGULATION: APPLICATION AND CHALLENGES

As would be expected by those familiar with the general theory of responsive regulation, the compliance pyramid as applied in a tax context seeks to select an enforcement strategy that reflects the behaviour of the taxpayer.¹³ As applied to the tax area, the enforcement pyramid works on the basis that most taxpayers voluntarily comply with the tax system. Many more can be regulated by way of persuasion in the context of co-operation and trust, for example by the authorities giving advice where a taxpayer is confused, rather than instantly charging a penalty.¹⁴ These compliant taxpayers form the majority, at the base of the pyramid. The taxpayers at the tip of the pyramid are those who are engaged in tax evasion and they must be dealt with by way of deterrence and penalties. The middle space is occupied largely by taxpayers who wish to be broadly compliant, but who might need more help or persuasion to comply.

It is likely, however, that some taxpayers within this middle space consider themselves entitled to take advantage of ‘grey’ areas in the law and believe themselves to be compliant already, within their own definition of the law, even though they may be aware that their view is contentious. Given the indeterminacy of some tax law, it may even be that the taxpayer’s view of the effect of a particular law is as likely to be upheld by the courts as that of the revenue authority’s view.

¹² Braithwaite, “Legal Certainty”, *supra* note **Error! Bookmark not defined.**; Judith Freedman “Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited” [2010] *British Tax Review* 717 [Freedman, “Improving”].

¹³ See Australian Government: Australian Taxation Office, *Introduction to the Compliance Model*, online: <<http://www.ato.gov.au>>.

¹⁴ See Murphy, *supra* note **Error! Bookmark not defined.** (for further examples). See also Part III of this article, which discusses methods used to encourage business taxpayers to refrain from exploiting all possible tax avoidance opportunities that they feel might be open to them.

In most systems of tax law, and certainly in the U.K. and in Canada, there is a line between evasion on the one hand (involving fraud or at least non-disclosure and thus illegal), and avoidance on the other. Avoidance does not depend on hiding the activity concerned, but relies upon a particular reading of the tax legislation and may often involve steps inserted for tax purposes rather than commercial reasons. At one end of this avoidance spectrum there will be aggressive, artificial or what the Canadian courts have termed “abusive” avoidance. Sometimes these abusive forms of avoidance are prevented from working by a general anti-avoidance statutory provision (GAAR, in Canada¹⁵) or the application of judicially developed principles (as in the U.S.¹⁶ and, possibly, the U.K.¹⁷). At the other end of the spectrum is tax planning or mitigation, which may be entered into for overall commercial reasons but may have elements which are designed to save tax. In most jurisdictions there will be occasions on which this will work to achieve the tax minimization sought technically and in the determination of the courts.¹⁸ The revenue authorities and tax payer may have different ideas about where the line should be drawn within this spectrum and without litigation there may be reasonably held differing views as to which

¹⁵ *Income Tax Act*, RSC 1985, c 1 (5th Supp) (as amended) s 245.

¹⁶ The USA now has a mixture of judicial doctrines developed since the initial decision in *Gregory v Helvering*, 293 US 465 (1935) and statutory codification of the economic substance doctrine introduced by *The Healthcare and Education Reconciliation Act of 2010*, Pub L No 111-152, 124 Stat 1029, inserting § 7701(o) into *Internal Revenue Code*, USC tit 26. See IRS, *Codification of Economic Substance Doctrine and Related Penalties* (14 September 2010), online: <<http://www.irs.gov>>.

¹⁷ The U.K. appeared to have developed a judicial doctrine in the case of *WT Ramsay Ltd v IRC* [1982] AC 300, but the position has been unclear since the decision in *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, [2005] 1 AC 684 [BMBF]. See also Judith Freedman “Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament” [122] *Law Quarterly Review* 52 [Freedman, “Interpreting Tax”].

¹⁸ See e.g. *Canada Trustco Mortgage Company v Canada*, 2005 SCC 54, [2005] 2 SCR 601 at paras 44–62 (“Unless the Minister can establish that the avoidance transaction frustrates or defeats the purpose for which the tax benefit was intended to be conferred, it is not abusive”). See also David G Duff & Harry Erlichman, eds, *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007) (for the Canadian position); *supra* note **Error! Bookmark not defined.** (for the U.K. position).

party is correct. The line between tax planning which the courts will hold to be effective and abusive tax avoidance which the courts will thwart is sometimes extremely unclear. It is this area which is referred to in this article as the “grey” area.

The revenue authorities not only have a problem with the group of deliberate evaders at the tip of the pyramid, who represent a major leakage of revenue, but they are also concerned about those taxpayers willing to utilize, and even insisting on their right to utilize, schemes to minimize taxation which fall into the grey area. The latter group of taxpayer is seen by the authorities (and others) as posing a threat to the collection of revenue that had been anticipated by the revenue authority on the basis of the authority’s interpretation of the law.¹⁹ This group of taxpayers, however, seeing itself as fully compliant, may be resistant to “persuasion”²⁰ since they will consider that they are being open and transparent and satisfying their legal obligations.²¹

Arising from this situation of the grey area taxpayers, the first problem discussed here relates to the extent to which persuasion is a legitimate device for seeking to control behaviour that is not universally accepted to be non-compliant, because there is more than one arguable view. This indeterminacy is not a problem unique to tax²² but is found frequently in areas of financial complexity where the law mirrors the complications of the underlying commercial arrangements. A great deal of effort may be expended in finding sophisticated ways of keeping to the strict legal position whilst achieving the objectives of those concerned in these situations. As John Braithwaite has pointed out,

¹⁹ See HM Revenue & Customs (HMRC), *Measuring Tax Gaps 2010* (16 September 2010) at s 1.1, online: <<http://www.hmrc.gov.uk>> [HMRC, *Measuring*] (defining the tax gap as the “tax that would be paid if all individuals and companies complied with both the letter of the law and HMRC’s interpretation of the intention of Parliament in setting law (referred to as the spirit of the law)”).

²⁰ On the meaning of “persuasion” throughout the article, see *supra* note **Error! Bookmark not defined.**

²¹ Although in some jurisdictions, in some situations, they may suffer a penalty if they litigate and lose. See e.g. Kathleen DeLaney Thomas, “The Case Against a Strict Liability Economic Substance Penalty” (2011) 13 University of Pennsylvania Journal of Business Law.

²² Doreen McBarnet, “When Compliance is not the Solution but the Problem: From Changes in Law to Changes in Attitude” in Braithwaite, *Democracy*, *supra* note **Error! Bookmark not defined.** at 229.

large public corporations in the public eye are good examples of taxpayers who usually will want to be fully compliant with the law as they and their advisers interpret it to be, whilst often seeking tenable tax schemes to minimize their taxes. He shows that this makes the pattern of large business compliance egg-shaped rather than pyramidal, with large numbers of corporate taxpayers falling into the grey area of tax avoidance. John Braithwaite admits that the approach to such firms has to be different from that taken with small businesses and individuals because “it is hard to make compliance strategies work when compliance behaviour is egg-shaped”.²³ He agrees that law reform is the first “circuit-breaker” needed to push those in the grey middle bulge down into the base of the egg, but he argues that the building of cooperative relationships is also necessary and will increase compliance at a reduced cost.²⁴

The difficulty is that, as explained above, the complexity in an area such as corporate taxation makes it hard to say that some behaviour in the grey areas is non-compliant, and views differ on the acceptability of such behaviour.²⁵ Reasonable onlookers and the authorities might draw the line between unacceptable avoidance and “acceptable” tax planning in different places, depending on their views of the role of taxation, the fact situation in each case and even the amount of revenue at stake.²⁶

²³ John Braithwaite, “Large Business and the Compliance Model” in Braithwaite, *Democracy*, *supra* note **Error! Bookmark not defined.** 177 [Braithwaite, “Large Business”] at 178 at 178–181.

²⁴ *Ibid* at 195.

²⁵ *Ibid*; Burton, *supra* note **Error! Bookmark not defined.**; McBarnet & Whelan, *supra* note **Error! Bookmark not defined.**; Judith Freedman, “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle” [2004] *British Tax Review* 332 [Freedman, “Anti-Avoidance”]; Sol Picciotto “Constructing Compliance: Game-Playing, Tax Law and the Regulatory State” (2007) 29:1 *Law and Pol’y* 11.

