DO OUR TAX SYSTEMS MEET RULE OF LAW STANDARDS?

Conference Papers, 20 November 2013

Edited By
Justine N Stefanelli
Lucy Moxham

Bingham Centre Working Paper 2014/06, September 2014
www.binghamcentre.biicl.org

Citation: This paper should be cited as: J N Stefanelli & L Moxham (Eds), *Do Our Tax Systems Meet Rule of Law Standards? Conference Papers 20 November 2013* (*Bingham Centre Working Paper 2014/06*), Bingham Centre for the Rule of Law, BIICL, London, September 2014.

About the Bingham Centre

Bingham Centre for the Rule of Law
Charles Clore House
17 Russell Square
London WC1B 5JP

Tel: +44 (0)20 7862 5154
Email: binghamcentre@biicl.org
Web: www.binghamcentre.biicl.org

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Preface and Acknowledgements

This Working Paper includes a selection of papers presented at the Bingham Centre conference on 20 November 2013, titled "Do Our Tax Systems Meet Rule of Law Standards?" which took place at the law offices of Berwin Leighton Paisner. The conference discussed whether aspects of a selection of national tax frameworks comply with the rule of law standards set out in Tom Bingham's celebrated book '*The Rule of Law*'. It offered different perspectives and included international speakers presenting comparative views. The conference also benefitted from the participation of a number of other participants, who either chaired sessions or presented on a specific topic. The conference followed a similar evening event in March 2013 which focused on the UK. Summaries of both of these events are available on the website of the Bingham Centre.

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The Bingham Centre is grateful to Berwin Leighton Paisner for its generosity in hosting both of these important events.

Introduction

Professor Sir Jeffrey Jowell KCMG QC, Director, Bingham Centre for the Rule of Law

Since the Bingham Centre began its work in December 2010 it has selectively monitored rule of law issues in the United Kingdom (UK) and elsewhere. One issue that comes up frequently is taxation. Are the rules sufficiently clear and understandable? Are they applied predictably and not retrospectively? Do they permit of fair challenge? Are they equally enforced? Do they too easily permit of avoidance? What degree of avoidance amounts to illegality, or evasion? We convened an evening event in March 2013 which considered these issues and brought together experts from practice, academia and government. Following that event it was clear, not only that one evening was not enough time to explore these issues adequately, but that the UK was not the only jurisdiction experiencing these kinds of problems.

We therefore held a one-day conference in November of the same year which explored these issues in more detail and included jurisdictions which are also struggling to create a system for taxation that is rule of law compliant. At that conference, we measured the British tax system against Lord Bingham's eight rule of law principles, and we examined taxation in the wider context of international law obligations. We learned about retrospective taxation in India, Jersey's tax relationship with the UK, and compliance with European Union state aid rules from the perspective of Gibraltar. The conference also approached issues regarding the structure, rules and procedures of the UK tax tribunal, issues of selective enforcement in light of Lord Bingham's third principle of equality before the law, and considered the problems faced by those trying to access the system to assert their rights or redress wrong-doing. The conference concluded with an enthusiastic and thought-provoking debate on the UK General Anti-Abuse Rule (GAAR) where two practitioners disputed whether it is the most appropriate remedy for exploitation of tax loopholes in the UK.

What follows is a selection of the presentations from that conference, authored by the impressive experts who participated on the day. These issues are far from resolved, and the Bingham Centre will continue to monitor developments with a view toward generating discussion and developing practice that respects the rule of law in this area.

CHALLENGES TO THE RULE OF LAW?
A COMPARATIVE PERSPECTIVE

Retrospective Taxation: The Experience of India

Harish Salve SA, former Solicitor General of India

The art of taxation consists of so plucking the goose as to obtain the largest amount of feathers with the smallest amount of hissing. (Jean Baptiste Colbert)

The levy and collection of tax has historically been one of the most controversial exercises. Its critics have considered it nothing less than theft sanctioned by law. Its protagonists elevate it to the platform of a great instrument to finance state welfare and achieve the elusive dream of egalitarianism. Like all such controversies, the truth may lie somewhere in between – especially when tax is imposed retrospectively.

Taxation has left its indelible mark on most societies. Even the architecture of civilizations has not been spared from the effects of taxation. Taxes on windows in the 17th Century impacted the architecture in England, Wales and Scotland and the tax based on frontages led to the defining feature of the architecture of buildings in the Netherlands.

The evolution of democracies with elected governments and bills of rights gradually changed the perception of taxes as the price for civilization. Chief Justice Marshall's *seductive cliché* that the power to tax involves the power to destroy was seemingly taken seriously by the Governments, until it was tempered by later judges and put to rest by the redoubtable Holmes with the trenchant observation that the power to tax is not the power to destroy while this Court sits!

Taxation in India also has a history similar to other taxes imposed in other colonies by foreign rulers. The first major tax to be imposed by the British was a tax on income. It was unsurprisingly resented because it was imposed to make India pay for the whole of the extra regiment sent to India, and also to recover *retrospectively* the costs of the regiment for the past six months.[1]

The tax was withdrawn for a while, but then it was imposed afresh in 1922 by enacting the Indian Income Tax Act 1922. This law continued in force, with amendments made from time to time although it suffered endless amendments which left it "*shapeless and order-less*"[2]. Realising the need for a fresh code, the government established a Direct Taxes Administration Enquiry Committee in 1959, and based on its recommendations, as well as those of the Law Commission, a new act was put in place which came into force in 1961. In less than three decades of its existence this law suffered more than 66 amendments.

Apart from the Income Tax Act, the three significant pieces of tax legislation in the field of indirect tax in India were the Central Excise and Salt Act which was imposed in 1944, the Customs Act which was first imposed in 1868 and sales tax laws which operated at the provincial and then the state level of government.

[1] 'Revolt of 1857 & Financial Burden on Indians' (*South Asian Research Centre for Advertisements, Journalism & Cartoons*, 2014) <https://www.sarcajc.com/tax___revolt_1857.html>.

[2] Jamshedji Behramji Kanga, Nani Ardeshir Palkhivala, and Dinesh Vyas, *The Law and Practice of Income Tax,* 8th Edition (LexisNexis 1990).

The principal commodity taxes in the late 19th century were taxes imposed under the British tax collection system upon salt and alcohol for portable consumption. Commodities were added over a period of time, although a quantum change was made in 1942 when excise duty was imposed on tobacco to raise finances for the war effort.

The tax on manufacture of goods continues under the 1944 Act as the principles of taxation in relation to indirect tax are – or at least were – fairly simple, and the procedure for levy and collection was exhaustively dealt with in the rules framed from time to time. Similarly, the principles underlying the imposition of customs duty on imports and exports were fairly simple. The Sea Customs Act of 1878 was replaced in 1962 by the Customs Act which continues to be in force. It is only in the mid-80s that the principles for valuation of goods became complex after India amended its laws to bring them in line with international principles of valuation and classification.

That apart, the growth in the economy as well as of economic activity generally and the proliferation of industry in India increased the impact of taxation and therefore disputes became more frequent and more complex even under the indirect tax laws. Prior to this the two principal acts of legislation that gave rise to disputes, which then led to court decisions and which in turn prompted the occasional retrospective amendment, were the income tax law and the sales tax law, and the problems relating to retrospective taxation therefore centred around this legislation.

Retrospective Laws and Legislative Competence

The Constitution of India imposes two limitations on the legislative power of Parliament or the State legislatures. The first is by way of legislative competence – in that the subjects of legislation are divided into three lists, with Parliament having the exclusive power to legislate on List I and the states having the exclusive power to legislate with respect to List II, and the two having concurrent power in relation to List III.

The second limitation is by way of Part III of the Constitution – the equivalent of a bill of rights. Tax laws are amenable to a challenge on the ground that they are discriminatory (in violation of equality before the law) or that they are unduly burdensome and harsh and thus an unreasonable restriction on the right to carry on business.

The first important challenge to retrospective changes being made was by way of a challenge to an amendment in 1951 imposing a duty on manufactured tobacco which was brought into force retrospectively, i.e. from the date of the introduction of the bill and not from the date in which the law came into force.

This legislation was challenged in court on two bases. The first was that the state legislature lacked the legislative competence to enact a sales tax law with retrospective effect. The argument was that sales tax was primarily an indirect tax, the essential feature of which was that its burden could be passed on to the consumer. Where it was imposed retrospectively, the burden of the past could not be so passed on to the consumer and therefore it ceased to be an indirect tax and for that reason was unconstitutional. This argument was tersely dispatched, following decisions of the Privy Council holding that the method of collecting the tax was an accident of its administration, and the fact that it could not be passed on did not affect its essential characteristic. The Court also followed and cited with approval the decision of the Privy Council in *Colonial's Sugar Refining Co Ltd v Irving*[3] which had stated the proposition with clarity – if there was a power to impose taxation conferred by a

[3] *Colonial Sugar Refining Co Ltd v Irving* [1905] UKPC 27, [1905] AC 369.

constitution, the legislature could equally make the law retroactive and impose the duties from a date earlier than that from which it was imposed[4].

The Supreme Court accepted that tax laws were subject to the discipline of Part III of the Constitution. However the Indian Supreme Court chose to follow the American decisions that had rejected the suggestion that mere retroactivity would render a tax law arbitrary and capricious.

These principles laid down in 1962 were followed consistently in a host of cases. The defining feature of these cases was that the amendments which are made retrospectively related invariably to either correcting some drafting flaw which clearly defeated legislative intent, or correcting some feature on account of which the Court found the law unconstitutional. As the Court explained in 1963,[5] while there could not be any dispute that the legislature in India had the power to make retrospective legislation, it would be open to a party affected by such laws to contend that the retrospective operation creates a situation which could be described as an unreasonable restriction which violates the right to carry on business or the right to hold and dispose of property.

While in theory the Court did subject tax laws to the fundamental rights to carry on business, and the right to hold and dispose of property, in practice the only few occasions on which the Court did strike down laws were situations where the tax was brazenly discriminatory. There is no reported decision in which the Court found a law imposing a tax retrospectively to have fallen foul of constitutional limitations on account of the law’s retroactivity itself.

