

---

## Making tax law more certain: A theory\*

John Braithwaite\*\*

---

*Rules can make tax law certain in simple and stable domains. A theory of how to make law more certain is developed for complex, dynamic domains. Its first step is to define overarching principles and make them binding. Next, a set of rules to cover the complex areas of tax law is defined. In a contest between a rule and an overarching principle, it will not be the rule that is binding. That is, the principle is not merely used to assist in interpreting the rule. Rather it is the principle that is binding with the rules used to assist in applying the principle. Specific sets of rules for the most commonly used types of transactions or business arrangements are also written. This might involve a dozen different sets of rules to regulate concrete arrangements. Such rules actually merely specify examples of how the principles apply. Each of the dozen sets of illustrative rules is followed with an explanation that the reason for the rules being this way in this concrete situation is to honour the overarching principles.*

An interesting feature of the contemporary private law of contract is that it is regulated by certain principles many of which are imported from the public law of consumer protection.<sup>1</sup> The literal language of a contract can be overridden if it is unconscionable, for example, if an immigrant who could not read the language were told simply that local custom required her or his signature here. Or the duty of good faith can be used to require each party to act consistently with the real purpose of a contract even if the written detail of the contract appears to offer one of the parties an escape from that purpose. Unconscionability and good faith are bigger principles in the law than the more detailed rules of contract. They are examples of far-reaching principles that connect the different doctrines and rules of contract. We see the same approach with traffic rules. The speed limit does give us a bright line rule, but keeping under the limit will not protect us if we drive too fast in unusually dangerous conditions, such as fog. There is no safe harbour in this law; meeting the bright line standard does not shelter us from prosecution for excessive speed; it only tells us how to keep out of trouble with the law in normal circumstances. Moreover, road safety authorities put a lot of effort into educating drivers to honour the underlying principle of cautious driving, that is, to be watchful for special hazards. That principle trumps the foot-fault rule that the law also gives us to guide our driving.

My argument in this article is that tax law needs this basic approach of combining rules and principles more than other areas of law. Most common law nations have tended, with complex domains of business law, to endure a see-sawing historical contest between the view that a rule of law means a rule of rules on one side, and on the other, attempts at grand simplifying projects to shift to a rule of principles. The rule of rules is more often in the ascendency in this contest and grand reform projects such as the latest in Australia – the Ralph Review<sup>2</sup> – fail to catalyse fundamental change toward a more principle-driven law. Simplifying projects are commenced without being completed. Or overarching principles are added to the law without repealing any of the thicket of rules that

---

\* Much of this article was developed while I was the Meyer Visiting Research Professor at New York University Law School. My thanks to Reuven Avi-Yonah, Joseph Bankman, Bob Baxt, Julia Black, Valerie Braithwaite, Michael D'Ascenzo, Peter Drahos, Judith Freedman, Rick Krever, Bevan Murphy, Tina Murphy, Fred Schauer, Andrew Stout, Ernst Willheim, Rob Williams and Leslie Zines for conversations that helped in refining the article.

\*\* Centre for Tax System Integrity, Australian National University.

<sup>1</sup> Collins H, *Regulating Contract* (Oxford University Press, Oxford, 1999).

<sup>2</sup> Review of Business Taxation, *A Strong Foundation* (1998).

necessitate the principles. So the simplification project of adding principles actually renders tax codes longer and more complex. By see-sawing back and forth between the rule of rules and the rule of principles we can and usually do end up with the worst of both worlds. Instead, our objective might be to get the right kind of integration between rules and principles that we get in the less challenging domain of traffic law.<sup>3</sup>

The debate on the difference between rules and principles, or rules and standards as the Americans prefer, is a philosophically abstruse debate that practitioners tend not to find very illuminating. Without defending this choice, I simply define principles in the way chosen by Joseph Raz: “Rules prescribe relatively specific acts; principles prescribe highly unspecific actions.”<sup>4</sup> Safe driving in light of road conditions is a principle; a proscription of speed over 80 km per hour is a rule. If you do not like this way of defining the distinction, you can just as happily interpret my argument as one about how to integrate general and specific rules.