²⁶ In fact the grey area is not uniform, but has to be seen as having various shades or gradations: see Judith Freedman, Geoffrey Loomer & John Vella, “Analyzing The Enhanced Relationship Between Corporate Taxpayers and Revenue Authorities: A U.K. Case Study” in James Dalton & Martha Eller Gangi, eds, *Recent Research on Tax Administration and Compliance: Selected Papers Given at the IRS 2009 Research Conference*, online: Internal Revenue Service <<http://www.irs.gov>> 103 at 119, 125–126.

This can make it difficult to say when persuasion to behave in certain way which is not clearly non-compliant is appropriate.

To most lawyers, the answer is that the courts must decide where that line should be drawn by determining the proper meaning of the law.²⁷ On this view, taxpayers in the grey area move into the bottom of the pyramid if the behaviour they have undertaken is held by the courts to be in accordance with a proper interpretation of the law. Only the courts can give that interpretation.²⁸ Until the issue has come to court, however, different views may be taken on the proper interpretation of legislation. It has been suggested that it may suit the revenue authority at times for matters not to be heard by the judges in case the courts decide against the authority's view of what the law should be.²⁹

Some would argue that the courts at times do not go far enough to construe the legislation in accordance with the intent of the legislature or what these critics would argue is the "spirit of the law". It is the task of the courts to find the intention of the legislature, primarily by reference to the wording of the statute. In some jurisdictions there will be more scope for purposive interpretation by the courts than in others. Some jurisdictions, but not others, may permit courts to look at background papers. Every tax system, however, imposes some limits on the extent to which courts can interpret legislation in such a way as to close gaps left by the wording of the statute. If by "spirit of the law" is meant simply the proper intention of the legislature as discovered by the application of permissible purposive construction, then of course the

²⁷ That is, in accordance with the formal conception of the rule of law described in *supra* note **Error! Bookmark not defined.**

²⁸ Lord Hoffmann, "Tax Avoidance" [2005] *British Tax Review* 197. See also Freedman, "Interpreting Tax", *supra* note **Error! Bookmark not defined.** (particularly the literature on statutory interpretation discussed at **Error! Bookmark not defined.**–**Error! Bookmark not defined.** and further in this article below); HM Revenue & Customs (HMRC), *Summary of Responses: A Code of Practice for Taxation on Banks* (London: HMRC, 2009), online: <<http://customs.hmrc.gov.uk>> (for the carefully worded but still controversial discussion of this issue).

²⁹ McBarnet, *supra* note **Error! Bookmark not defined.** at 237 (in the context of both the Financial Reporting Review Panel and the U.K. Inland Revenue, as it then was). See also David M Fogel, "The Inside Scoop About the IRS's Appeals Division" (2 June 2003) 99 *Tax Notes* 1503 cited in Joshua D Blank, "In Defense of Tax Privacy" 61 *Emory LJ* [forthcoming in 2011] at 35, n202.

courts should be finding the spirit of the law and the taxpayer should be abiding by this.³⁰ But others suggest that the spirit of the law may be found outside the decision of the courts, in terms of what is acceptable to the revenue authorities or current government, or perhaps even non-governmental organizations.³¹ This means that there may be a gap between the quite proper interpretation given by the courts (based on the limitations of the system, on language and on the legislative process) and the view of the current revenue authorities on the meaning and intent of the law.³²

³⁰ See Organisation for Economic Co-operation and Development (OECD) *OECD Guidelines for Multinational Enterprises* (25 May 2011), online <<http://www.oecd.org>> at ch 11 (“Complying with the spirit of the law means discerning and following the intention of the legislature. It does not require an enterprise to make payment in excess of the amount legally required pursuant to such an interpretation” although the commentary goes further and states that “An enterprise complies with the spirit of the tax laws and regulations if it takes reasonable steps to determine the intention of the legislature and interprets those tax rules consistent with that intention in light of the statutory language and relevant, contemporaneous legislative history”). It is not necessarily the case that the law of the jurisdiction permits consideration of the latter factor.)

³¹ See HMRC, *Measuring*, *supra* note **Error! Bookmark not defined.**. See also ActionAid, *Calling Time: Why SABMiller should stop dodging taxes in Africa* (London: ActionAid 2010) at 7 (“Tax avoidance activities are designed to comply with the letter of the law, not to break it as in the case of tax evasion. We use the term to cover strategies that are legally permissible, but which ActionAid regards as ethically questionable. Throughout this report, we use the terms ‘tax dodging’ and ‘tax avoidance’ interchangeably.”).

³² See Hoffmann, *supra* note **Error! Bookmark not defined.** (the “only way in which Parliament can express an intention to impose a tax is by a statute that means such a tax is to be imposed”). On this view, if the wording of the statute as interpreted by the courts does not successfully impose the tax then it cannot have been the intention of parliament to do so.” The intention of parliament in this sense must be distinguished from the intention of the government, or their advisers, or individual members of the government, who might have felt very differently, or would have felt differently had they thought about it. See Jeremy Waldron, *Law and Disagreement* (Oxford: Oxford University Press, 1999) at ch 6, taking issue with Andrei Marmor’s *Interpretation and Legal Theory*, 2d ed (Oxford: Hart Publishing, 2005). See also *HMRC v Mayes* [2011] EWCA Civ 407, [2011] STC 1269. In this case relating to a complex and highly artificial tax avoidance scheme, the Court of Appeal reluctantly found for the taxpayers. The legislation did not provide any underlying or overriding purpose that enabled the courts to apply a purposive interpretation to reach the result that they felt instinctively would have been correct. Lord Justice Thomas and Lord Justice Toulson both commented that this was a

It is notable that the Organisation for Economic Co-operation and Development's (OECD) *Study into the Role of Tax Intermediaries* (The Intermediaries Study)³³ defines the aggressive tax planning that it seeks to control as including “[p]lanning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. Revenue bodies’ concerns relate to the risk that tax legislation can be *misused* to achieve results which were not foreseen *by the legislators*.”³⁴

The OECD’s study is careful to talk about the intention *of the legislators* and describes this behaviour as *misuse*. The intentions of the legislators are not, however, always crystal clear. Taking a position that is tenable, even if the tax authorities do not like it, might not necessarily be misuse. Sometimes the tax authorities and the commentators slip into equating the intention of the legislators with that of the tax authorities. Thus, John Braithwaite himself refers to the “many who do not intend to comply with what the [Australian Tax Office] regards as the policy purposes of the parliament’s laws”.³⁵

If it is accepted, however, that ultimately the question of the proper interpretation of the intention of the legislature must be a question for the courts, then the issue must be whether the legislature is adequately conveying its intention to the courts and whether the courts are interpreting legislation competently. Moreover, unless a purely legal analysis is utilized to draw the line between what is tax avoidance and what is not, the question arises: where else could the required standard of behaviour possibly come from? Who should adjudicate between the interpretation of the tax authorities and that of the taxpayer on the true meaning of legislation if it is not the courts?

The question of who decides the meaning of avoidance is discussed further below. The first problem discussed in this article, however,

result that parliament could not have foreseen or intended, but by this they meant that they could not look at “intention of parliament” in the wider sense but could only look at the wording of the statute. .

³³ OECD, *Study into the Role of Tax Intermediaries* (np: OECD, 2008), online: <<http://www.oecd.org>> [OECD, *Intermediaries*].

³⁴ *Ibid* at 10 [emphasis added].

³⁵ Braithwaite, “Large Business”, *supra* note **Error! Bookmark not defined.** at 179.

addresses the discretionary scope tax officers have where treatment of a taxpayer, before and until a contentious issue reaches the courts, is concerned. . Given that it is generally considered necessary in order to satisfy the requirements of the rule of law³⁶ for taxes to be imposed clearly by their legislatures and not by administrators, to what extent under responsive regulation regimes can revenue authorities pay more attention to taxpayers who are working within the limits of the law as they believe it to be but who are applying an interpretation that the revenue authorities find questionable, or perhaps even one they reluctantly agree with but the result of which they dislike?