The bar was set rather high- the reasonableness of each retroactive tax depends on the circumstances in which it comes to be made, and the test of the length of time covered by the retrospective operation could not by itself be a decisive test. For example where a statute may have continued to be in operation for years and was then found to be constitutionally flawed on account of a feature which was amenable to correction by an amendment, if, after the final judicial verdict, the law was amended and brought into place retrospectively, the length of time would be irrelevant.

In a later case decided in 1969,[6] the Supreme Court cited an article that had appeared in the Harvard Law Review which suggested that "it is necessary that the legislature should be able to cure inadvertent defects in statutes or their administration by making what has been aptly called small repairs". Clearly what the Court had in mind were cases where, on account of bad drafting or introducing some feature in the tax law that made it unconstitutional, the State stood to suffer loss of revenue and there was a corresponding windfall upon a taxpayer. In such a situation the legislature could legitimately make a retrospective amendment and also introduce a validating clause.

Validating Clauses – Their Validity

One of the interesting issues which has recurred in Indian jurisprudence is the challenge to validating clauses that seek to override judicial verdicts.[7] The Indian Constitution recognizes separation of powers. In the early 1960s, the Supreme Court of India dealt with challenges to the constitutional validity of statutes brought into force with retrospective effect in a manner so as to nullify the effect

[4] *Chhotabhai Jethabhai Patel and Co v The Union of India and Anther* [1962] AIR, [1962] SCR Supl. (2) 1.
[5] *Khyerbari Tea Co Ltd & Anr v The State of Assam* [1964] AIR 925, [1964] SCR (5) 975.
[6] *Buckingham and Carnatic Co Ltd v Workers of the Buckingham and Carnatic Co Ltd* [1953] AIR 47, [1953] SCR 219.
[7] A Validating Clause is a provision that validates a recovery or a demand of tax notwithstanding the judgment of the Court to the contrary.

of a decision of the Court. The Court recognised that as a facet of the power to make laws with retrospective effect, it was open to the legislature to correct the defect and change the basis on which the decision of the Court had been rendered, and having done so it was open to legislatively declare that notwithstanding anything contained in any judgment or decree of a Court, the imposition of tax for the past also would be valid. The key feature of such legislation had to be correction or change of the very basis on which the decision had been given. As the Court explained "a Court's decision must always bind unless the conditions on which it is based are so fundamentally altered that the decision could not have been given in the altered circumstances".[8]

There were some cases in which an amendment failed to 'cure the defect' – in those cases the Court held that the law seeking to validate past collections would constitute a usurpation of judicial power and would therefore be unconstitutional. However, if the amendment carefully altered the basis of the judgment which had declared a demand or a recovery of tax illegal (irrespective of whether it was merely a matter of interpretation or on account of some feature of the law the Court had found the statute to be unconstitutional) then the legislature could not only legislate retrospectively but could also validate past collections or past demands.

Clarificatory or Retrospective – Who Decides

A number of retrospective amendments of recent times have been passed off as 'clarificatory' or 'declaratory'. Where the amendment is not made expressly retrospective, but is statutorily described as being a clarification (i.e. by use of words such as "for the removal of doubts it is clarified") the Supreme Court has held that the mere legislative assertion that an amendment is a clarification is not conclusive, and that whether a change is clarificatory or substantive (and therefore not retrospective) is a matter of statutory interpretation and therefore for the Courts to adjudicate.[9] Where a law is challenged as being unconstitutional, the legislative assertion that the law is clarificatory would be of no avail.

Current Trends

Retrospective legislation did occur from time to time, but for the most it was designed to deal with some Court verdict which upset the existing law or upset the existing understanding of the law. The first controversial retrospective amendment was in 1983. The Income Tax Act conferred a tax exemption upon new industrial undertakings as a percentage of capital employed in such undertakings. Since the inception of the exemption, a Rule that had been in place for computation of the capital had had been employed. This Rule was struck down by various High Courts as being inconsistent with the parent Act insofar as it provided for the exclusion of long-term liabilities from the computation of Capital Employed. Parliament retrospectively amended the parent statute itself and engrafted the Rule in the parent statute. This retrospective amendment was challenged on the ground that business undertakings had altered their position acting on the belief that the parent law would prevail and that the Rules that were plainly inconsistent would be ignored, and therefore if the law was now retrospectively altered to ratify, as it were, rules that were illegal, it would seriously upset settled affairs and thus be harsh and burdensome.[10] The majority judgment held that the rules were valid even as they were framed, and therefore the retrospective amendment was really

[8] *Shri Prithvi Cotton Mills Ltd & ANR v Broach Borough Municipality & Ors* [1970] AIR 192, [1970] SCR (1) 358.
[9] *Union of India & Ors v M/S Martin Lottery Agencies Ltd* [2008] SLP 6083, [2009] SCR 3239.
[10] *Lohia Machines Ltd & Anr v Union of India & Ors* [1985] AIR 421, [1985] SCR 686, [1985] SCC 197.

clarificatory in nature. The issue of such a challenge to retroactivity was not decided by the majority. The dissenting judgement which accepted the proposition that the original rules were ultra vires, struck down the retrospective amendment to the statute as being an unreasonable restriction on the right to carry on business.

Recent years have seen a spate of retrospective changes made to direct tax laws and also to indirect tax laws. One common feature of most of these changes in the 1980s and early 1990s was that they either cured some defect or made some change which could not, in all fairness, be condemned as a change of law as such – it was more a case of parliamentary intent misfiring. The trend has distinctly changed in recent times.

The trend has clearly changed since 2000. Moreover this is clearly discernible in the realm of direct tax law - possibly on account of the fact that in current times, after the rationalisation of indirect taxes (partly on account of WTO commitments) direct taxes, particularly corporate tax, have become the largest source of revenue.

These changes have not merely been procedural – but substantive as well. For example, in 2001, retrospective changes were made with effect from 1961 to disallow a claim of expenses (which would otherwise constitute a legitimate business expense), where income in relation to which such expenses had been incurred is exempt from tax. There was no language in the law to suggest any such disallowance – just the assertion of the tax office, and that too in recent times. The assertion of the tax office was, by retrospective amendment, made the law in force.

Over the years, such changes have become a steady stream. The one area of greater concern is the retrospective amendments dealing with incomes of non-resident assessees. In 1976, a series of changes were made in the scope of total income deemed to accrue or arise in India to non-resident assessees. This provision was frequently amended as more and more categories of incomes of non-residents were brought to tax in India. The most prolific amendments were to the definition of *royalty* earned by foreign enterprises in an endeavour to tax incomes for which the only connection with India was that the service received from the non-resident was used by a resident assessee in India. It was no different from taxing Ede and Ravenscroft for the profits they earn on sale of collars and bands to Indian counsel!

Although the Indian Constitution provides that a law does not become unconstitutional solely on account of the fact that it has extraterritorial operation, the question of whether Parliament could make a law that directly seeks to tax income that has no territorial nexus with India is a vexed issue which has not been resolved. In a decision given in 2007[11] the Supreme Court accepted the proposition that the provisions of a statute have to be construed in harmony with the principle that income which has no territorial nexus with India would not fall within the mischief of the fiction of "income deemed to accrue or arise in India".

This decision has been sought to be retrospectively modified by a number of amendments made to provisions where this principle of presumption against extraterritoriality would apply. The validity of some of these provisions has been put in issue but the matter has not yet been decided by the Indian Courts.

India has witnessed in recent times an exponential growth in foreign direct investment. Prior to the breakup of the USSR India had very close economic relations with the USSR, including by way of

[11] *Ishikawajima-Harima Heavy Industries Ltd v DIT* [2007] 288 ITR 408 (SC).

rupee-ruble trade, and was able to finance a significant portion of its major imports such as oil and arms through this special relationship. The breakdown of the USSR also saw the lowest point of the Indian economy - Indian foreign exchange had reached a point where in order to prevent defaulting on foreign loan repayment schedules, India had to pledge planeloads of its gold reserves to raise more loans.

The wave of economic reform which put India on the path to becoming a market economy can therefore be traced to 1991. With this change came the need for foreign investment. During this period, a large number of developing economies, not just India, saw quantum growth in foreign direct investment – by the mid-1990s the FDI flows became greater than the flows of official development assistance.

With increasing FDI came the presence of multi-national corporations (MNCs). By 2005 almost 36% of FDI flows were rooted to the developing countries. India has had its fair share of foreign investment. On account of this the Indian service industry has grown exponentially, and a large part of the growth is attributable to the advent of foreign investment and the presence of MNCs in India.

Indian tax law has undergone significant changes to deal with the economic change in which a significant portion of tax revenue now flows from either multinational corporations carrying on business in India, or from transnational transactions where one of the parties receiving income is a non-resident. Even the size of businesses in India has grown. In the 1980's, a tax dispute involving Rs.10 million (GBP 100,000) was considered a huge dispute – now it would considered insufficient to justify the fee of an eminent silk! Assessments of income measured in billions of dollars are now reasonably common.

The two areas that have seen significant changes in India are the provisions for taxation of offshore income of non-residents (on the basis of some connection with India) and enacting provisions for transfer pricing determination, so that in transactions between associated enterprises operating within India and outside India, the fair amount of income attributable to within India can be brought to tax under Indian tax law. All such laws are relatively new to Indian jurisprudence, and drafting them is a daunting task for Indian draftsmen. Fiscal legislation is experimental and more so in new areas which are evolving to keep pace with the changing dynamic of global business.

However, the interest of certainty and stability, and the need to inculcate public faith in the dispute resolution process, demand that laws are not frequently changed. Every time the Income Tax Department misreads the law, it is not necessary to change the law to accord with the intent of the assessing officers. There is no harm in accepting that the courts are better judges of parliamentary intention and if they find that the assessing officer has misread the law, unless the situation is such as to clearly warrant parliamentary intervention, certainty and stability would demand that the law not be changed for the asking.