## THE THEORY SUMMARISED

The argument will be that the best way to integrate rules and principles in complex areas of tax law is:

1. Define the overarching principles and make them binding on taxpayers.
2. Make one of those overarching principles a general anti-avoidance principle (perversely normally referred to as a GAAR, a general anti-avoidance rule which states that schemes are illegal when their dominant purpose is a tax advantage rather than a business purpose, even if the scheme “works” as a shelter from detailed tax rules).
3. Define a set of rules to cover the complex area of tax law.
4. The legislature lays down, perhaps through an Acts Interpretation Act,<sup>5</sup> that in a contest between a rule and an overarching principle, it will not be the rule that is binding. That is, the principle is not merely used to assist in interpreting the rule. Rather it is the principle that is binding with the rules used to assist in applying the principle (just as in the speed and safe driving conditions example).
5. In a complex field of tax, write specific sets of rules for the most commonly used types of transactions or business arrangements. This might involve a dozen different sets of rules to regulate concrete arrangements. Such rules actually merely specify examples of how the principles apply.
6. Follow each of the dozen sets of illustrative rules with the explanation that the reason for the rules being this way in this concrete situation is to honour the overarching principles. This is a way for the legislature to make it clear to judges that it is the principles that are the binding feature of the law. Hence when a legal entrepreneur re-engineers concrete financial product number 11 as an 11A, or corporate structure number 9 as a 9A, to get around the law, judges must go back to the principles to decide what to do.
7. When judges fail to do this, reverting to old habits of privileging rules, enact a simple statute that says the 11A shelter violates named principles in the tax law and should be disallowed in future. Its effect is simply to strike down the court’s precedent in the 11A case and to engage the judiciary in a conversation with the legislature on the clarity of its intention to have a principle-driven tax law.<sup>6</sup>
8. Foster educative dialogue with judges, company directors and the community about the principles in the tax law in the hope that conversations among judges and tax practitioners,

---

<sup>3</sup> A not dissimilar aspiration is articulated in Michael D’Ascenzo’s hope that tax law “will be written in a way that exposes the underlying principles”. D’Ascenzo M, “Along the Road to Damascus: A Framework for Interpreting the Tax Law” (2000) 3(6) *J Australian Taxation* 384.

<sup>4</sup> Raz J, *Legal Principles and the Limits of Law* (1972) 81 *Yale LJ* 823 at 838.

<sup>5</sup> Other elements of the legislative history of specific statutes can also be mobilised to this end, for example, explanatory memoranda and Second Reading Speeches in the Australian parliamentary context.

<sup>6</sup> I am indebted to conversations with Daniel Shaviro and Ernst Wilhelm for this thought.

around the boardroom table and around the table at dinner parties will develop shared sensibilities on what those principles mean.

## THE THEORY JUSTIFIED

In a more general paper on why binding principles backed by non-binding rules generate more certainty in complex areas of law than the reverse, I have provided a more detailed justification for the above propositions.<sup>7</sup> All I mean by the principles being binding and the rules non-binding is that in a conflict between a principle and a rule that is derived from it, the presumption is in favour of following the principle. I will merely summarise the key arguments in the more general paper here.<sup>8</sup> The paper argues first that with simple, stable phenomena that rarely involve large economic stakes (conditions that do not generally apply to tax), rules deliver satisfactory consistency in legal decision-making. It is only in domains that are complex, dynamic, and where litigants may find the economic stakes high enough to invest in legal advice to see if there is a way around the law, that precise rules fail to deliver consistency on their own. Why?

HLA Hart pointed out that rules have a core meaning and a penumbra where their meaning is more uncertain.<sup>9</sup> The more complex and changing the phenomenon being regulated, the wider that penumbra is likely to be. A factor that drives much uncertainty is that wealthy legal game-players aim for the penumbra, play the game in ways that expand the gray area of the law. Flux is particularly important here. The penumbra of simple rules that regulate stable phenomena is small. It does exist as in Lon Fuller's example of a statue of a truck in a park where vehicles are prohibited.<sup>10</sup> The unforeseen rare event of the failure to encompass the truck statue in the rule will never cause great problems in regulating the static phenomenon of parks. But in dynamic domains like tax, uncommon things like concrete trucks can be rendered common by game-playing investors seeking a tax advantage.<sup>11</sup>