The use of persuasion to encourage compliance beyond that which might be required by law could result in unequal or disproportionate burdens on taxpayers who are not actually disobeying the law. Further, giving tax officials too much power to decide when to pursue a matter and when to apply a light touch, or even to settle with a taxpayer, could lead to an incentive for corporate managers to attempt to exercise influence over tax officers. There might even be a temptation towards corruption or at least regulatory capture resulting from “large unchecked power”, as has been argued by Grbich in an Australian context.³⁷ If some taxpayers are dealt with by using a “light touch” because they are trusted, others might complain that the same advantages are not available to them, perhaps because a scheme that is available to one sector of the population is not available to all.³⁸

³⁶ See *supra* note **Error! Bookmark not defined.**

³⁷ Yuri Grbich, “After Bellinz and Ralph: A New Focus for Decision-Making in the Australian Tax System” in Michael Walpole & Christopher Evans, eds, *Tax Administration in the 21st Century* (Sydney: Prospect Media, 2001), cited in Braithwaite, *Markets*, *supra* note **Error! Bookmark not defined.** (this is not a suggestion that any corruption has actually taken place, either in the U.K. or elsewhere. Grbich was making the point that tax officials might develop a desire to please those whom they are supposed to be regulating under responsive regulation). See also Burton, *supra* note **Error! Bookmark not defined.** at 102. Most jurisdictions will have administrative mechanisms to review this exercise of power internally within the revenue organization itself and by giving powers to external review bodies—for example the National Audit Office in the U.K. and the Treasury Inspector General for Tax Administration in the U.S.; nevertheless a situation is set up where a large degree of discretion is given to individuals.

³⁸ See e.g. Part III, below, especially *infra* note **Error! Bookmark not defined.** (for the discussion of the enhanced relationship between the U.K. revenue authority and large businesses).

Collectively these issues will be referred to in this article as the “rule of law” problem.

The second problem highlighted in this article is the relationship between responsive regulation and risk management. For tax authorities that are short of resources, an attraction of the compliance pyramid is that it offers less intensive approaches to administration for those voluntarily compliant taxpayers located at the base, allowing more concentration of resources higher up the pyramid where they can make a real difference. It is clearly reasonable to have some system of resource allocation, since no system has unlimited resources. Assigning to taxpayers a level of risk related to their behaviour and their own governance mechanisms, assists in placing them on the compliance pyramid,³⁹ but a mechanistic risk rating process will be far from responsive and tax authorities should not equate the two approaches. Past behaviour may not be a guide to future actions; resource allocation based on such a backward-looking risk rating could mean that problems are not anticipated and that improved behaviour is not rewarded quickly enough to have an impact.⁴⁰

This second problem is compounded when combined with the existence of the grey area discussed above. A high risk rating based on behaviour that the taxpayer considers acceptable, though the tax authority does not, could lead to a negative reaction from the taxpayer. It might actually reduce co-operation in other areas of this taxpayer’s tax administration, since this would not be seen to lead to any benefits, even though the taxpayer might be ready to be transparent and open about what it is doing. It could push the taxpayer further from the behaviour required rather than closer. For these reasons it is not clear that risk rating for the purposes of resource allocation is necessarily always consistent with the use of responsive regulation, although superficially it appears to fit well. This will be referred to in this article as the “mixed objectives” problem. The “rule of law” and “mixed objectives” problems described above are discussed further in Part III.

³⁹ John Braithwaite, “Meta Risk Management and Responsive Regulation for Tax System Integrity” (2003) 25:1 Law and Pol’y 1.

⁴⁰ See Julia Black, “The Emergence of Risk-Based Regulation and the New Public Risk Management in the United Kingdom” [2005] PL 512 [Black, “Emergence”]; Robert Baldwin & Julia Black, “Really Responsive Regulation” (2008) 71:1 Mod L Rev 59.

III. RESPONSIVE REGULATION AND ENHANCED CO-OPERATION WITH LARGE BUSINESS

A. SPREAD OF THE MODEL AND APPLICATION TO LARGE BUSINESS TAXPAYERS

Tax officials around the world who have never read an academic article, or even heard of John Braithwaite, are familiar with the regulatory pyramid and compliance model developed by his team. A pyramidal model of responsive regulation was introduced into the Australian Tax Office (ATO) in 1998, based on the work of Braithwaite's Centre for Tax System Integrity (CTSI).⁴¹ Through this medium and by adoption in a number of jurisdictions, these ideas are being introduced more widely.

The OECD has helped to spread this concept. Taking large business taxpayers as a case study we can note the impact of the Intermediaries Study.⁴² This focused on large corporate taxpayers as those supplying much of the demand for aggressive tax avoidance schemes,⁴³ which are provided by professional and other intermediaries. The Intermediaries Study develops a conceptual framework for an enhanced relationship between large corporate taxpayers and tax administrations as a way of tackling what it perceives to be increasing aggressive tax avoidance. This requires a collaborative, trust-based relationship between revenue bodies and large corporate taxpayers and may require both sides to go beyond statutory obligations. The framework was informed by the experiences of jurisdictions which have already established such co-operative relationships such as Ireland, the Netherlands, and the U.S.⁴⁴

To explain the concept with an example, perhaps the most developed and most co-operative model of this relationship is to be found in the

⁴¹ Murphy, *supra* note **Error! Bookmark not defined.**

⁴² OECD, *Intermediaries*, *supra* note **Error! Bookmark not defined.** See also OECD, *OECD Tax Intermediaries Study: Working Paper 5: Risk Management* (np: OECD, 2007), online: <<http://www.oecd.org>>. See also EC, Fiscalis Risk Management Platform Group, *Compliance Risk Management Guide for Tax Administrations* (2010), online: <<http://ec.europa.eu>>.

⁴³ See OECD, *Intermediaries*, *supra* note **Error! Bookmark not defined.** at 10–11 (for the OECD definition of aggressive tax planning).

⁴⁴ *Ibid* at Annex 8.1.

Netherlands. It has been noted that it builds on a long tradition in the Netherlands of a consensus or “polder” model⁴⁵ and so does not derive purely from more modern writing on responsive regulation, but the similarities are obvious.⁴⁶ The approach, known as “horizontal monitoring”, was adopted by the Dutch tax authorities in combination with risk rating when it appeared that a “command and control” and a “one size fits all” approach was failing, in particular with large multinationals.⁴⁷ The system, based on voluntary individualized enforcement covenants, requires voluntary reporting in return for reduced auditing. The requirement to disclose goes beyond reporting actions involving “tax risks” and requires disclosure of the taxpayer’s views about the legal consequences of its actions and the positions taken by it. This has been criticized by Richard Happé as being too vague a requirement and he also points out that the entire system is based even more on trust than similar systems in other countries (such as Australia), where more due diligence verification takes place before an agreement is entered into by the authorities with a taxpayer than in the Netherlands. Nevertheless, the Dutch horizontal monitoring system does require that the tax authority is satisfied with the company’s tax control framework and that the audit committee of the company is obliged to review the company’s tax strategy for tax planning.⁴⁸ In return, the company not only has its administrative burdens reduced as a result of less auditing, but it is also able to obtain certainty upfront on some tax issues.⁴⁹ This underlines the importance of the two-way trust: the relationship works only if the taxpayer and tax authority both gain something. But this could raise questions if it were to involve the tax

⁴⁵ Named after the polders of land, which is land regained from the sea through the construction of embankments or dikes, requiring co-operation from all living on them to maintain them.

⁴⁶ Richard Happé, “Multinationals, Enforcement Covenants, and Fair Share” [2007] Intertax 537, reprinted in Judith Freedman, ed, *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford: Oxford University Centre for Business Taxation, 2008) at 157.

⁴⁷ *Ibid.*

⁴⁸ Eelco van der Enden, Jos de Groot & Eric van der Stroom, “Netherlands” in Anuschka Bakker & Sander Kloosterhof, eds, *Tax Risk Management: From Risk to Opportunity* (Amsterdam: International Bureau of Fiscal Documentation, 2010).

⁴⁹ *Ibid* at 332.

authority making concessions, or resulted in withdrawal of the covenant because the company wanted to test the meaning of legislation by litigating it.

Happé reports that the Dutch Ministry of Finance has suggested that taxpayers who have concluded a covenant and then are “caught doing something you should not, you will be dealt with more severely than in other situations”.⁵⁰ He comments that in such a situation the authority would be “expected to respond proportionately, within the boundaries of the law”, but he adds that what these words mean is unclear. The relationship created by enforcement covenants thus raises rule of law questions about clarity and equality of treatment of different taxpayers and the extent to which the covenant can reasonably be permitted to allow variations in such treatment by way or responsive regulation.