Recognising the need for certainty, the income tax law has been amended to provide for a mechanism whereby non-resident assessees can obtain advance rulings in respect of potential transactions. The *raison d'être* of such a mechanism is to impart certainty beforehand for transactions entered into. When interpretations of law by advance ruling authorities are frequently tinkered with, it erodes public confidence in the procedure prescribed and defeats the fundamental purpose underlying their creation. The biggest blow to the reputation of the Indian system has been the retrospective amendment in the Vodafone case.

The Vodafone Case[12]

One of the greatest success stories in India (before it unravelled in the last three years) was the telecom sector. India opened up mobile telephony from 1996. The original fixed licence fee regime was boldly scrapped by the government in 1999 when it was found to be an impediment to the growth of the telecom industry. The revenue sharing regime was then introduced and Indian Telecom thereafter exploded at a rate of growth hitherto unknown in the sector. In its finest years, despite the prices of mobile telephony coming down (thus benefiting the consumer), the exponential growth in the business made it a lucrative investment option. Those who had initially ventured into the trade, risking political as well as fiscal uncertainty (this was the first major infrastructure sector opened up in India for foreign investment) managed to create substantial values. The licenses are given by the government on a circular basis[13], and each such circle became an investment centre. The success encouraged Telcos to acquire pan-India licenses and hook up operations so as to become nationwide service providers. Hutchison, who is a reputed global telecom player, was one of the first to enter India. Having come into India by investing in the license of one circle, and encouraged by the success, Hutchison, together with its Indian partner, grew its business to make it pan-Indian. This was achieved in two ways: organic growth by setting up its own operations by obtaining new licenses for new circles, and by acquiring other small telecom players who had existing operations in other circles. On account of this kind of growth, the ownership structure of the Hutchison Telecom operations in India was fairly complex - although in no way unusual for such multinational operations.

Hutchison, which is a Hong Kong-based group, made its Indian investment through a listed company in Hong Kong, which in turn held shares in downstream companies in the Cayman Islands. These companies in turn held shares in downstream companies based in Mauritius (a favoured investment destination for investments into India due to a favourable tax treaty – which continues unaltered). And these Mauritius companies then held shares in an Indian holding company which controlled operational subsidiaries in India.

When Hutchison decided to exit India, Vodafone was keen to enter India and agreed to buy the Hutchison Telecom operations in India. The deal was structured like all such deals – Vodafone acquired an appropriate company below the listed company in Hong Kong, the acquisition of which gave them equity interests and control over all the downstream companies and thereby control over the Indian operations. This transaction was outside India, the agreements entered into in England and Hong Kong, monies paid outside India, and control taken over by changing the boards of the companies in the Cayman Islands and Mauritius, etc.

Hutchison and Vodafone were correctly advised that, in this transaction, the capital gain accrued upon the acquisition of a share of the Cayman Islands company outside India was not taxable in India. This was for the simple reason that (unlike other regimes elsewhere) Indian legislation had not been amended to provide for "look-through" provisions where in appropriate cases (defined with clarity in the statute) the tax authorities could tax a gain in a jurisdiction where the ultimate assets (from which the values are derived in the upstream shares) are located, even if the immediate source of the gain (such as the transfer of a share of an upstream company) was outside the jurisdiction.

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[12] *Vodafone International Holdings BV v Union of India & Anr* [2010] SLP(c) 26529.

[13] The large metros are a circle, and in other areas, it generally is district wise.

Apart from the language of the law, and the fact that a provision which would bring such a gain to tax had not been added to the Indian statute,[14] Hutchison and Vodafone presumably – and rightly – derived some comfort from historical precedent. Hutchison had similarly acquired shares in a number of offshore companies that had telecom operations in India through downstream companies, and that had exited India by selling their upstream company shares to Hutchison, and at no point in time had the Income Tax Department suggested that these transactions were liable to tax on their capital gains, nor had Hutchison ever deducted any tax when it paid for such shares. The Income Tax Department in fact publicly declared that their attempt to hold the transaction between Vodafone and Hutchison taxable was a "test case".

There is no harm in a tax department running a test case, and if the assessee is ultimately found to be within the dragnet of the law, it is no defence to such an assessee that it was wrongly advised and was ignorant of the law. One important detail was that the assessee who derived the gain on account of the increase in the value of the Indian business was not Vodafone but Hutchison. If the general understanding of the tax department and all assessees was that such transactions are not taxable, it was inherently unfair to run such a test case against Vodafone holding it responsible for *failing* to deduct tax on the sum paid by it to Hutchison. It is inherently unfair to suggest that in a "test case" scenario, a purchaser of an asset who has paid money could be held to have "failed" to deduct tax.

The second major conceptual flaw in this approach is that it amounts to extending procedural provisions for withholding tax to offshore transactions which have been consummated in jurisdictions in which Indian tax law does not apply. If Vodafone had deducted tax from Hutchison from consideration payable under an English law agreement arrived at outside of India and to be performed outside India, Hutchison could have legitimately treated Vodafone as being in breach, for the provisions in the Indian income tax law which statutorily declare that deduction of tax would constitute a constructive receipt of the money by the recipient have no application outside India. Quite plainly, it would amount to applying Indian law to a commercial transaction outside India between two non-Indians where no part of the transaction (for sale of the share) takes place in India. This would be contrary to settled principles of conflict of laws. Vodafone therefore closed the transaction by paying the entire sale consideration to Hutchison and acquiring the upstream share and control of the Indian entities.

The Indian Tax Department found it easier to pursue Vodafone (which now had a business presence in India and could be embarrassed if it refused to cooperate with the Indian tax authorities), and the only way it could do so was by alleging that Vodafone was an assessee in default for having failed to deduct tax. When the matter was still in the Indian Courts in proceedings of judicial review, Prime Minister Gordon Brown wrote to Prime Minister Manmohan Singh complaining about a retrospective application of tax laws - on the basis that similar transactions had never been taxed in the past. The response of the Indian Prime Minister was unexceptionable – that there was no retrospective application of any law but a controversy as to an application of existing Indian law as to such transactions, and that it would be resolved finally in the Indian Courts.

The Supreme Court of India, in a judgment that warrants study, held that under the law as it stood, the transaction was not taxable in India. It rejected the suggestion that there had been any attempt at impermissible tax avoidance by resort to artifices, finding that the creation of the structure which

[14] The Australian and Canadian Courts had held such gains as not being taxable, which led to amendments inserting *look through* provisions.

was in place had been driven by commercial considerations and could not be condemned as a tax saving device.

In the immediately subsequent Finance Act, the provision relating to taxation of income of non-residents was drastically amended, virtually overriding every single legal argument that the Supreme Court of India had accepted while holding that the transaction was not liable to tax. The Memorandum[15] explaining the provisions of the Bill had this to say:

> Certain judicial pronouncements have created doubts about the scope and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities. Therefore, there is a need to provide clarificatory retrospective amendment to restate the legislative intent in respect of scope and applicability of section 9 and 195 and also to make other clarificatory amendments for providing certainty in law.

The power of the Indian Parliament to make such laws is not in issue, but such an amendment posed a serious question mark upon the wisdom of those who proposed such amendments. The fallout of the amendment has established that it was a huge mistake: two expert committees set up to examine this issue have categorically held so.

Holding that these amendments were being brought "for the removal of doubts" was a serious assault on the rule of law. To say that there was a need to clarify the law posits that the tax officer was right, and the High Court and Supreme Court were both so wrong that they completely missed discerning parliamentary intent. This undermines the foundation of the rule of law in which the Courts (and not the executive) have the last word in the matter of statutory interpretation and discerning parliamentary will.

Besides, comity between institutions called for greater respect being shown for the painstaking judgment of the Supreme Court, which examined the law not just in India but in other jurisdictions as well to come to the conclusion that India did not have *look through* provisions whereby such a transaction could have been taxed and that the settled law on the subject was that if shares carrying controlling interest are transferred, there is a single transaction of the transfer of a share; not two transactions in parallel in which there is a transfer of shares and a transfer of control.

It is open to Parliament to notionally provide, for purposes of imposing tax on transnational transactions, that an offshore transfer of a share is deemed to bring about the transfer of an asset in India in specified circumstances; in fact other jurisdictions have also done so. What is objectionable is to suggest that such a major change of policy in its tax law is "for the removal of doubts". The Supreme Court noticed that amendments which would enable such tax to be levied had been proposed in the draft Direct Taxes Code which was in public domain for discussion and which had not yet been legislated upon.

The Fallout of the Retrospective Amendment

The only explanation for this action is that it was, to borrow the expression used by the late renowned tax jurist Mr NA Palkhivala (criticising a retrospective amendment which had been made in 1983), a triumph of bureaucratic obstinacy over good sense.

This amendment was not one of a kind. The last few years have seen a spate of such amendments. In the past amendments were normally made where the government was keen to get over the

[15] Memorandum on the Finance Act 2012.

judgment of the Supreme Court, or at least a judgment of the High Courts, on a particular issue. Of late amendments, including retrospective amendments, have been made to get over decisions of Tax Tribunals and even in some cases advance ruling authorities. There was considerable international disquiet over this retrospective amendment. The government at one time seemed to hope the controversy would go away if Vodafone challenged the retrospective amendment in the Supreme Court of India for the reason that if the amendment was struck down, it would solve the political problem of unscrambling the amendment, and if the amendment was upheld, it possibly could provide some moral justification for the change. Unfortunately for the government, Vodafone refused to oblige and as the press reports suggest, it has decided to pursue its remedies under bilateral investment treaties.

Left with the political problem of unscrambling such an amendment when justification for the amendment failed to convince those who mattered, thereby creating a serious dent in FDI proposals to India, the government then took to appointing an expert committee for rendering advice on the matter. This expert committee was headed by one of the most respected economists of India: Mr. Parthasarthy Shome. After examining the matter in some detail, this is what he had to say.