The penumbra problem is not the only game-playing threat. Rules look more certain when they stand alone; uncertainty is created in the juxtaposition with other rules. With simple rules that regulate simple phenomena it is easy to draft them so there is no conflict between a rule that says A is proscribed and another that X is specifically allowable. The conflict arises when A and X are both correct descriptions of an action.<sup>12</sup> In complex terrain, however, economic and technological change can suddenly create new conflicts of this sort. It can be hard for the state to see this coming when there are well paid legal entrepreneurs on the lookout for opportunities to expand the penumbra of one rule to slightly overlap the penumbra of another, creating compliant non-compliance.<sup>13</sup> Indeed with tax, the discovery of such an overlap can be widely used for years without the state being aware of this. A firm can commit what the state would assume to be a breach of a criminal law or conduct that would attract a civil penalty secure in the knowledge that in the unlikely event of the well-concealed conduct being detected the company has a letter from a respected lawyer arguing that the conduct is legal by virtue of such an overlap. A court may find the lawyer's argument to be wrong, but so long as it is a "reasonably argued position"<sup>14</sup> the letter advancing it may absolve the company of liability for any penalty. This impunity, combined with the huge benefits that can be secured, motivates wealthy taxpayers in some cases to spend tens of millions of dollars on professional advice to such ends.<sup>15</sup> Moreover, legal game-playing is not an activity of a small minority of the big players.

---

<sup>7</sup> Braithwaite J, "Rules and Principles: A Theory of Legal Certainty" (2002) *Aust J L Philosophy* 47.

<sup>8</sup> With permission of the *Australian Journal of Legal Philosophy*.

<sup>9</sup> Hart HLA, *The Concept of Law* (Oxford University Press, Oxford, 1961).

<sup>10</sup> Fuller LL, "Positivism and Fidelity to Law – A Reply to Professor Hart" (1958) 71 *Harv L Rev* 630 at 663

<sup>11</sup> "Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them": Weisbach DA, "Formalism in Tax Law" (1999) 66 *U Chi L Rev* 860 at 869.

<sup>12</sup> See McBarnet and Whelan's account of the use of "ex-files", express exemptions, in British accounting standards. McBarnet D and Whelan C, *Creative Accounting and the Cross-eyed Javelin Thrower* (John Wiley, Chichester, 1999) p 103.

<sup>13</sup> McBarnet and Whelan, n 12.

<sup>14</sup> In the US, the test to secure such immunity is a "more-likely-than-not opinion". See Bankman J, "The New Market in Corporate Tax Shelters" (1999) 83 (June 21) *Tax Notes* 1775.

<sup>15</sup> In the *ASA* case transaction costs were estimated at US\$24.8 million. 27% of the reported tax savings of US\$93.5 million (*ASA Investering Partnership v Commissioner* 76 TCM (CCH) 325 (1998)). In cases of this ilk, the IRS has observed tax

An investment banker may not have been too wide of the mark in the late 1990s when he said to Joseph Bankman, “There isn’t a Fortune 500 Company that doesn’t invest in these deals [the United States market in corporate tax shelters]”.<sup>16</sup>

This problem multiplies as the state enacts more and more rules to plug loopholes opened up by legal entrepreneurs. The thicket of rules we end up with becomes a set of sign-posts that shows entrepreneurs precisely what they have to steer around to defeat the purposes of the law. Broad prescriptions against a phenomenon like insider trading can engender more certainty than a patchwork of specific rules that define A,B,C,D,E and F all as forms of insider trading. The lush form of such an insider trading statute nurtures the plausibility of a legal argument that another form of insider trading – G – must be legal because the clear intent of the legislature was only to proscribe A to F, when in fact the legislature had never thought of G. Legal uncertainty arises from the fact that a thicket of rules engenders an argument of a form that some judges will buy and others will not. This produces one kind of very strong predictability in the law. If you know which judges you will and will not get, you can predict the outcome of your case with a high degree of certainty. In a multiple discriminant analysis of House of Lords decisions, over 90% cent of tax and criminal cases could be correctly predicted (in terms of whether the state or the other party – the taxpayer, the defendant – won) and more than 80% of public, constitutional and civil cases could be correctly predicted in advance by knowing just one fact about that case.<sup>17</sup> That fact was which judges would sit on the case. Unless they can manoeuvre to select their own judge, this kind of predictability is not much use to citizens in pre-litigation decisions as to whether to back one view or another of what the law means.