B. “ENHANCED CO-OPERATION” BETWEEN LARGE BUSINESS AND THE REVENUE AUTHORITY IN THE U.K.

We shall now turn to the U.K. for a further example of this type of relationship between the tax authority and large corporations, known in the U.K. as “enhanced co-operation”. It arose from a review of links with large businesses, known as the Varney Review,⁵¹ which aimed at creating a relationship based on trust and understanding between large corporate taxpayers and HMRC. HMRC put forward proposals designed to achieve four desired outcomes: greater certainty, an efficient risk based approach to dealing with tax matters, speedy resolution of issues, and clarity through effective consultation and

⁵⁰ Happé, *supra* note **Error! Bookmark not defined.** at 168.

⁵¹ See HM Revenue & Customs (HMRC), *2006 Review of Links with Large Business* (London: HMRC, 2006) [HMRC, *Review of Links*]; HMRC, *Making a Difference: Delivering the Review of Links with Large Business* (HMRC, March 2007); HMRC, *Approach to Compliance Risk Management for Large Business* (London: HMRC, 2007) [HMRC, *Approach*]; HMRC, *The framework for a better relationship: Making a Difference: Review of Links with Large Business* (London: HMRC, 2008). See also Judith Freedman, Geoffrey Loomer & John Vella, “Corporate Tax Risk and Tax Avoidance: New Approaches” [2009] *British Tax Review* 74 [Freedman, Loomer & Vella, “New Approaches”] (for a detailed discussion of the U.K. tax approach; note that the 2007 guidance on tax compliance risk management discussed in that paper was revised in 2009, and has now been revised further as described in this article. This revision meets some of the criticisms made in that article).

dialogue. The proposals, which all sought to contribute towards the enhanced relationship, included the introduction of a system of advance rulings for businesses in certain circumstances, a new approach to transfer pricing enquiries, a process for the quick and efficient resolution of issues, a new consultation framework, improved guidance, and the introduction of a risk rating system, intended to give a “more cost effective use of resources and efficient resolution of issues”.⁵²

C. THE RISK RATING PROCESS

The risk rating process is premised on the basis of voluntary compliance from low-risk rated companies, allowing resources to be focused on those who present higher risks. There is considerable reliance on the taxpayer’s own systems and governance in deciding the risk assessment.⁵³ The process used to decide on risk status is described in HMRC’s on-line Tax Compliance Risk Management Manual (TCRM).⁵⁴ The TCRM is written for HMRC’s own staff but doubles as a document giving guidance to taxpayers. Each large company dealt with by the Large Business Service (LBS) of HMRC and some smaller companies also are awarded a risk rating.⁵⁵ This may be low risk or non-low risk and the risk level determines the volume of HMRC’s interventions in the company’s affairs and the nature of the working relationship between the two. In essence, a light touch is adopted for low-risk companies, thus releasing resources that can be directed towards higher risk companies. For taxpayers who are rated as low risk there is not normally another Business Risk Review for three years. For others the risk rating is revisited annually and there are also other more

⁵² HMRC, *Review of Links*, *supra* note **Error! Bookmark not defined.** at 6, 16.

⁵³ HMRC, *Approach*, *supra* note **Error! Bookmark not defined.** at para 3.11; Braithwaite, “Large Business”, *supra* note **Error! Bookmark not defined.**

⁵⁴ HMRC, *Index Tax Compliance Risk Management Process (TCRM)—Main Contents*, online: <<http://www.hmrc.gov.uk>> [HMRC, TCRM].

⁵⁵ See HMRC, *Large Business Service*, online: <<http://www.hmrc.gov.uk>>; HMRC, *Large Businesses serviced by Local Compliance—delivering a new relationship*, online: <<http://www.hmrc.gov.uk>> (this approach was initially adopted by the Large Business Service for the 770 largest companies in the U.K. but was then rolled out to some smaller businesses falling within HMRC’s Local Compliance (Large & Complex) teams (LCLC) and now the principles are filtering through to smaller businesses).

frequent interventions.⁵⁶ The idea is that taxpayers will be keen to have fewer interventions by being classified as low risk and HMRC may make savings by examining primarily the systems of those companies rather than every detail and by making fewer interventions because they trust the figures coming from the taxpayer. The HMRC risk rating is confidential and not required to be disclosed in published accounts.

Risk is based on a number of factors, including level of complexity of the business and its relationships with others, pace of change, governance, openness and co-operation, ability to deliver the “right” tax through systems processes and skills, tax strategy and finally “contribution”, that is whether the amount of tax declared looks “reasonable.”⁵⁷ It can be seen from this brief description that many judgments are involved in this assessment. Who decides what is the “right” or reasonable amount of tax, how are tax systems to be judged and what kind of tax strategy is acceptable? HMRC’s view of this is given in the TCRM, which was revised in April 2011 to make some clarifications, as discussed below.

On the whole and even given the uncertainties, anecdotal and survey evidence suggests that business has found the approach helpful.⁵⁸ Problems that have emerged have to some extent been recognized in the revision of the TCRM issued in April 2011. The minutes of the Business Tax Forum (BTF), a group of tax directors from major companies that meets with high ranking HMRC officials on a regular basis, reveal several of these issues.⁵⁹ Not surprisingly, these are similar

⁵⁶ HMRC, *TCRM*, *supra* note **Error! Bookmark not defined.** at TCRM1000.

⁵⁷ *Ibid* at TCRM3310.

⁵⁸ Freedman, Loomer & Vella, “New Approaches”, *supra* note **Error! Bookmark not defined.**; Sally Malam et al, *Large Business Customer Survey: Full Report, August 2010: Her Majesty’s Revenue and Customs Research Report 102* (London: HMRC, 2010), online: <<http://www.hmrc.gov.uk>>; IFF Research, *Large Business Panel Survey: Businesses’ Experience of HMRC: Her Majesty’s Revenue and Customs Research Report 142* (London: HMRC, 2011), online: <<http://www.hmrc.gov.uk>> (the 2011 report largely confirms the findings of the 2010 report).

⁵⁹ See HM Revenue & Customs, *Business Tax Forum*, online <<http://www.hmrc.gov.uk>> (for minutes of these meetings and membership of the BTF) [HMRC, *BTF*].

to survey comments based on interviews with a group of company representatives undertaken by the author and colleagues.⁶⁰

D. CUSTOMER RELATIONSHIP MANAGERS

One area that has concerned business is the degree to which having a customer relationship manager (CRM) can assist to increase transparency and save time. For large businesses which have them, CRMs who get to know the business and work closely with it, have proved to be beneficial in many cases, always subject to the quality of the individual CRM.⁶¹ In particular, a CRM assists with transparency of decision making, though once technical specialists get involved this seems to decrease again.⁶² This suggests that investment in understanding the business of customers and spending time talking with them pays off, as would be expected from the work on responsive regulation.

Re-enforcing the value businesses find in dealing with CRMs, the BTF minutes note that transparency of decision making remains a problem and question why and when specialists are sometimes involved rather than leaving matters to the CRM.⁶³ In some areas, notably transfer pricing, specialists are called in to deal with issues arising and some businesses feel that the advantages of having a CRM are diluted.

This shows the difficult balance between the encouragement of trust and voluntary compliance through good relationships with revenue officials and the maintenance and application of consistent standards across all taxpayers. If all matters were to be left to CRMs, it can be imagined that policy coherence and horizontal equity between taxpayers could be lost. On the other hand the relationship of trust will work only if the officials have sufficient authority. This is a general problem with the management of the exercise of discretion. Moreover the CRM relationship with business has the potential to open up

⁶⁰ Freedman, Loomer & Vella, "New Approaches", *supra* note **Error! Bookmark not defined.**

⁶¹ Malam et al, *supra* note **Error! Bookmark not defined.** Freedman, Loomer & Vella, "New Approaches", *supra* note **Error! Bookmark not defined.**

⁶² *Supra* note **Error! Bookmark not defined.**

⁶³ HMRC, *BTF*, *supra* note **Error! Bookmark not defined.** at 20 July 2010; IFF Research, *supra* note **Error! Bookmark not defined.** at 3.26.

questions about over-familiarity and this problem needs to be guarded against by moving CRMs around fairly frequently, but not so frequently that they cannot get to know the business they are working with.