> The Committee concluded that retrospective application of tax law should occur in exceptional or rarest of rare cases, and with particular objectives: first, to correct apparent mistakes/anomalies in the statute; second, to apply to matters that are genuinely clarificatory in nature, i.e. to remove technical defects, particularly in procedure, which have vitiated the substantive law; or, third, to "protect" the tax base from highly abusive tax planning schemes that have the main purpose of avoiding tax, without economic substance, but not to "expand" the tax base…Thus, the above facts clearly show not only the absence of any evidence proving that these retrospective amendments are clarificatory in nature but also demonstrate lack of any legislative intent of taxation of capital gains arising on account of indirect transfer.[16]

Unfortunately, despite this the matter remains where it was without any resolution.

In October 2013, the World Bank published a report[17] downgrading India in the index of investment friendliness; from its position of 131 in 2011, India was moved to 134. India's position remained below countries like Uganda, Ethiopia, and Yemen, while India's smaller neighbours like Sri Lanka fared better. To address this fall in confidence, the government appointed a committee headed by another eminent Indian economist and businessman, Meleveetil Damodaran. The remit of this committee was generally to examine issues which contributed to this decline in investment friendliness. In doing so, the committee squarely addressed the question of retrospective taxation and had the following to say:

> It has often been said that death and taxes are equally undesirable aspects of human life. Yet, it can be said in favour of death that it is never retrospective. Retrospective taxation has the undesirable effect of creating major uncertainties in the business environment and constituting a significant disincentive for persons wishing to do business in India. While the legal powers of a Government extend to giving retrospective effect to taxation proposals, it might not pass the test of certainty and continuity. This is a major area where improvements should be attempted sooner rather than later….[18]

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[16] Report of the Expert Committee on Retrospective Amendments made by the Finance Act, 2012 to Income-Tax Act, 1961 Relating to Taxation of Non-Residents on Indirect Transfer, 9 October 2012.
[17] International Finance Corporation and the World Bank, *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises* (World Bank Group).
[18] Damodaran Committee Report for Reforming the Regulatory Environment for Doing Business in India, 17 September 2013.

There is now near unanimity amongst jurists and economists on what the paradigms for fair taxation constitute. Amongst the ten commonly accepted rules are equity and fairness, certainty, tax neutrality, economic growth and efficiency, transparency, and visibility. Major changes to tax laws which amend fundamental principles retrospectively plainly violate each of these paradigms. Assessees are entitled to plan their affairs and make investments based on the state of the law at the time when they make investment. Changing the rules of the game after the match has been played is a brazen violation of the principles of equity and fairness.

Certainty is one of the most important principles in present times where transnational investment is the lifeblood of economic growth in developing economies. In the guiding principles of good tax policy issued by the American Institute of Certified Public Accountants in 2001 explaining the standard principles it said "certainty is important to a tax system because it helps to improve compliance with the rules and to increase respect for the system. Certainty generally comes from clear statutes as well as timely and understandable administrative guidance that is readily available to taxpayers".[19] A retrospective amendment hardly qualifies as a sensible measure by this yardstick.

Economic growth and efficiency are important for all economies in present times, especially in developing economies where economic growth is vital in raising hundreds of millions of people out of abject poverty. As the guidelines of the American Institute of Certified Public Accountants wisely said:

> The tax system should not impede or reduce the productive capacity of the economy. The tax system should neither discourage nor hinder national economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is achieved by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax.[20]

One example of an amendment made at this same time illustrates nicely how costs are multiplied by retrospective amendments. The tax department sought to tax income earned by companies that own satellites and rent satellite space to broadcasters, even where the broadcasters and the companies that own the satellite are non-resident, the contracts between them were executed outside of India, the payments are made outside of India and the up-linking occurs outside of India. In the first instance, they sought to tax sums paid for renting satellite capacity as "royalty" on the specious ground that the satellites process the data of the broadcasters and thereby the broadcasters use the software of the satellites, and thus any sums paid in such a situation would be taxable in India as the technology is being used in India upon its down-linking.

When this claim failed in the High Courts, a retrospective amendment was brought to displace the reasoning of the High Court. Since the appeals of the revenue are pending in the Supreme Court, it was perhaps felt that there was no need for a validating provision as the appeals will now have to be disposed of on the basis of the amended statute due to its retroactivity.

This kind of uncertainty and inequity in tax laws drives up the cost of doing business in India by increasing the risk of doing business. The higher the risk, the greater the return that would be demanded by an investment in India and this will necessarily impact economic growth and efficiency. The problem of such amendments is that while the amendment may relate to one sector only, the

[19] American Institute of Certified Public Accountants, 'Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals', (*AICPA*, March 2001).
[20] Ibid.

increased perception of risk is felt across all sectors due to a general sense of uncertainty in the belief of a system in the rule of law.

The government of India has shown remarkable restraint while dealing with the question of tax avoidance. While the tax department keeps up its attempt to persuade the Supreme Court of India to drift away from the *Duke of Westminster*[21] and move closer to the patriotic approach which guided Justice Learned Hand in *Helvering v Gregory*[22], the retrospective amendment brought into place post Vodafone did not alter the judgment of the Court which then adhered to the *Duke of Westminster* principle as further evolved in the later English cases from *Ramsay*[23] to *Craven*[24]. Instead, the government has wisely pursued the path of the GAAR although the proverbial devil still lies in the details. It is important that a clear declaration that the rules of GAAR be applied prospectively. What remains to be seen is if at some point of time in the near future, this declaration of prospective application is revised retrospectively.

All life is an experiment. Principles of economics and principles of governance are also experiments. Besides, mankind has a tendency to do the right thing - although at times after exploring other options. The government of India made retrospective amendments in the past to tax laws. These primarily impacted Indian business and therefore did not create the kind of international furore which the Vodafone amendments have created. Indian businessmen - especially in the 1980s and 1990s - were used to the style of governance which was reflected in the *Vodafone* case retroactively. Besides, prior to the opening up of global markets to Indian investors, even if they lost faith in the fairness of the administration they had little in the way of alternatives. And there was not much to lose – whatever else the tax department may have been known for, fairness was not one of its renowned attributes.

Through the 1970s and 1980s India flirted with socialism where it was fashionable to tax the rich and it was morally justified to impose harsh burdens on private profit; profit was after all almost a vice. The world has changed at a rapid pace and so has the Indian economy. Globalisation and free flow of capital which has brought in huge value and growth to India has also brought about dramatic change in the business culture and character. There is a corresponding expectation that economic governance would follow global norms of fairness and transparency. Add to this the communication explosion of the 21st century – the *Vodafone* controversy was an accident waiting to happen.

The judgement of the *Vodafone* case was an example of how a Supreme Court could rise to the occasion, familiarise itself with current trends of tax jurisprudence and render a judgement which established that the Indian judiciary had no bias in favour of the Indian state and was unflinching when it came to striking down an unreasonable tax demand of billions of dollars.

The retrospective amendment was an indication that the Indian bureaucracy still has a long way to go in changing its old mindset of obstinacy. The post-amendment dithering despite expert committee reports to the contrary are evidence of the fact that the Indian political system has evolved up to the point of inviting criticism but lacks political maturity to take the final step. The evolution will be complete when the political system accepts that good economics is, in the 21st Century, good politics, and good governance is the courage to acknowledge mistakes; for public good and public interest

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21 *IRC v Duke of Westminster* [1936] 19 TC 490.
22 *Gregory v Helvering* [1935] 273 US 465.
23 *Ramsay v IRC* [1982] AC 300.
24 *Craven (HM Inspector of Taxes) v White* [1989] AC 398.

are best served by institutions that have the resilience and strength not merely to invite criticism but to do the right thing without being deterred by populism or passing political compulsions. The capacity to act in the interest of public good transcending political compulsions is the ultimate test of a mature democracy.

Cooperative Independence: Jersey's tax relationship with the United Kingdom

William Redgrave, Jersey Advocate, Baker and Partners

The Island of Jersey has an interesting relationship with the United Kingdom in connection with tax. The relationship is sometimes misunderstood. Official pronouncements on the topic have not always been completely aligned. This paper seeks to explore that relationship.

Jersey's status vis à vis the UK

Jersey, like the other Channel Islands, is not part of the United Kingdom. Nor is it a member of the European Union.[1] Jersey is a Crown Dependency, with the British monarch as its sovereign. Unlike the more geographically distant Crown Dependencies, the Channel Islands did not become subject to the British Crown by colonisation or treaty. They were part of the Duchy of Normandy before William the Conqueror's invasion of England in 1066, and from that date on they had the same sovereign, the Norman kings of England being also Dukes of Normandy. In 1204 King John lost Normandy but the Channel Islands elected to remain with England.

Jersey maintained its ancient and distinct laws, customs and privileges, with their Norman and French origins. It always had a separate legal system from that of England. It was always a separate jurisdiction with its own judiciary and laws. Medieval charters confirmed and enshrined Jersey's separate legal system. Key features were that all matters concerning Jersey men were to be tried in Jersey, following Norman customary law, by the Bailiff (the chief magistrate, who was appointed by the Crown), assisted by two locally elected jurats.

Charters also affirmed Jersey's independence from the British mainland in terms of tax. They asserted that no islander was to pay tax to the English king for English purposes. However the Crown reserved the right to control taxes levied in Jersey for Jersey purposes, and the Crown reserved the right to legislate for Jersey. Jerseymen were not required to pay import duties at English ports.

The current position is recognisably similar. The judicial system is more developed, but it is still headed by a Bailiff, who is assisted in some matters by elected lay jurats. There are other judges, including a Deputy Bailiff and Commissioners, who are usually English QCs or retired judges. There is a Jersey Court of Appeal, and the ultimate appeal court is the Judicial Committee of the Privy Council in London.

As to the substantive law, Jersey customary law draws on many sources, including Norman and French customary law, Roman law and English law. It has a less rigid reliance on precedent than England. English court decisions are influential when the subject matter is similar. Only Privy Council decisions on Jersey appeals are strictly binding.