A smorgasbord of rules engenders a cat and mouse legal drafting culture – of loophole closing and reopening by creative compliance.<sup>18</sup> As the law grows in this loophole-closing game, the “interaction costs” of drafting new rules to ensure that the various provisions work together expand. Once started, the process causes law to grow exponentially because “the number of interactions is approximately proportional to the square of the number of rules”.<sup>19</sup> If  $n$  rules exist, a new rule interacts with  $n$  prior rules, the next rule with  $n+1$ , and so on. Moreover, loophole-closing cat and mouse law engenders a structurally inegalitarian form of uncertainty. The law thus engendered becomes so complex that little people who cannot afford sophisticated legal advice do not understand it. In practice a particular law may be certain in the way lawyers apply it to ordinary people, but perceptually its complexity makes it uncertain to them as a guide to their actions, untutored as they are by legal advice. The rich, in contrast, deploy legal entrepreneurship to make the law uncertain in practice. As citizens go about activities like paying taxes, creative compliance creates a law that is perceptually unclear to ordinary people, and therefore uncertain for them, and uncertain in practice for the rich who more clearly perceive and exploit this uncertainty.

Again we must remember that this structural fact of a formal lawyering of rules is not true of simple regulatory domains. There is no important sense in which traffic rules in a legal system are more incomprehensible to the poor than the rich, or that they work in a way that enables the rich to make them more legally uncertain in practice in their application to the driving of the rich.<sup>20</sup> The rich

---

professionals to offer a choice of fees, either up-front payment of 25% of taxes paid or a contingent fee of 50% of taxes paid. PricewaterhouseCoopers has been known to ask wealthy clients for a contingency fee of between 8 and 30% of their tax savings. Deloitte and Touche have been revealed to be charging companies a contingency fee of 30% of taxes saved for achieving a total wipe-out of US State and federal taxes. See Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (Washington, DC, July 1999) p 23. Novack J and Saunders L, “The Hustling of X Rated Shelters”, *Forbes* (14 December 1998) p 2.

<sup>16</sup> Bankman, n 14. Bankman claims that Bear and Sterns & Co generated over \$100 million in fees for advice on lease-strip shelters in a matter of months.

<sup>17</sup> Robertson D, *Judicial Discretion in the House of Lords* (Clarendon Press, 1998) pp 48-55.

<sup>18</sup> McBarnet and Whelan, n 12, p 28.

<sup>19</sup> Weisbach, n 11 at 871.

<sup>20</sup> Even so, ironically, traffic regulation, as stated in the introduction, is one of the domains where the prescription of this article has been adopted in many jurisdictions – precise rules that can be overridden by a principle (combined with community education about the principles of safe driving). An example is Illinois, *Illinois Compiled Statutes*, Ch 625, 5/11-601(a) (Michie 1993):

may be more able to bribe police and magistrates in traffic cases, but this is not a matter of uncertainty in what the law says.

One result of a protracted dynamic of rules multiplying exponentially is that no one can keep them in their head. Ordinary people certainly cannot have conversations that make any sense about much of tax law. Even the most expert tax lawyers increasingly limit their expertise to particular domains and, for much of the law, cannot conduct a coherent conversation without needing to pull a volume of the law off their shelf and pore over it to prepare for the conversation. In my research group's comparison of nursing home regulation in Australia (which involved 31 broad and vague principles/standards) compared with United States regulation (with over a thousand more precise rules), it was the vague Australian principles that were subject to more consistent adjudication – measured by having two inspection teams rate compliance of the same homes independently at the same points in time.<sup>21</sup> The main conclusion of that research was that superior regulatory conversations – among regulators, among nursing home staff and between regulators and staff – was possible under a rule of a few principles than under a rule of many rules. These empirical findings motivated the centrality of Julia Black's idea of regulatory conversations in the shared sensibilities part of the theory above (point 8).<sup>22</sup> Rules can be very important in fostering conversations that lead to shared sensibilities about the law's requirements, but only if they are limited in number and are interrelated in ways that are not incomprehensibly intricate.