E. CRITERIA FOR RISK RATING: TAX PLANNING

One example of the concerns with the enhanced relationship was that there was initially a view that very large and complex businesses could never receive a low risk rating. This seemed to remove an incentive to amend behaviour to achieve a low risk rating, since it was thought that was impossible anyway in the case of many of the companies targeted.⁶⁴ There would be a problem with placing taxpayers on a linear risk rating system when in fact the material factors are far more varied than this suggests. The guidelines now attempt to make plain that

while factors such as the size and complexity of a business create their own risks and can make it more challenging for customers to comply with their tax obligations, even the largest and most complex businesses can be classified as Low Risk if they mitigate these risks to an acceptable level through their behaviours.⁶⁵

It is stressed in the revised TCRM that this is not purely theoretical. There are already a number of highly complex large businesses which have been identified as low risk.⁶⁶ Attaining this classification, however, requires not only transparency and adequate governance systems but also consideration of the approach of the taxpayer to tax planning. Whilst the TCRM is clearly intended to clarify the position, this leaves a considerable amount of discretion with the CRM and HMRC generally.

The BTF minutes for July 20, 2010 noted that there was a feeling that HMRC had made it more difficult to become low risk and that there was some ambiguity over what was considered to be “tax planning”. This is the problem that lies at the heart of how to decide whether a corporate taxpayer is “compliant” or within the grey area described above and, as discussed there, taxpayers and HMRC may

⁶⁴ Freedman, Loomer & Vella, “New Approaches”, *supra* note **Error! Bookmark not defined.**

⁶⁵ HMRC, *TCRM*, *supra* note **Error! Bookmark not defined.** at TCRM3100.

⁶⁶ *Ibid* at TCRM3310.

take different views of the position. The new TCRM is intended to clarify this also. One of the seven factors that will be assessed in assessing risk is tax strategy, which is described as “the customer’s involvement in tax planning which does not support genuine commercial activity”.⁶⁷

This is further explained at TCRM3330.⁶⁸ To be sure to be low risk a customer must not structure transactions in a way which “gives a tax result contrary to the intentions of Parliament” and must tell HMRC about “transactions involving innovative interpretation of tax law and fully disclose any legal uncertainty”. Occasional engagement in tax planning that contravenes these guidelines might be tolerated provided there is full disclosure but failure to inform HMRC about this activity as well as more regular engagement in such activity both increase the chance of being found not to be low risk.

The difficulty with these guidelines is that they rely on criteria which are not to be found in the U.K. statutes or case law. There is currently no statutory GAAR in the U.K.,⁶⁹ nor a judicial anti-avoidance doctrine which explicitly bases validity upon “genuine commercial activity”.⁷⁰ It is arguable that this might be a desirable requirement, but it is not one under current law. The current position in the U.K. is that there is no judicial doctrine that applies to tax avoidance but that the courts must apply purposive interpretation as in other areas.⁷¹ The courts must ask “whether the relevant statutory provisions,

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

⁶⁹ See HM Treasury, News Release, 04/11, “Details of Avoidance Study Group set out” (14 January 2011) (the question of whether the U.K. should adopt a GAAR is currently under discussion and the author is a member of a study group set up under the leadership of Graham Aaronson QC to advise ministers on this issue; the study group is due to report in October 2011).

⁷⁰ See Financial Markets Law Committee (FMLC), *Issue 146—Proposed HMRC Code: Response to the June 2009 HM Revenue & Customs Consultation Document on a Code of Practice for Banks* (London: FMLC, 2009), online: <<http://www.fmlc.org>> (comments on a proposed code of practice on taxation for banks).

⁷¹ *BMBF*, *supra* note **Error! Bookmark not defined.** especially para 33.

construed purposively, were intended to apply to the transaction, viewed realistically."⁷²

BMBF and subsequent cases have reiterated that this does not amount to an overriding power to strike down transactions that have no commercial purpose.⁷³ It is not entirely certain how far the courts believe that viewing the facts realistically can take them but the House of Lords was clear that it would be going too far to say that transactions or elements of transactions which had no commercial purpose should always be disregarded. It is all a question of the interpretation of the relevant statute.

The test of commerciality expressed in the TCRM can be, therefore, only a rule of thumb that is applied by HMRC. Many tax directors of large companies would agree that this was a fairly useful guide to the type of activity that will ultimately be upheld by the courts⁷⁴ but it is not the actual test that is to be applied as a matter of law. Furthermore, the advisers and directors of the taxpayer might have a different interpretation from HMRC of the meaning of the statutory provision, including what is included as “commercial”, even taking into account the need to construe statutes purposively and in line with the “intention of the legislature”.⁷⁵ Nevertheless, it follows from the description of the factors relevant to risk rating in the TCRM that taxpayers disagreeing with HMRC interpretations too often will find it difficult to obtain or maintain a low risk rating. Potentially, this places good deal of power in the hands of HMRC in asserting their interpretation of the legislation. The taxpayer can of course still appeal to the courts and argue against HMRC’s view of the tax liability based on the interpretation of particular legislation, but it might lose its low risk rating, which HMRC seeks to argue is a valuable status to have as it results in lower

⁷² *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HK CFA 46, para 35, cited in *ibid*.

⁷³ *Ibid* at para 36; *HMRC v Mayes*, *supra* note **Error! Bookmark not defined.** at para 74.

⁷⁴ See Freedman, Loomer & Vella, “New Approaches”, *supra* note **Error! Bookmark not defined.** at 111 (where tax directors interviewed referred to commerciality as a guide).

⁷⁵ See *supra* note **Error! Bookmark not defined.**

administrative costs and burdens.⁷⁶ If low risk status is desirable, and many large companies seem to agree it is, although others query the benefits,⁷⁷ then this is a potential rule of law concern, as the taxpayer has no mechanism for appealing the risk rating, since this is purely an administrative tool.

It is significant that the BTF minutes for November 2010 stated that HMRC confirmed that a taxpayer cannot be low risk if it participates in avoidance schemes. Business representatives responded that there were still areas of confusion regarding tax planning and some thought that the benefit of being transparent was diluted by this complication. It would appear that they felt that they should be able to interpret the law in a way that seemed reasonable to them provided they disclosed this, rather than being given a higher risk rating purely because they took a different view from that of HMRC.⁷⁸ So it seems that whilst some businesses do value low risk ratings and other advances resulting from enhanced co-operation, such as real time working, and may even be prepared to modify their behaviour to gain these perceived benefits, others are not certain that the benefits of a low risk rating outweigh the resulting loss of freedom to engage in tax arrangements that HMRC dislikes, but which the business considers to be reasonable tax planning. The question then is whether if the objective is primarily to increase resource allocation, risks could not be achieved simply through

⁷⁶ HMRC, *Review of Links*, *supra* note **Error! Bookmark not defined.** at ss 1.11–1.15. See also HMRC, *BTF*, *supra* note **Error! Bookmark not defined.** at 1 November 2010, s 5; (HMRC claims as a further benefit of being low risk that they would trust the business to raise any tax issues so that the low-risk business can set the agenda).

⁷⁷ As explained above, the consequences relate to the frequency of interventions by HMRC and thus the cost and burden of administration. In an HMRC survey two thirds of companies responding indicated that they took their risk status into account when structuring their tax affairs (IFF Research, *supra* note **Error! Bookmark not defined.**). On the other hand, in interviews some directors have suggested that the benefits of a low risk rating are not always clear: Freedman, Loomer & Vella, “New Approaches”, *supra* note **Error! Bookmark not defined.**; HMRC, *BTF*, *supra* note **Error! Bookmark not defined.** at 1 November 2010. See also IFF Research, *supra* note **Error! Bookmark not defined.** at 1.24 (“In the follow-up interviews some businesses did, however, indicate that they felt that the benefits of being low risk could be clearer and that it was important that low risk meant less scrutiny and that it provided cost and time savings”).

⁷⁸ HMRC, *BTF*, *supra* note **Error! Bookmark not defined.** at 1 November 2010.

transparency rather than also expecting businesses to refrain from certain types of tax planning.