[1] Thus Channel Islanders' passports, though British passports, are marked to the effect that the holder does not have the right of free movement within the EU. Jersey is however bound, under Protocol 3 to the UK accession treaty, by EU rules on customs matters and quotas; on free movement of goods; and on not discriminating against EU citizens.

Jersey has its own legislature, the States of Jersey. Almost all legislation governing Jersey originates in the States of Jersey and is then formally approved by the Crown, which may recommend amendments but which by convention does not override the will of the States. Legislation from the UK parliament can be expressly extended to cover Jersey, but this rarely happens. The ancient right asserted by the Crown to legislate for Jersey is now generally regarded as existing only subject to the consent of the States of Jersey.

It is said that there may be a residual Crown power to intervene in Jersey's affairs to uphold good government, i.e. where there has been a complete breakdown in law and order or good governance. Something similar happened in Turks and Caicos recently. No one seriously expects that power to be invoked in the Channel Islands.

Jersey is developing an international personality. For over half a century, Jersey has only been bound to treaties signed by the UK if it consents to be so bound. In recent years Jersey has entered into international agreements in its own right, in relation to matters such as tax information exchange. The UK accepts that it and Jersey have different interests in matters such as tax, and Jersey ploughs its own furrow.

Historic tensions over tax

Jersey's tax system was always separate and distinct from that of the UK. When UK income tax and corporation tax increased throughout the twentieth century, Jersey was not bound to follow, and did not do so. Its taxes have therefore been lower than those of the UK and most other European countries throughout the period of expansion in the financial sector. Currently income tax is 20%, the equivalent of VAT is 5%, and there is no corporation tax, save for a 10% levy paid by local financial services businesses.

Wealthy Britons started moving home to Jersey in the nineteenth and early twentieth century, some attracted by the cleaner air. From the middle of the twentieth century, when the tax gap with the UK widened, many more settled in Jersey in order to reduce their tax bills.

A finance industry began to take off in the 1960s, as providers of financial services realised that Jersey's lower taxes provided a way of restructuring the holding of personal wealth of non-Jersey residents through trusts and companies to mitigate taxes, and businesses reduced taxes by use of Jersey companies. An obvious attraction for many seeking offshore financial services was Jersey's proximity to the UK, and its common language and time zone.

During the 1960s, dozens of international banks opened branches in Jersey. Legal and financial services developed alongside them. Jersey's introduction of a Trusts Law in 1984, which provided conditions favourable for trustees to operate commercially, hastened the development of trust companies, acting as professional trustees and company directors. Funds have recently been a major growth area.

The finance and legal sector has in recent decades come to dominate Jersey's economy, as agriculture and tourism have declined. Now, the finance industry employs a quarter of Jersey workforce and generates 40% of Jersey's annual income from economic activity. Its banks hold about £150 billion on deposit. The population is 100,000.

Jersey has attracted criticism and suspicion, in common with other offshore finance centres, on the basis that its services can be used by criminals to hide proceeds of crime, and to evade taxes. This undoubtedly did happen. Corrupt politicians seeking to hide their loot, or fraudsters or straightforward criminal tax evaders, did use Jersey, along with many other finance centres, as part of their money laundering schemes. In the early days regulation was light and some in the finance industry did not ask, or did not care, where the money was coming from or why it was coming to Jersey.

However that has all changed in recent decades, as Jersey has embraced international initiatives to combat money laundering and to share information with other countries in the fight against financial crime. Since 1999 Jersey has had comprehensive and stringent anti-money laundering laws and regulations, and unlike in some other countries those laws are enforced. Following civil and criminal proceedings in Jersey, huge sums in looted public funds have been repatriated to Nigeria and Brazil, among other countries, and major money launderers have been convicted and sentenced to long prison terms in Jersey. Financial services businesses which have inadequate controls to prevent abuse by criminals have been sanctioned, named and shamed, and in some cases closed down.

Jersey has also, in the past decade, committed to tax information exchange agreements, covering both criminal and civil tax matters, with almost all the OECD and EU states, and it is exploring automatic disclosure in concert with other G5 countries. This has enabled Jersey's government to claim that it is at the forefront of tax transparency.

More recently, criticism has moved on to Jersey's perceived role in aggressive tax avoidance schemes. Nakedly artificial schemes involving notional trading losses, such as those employed by Jimmy Carr and Chris Moyles, have attracted public indignation in the UK, at a time of public spending cuts. The UK has been blamed for the "harmful tax practices" of its Crown Dependencies.

Until very recently the official view from Jersey, as in many places, was that tax avoidance was entirely legitimate. A good example of this sentiment appears in the Jersey Royal Court's judgment in *In the matter of the S trust*.[2] Commenting on an English decision about whether the placing of funds into a trust may be reversed when the tax consequences prove undesirable, the Court remarked at para 39:

> The second aspect of the *Pitt v Holt* test that troubles us is the weight given to the interests of the tax authority. We entirely accept that it is open to the courts of any country to lay down their own judicial policy in relation to the exercise of an equitable jurisdiction. The preference accorded to the interests of the tax authority in the United Kingdom is not one, however, with which we are sympathetic. In our view, Leviathan can look after itself. We should not be taken as indicating any sympathy for tax evasion, which we regard as fraudulent and as entirely undeserving of any favourable discretionary treatment. But in Jersey it is still open to citizens so to arrange their affairs, so long as the arrangement is transparent and within the law, as to involve the lowest possible payment to the tax authority. We see no vice in this approach. We accordingly see no reason for adopting a judicial policy in this country which favours the position of the tax authority to the prejudice of the individual citizen, and excludes from the ambit of discretionary equitable relief mistakes giving rise to unforeseen fiscal liabilities. We see no fairness in such a policy.

As it happens, in the final decision in *Pitt v Holt* itself, in the Supreme Court,[3] Lord Walker at paras 65-66 had some pointed remarks to make about Jersey's professional trustee industry. These remarks may be indicative of a more cynical approach to be expected from the English judiciary towards Jersey structures in future:

[2] *In the matter of the S trust* [2011] JLR 375.
[3] [2013] UKSC 26.

In the private client world trusts are mostly established by and for wealthy families for whom taxes (whether on capital, capital gains or income) are a constant preoccupation. It might be said, especially by those who still regard family trusts as potentially beneficial to society as a whole, that the greater danger is not of trustees thinking too little about tax, but of tax and tax avoidance driving out consideration of other relevant matters.

That is particularly true of offshore trusts. They are usually run by corporate trustees whose officers and staff (especially if they change with any frequency) may know relatively little about the settlor, and even less about the settlor's family. The settlor's wishes are always a material consideration in the exercise of fiduciary discretions. But if they were to displace all independent judgment on the part of the trustees themselves (or in the case of a corporate trustee, by its responsible officers and staff) the decision-making process would be open to serious question … it may be that some offshore trustees come close to seeing their essential duty as unquestioning obedience to the settlor's wishes.

Shoulder to shoulder

The official tone has shifted noticeably as politicians have absorbed the public mood. In October 2013 the UK government signed an automatic tax information exchange agreement with Jersey. The records of UK taxpayers with bank accounts in Jersey will be automatically passed to HMRC.

At the launch of this agreement the two governments declared, in essence, that they stood shoulder to shoulder on tax. The Chief Minister of Jersey and the UK Chancellor respectively enthused:

> We welcome the agreement with Jersey which demonstrates our shared commitment to tackling tax evasion. The agreements will enable HMRC to clamp down further on those individuals who seek to hide their assets offshore.[4]

> This agreement once again demonstrates our long-held commitment to international co-operation on tax matters. It sends another clear signal that Jersey has no need or desire to tolerate tax evasion or aggressive tax avoidance.[5]

This love-in culminated in Prime Minister Cameron declaring that it was "not fair" to describe Jersey as a tax haven any longer.

It may be significant that Mr Gorst included reference to aggressive tax avoidance in his statement. Jersey has signalled a determination to rid itself of the stigma of association with the more disreputable schemes that were being promoted some years ago. Jersey's financial regulator has said it will consult with the finance industry on developing a "sniff test" which will "identify aggressive tax avoidance schemes" with which Jersey's association would be "detrimental to the good reputation of the island." It remains to be seen what will come of this rather imprecise aspiration.

Jersey has responded to criticism that its economy is a drain on UK tax takings by publicising a report in 2013[6] which claimed that Jersey is in fact a net contributor to the UK's coffers, on the basis that:

1. It is a conduit for £0.5 trillion of foreign investment into the UK, via Jersey trusts, companies and funds etc, facilitating the flow of funds into UK banks, and transactions in UK securities and property, which raise UK tax of £2.5 billion;

[4] 'Jersey signs tax agreement with UK' (*States of Jersey*, 22 Oct 2013), statement of George Osborne <http://www.gov.je/News/2013/pages/JerseyUKAgreement.aspx>.
[5] Ibid, statement of Ian Gorst.
[6] 'Jersey's value to Britain', a report by Capital Economics commissioned by Jersey Finance, 2 July 2013 <http://www.jerseyfinance.je/valuetobritain>.

2. Tax leakage from the UK via Jersey-based tax evasion or aggressive avoidance is estimated at only £600m;

3. Jersey's finance industry has created 100,000 more UK jobs than it has destroyed.

However it is to be expected that the UK authorities will seek to do more to reduce the tax leakage figure. It may even be that the scope of criminal prosecutions for tax evasion will be widened, to embrace the more obviously bogus avoidance schemes. The then Director of Public Prosecutions, Keir Starmer QC, spoke publicly in January 2013 of "an important breakthrough … the ability of HMRC and the CPS to extend the reach of the criminal law by including a further category of offender in the list of successfully prosecuted cases – namely, those who devise and operate sophisticated schemes to abuse direct tax regimes: dishonest tax avoidance schemes." He identified "the telltale signs of dishonesty, whether that be false or misleading documents, false turnover figures, hidden trading transactions, or payments that do not reflect commercial reality."[7] Jersey businesses wondering whether to continue operating aggressive tax avoidance schemes may be influenced by this development.