Legal entrepreneurship when economic stakes are high does not work simply by exploiting change and complexity that is inherent in post-industrial societies. It also works by contriving change and complexity. When the Australian Government privatised Qantas on terms it thought were generous for the new shareholders, it wanted only Australian citizens who had funded Qantas over the years through their taxes to gain the benefit. The Macquarie Bank responded by creating a new financial product called a QanMac to get around this rule; foreign QanMac owners secured identical functional economic benefits to Australian owners of Qantas shares. Financial engineering to create new products that have never been conceived by the law is a growing phenomenon of particular importance to corporations law and tax compliance at the big end of town. "The same minds that figured out how to split a security into a multitude of different cash flows and contingent returns are now engineering products in which the tax benefits are split off from the underlying economics of a deal."<sup>23</sup> Financial engineering is just a newer modality of a more longstanding tradition of contrived complexity. Multinational corporations have long exploited their capacities to contrive complexity in their books, organisational complexity and jurisdictional complexity in order to escape liability even for comparatively simple criminal laws such as those against bribery.<sup>24</sup>

Complexity in the books is used to enable the laundering of slush funds and deployment of a network of subsidiaries to contrive off balance sheet financing. Jurisdictional complexity can be exploited, for example, to shift losses to the jurisdiction where they will deliver maximum tax deductions and profits to jurisdictions where gains are untaxed. Organisational complexity can take the form of the appointment of a "Vice-President Responsible for Going to Jail" to ensure there will be no corporate or CEO criminal liability, or more commonly it takes the form of a smokescreen of diffused accountability, where everyone can credibly blame someone else: there seem to be little bits of blame in many places without the possibility of aggregating this to a pattern that satisfies the rules of criminal responsibility.<sup>25</sup> Poor criminal defendants cannot contrive this kind of complexity into

---

No vehicle may be driven upon any highway of this State at a speed which is greater than is reasonable and proper with regard to traffic conditions and the use of the highway, or endangers the safety of any person or property. The fact that the speed of a vehicle does not exceed the applicable maximum speed limit does not relieve the driver from the duty to decrease speed when ... special hazard exists with respect to pedestrians or other traffic or by reason of weather or highway conditions.

<sup>21</sup> Braithwaite J and Braithwaite V, "The Politics of Legalism: Rules Versus Standards in Nursing Home Regulation" (1995) 4 *Social and Legal Studies* 307. Braithwaite V, Braithwaite J, Gibson D, Landau M and Makkai T, *The Reliability and Validity of Nursing Home Standards* (Department of Health, Housing and Community Services, Canberra, 1991).

<sup>22</sup> Black J, "Talking About Regulation" (1998) (Spring) Pub L 77.

<sup>23</sup> Novack and Saunders, n 15.

<sup>24</sup> See Braithwaite J, *Corporate Crime in the Pharmaceutical Industry* (Routledge, 1984).

<sup>25</sup> Braithwaite, n 24.

their affairs, which is why most inmates of our prisons are poor even though the evidence is clear that it is the rich who commit the criminal offences that cause greatest loss of property and injury to persons.<sup>26</sup> With respect to criminal law, this hardly plays out as a major source of uncertainty: a detected serious criminal offender of limited means is fairly certain to be convicted; major corporate criminals are almost certain never to be convicted partly because they are less likely to be detected and partly because of entrepreneurship in excuses and contrived complexity. Put another way, there is uncertainty that is structurally predictable by features of power in society rather than by features of the law.

Frederick Shauer argues: “In many cases, indeed in most cases, the result indicated by applying a rule will be the same as the result indicated by directly applying the rule’s background justifications.”<sup>27</sup> What I am arguing is that this is true of the law of fraud applied to welfare cheats, false for the law of fraud applied to top management of large corporations. As we criminologists put it, the best way to rob a bank is to own it.

## IS THERE A SOLUTION?

When a tax authority targets a shelter used by a wealthy individual or corporation it can go after it first under specific rules in the law and if that fails the tax authority can attack it under the General Anti-Avoidance Rule (GAAR).<sup>28</sup> Many tax experts I have interviewed in the course of my research think the GAAR something of an irrelevance because in jurisdictions that have it the courts rarely apply it, perhaps because they think it opens the door to giving too much discretion to the tax authority.<sup>29</sup> If that is so, the implication of the argument in this article, if it is right, is that we need to persuade such courts that the reality is the opposite of their intuitions – a rule of rules that closes the judicial door on a GAAR actually reduces certainty and increases administrative discretion.<sup>30</sup> But it may be that for this to be true, judicial conversations need to be open to sharing the sensibilities of regulatory conversations between regulators and regulatees.<sup>31</sup> Indeed in some way that does not threaten the separation of powers and judicial independence, judges need to become part of those conversations – Lord Mansfield’s project with making English commercial law relevant to the needs of merchants two centuries ago. To the extent that judiciaries prove incapable of this, then the case is strengthened for specialised courts such as the United States Tax Court.