Whilst the revised TCRM issued in April 2011 did not deal conclusively with all the issues raised in the BTF meetings and in surveys, it did clearly seek to respond to some of the concerns. The experiment of enhanced co-operation with business is generally considered to be a successful one.⁷⁹ The modifications and improvements may be considered to be a good example of the helpful outcome of a valuable regulatory conversation.⁸⁰ Even this interaction can raise some concerns, however, since there is sometimes a perception that the largest businesses with access to CRMs and the ability to enjoy a close relationship with HMRC may obtain benefits not available to other, smaller taxpayers. If the advantages of an enhanced relationship are as claimed then it follows that those to whom such a relationship is not available are not being treated as advantageously as the larger firms. This is supported by HMRC's own survey material which shows that businesses without a CRM were less satisfied with the service provided by HMRC than were those with a CRM.⁸¹

IV. APPLYING THE THEORY TO PRACTICE

A. THE RULE OF LAW AND THE MIXED OBJECTIVE PROBLEMS.

In the examples of a new approach to tax compliance outlined in Part III, there are suggestions of both the rule of law problem and the mixed objectives problems referred to at the end of Part II.

In his Fasken lecture, John Braithwaite states that lawyers need to be weaned off the obsession with regulation being only about rule compliance.⁸² Insistence on a literal interpretation of detailed rules is clearly unhelpful in the tax area as in any other. Many, including this author, have argued that tax legislation should be based on principles so

⁷⁹ IFF Research, *supra* note **Error! Bookmark not defined.**

⁸⁰ Malam et al, *supra* note **Error! Bookmark not defined.** Freedman, Loomer & Vella, "New Approaches", *supra* note **Error! Bookmark not defined.**

⁸¹ IFF Research, *supra* note **Error! Bookmark not defined.** at 1.3–1.9.

⁸² Braithwaite, "Essence", *supra* note **Error! Bookmark not defined.**

that creative compliance and game-playing are discouraged.⁸³ As discussed above, however, there are areas of genuine uncertainty in the tax arena and appeals to morality will not resolve these uncertainties. Not only is there not always an obvious morally right answer to the question of how much tax should be paid, but taxpayers will argue, reasonably, that their liability to pay tax is about the duty imposed on them by law, so that only the law can answer that question.⁸⁴ Taxes are not voluntary contributions and therefore there must be a question mark over the extent to which sums not clearly required to be paid by law should be coaxed out of taxpayers by persuasion.⁸⁵

Braithwaite himself acknowledges that “routine regulatory encounters taking the high moral ground tend to be counterproductive.”⁸⁶ If that is the case then proper consideration has to be given to the actual legal position rather than some vague and unenforceable notion of the “spirit of the law”, if that is read as going beyond the law as it would be applied by the courts.⁸⁷ If the only purpose of relying on the spirit of the law is to impose payment of more than the law would require, or even to avoid the trouble and expense of having to investigate what the law would require in fact, this does seem to be a potential rule of law problem.

So we can see the possibility, as discussed in Part III above, that if large corporate taxpayers consider that HMRC’s view on the acceptability of tax planning is too far away from their own and that

⁸³ Braithwaite, “Dancing”, *supra* note **Error! Bookmark not defined.**; Freedman, “Anti-Avoidance”, *supra* note 26; Freedman, “Improving”, *supra* note **Error! Bookmark not defined.**

⁸⁴ See *ibid.*

⁸⁵ Indeed company directors must also consider their fiduciary duty to the members of the company as a whole, which will often be to enhance shareholder value through maximizing profits, although not at all costs. For example in U.K. company law arguably it has always been acceptable to take into account potential reputational damage and this is now stated explicitly in s 172 (1) of the *Companies Act 2006*. For a history and critique of the section and the surrounding discussion, see Andrew R Keay “Working Paper: Centre for Business Law and Practice: The Duty to Promote the Success of the Company: Is it Fit for Purpose?” [unpublished, archived online: Social Science Research Network <<http://papers.ssrn.com>>].

⁸⁶ Braithwaite, “Essence”, *supra* note **Error! Bookmark not defined.**

⁸⁷ See *supra* notes **Error! Bookmark not defined.**, **Error! Bookmark not defined.** and accompanying text.

which the courts will take in due course, they may consider that a low risk rating is too high a price to pay for having limits imposed on them beyond the legal limits. Further, if taxpayers were to continue to be unclear about the benefits of transparency because interpretations they felt were reasonable were being challenged, then, although the risk rating might continue to have resource allocation benefits by virtue of focusing HMRC on activities it considered to be high risk, it would not work well as a method of encouraging compliant behaviour. This is an example of the “mixed objectives” problem. Taxpayers might feel that since they were high risk anyway they might as well be even more aggressive in their tax planning strategy.

It can be seen, therefore, that it is important both in terms of going no further than the law permits and in more pragmatic terms of obtaining trust and co-operation, for HMRC to keep closely to the law as it would be interpreted by the courts if risk rating is to achieve its objectives. Whilst the law is too uncertain to make this a precise exercise, the criteria used should be those taken from legislation and case law. Awareness of this need is shown by the BTF discussions, although the fact that business has raised this as an issue shows that it is an area that has to be closely watched and a careful balance found. Similarly, the outcome of discussions on the Code of Practice on Taxation for Banks in the U.K. in 2009⁸⁸ showed that critics believe that references to requiring banks to comply with the “spirit of the law” and to the requirement that banks should not engage in tax planning other than that which “supports genuine commercial activity” go too far to the extent that they require behaviour going beyond that which is required by law. The Financial Markets Law Committee criticized the proposed Code for seeking “to introduce, through non-statutory means and for one section of the tax paying community only, an obligation to comply with what is presumably regarded as a more exacting standard of behaviour than is currently provided for in legislation.”⁸⁹ HMRC responded,

We agree that HMRC should not become responsible for legal interpretation. Banks will continue to be taxed in accordance with the law. The Code is not law, but a statement of principles which provide a

⁸⁸ FMLC, *supra* note **Error! Bookmark not defined.**

⁸⁹ *Ibid* at 6.1.

benchmark for corporate behaviour in relation to governance, tax planning and the relationship with HMRC.⁹⁰

Nevertheless, the Code continues to use language that could be seen as requiring the banks to go beyond their legal obligations. Moreover, HMRC's reiteration of the genuine commercial activity test in the April 2011 TCRM revision shows that they still think use of this benchmark is acceptable, despite the fact that it continues to be rejected by the courts.⁹¹ Many banks have signed up to the Code⁹² and corporate taxpayers have not seen fit to object too openly to these tests being set out in non-statutory contexts. It remains to be seen whether any of this has the effect of modifying taxpayer behaviour in the long run or whether it merely affects presentation.

More generally, the combination of the Code and pressure from non-governmental organizations, protest groups and the media, which has been growing in recent months in the U.K. and elsewhere,⁹³ may have some effect due to the concerns of business about reputation, although how significant this will prove to be for the companies involved in the long run remains to be seen. To the extent that decisions which could

⁹⁰ *Ibid* at response on question 1.

⁹¹ *Supra* note 68.

⁹² Not wholly surprisingly given the economic situation and the weak position of the banks, including the fact that the U.K. government has a stake in some of them. See HMT Budget 2011, para. 1.91: "Two hundred banks have now adopted the Code, including the top 15 banks operating in the U.K.". This appears to have been the result of a certain degree of governmental pressure, see "UK banks given tax deal deadline", *BBC News: Business* (17 October 2010), online: <<http://www.bbc.co.uk>>.

⁹³ See UK Uncut, *UK Uncut*, online: <<http://www.ukuncut.org.uk>>. The organization has arranged several protests against the perceived avoidance of tax by large corporations or their owners. More established charities such as Christian Aid and Action Aid have also run campaigns against tax avoidance, mostly focusing on problems of international taxation depriving developing countries of tax revenue: see Act!onAid, *supra* note **Error! Bookmark not defined.** On reputational effect and tax and corporate social responsibility more generally see Freedman, Loomer & Vella, "New Approaches", *supra* note **Error! Bookmark not defined.**; Prem Sikka, "Smoke and Mirrors: Corporate social responsibility and tax avoidance" (2010) 34 *Accounting Forum* 153; Oxford University Centre for Business Taxation, *Summer Conference: July 11: Taxing Corporations: Competitiveness, Transparency and Responsibility*, online: <<http://www.sbs.ox.ac.uk>> (presentations and videos available for download).