Whatever "sniff test" may in due course be officially or unofficially applied in Jersey to new tax avoidance schemes, there are likely to be more headlines involving Jersey-based schemes entered into a few years ago, ending up with unwelcome consequences for the client and/or the promoter.

Conclusion

Jersey defends its independence in tax matters while cooperating in combatting unacceptable and illegal tax practices. It remains to be seen whether tensions on the subject will emerge again, but at present the appearance is of harmony.

[7] 'Prosecuting tax evasion', The Crown Prosecution Service, Speech by Keir Starmer QC, 23 Jan 2013 <http://www.cps.gov.uk/news/articles/prosecuting_tax_evasion/>.

Low Tax Regimes: Rights and Responsibilities - The Challenges of Complying with the European Rule of Law

Michael Llamas QC, Chief Legal Advisor to HM Government of Gibraltar

Introduction

Rights and Responsibilities in the case of a low tax jurisdiction such as Gibraltar has meant the right to apply a tax rate at whatever level the Gibraltar Government considers most appropriate for the development of its economy for so long as that rate is applied in a uniform manner and the responsibility to introduce transparent and effective gateways for the exchange of information on tax matters.

These are the two parallel paths that Gibraltar has been embarked upon over the last 15 years in accordance with an emerging European and international rule of law on matters concerning taxation. It has been a tremendous challenge but one from which Gibraltar expects to emerge stronger and bolder.

Rights

Gibraltar introduced its first Income Tax Act in 1952. Following a recommendation made 30 years earlier in a 1922 Report prepared by the UK's Inter-Departmental Committee on Income Tax, and addressed, somewhat ominously, to "Colonies Not Possessing Responsible Government", Gibraltar like many other irresponsible colonies, adopted, as advised, a territorial system of taxation whereby income would be chargeable to tax only if it accrued in or derived from within the territory. It is the tax system that is still in place in Gibraltar today as in other Commonwealth countries such as India, Kenya and Singapore as well as Hong Kong.

This was followed by the adoption of Gibraltar's principal offshore legislation in 1967, the Companies (Taxation and Concessions) Ordinance, which created the so-called "exempt company". In essence, the company was exempt from taxation in Gibraltar if it transacted all its business outside Gibraltar and if no Gibraltarian or resident of Gibraltar held any of the shares in the company. That legislation formed the bedrock for the gradual emergence of Gibraltar as an international finance centre. It also enabled the difficult transition we had to undergo from a fortress economy to a self-sufficient economic territory not dependent on any financial assistance from the UK.

The exempt company legislation remained on the statute book uncontested and, seemingly in accordance with the European Rule of Law, for 26 years of EU membership. That is to say, from 1 January 1973, when Gibraltar joined the EEC together with the United Kingdom, until 12 February 1999 when the EC Commission made its first enquiry as to the compatibility of Gibraltar's offshore tax legislation with EU state aid rules.

That letter came on the back of the adoption of two principal initiatives taken in the late 1990s to tackle so-called harmful tax competition at EU-level. First, on 1 December 1997, the ECOFIN

Council adopted a "Code of Conduct for Business Taxation"[1] and then on 10 December 1998 the Commission adopted a "Notice on the application of the State aid rules to measures relating to direct business taxation"[2] in which it clarified how it would henceforth apply EU state aid rules to general tax measures. Both initiatives concerned themselves primarily with tax rates. The fiscal Odyssey commenced in February 1999 has entailed three formal state aid investigations by the European Commission into our tax laws and 4 Court cases. And, as I shall explain, it is still ongoing.

With regard to state aid, it is an established principle of European law that a measure by which the public authorities grant certain undertakings favourable tax treatment which, although not involving the transfer of State resources, places the recipients in a more favourable financial position than other taxpayers amounts to State aid.

It was clear from early on that the exempt company legislation would constitute state aid within that meaning. Gibraltar therefore abolished the exempt company legislation and on 12 August 2002 notified the European Commission of an entirely new general tax system applicable to all companies in Gibraltar consisting of a payroll tax, a business property occupation tax and a registration fee.

- *Payroll Tax*. All Gibraltar companies would be liable to an annual payroll tax of GBP 3,000 per full-time or part-time employee employed in Gibraltar.
- *Business property occupation tax.* All companies occupying property in Gibraltar for business purposes would be charged a business property occupation tax at a rate equivalent to a percentage of their liability to the general rates charged on property in Gibraltar.
- *Registration fee.* There would be an annual registration fee applicable to all companies in Gibraltar of GBP 150 for companies that do not generate income, and GBP 300 for companies that generate income.
- Cap. Liability to payroll tax together with business property occupation tax would be subject to a maximum liability of a sum equivalent to 15% of profits.

By decision taken on 30 March 2004[3] the Commission found that the new system constituted state aid. It did so on two main grounds: (1) it was materially selective in that certain companies in Gibraltar, namely the former exempt companies, were still being favoured; (2) it found it was regionally selective in that companies in Gibraltar were subject to a lower rate of tax than companies in the United Kingdom.

Gibraltar and the United Kingdom Governments successfully challenged both grounds of the decision before the European General Court,[4] but then lost on the sole ground of material selectivity on an appeal brought by the European Commission and Spain before the Court of Justice[5]. It has been seven years of complex litigation.

[1] ECOFIN Council, *Code of Conduct for Business Taxation* (ECOFIN Council, 1997).
[2] European Commission, *Notice on the application of the State aid rules to measures relating to direct business taxation* (OJ No C 384, 1998).
[3] Commission Decision 2005/261/EC (30 March 2004) regarding the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform (OJ 2005 L 85, 1).
[4] Joined Cases T-211/04 and T-215/04, *Government of Gibraltar and United Kingdom v Commission* [2008] ECR II-3745.
[5] Joined Cases C-106/09 P *Commission v Government of Gibraltar, United Kingdom of Great Britain and Northern Ireland, Kingdom of Spain* and C-107/09 P *Kingdom of Spain v European Commission, Government of Gibraltar, United Kingdom of Great Britain and Northern Ireland* [2011] ECR I-11113.

On material selectivity, the ECJ found that although the Payroll Tax and the Business Property Occupation Tax applied *de jure* in the same general way to all companies in Gibraltar, *de facto* they resulted in excluding any taxation of offshore companies, since they have no employees and also did not occupy business property. Consequently, the Court found that the fact that offshore companies were not taxed in Gibraltar was not a random consequence of the regime at issue, but the inevitable consequence of the fact that both corporate taxes were specifically designed so that offshore companies, which by their nature have no employees and do not occupy business premises, avoid taxation.

More serious, in that it had implications going well beyond compliance with EU state aid rules, was the Commission's finding of "regional selectivity" which treated Gibraltar as something which it was not, namely, a UK region. Not only did it subject Gibraltar to a tax system enacted by a legislature in which it has no representation. But also, under the guise of the application of EU state aid rules, the European Commission had embarked on a course that would have put an end to the viability of the Gibraltar economy by requiring Gibraltar to operate the same tax system as the UK notwithstanding the fact that the UK and Gibraltar constitute, and have always constituted, two entirely separate and distinct fiscal territories. The fiscal, political and constitutional consequences of that application of EU state aid rules cannot be overstated. It would have far-reaching effects on fiscal sovereignty, on the UK-Gibraltar relationship and possibly on the devolution process within the UK itself. It seemed peculiar to us that EU state aid rules, which have been designed to regulate commercial transactions and to ensure a level competitive playing field between companies, were to be allowed to interfere with the internal constitutional architecture of Member States in this way.

By the time the case was heard by the General Court, the Court of Justice had delivered its judgment in *Portugal v Commission* which concerned the fiscal powers enjoyed by the autonomous region of the Azores.[6] In that case, the Court established the test on regional selectivity. It ruled at para 58 of its judgment that an infra-State body may have a legal and factual status which makes it sufficiently autonomous for that body to play a fundamental role in defining the political and economic environment in which undertakings operate in its territory. If so, it is the area in which the infra-State body exercises its powers, and not the country as a whole, that constitutes the relevant context or framework for assessing whether a measure adopted by that body selectively favours certain undertakings.

In order to assess whether an infra-State body enjoys sufficiently autonomous powers the Court set out this test:

- First, **constitutional autonomy**: from a constitutional point of view, that body must have a political and administrative status separate from that of the central government.
- Secondly, **procedural autonomy**: the central government must not be able directly to intervene as regards the content of the tax measure in question.
- Third, **economic autonomy**: the financial consequences of the lower tax rate must not be offset by aid or subsidies from other regions or from the central government, that is, the authority must assume the political and financial consequences of the measure.

The General Court ruled in our favour although Court of Justice avoided adjudicating the matter by ruling only on material selectivity.

[6] Case C-88/03P *Portugal v Commission* [2006] ECR I-7115.

The Income Tax Act 2010

Having abandoned the Payroll Tax System, the new Income Tax Act 2010 (ITA 2010) entered into force on 1 January 2011. The ITA 2010 is principally a revision and consolidation of the Income Tax Act 1952 which it has replaced. It is now the only company taxation regime in Gibraltar. The ITA 2010 did three principal things: (1) it introduced a uniform corporate tax system for all companies in Gibraltar with a 10% corporate tax rate (down from 22%); (2) it maintained the territorial system of taxation that had been in force in Gibraltar since 1952; (3) it did not charge to tax domestic-source passive income, notably, interest and royalties.

In May 2012, Spain filed a complaint with DG COMP claiming that the ITA 2010 constituted unlawful state aid. Spain has argued, essentially, that the effect of the territorial system of taxation and the non-taxation of passive income is to provide, de facto, an advantage for the previous offshore companies.

So we are back in here. After one year of negotiations, in October 2013 the European Commission decided to open a formal investigation procedure into the ITA 2010 on the issue of the non-taxation of interest and royalties. The investigation is currently ongoing.

EU Code of Conduct

In order to overcome the limited competence that the EU enjoys over direct taxation matters, in 1997 the ECOFIN Council adopted the Code of Conduct on Business Taxation and created the Code Group, known in its initial years as the Primarolo Group, after its Chair Dawn Primarolo in the first years. It is made up of tax officials of all EU Member States.