Australia’s GAAR, Pt IVA of the *Income Tax Assessment Act 1936*, depends on showing that there exists a scheme, that there is a tax benefit in relation to it, and that a person who put the scheme in place did so for the purpose of securing that tax benefit. ATO Second Commissioner, Michael

---

<sup>26</sup> See Braithwaite J and Pettit P, *Not Just Deserts: A Republican Theory of Criminal Justice* (Oxford University Press, 1990) Ch 9.

<sup>27</sup> Schauer F, *Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life* (Clarendon Press, 1991) p 100.

<sup>28</sup> At least this is the case under Australian law and administration. Nations with a GAAR include Australia, Canada, Hong Kong and New Zealand in the common law world and a variety of civil law jurisdictions including Germany, France, Belgium, The Netherlands, Spain and Sweden. See Cooper GS, “International Experience with General Anti-Avoidance Rules” (2001) 54 *SMU L Rev* 83.

<sup>29</sup> I am particularly grateful for a discussion with Reuven Avi-Yonah on this question. The empirical observation that the GAAR is rarely used to decide cases in the courts in Australia and Canada is accurate, but it may not be correct that the reason for this is the courts’ fearing to give too much discretion to tax authorities. It may also be that the GAAR effectively deters schemes pre-litigation. See Cooper, n 28 at 127. Rick Krever, in commenting upon the ideas in this article, made the point that GAARs are only used in practice “to deal with tax expenditures, not tax measures”. On this view, what is needed is not a GAAR, but a remedy to the problem of politicians wanting to introduce tax expenditures “without specifically spelling out who the intended beneficiaries are because it would be politically dangerous to explicitly identify the intended beneficiary group”.

<sup>30</sup> An additional reason for this with tax is that when one nation treats a particular kind of transaction more in terms of form and another state more in terms of substance, global firms can arbitrage substance and form by structuring transactions so that a part that gets a benefit under a form conception is located in the state that privileges form and another part that does better under a substance conception is channelled to a state that so treats it.

<sup>31</sup> From my conversations with elite tax lawyers, there would be a lot of agreement with the following claim by David Weisbach, but not universal agreement: “I believe David Halperin’s claim that tax lawyers are sufficiently trained and share a sufficiently common understanding of the tax law to be able to determine which transactions anti-abuse rules target and which they do not”: Weisbach, n 11 at 881 (citing Halperin D, “Are Anti-Abuse Rules Appropriate?” (1995) 48 *Tax Law* 807 at 809).

D'Ascenzo, has argued that "the High Court decisions in *Peabody*,<sup>32</sup> *Spotless*<sup>33</sup> and *Consolidated Press*<sup>34</sup> provide 'important and consistent statements of principles' which can help guide the weighing up of tax and non-tax purposes".<sup>35</sup> These principles are distinctively Australian. Australian courts have rejected the "Ramsay principle" developed by the United Kingdom courts<sup>36</sup> and have distanced themselves from United States doctrines such as "substance over form" and the "step transaction" doctrine.<sup>37</sup> Section 177D(b) defines eight factors as in effect badges of avoidance. "These provide 'warning lights' about the possible application of Part IVA. For example, a round robin [one of the eight factors in s 177D] may well be legally effective to record a loan and a repayment, but it may well assist in drawing the tax avoidance conclusion."<sup>38</sup> Transactions that are not objectionable by themselves may constitute avoidance in combination. Consistent with the approach advocated in this article, the Full Federal Court in *Consolidated Press* stated in relation to s 177D:

The section requires the decision-maker, be it the Commissioner or the Court, to have regard to each of these matters. It does not require that they be unbundled from a global consideration of purpose and slavishly ticked off. The relevant dominant purpose may be so apparent on the evidence taken as a whole that consideration of the statutory factors can be collapsed into a global assessment of purpose.<sup>39</sup>

As a result of High Court decisions such as *Peabody* and *Spotless* combined with the clarification of the ATO's position in Public Rulings such as TR 20000/8 (investment schemes), TR 98/22 (linked or split loan facilities) and TR 95/30 (sale and leaseback) and the publication of the ATO's administrative approach in a variety of other ways, Second Commissioner Michael D'Ascenzo concludes:

These reference points arguably provide a more certain basis than is available in other jurisdictions as to when the General Anti-Avoidance Rule (GAAR) is likely to be applied, or, in jurisdictions which do not have a GAAR, as to when the courts will intervene on the basis of judicial doctrines that have been developed in those jurisdictions to counter tax avoidance.<sup>40</sup>