impose costs on corporate taxpayers are taken on the basis of interpretations that go beyond the law, the points made by the Financial Markets Law Committee seem to remain a matter for concern. It has been reported, for example, that banks are beginning to require additional checks before lending to partnerships because of concerns about tax planning.⁹⁴ This may have some good effects if it means they are less likely to fund aggressive pre-packaged tax avoidance schemes which have little chance of being upheld by the courts in the long run, but is less helpful if it is adding additional costs to loans to commercial structures. There is clearly a balance to be achieved: if pressed too far the policy behind the Code of pushing the question of tax strategy into the Board room and beyond strict legal rules could be counter-productive,⁹⁵ but if a firm view of legal responsibilities is kept in sight it may be a useful tool to prevent companies concerned about their reputation from taking positions that are unlikely to succeed if litigated. Of course some corporate taxpayers will continue to be bullish about their right to minimize their taxes regardless of these reputational issues. For those the remedy will be escalation up the pyramid to enforcement through the courts if necessary, but it would be wrong if those companies not concerned about reputation were required to behave only in accordance with the law, whilst more compliant companies were required to go beyond the law. Far better to change the law if it cannot prevent unacceptable behaviour as it stands.⁹⁶

Some would argue that this analysis places too great an emphasis on the construction of the legislation by the courts. They might say that there needs to be confidence in the fairness of the tax system and perhaps more account should be taken of the views of the public, of non-governmental organizations and others with an interest in tax administration when determining the amount of tax that each taxpayer should pay as well as of the administrators who must operate the system. Picciotto has argued that “the issue of indeterminacy and

⁹⁴ Jamie Kaffash, “Firms suffer from banks’ fear of avoidance” *Accountancy Age* (4 May 2011).

⁹⁵ For example, directors might complain of tax uncertainty or even threaten to move business outside the U.K.

⁹⁶ Freedman, “Anti-Avoidance”, *supra* note **Error! Bookmark not defined.** (arguing for a statutory general anti-avoidance provision for this purpose).

formalism is fundamentally about democracy, since it concerns the processes for generating the authoritative meaning of laws.”⁹⁷ He goes on to comment that

A wider and indeed more democratic, legitimacy [than can be obtained from relying simply on the authority of lawyers as technical specialists] comes from adopting a more open epistemology, which acknowledges that legal rules have a wider social resonance and impact, and that their understanding must be informed by wider social practices, especially those of the persons to whom they are addressed.

If this is intended to suggest that there should be wide consultation in formulating tax policy and drafting tax legislation, going beyond the legal experts, then this would command wide acceptance, but it does not support the interpretation of tax legislation in a way that would not be upheld by the institutions intended to give effect to enacted legislation following a process established by the elected representatives of a democratic society. In other words the legal provisions should reflect social norms and give full effect to them as far as possible, but this should be fed into the process prior to and not post enactment. This might require better ways of discussing tax legislation before it is enacted as well as better methods of drafting. But it is not a reason to elevate some concept of “the spirit of the law” above the law as it will be understood by the courts at the interpretation stage. To do that would be fundamentally undemocratic and open to abuse by pressure groups and lobbyists as well as undermining the legal system and ultimately potentially putting the revenue authorities in a very difficult position in which they were being pressured one way or the other.⁹⁸

⁹⁷ Picciotto, *supra* note **Error! Bookmark not defined.**

⁹⁸ See e.g. the current debate in the U.K. over the settlement by HMRC with Vodafone plc. UK Uncut argued that Vodafone was “let off” a £6 billion tax bill. This figure has been described by HMRC as “absurd”. The case was settled for £1.25 billion, which HMRC considered was reasonable and which it was within their authority to agree as a matter of management of the revenue collection system. Nevertheless both HMRC and Vodafone were widely and vehemently criticized by the media and by UK Uncut, sometimes with very little understanding of the true position.. This shows the dangers of moving to public opinion as a test of the amount of tax to be paid rather than the law. See UK Uncut, *Major victory: NAO to investigate HMRC's dodgy deal* (25 January 2011), online: <<http://www.ukuncut.org.uk>> ; Duncan Robinson, "Protesters target Vodafone over taxes", *Financial Times* (27 October

So, insisting on compliance with some concept of the “spirit of the law “ that goes beyond legal compliance seems to pose rule of law problems, as defined above, in the sense of government needing to govern by known rules. In order to satisfy this requirement it may be, however, that precision is not essential. There can be some room for discretion without breaching the requirements of the rule of law. Philip Pettit (an important influence on John Braithwaite),⁹⁹ for example, argues that the best sort of law may have to leave some discretion in the hands of governments agents, but measures are then needed to ensure that those agents cannot act on a wholly arbitrary basis.¹⁰⁰

If this discretion is guided by principles embodied in the law itself, it may be that the discretion given is no greater than under a system of detailed rules. Detailed and prescriptive legislation in the U.K. does not appear to have removed the need for extensive extra-statutory guidance. In addition, these detailed rules they often give rise to game playing and even absurdities because of unintended conflicts and errors. In such a situation courts may be required to contort language to come to a sensible solution or they may refuse to do that as being beyond their remit and so the matter has to go back to the legislature to deal with by

2010); U.K. Parliament, Treasury Committee, *Uncorrected Transcript of Oral Evidence: to be published as HC 731-ii* (16 March 2011), online: <<http://www.publications.parliament.uk>>. The National Audit Office has now examined the power of HMRC to reach such settlements, although not the specific case, and has made recommendations for improving HMRC’s governance in this area: National Audit Office, *HM Revenue & Customs 2010–11 Accounts, Report by the Comptroller and Auditor General* (July 2011). This is not a purely U.K. phenomenon: in the U.S. the New York Times has recently attacked GE, see David Kocieniewski, “At G.E. on Tax Day, Billions of Reasons to Smile”, *New York Times* (25 March 2011) A1; for a response from GE, see GE Reports, *GE and Taxes* (28 March 2011), online: <<http://www.gereports.com>>.

⁹⁹ See John Braithwaite & Philip Pettit, *Not Just Deserts: A Republican Theory of Criminal Justice* (Oxford: Oxford University Press, 1990).

¹⁰⁰ Pettit, *supra* note **Error! Bookmark not defined.** at 174–175. On the need for mechanisms to control revenue discretion under the existing U.K. system, see Judith Freedman & John Vella, “HMRC’S Management of the UK Tax System: the Boundaries of Legitimate Discretion” in Christopher Evans, Judith Freedman & Richard Krever, eds, *The Delicate Balance: Tax Discretion and the Rule of Law* (Amsterdam: IBFD, 2011).

yet further complex legislation. Such problems seem less rather than more likely to arise in legislation based on principles.¹⁰¹

Thus a plea for matters to be governed by legislation is not a plea for a return to literal interpretation of detailed rules but for a statutory framework capable of sensible application in controlling discretion. This comes down to drafting good legislation that governs any necessary areas of discretion through principles that can be overseen by the courts, rather than leaving matters entirely to extra-statutory regulation that cannot be supervised in this way. In this way the spirit of the law and the legislation can become close to the same thing and there is no need for revenue authorities to persuade taxpayers to comply in a way that goes beyond the law.

Not only can responsive regulation in the large business context raise questions about interpretation of the law, but to an extent it gives the authorities discretion as to when and how to apply the law. It suggests that enforcement should be based not purely on the severity of any non-compliance but also on the willingness to comply with the regulator. Potentially this could result in the revenue authority applying its powers in an arbitrary way depending on its relationship with a taxpayer rather than by reference to a scale set out by way of a legal framework. Critics such as Yueng¹⁰² argue that this may not result in a fair and proportionate response.