The Code of Conduct raises serious rule of law issues. It operates behind closed doors and, as far as territories such as Gibraltar are concerned, with a large measure of opaqueness and no legal recourse against its decisions however damaging they may be. Although the EU Code of Conduct is not a legally-binding instrument, it has strong political force and has become the yardstick by which harmful tax measures within the EU and in the overseas territories of EU Member States are assessed. The Code requires Member States to refrain from introducing any new harmful tax measures (the 'standstill principle') and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code (the 'rollback principle').

The criteria for determining harm are set out in paragraph B of the Code as follows:

1. Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents.

2. Whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base.

3. Whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages.

4. Whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD.

5. Whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.

Earlier this year, the Code voted in favour of the ITA 2010 (all the Member States except Spain voting for us) and in June 2013, ECOFIN endorsed the ITA 2010 as compliant with the Code.

Responsibilities

Other work has been carried out by the Gibraltar Government at the same time to reposition Gibraltar as a competitive and reputable jurisdiction which complies with EU and international standards. Let me highlight just a few of these.

OECD

On 27 February 2002 the Gibraltar Government submitted to the OECD a letter of commitment to transparency and exchange of information. Gibraltar has entered into 27 OECD Tax Information Exchange Agreements. These include major partners (the UK, USA, France, Germany, India, Italy, Ireland, Portugal, Netherlands, Belgium, Austria, Australia, New Zealand, South Africa, Malta, Mexico, Turkey, Poland, Greece, Guernsey and the seven Nordic countries (Sweden, Finland, Denmark, Norway, Iceland, Faeroes and Greenland). In 2009, the Gibraltar Government passed the International Co-operation (Tax Information) Act 2009 which serves as a gateway to give effect to OECD requirements on transparency and exchange of information. Gibraltar is now on the G20-instigated OECD 'white list' of co-operative jurisdictions.

On 7 June 2013, Gibraltar asked that the OECD and Council of Europe Convention on Mutual Administrative Assistance in Tax Matters be extended to Gibraltar. Such an extension forms an integral part of our ongoing policy of having Gibraltar recognised as being at the very forefront of jurisdictions seeking to eradicate tax evasion.

IMF

Gibraltar was the first jurisdiction to volunteer to undergo the full range of Module 2 assessments by the IMF on banking, insurance, investment services, and trust and company management. The IMF has found that Gibraltar "is at the forefront of the development of good practices". It further noted "that Gibraltar was one of the first jurisdictions to have introduced regulation and supervision of the company and trust services business," and highlighted the fact that "Gibraltar has been a pioneer in the supervision and regulation of Professional Trusteeship and Company Management services providers".[7] The IMF concluded that "Gibraltar ranks as a well-developed supervisor. The regulatory regime across the industry meets most international standards and accords with best practice."[8]

In a further review in May 2007, the IMF came to the conclusion that

[7] International Monetary Fund, *Gibraltar: Detailed Assessment Report on Anti-Money Laundering and Combating the Financing of Terrorism* (International Monetary Fund 2007).
[8] Ibid.

> the Gibraltar authorities are concerned with protecting the reputation and integrity of Gibraltar as a financial centre, and are cognizant of the importance of adopting and applying international regulatory standards and best supervisory practices. Gibraltar has a good reputation internationally for co-operation and information sharing.[9]

FATF

In June 2000, Gibraltar was reviewed fully by the Financial Action Task Force and classified as a co-operative jurisdiction. The Financial Action Task Force stated:

> Gibraltar has in place a robust arsenal of legislation, regulations and administrative practices to counter money laundering. The authorities clearly demonstrate the political will to ensure that their financial institutions and associated professionals maximise their defences against money laundering, and cooperate effectively in international investigations into criminal funds. Gibraltar is close to complete adherence with the FATF 40 Recommendations.[10]

EU

The fact that Gibraltar forms part of the EU means that it complies with all regulatory and supervisory standards adopted by the EU, just like all the Member States. For instance, Gibraltar has fully transposed the EU Savings Directive and all the Anti-Money Laundering Directives. It has also transposed Council Directive 2011/16/EU on administrative cooperation in the field of taxation which the OECD considers to be TIEA equivalent. This means that since 1 January 2013, Gibraltar has had TIEA-equivalent arrangements in place with all 28 EU member states - in addition to the bilateral agreements that Gibraltar has signed with over half of EU Member States. Therefore, in addition to the 27 TIEAs signed so far Gibraltar has TIEA-equivalent arrangements in place with a further 13 countries, namely Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Luxembourg, Romania, Slovakia, Slovenia and Spain.

In February of this year we announced that we were fully up to date with the transposition of all EU directives in Gibraltar. On 4 November in a reply to a Question in the European Parliament, the Commissioner with responsibility for the Internal Market, Michel Barnier, stated:

1. There are no infringement proceedings against the United Kingdom concerning the non-transposition of Directives on financial services in Gibraltar.

2. There are no Directives on exchange of information or mutual assistance on tax matters outstanding for transposition in Gibraltar.

3. There are no Directives to combat money laundering outstanding for transposition in Gibraltar.

4. There are no Directives, the transposition date of which has passed, which have not been transposed in Gibraltar.

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[9] International Monetary Fund, *Gibraltar: Assessment of Financial Sector Supervision and Regulation including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Insurance Supervision, and Anti-Money Laundering and Combating the Financing of Terrorism* (International Monetary Fund 2007).

[10] Financial Action Task Force, *Mutual Evaluation Report on Gibraltar* (FATF 2002).

5. There are no well-founded complaints against Gibraltar for any alleged failure to provide or exchange information or to collaborate on tax, financial services or money laundering matters.[11]

FATCA

More recently, Gibraltar has committed to entering into a FATCA agreement (Foreign Account Tax Compliance Act) with the US and to enter into similar arrangements with the UK in keeping with the same timetable and thereby participate in the development of a new global standard for multilateral automatic information exchange.

Furthermore, building on Gibraltar's actions as regards the EU Savings Directive, it has also committed to the pilot multilateral automatic exchange of tax information announced by the E5 countries (the UK, France, Germany, Italy, and Spain). Gibraltar would also call on other jurisdictions to commit to this initiative which will take us to a new level of tackling tax fraud.

Conclusion

Gibraltar has taken part in the UK Government's Balance of Competence exercise, specifically in relation to the Call for Evidence on Taxation. We have invited the Government to identify core elements of taxation policy which must, at all times, remain outside EU competence. In our view this need arises from the fact that it would be dangerous to consider that those core elements are safeguarded by the unanimity requirement for taxation measures in Article 115 TFEU. Whilst that unanimity requirement should never be abandoned, it is not a sufficient safeguard against EU-level action on taxation. It is of equal importance to prevent the EU (including its courts) from acquiring "surreptitious competence" in such core elements of taxation policy through the backdoor of other EU competences such as EU rules on free movement and, in particular, state aid.

A clear candidate for those core elements must be the power for States, and for independent fiscal jurisdictions such as Gibraltar, to set rates of taxation. The responsibilities lie elsewhere and, notably, in the creation of transparency and the establishment of efficient gateways for exchange of tax information and the fight against tax evasion.

[11] 'Brussels has received no credible complaints on Gibraltar finance centre' (*GBC News*, 4 Nov 2013) <http://www.gbc.gi/news/2707/brussels-has-received-no-credible-complaints-on-gibraltar-finance-centre>.

TAX AND ACCESS TO JUSTICE

The Tax Tribunal: Jurisdiction, Process and Substance

Sir Stephen Oliver QC, Pump Court Tax Chambers and
former President of the First-Tier Tax Chamber

Introduction

Each of the tribunals created under the Tribunals, Courts and Enforcement Act 2007 (TCEA) has its own separate rules; these are based on a common framework. The differences reflect the particular demands of the system for which that tribunal was created. In readiness for the creation of the tax tribunals in April 2009, First-tier and Upper Tribunal Rules were drafted by Parliamentary Counsel with instructions from the Rules Committee appointed by the Senior President of Tribunals.

Those Rules were, as one would expect, designed to fulfil the requirements of Article 6 of the European Convention on Human Rights and, as I shall briefly explain, the rules of the Tax Tribunals fall fairly within the spirit of Part Two of Bingham's work *The Rule of Law*,[1] the source of which had been Bingham's Sir David Williams Lecture, given in Cambridge in 2006.

For the first two years of the new Tax Tribunals, which had taken over from the Special and General Commissioners and the VAT and Duties Tribunals, I had "hands on" experience of the new Rules in my capacities as president of the First-tier Tribunal and Judge of the Upper Tribunal. Issues of interpretation of the Act and the Rules frequently arose; but those lay in areas of detailed procedure such as the transitional provisions. In all other respects I found the Rules to be principles, comprehensive and workable. They provided the Tribunal with the flexibility so essential to its case management function. The rules, practice and procedures of the Tax Tribunals fully complied, from my viewpoint, with Bingham principles.

My one reservation arises out of the abolition, last year, of the Administrative Justice and Tribunals Council (AJTC). There is now no independent oversight of the tax appeal system (or indeed of any of the tribunals in the administrative justice system). This, I suggest, should be a matter of concern to the Bingham Foundation.

I shall start by briefly examining the procedures of the tax appeal system in the light of the relevant Bingham principles. The latter part of this contribution will be directed at the case for the establishment of some body that could provide a measure of independent oversight of the system.

The Rules, Practice and Procedure

The first relevant Bingham principle is this: "The law must be accessible and, so far as possible, intelligible, clear and predictable". This covers the right of appeal and the machinery involved in exercising that right.