External tax law consultants are routinely involved on the ATO's Part IVA Panel as part of its strategy to cultivate consistently shared sensibilities on what passes the "smell test" and what does not. The possibility that shared sensibilities have been cultivated in the dialogue between the courts and the ATO is suggested by the ATO's claim in relation to its aggressive tax planning litigation in 2001 that 13 cases had been finalised on "8 procedural issues – all favourable to the Commissioner" and "5 substantive issues – all favourable to the Commissioner".<sup>41</sup>

Tax laws can be written by setting down binding principles, of which one is the GAAR, then detailed rules to illustrate how the principles should be applied to common concrete commercial arrangements.<sup>42</sup> If there are 1000 rare ways of setting up the kinds of arrangements covered by the law, but only a dozen are used with any frequency, then these are the 12 concrete arrangements that should be fleshed out into rules.<sup>43</sup> Rules are used to define a dozen mainstream examples of how the principle applies. This means business is not left to flounder making sense of how to apply broad

<sup>32</sup> *FCT v Peabody* (1994) 181 CLR 359.

<sup>33</sup> *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

<sup>34</sup> *FCT v Consolidated Press Holdings* (2001) 27 ATR 229; [2001] HCA 32.

<sup>35</sup> D'Ascenzo M, "Part IVA and the Common Sense of a Reasonable Person" (Paper to 2002 Queensland Taxation Institute Convention, Surfers Paradise, 17 May 2002) p 11.

<sup>36</sup> *John v FCT* (1989) 166 CLR 417.

<sup>37</sup> *ANZ Savings Bank Ltd v FCT* (1993) 42 FCR 535.

<sup>38</sup> D'Ascenzo, n 35, p 4.

<sup>39</sup> *FCT v Consolidated Press Holdings (No 1)* (1999) 91 FCR 524 at 552.

<sup>40</sup> D'Ascenzo M, "A Practical Guide on Part IVA (of the Income Tax Assessment Act)" (Paper to the 15th National Convention of the Taxation Institute of Australia, Sydney, 24 March 2001) p 1.

<sup>41</sup> Minutes of the National Tax Liaison Group, 9 March 2001, at 14.

<sup>42</sup> See generally Jones JA, "Tax Law: Rules or Principles?" (1996) 17 *Fiscal Studies* 63.

<sup>43</sup> Writing rules to cover the other 988 is precisely the drafting error we wish to avoid. Or, more precisely, we wish to avoid having to foresee them all and to avoid making the law iteratively more complex to cover them as they are used one after the other to game the law.

principles in their normal operations<sup>44</sup> and are warned to be wary of tax advisers who counsel that the principles are so vague that a legal case can be made to justify almost anything in terms of them. At the end of the concrete rule specifications, the law explains that these rules are defined in this way because they instantiate named principles. This is a further safeguard against lawyerly tendencies to privilege rules that can then be gamed. Another is an Acts Interpretation Act, such as those revised in New Zealand and Australia to complement their GAARs, that require courts to give effect to purposes of Acts<sup>45</sup> or more specifically that defend the “the integrity of the tax system”.<sup>46</sup> In spite of all of this, courts are still likely at times to indulge their proclivity to privilege the rules over the principles in the law, say in response to a taxpayer whose advisers game one of the sets of rules that cover a concrete financial product or form of corporate structuring (9) into a minor variation (9A) that shelters income. Even then, there is an alternative to writing new rules to plug the loophole. It is for the legislature to enact a simple law that says the 9A shelter violates specified principles in the tax law and should in future be disallowed, striking down the precedent. The simplest drafting device for doing this is for the new statute to state that the 9A shelter comes within the scope of section X under the old statute. This not only strikes down the judicial precedent in the 9A case, it also widens the scope of the old statute by making a legislative intent clear to apply the offended principle in the law to a wider range of structurings than the judiciary understood.

While the strategy of attacking a shelter first in terms of rules and then in terms of a GAAR when this fails may have more general relevance beyond tax law, it is not likely to be appropriate for conduct where the community wishes to criminalise and imprison offenders. Where imprisonment is at risk people are entitled to know with some precision, and in advance, what puts them at risk of losing their liberty. In saying this, however, we have seen that we cannot assume that precise rules actually do protect us against arbitrary exercises of the most frightening state power when the economic phenomena at issue are complex.<sup>47</sup> Fortunately, the criminal law is only occasionally the instrument the regulator who wishes to be effective in these areas wants to use. So the prescription here would be never to deprive a person of their liberty in circumstances where there is conflict between what is commended by a precise rule a citizen has relied upon and what is commended by the principle that justifies that rule.