Most tax systems recognize the need for the tax authority to have some discretion not to enforce tax law in every case if, for example, it would be inefficient to do so, and the U.K. is no exception.¹⁰³ The question is how this discretion should be controlled and not be permitted to become a power for the revenue authority to make tax law. This would be unacceptable to taxpayers as a whole and therefore counter-productive. In the context of the example in Part II of the relationship with large business, this shows the importance of clear published guidance on risk rating and on the actions HMRC will take in any given situation.¹⁰⁴ It may also argue for some kind of appeal

¹⁰¹ See Freedman, "Improving", *supra* note **Error! Bookmark not defined.**

¹⁰² Yeung, *supra* note **Error! Bookmark not defined.**

¹⁰³ Evans, Freedman & Krever, *supra* note **Error! Bookmark not defined.**

¹⁰⁴ See HMRC, *HMRC Litigation and Settlements Strategy*, online: <<http://www.hmrc.gov.uk>> (this may be as much for the protection of HMRC as it is for the

mechanism, perhaps to an administrative organization rather than a court, if there is disagreement over the way the relationship is managed,. This may be a more difficult issue than interpretation, given that ultimately interpretation issues can always be taken to the courts but complaints about the operation of the management discretion may have no formal procedure available, although there may be administrative procedures in existence for this purpose.¹⁰⁵

B. RISK RATING AND RESPONSIVE REGULATION

As described in Part III above, taxpayers may be risk rated and treated differently depending on where they fall on the risk scale. In some ways this is entirely consistent with responsive regulation. There is an assessment of the taxpayer's willingness to comply. A compliant taxpayer is rated as being low risk and therefore not to be subjected to a high level of audit, since that taxpayer is trusted to self-regulate, to some extent. Initially this sits well with the pyramid of compliance, but it could become static, non-responsive and backward looking if not regularly reviewed and this would then be far from responsive. It could also lead to under-deterrence of low level risk activity, which might be inefficient in the long run.¹⁰⁶ This might also reduce confidence in the fairness of the administration of the tax system, to the ultimate detriment of compliance by the majority. In his Fasken lecture, John Braithwaite explains that

[t]he pyramid is not about specifying in advance what are the types of matters that should be dealt with at the base of the pyramid, which are the more serious ones that should be in the middle and which are the most egregious ones for the peak of the pyramid. Even with the most serious matters . . . we stick with the presumption that it is better to start with a dialogue at the base of the pyramid.¹⁰⁷

taxpayer, for example in the context of settlements with large business it is important that HMRC has a published Settlements Strategy and can show it has followed its own procedure); National Audit Office, *supra* note **Error! Bookmark not defined.**

¹⁰⁵ Evans, Freedman & Krever *supra* note 101.

¹⁰⁶ See Black, "Emergence", *supra* note **Error! Bookmark not defined.** at 512; Baldwin & Black, *supra* note **Error! Bookmark not defined.** at 66.

¹⁰⁷ Braithwaite, "Essence", *supra* note **Error! Bookmark not defined.**

This does give rule of law problems with proportionality and fairness between taxpayers, as touched upon above. However, provided taxpayers are being open and transparent about transactions which they believe are within the statute but where there may be some uncertainty, it would suggest that the starting point should continue to be a low-risk relationship. This should be so even if HMRC takes the view that there might be tax avoidance which the courts would strike down or which is not in accordance with HMRC's view of the intention of Parliament.

Too rapid an escalation up the pyramid might jeopardize the responsiveness of the risk-rating system and this analysis does seem consistent with some of the comments in the BTF minutes.¹⁰⁸

Some anecdotal comments on the risk-rating of large companies also chime with comments made by Baldwin and Black that risk-based frameworks may focus resources in high risk areas at the expense of lower risk areas. In time, unless supplemented by other programs, this could lead to under-deterrence of low-level risk activity and "substitute widely spread risks for lower numbers of larger risks."¹⁰⁹ In the context of the example discussed in Part III, once rated as low risk, companies might feel they can get away with more "innovative interpretations" for a period of three years until the next business risk review is due.¹¹⁰ No doubt this is a possibility of which CRMs will be well aware and in any event it would only work once.

The exchanges around risk rating of large business in the U.K. for tax purposes underline the potential difficulties with using responsive regulation combined with risk rating in this area. At the same time they also bear out the value of regulatory conversations as a mechanism for controlling this process and working towards a good balance.¹¹¹ The BTF is able to make its criticism openly and has achieved a clarification of the TCRM as shown in Part II above, although some potentially contentious language is still used. HMRC has noted the limitations on its powers in the notes accompanying the Code of Practice on Taxation for Banks but without changing course on the basic contents of the

¹⁰⁸ HMRC, *supra* note **Error! Bookmark not defined.**

¹⁰⁹ Baldwin & Black, *supra* note **Error! Bookmark not defined.** at 67.

¹¹⁰ TCRM3410 *supra* note55; Freedman, Loomer & Vella, "New Approaches", *supra* note **Error! Bookmark not defined.**

¹¹¹ Black, *Rules*, *supra* note **Error! Bookmark not defined.**

Code. It seems likely that the conversation will need to be an on-going process and that the tension between the different objectives of risk-rating will need to be kept in mind.

It is not only the relationship between HMRC and the taxpayers in question that need to be taken into account in this process. A regulatory conversation that is seen as becoming too restricted to the parties themselves and too “friendly” will not help tax compliance more generally and will open up business and the tax authority to criticism, as described above.¹¹² In its own TCRM available on-line until the April revision, HMRC apparently felt they should address concerns about the treatment of low risk taxpayers in the frequently asked questions section of the TCRM (which, it should be remembered, is largely addressing the concerns of its own staff).

The question posed was “Isn’t this contrary to HMRC’s responsibility to collect the right amount of tax from the largest taxpayers in the UK?” The answer given:

No. We expect Low Risk customers to have extensive tax compliance procedures and processes, well qualified staff or advisers, a relatively conservative strategy towards tax filing and mitigation positions, be committed to open disclosure of potential risks and adopt a collaborative approach to resolving them.

We need to deploy our best technical skills fully where this kind of relationship does not exist and experience has shown that the amount of tax recovered by compliance interventions across this customer group represents a very small proportion of LBS compliance yield. The resource we and our customers would otherwise spend on such compliance interventions is better spent improving compliance elsewhere.¹¹³

This is a sensible defence of the resource allocation mechanism being used, but the very fact that the question is being asked suggests that concerns about equity as between taxpayers have been raised. Thus, where risk rating is used as a device to save administrative costs and prevent the need for regular audits there is a danger that, whilst it may be very efficient, it is a tool that needs to be handled with care.

¹¹² *Supra* note **Error! Bookmark not defined.**

¹¹³ HMRC, TCRM 1400 annex L, accessed 19/1/2011, no longer available on-line but on file with author.

Treating taxpayers differently depending on their profile enables tax authorities to use their limited resources efficiently but also has the potential to result in unfair treatment for one taxpayer in relation to others. The line between good management and an unfair or disproportionate use of this tool is a thin one. As pointed out by Baldwin and Black, the criteria used may not be purely technical but in fact may be contentious. Although apparently an administrative device, this could hide important policy issues and make scrutiny and accountability in relation to those issues difficult.¹¹⁴ There could be tension between efficiency and constitutional values unless the discretion available to revenue authorities is used with great care.

V. CONCLUSION

The discussion in this article of the application of responsive regulation and risk-rating to a particular area of tax administration, large business compliance, shows that John Braithwaite's ideas have great value in tax administration provided they are handled with care and not pushed too far. Care has to be taken, however, not to extend expectations of taxpayers beyond legal requirements.

If there is a perception that taxpayers are being required to go beyond the law in their compliance, the approach could become counter-productive. In addition, the motivation of responsive regulation needs to be clear. If the aim is to encourage transparency and self-regulation, it may be better and clearer to focus on that without also trying to prevent taxpayers from adopting arguable interpretations of the law with which the revenue authorities disagree. This might get in the way of encouraging more important types of co-operation, such as full real time disclosure. Contentious legal issues could be left to legal decision, rather than risk rating. Subject to this, a co-operative and trusting environment can be efficient and positive in its results for all concerned.

This is not an argument for the literal application of rigid, detailed legislative rules; far from it. Instead it is argued that good legislation based on principles would amount to an improved method of conveying and ascertaining parliamentary intention in the tax arena and would provide a better framework for controlling the proper use of discretion

¹¹⁴ Baldwin & Black, *supra* note **Error! Bookmark not defined.** at 67.

by revenue authorities. Combined with responsive regulation, sensitively applied, and good supporting mechanisms for scrutinizing and controlling discretion, this would lead to a sensible and workable basic framework for managing the inevitable uncertainties of taxation in a complex world. Further assistance can be provided by having extensive consultation and other regulatory conversations, but these conversations must include all groups and not only parties involved in particular areas if they are to inspire confidence in the public. It is not, however, for the public or the media or, for that matter, the revenue authority to decide how much tax is payable, but for the legislature, having been informed by public debate and in the terms it has communicated to the courts. Once legislation is in place that should be enforced equally in relation to all taxpayers but it is reasonable for audit and enforcement resources to be allocated based on risk within that framework. Juggling all these factors will require constant vigilance but if the balls can all be held in the air at once this could give an outcome which would be at least satisfactory. In the complex world of large corporate taxation, this would be a good result.

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