## CONCLUSION

One article that has influenced me greatly in this work is David Weisbach’s “Formalism in Tax Law”: “Rules must specify the treatment of a greater number of transactions than standards [principles] and, therefore, they are systematically more complex than standards.”<sup>48</sup> This is because, according to Weisbach, “rules can less afford to overlook uncommon transactions than can standards”.<sup>49</sup> While the argument here and in my more general treatment of this topic has been that this is right, it is also contended that tax law can list rules for transactions that are common, leaving judicial enforcement of the principles and the GAAR to mop up when unusual transactions are in contest. This hybrid of rules-principles would actually put the brakes on economically wasteful legal entrepreneurship to manipulate the rules. It is a strategy for reaping the benefits of rules – clear guidance to taxpayers in common situations – while limiting their pathologies: exponential growth in legal complexity,

<sup>44</sup> Another way to decide which arrangements should be defined by illustrative sets of rules would be to apply Louis Kaplow’s theory of when law should regulate through rules versus standards (principles in my/Raz’s usage). Simplifying, Kaplow contends that because rules have higher promulgation costs in deciding how to craft them ex ante, rules should only be written when the law will be applied frequently. Standards have lower promulgation costs than rules but higher application costs (costs in determining how they should apply to specific situations). Hence, standards are more economically efficient in application to arrangements that arise only rarely. Kaplow L, “Rules Versus Standards: An Economic Analysis” (1992) 42 Duke L J 557 at 568-588.

<sup>45</sup> Sections 15AA and 15AB, *Acts Interpretation Act 1901* (Cth).

<sup>46</sup> Section 6-6B, *New Zealand Tax Administration Act 1994*.

<sup>47</sup> Charles Black writes: “Some lawyers talk as though they thought maximum clarity always desirable even though they wouldn’t have to probe very deeply to find that fraud, and fiduciary obligation, and undue influence, have been carefully isolated from exact definition”: Black CL Jr, *Law as an Art in The Humane Imagination* (Oxbow Press, 1986).

<sup>48</sup> Weisbach, n 11 at 867.

<sup>49</sup> Weisbach, n 11 at 867.

burgeoning compliance costs, expanding waste of private and public resources on legal game-playing and countering it, a tax system that ordinary people cannot comprehend and therefore has low legitimacy and hence reduced prospects of voluntary compliance.

The solution proposed here could never be a panacea, even if the theory that underpins it is right. It may be just one of many things that are needed for a high integrity tax system. While simple in its conception, implementation of this approach is necessarily difficult when what is being responded to is complexity and flux. Selecting the right examples of arrangements that are specified as covered by the principle, and getting the examples right in how they are described, is no easy matter. Just as rule writers make the law hopelessly cluttered and complex by seeking to cover all contingencies, implementers of the theory in this article could easily make the mistake of cluttering the statute “with descriptions of things that never happen”.<sup>50</sup>

The current tax systems of common law nations are a major cause of growing, and perhaps justifiable, citizen distrust in their governments. Good tax administration involves virtuous circles of trust begetting trust instead of vicious circles of distrust begetting distrust. There are a number of obstacles to flipping the vicious circle into the virtuous circles that our RegNet research group<sup>51</sup> has documented to exist in other domains of regulation – such as Australian nursing home regulation in the late 1980s and early 1990s.<sup>52</sup> It is not the objective of this article to catalogue all of these obstacles to social capital formation and economic growth through a high integrity tax system. It has been just to argue that one of them is certainly a pathological tax law that makes the mistake of supposing that a rule of law is best accomplished by a rule of just rules.

---

<sup>50</sup> I am grateful to the Australian Taxation Office’s Chief Tax Counsel, Michael D’Ascenzo, for this point and the words quoted.

<sup>51</sup> <http://regnet.anu.edu.au>.

<sup>52</sup> Braithwaite J, “The Nursing Home Industry” in Tonry M and Reiss AJ (eds), “Beyond the Law: Crime in Complex Organizations” in *Crime and Justice; A Review of Research* Vol 18 (University of Chicago Press, Chicago, 1994) p 11.