The tax tribunals are creatures of statute. Rights of appeal arise when, and only when, the statute gives them. Essentially, those rights exist where a decision affecting the "individual" or HMRC has been issued or some prescribed matter (such as the published obligation to file self-assessment

[1] Tom Bingham, *The Rule of Law* (Penguin 2010).

returns on line) affects his ability to comply with the law. “Judicial Review” is reserved to the High Court, save where the High Court has transferred a particular application to the Upper Tribunal. The decided cases on the jurisdiction of the Tax Tribunals have, in effect, established that, unless the substantive tax states otherwise (as where it where it authorises the Tax Tribunal to consider the reasonableness of an administrative act or decision), all matters based on grounds for Judicial Review remain, until delegated to the Tax Tribunals by the High Court, the responsibility of the High Court.

In the past the tax tribunal rules were made by the Treasury, of which HMRC is the agent for the management and administration of tax. The rules now have an independent source. Since the TCEA, the drawing up of the rules has been the responsibility of the tribunals (through an independent rules committee); they are published and revised periodically and aim has been to make them intelligible, clear and predictable.

Hearings of tax appeals are open to public (unless the tribunal specifically directs). All decisions are accessible to the public and reasoned decisions are published when the nature of the case demands this.

The statutory code and the accessibility to judicial review ensure that, to quote the second of the Bingham principles, “Legal rights and liabilities should ordinarily be resolved by application of the law and not the exercise of a discretion”. The tax code provides appeal rights where decisions of HMRC directly affect the person’s liability to or relief from tax. And where the system gives HMRC a regulatory or management role authority which depends on the exercise of administrative discretion, as frequently occurs in areas of indirect taxes known as “ancillary matters”, the substantive law gives the tribunal a “reasonableness” jurisdiction.

Bingham principles then require that – “The laws of the land should apply equally to all, save to the extent that objective differences require differentiation”. Taxpayers and traders, great and small, are, broadly speaking, on the same footing where tax appeals are concerned. HMRC, as the revenue authority, are parties to every appeal and their different function justifies a different status. Otherwise access to the Tax Tribunals is the same for all. There are no First-tier Tribunal “court fees”. There are no awards of costs, unless a party has behaved wholly unreasonably or unless a taxpayer has taken the initiative and persuaded the tribunal that the matter is sufficiently complex to bring the appeal into the costs regime.

A separate Bingham principle states that – “The law must afford adequate protection of fundamental human rights”. The issue here is whether the rules and procedures of the Tax Appeal system comply with Article 6 and provide a means for resolving, without prohibitive cost, bona fide disputes that the parties are unable to resolve. I think they do.

The Rules were framed with Article 6 as their underlying principle. I refer particularly to rules 2(1) and 2(2). These state that their “overriding objective” is to deal with cases “fairly and justly”; that includes dealing with cases in ways that are proportionate to the importance of the case, the complexity of the issues, than anticipated costs and the resources of the parties, avoiding unnecessary formality and seeking flexibility, ensuring that the parties are able to participate and avoiding delay.

The Need for Independent Oversight

But who is to make sure that proper effect is given to the Bingham principles? Who is there to look after the interests of individual taxpayer and small businesses? Take the case of taxpayers who have been penalised for failing to comply with the formal requirements of the self-assessment or the PAYE regimes. The well-represented have professionals and trade organisations to look after their interests. However the interests of a large proportion of taxpayers simply have no voice and no one to speak for them.

The AJTC ceased to exist in 2013 by Order under the Public Bodies Act 2011. Until then, it had existed under the authority of the TCEA as an advisory non-departmental public body of the Ministry of Justice. Its role had been to keep the administrative justice system under review, to consider ways of making the system accessible, fair and efficient and, in relation to tribunals, to keep them under review and report on their constitution and workings. Parliament's Public Administration Select Committee had considered the abolition proposal and concluded that independent oversight of the administrative justice system was required. My experience as president of five tribunals (of which two were concerned with tax and duty appeals) is that some form of independent supervision is not just valuable, it is essential to secure proper and continuing adherence to the Bingham principles.

Why was the AJTC of such value to the administrative appeal system generally and to tax appeals in particular? It had the function of "reaching out" and looking to the interests of all users of the tax tribunals, and in particular those with no representative or voice. It made sure that they understood the system and its published material. It was designed to explore strengths and weaknesses of the tax tribunals and was well qualified, in ways that were not characteristic of the judiciary and the administration, to expose these and make appropriate recommendations. To give a few examples, the AJTC and its predecessor, the Council on Tribunals, examined the tribunal's rules and published suggestions designed to improve their intelligibility: it attended hearings and reported on the judicial and administrative treatment of appellants; it ensured that the tribunals themselves were accessible to all users, both physically and geographically; it drew attention to over-cosy relationships between tribunal and the revenue authority; it kept an eye on the speed with which a tribunal processed appeal and commented to the tribunal president on occasions when, for example, judges took more than two months to produce their judgments. Of considerable importance, though not strictly an Article 6 matter, the AJTC reviewed the level of successful appeals and assessed whether this reflected the standards of the administration.

Oversight of the tax tribunals cannot be provided by the judiciary. They do not have the objectivity. The Ministry of Justice likewise does not have the objectivity to fulfil the role, nor does it have any real incentive to do so. Just as the AJTC effectively performed functions that were beyond the judiciary and not really appropriate to the administration, a specially created body could do so.

A Proposal

The Government, it appears, is not prepared to have a non-designated public body to oversee the administrative tribunals, let alone tax tribunals. It should, I believe, still be possible for a private body to be created to represent the users of the tax tribunals. This would focus only on appeals concerned with matters within the responsibility of HMRC. It could be constituted as an independent committee of tax tribunal users. The committee would comprise delegates from, for example, the CABx, the Low Incomes Tax Reform Group, TaxAid, the professional bodies and HMRC. Its function would be to examine relevant features of access to justice regarding the First-tier and the Upper Tribunals. It would respond to expressions of concern from users and, as necessary, report to the tribunal presidents. If the Bingham Foundation were to take an initiative in this respect, the chances of generating support from users and professional groups would, I believe, be considerably enhanced.

Access to Justice in the UK: Complaint and Oversight Mechanisms

Jane Shillaker, TaxAid[1]

TaxAid is a unique charity that provides free, independent advice across the range of tax issues to people on low incomes. We use this unique experience to advise HMRC where we find that the tax system bears particularly harshly or unfairly on the low paid or those with, for example, mental health problems or physical disabilities. We enjoy a good working relationship with HMRC and welcome initiatives on their part to facilitate access to HMRC by the voluntary sector on behalf of their clients. Our clients typically come to us when they are in crisis. They will have tax debt often spanning several years. They may already have approached HMRC but not understood what is required of them to resolve matters – or they may just be too scared even to ask. They may in the past have used an accountant but can no longer afford the fees – or they may be totally unfamiliar with where to go for help even if they could afford the fees.

This paper is based on a talk given at the Bingham Centre for the Rule of Law in November 2013. In that talk, I drew on my experience as a manager at TaxAid to outline some common tax issues which our clients come across and used these to illustrate access to justice (or lack of it) in the case of the unrepresented taxpayer[2]. I focussed on three topics – PAYE underpayments, employment: self-employment issues and confusion over remedies.

PAYE Underpayments

Two of Tom Bingham's principles in "The Rule of Law"[3] concern accessibility and discretion. He observes: "If we are to claim the rights which the civil…law gives us, or to perform the obligations which it imposes on us, it is important to know what our rights and obligations are".[4] And that: "the rule of law does not require that official or judicial decision makers should be deprived of all discretion, but it does require that no discretion should be unconstrained so as to be potentially arbitrary. No discretion may be legally unfettered."[5]

Both of these aspects of the rule of law – knowledge of rights and obligations and unfettered discretion and – come into play in the experience of taxpayers in recent years with regard to one particular issue – the notification of underpayments of tax arising within the PAYE system.

In recent years HMRC has brought up to date its records on all those taxpayers not within the self-assessment system who have income from employment or a pension. These taxpayers pay any tax due through the PAYE system. It became apparent from this exercise that HMRC had failed to

[1] CTA and Outreach Manager at the charity TaxAid. *The opinions expressed in this paper, whilst drawing on my experience at TaxAid, are entirely my own and not those of TaxAid.*
[2] By unrepresented, I mean a taxpayer who for whatever reason does not have an accountant or tax adviser working for him or her. Where a taxpayer engages an accountant or tax adviser as their agent, HMRC will record this on their systems and correspond primarily with that representative. There will be a presumption of knowledge and competence underlying the relationship; similarly there will be an expectation by HMRC that the taxpayer has been made aware by his representative of his or her obligations under the various tax statutes. I am not referring to legal representation when a matter is go to before the courts or tribunals.
[3] Tom Bingham, *The Rule of Law* (Penguin 2010).
[4] Ibid 38.
[5] Ibid 54.

communicate obligations expected of taxpayers to an extent that created injustice. PAYE when implemented in 1944 was undoubtedly an innovative way of ensuring that tax was collected efficiently and relatively painlessly from the vast majority of taxpayers. It was also set up on the basis of a pattern of employment – one job for many years followed by one pension and the state pension – which in the 21st century rarely still holds good. For this reason, records were maintained by reference to the employer rather than the employee, creating the risk that someone with more than one source of PAYE income might well not have their records linked together.

The system assumes that at the end of each tax year HMRC will carry out a check or reconciliation to make sure that the tax deducted is in line with the overall liability to tax of the individual. This reconciliation remained in part a manual task until the introduction of a new computer system about 4 years ago. Pressure of work meant the annual reconciliation was not always up to date; add to this the large increase in taxpayers with multiple PAYE sources and it was hardly surprising that in 2010 it was announced that some 6 million or so taxpayers were to be notified of under or overpayments of PAYE for 2008/9 and 2009/10[6]. If the experience at TaxAid is anything to go by, a significant number were also made aware of underpayments for years before that (it was accepted that tax could not be collected more than four years after the end of the tax year to which it related but at times HMRC systems did not always pick this up and adjust for it). TaxAid even now are being contacted where taxpayers have been notified of more than one year of arrears, although this is becoming increasingly uncommon.

Often underpayments of tax arose because the taxpayer had been allowed their tax free personal allowance against more than one source of income; another common problem was failure to code state benefits, in particular incapacity benefit[7], or to code out the correct amount. State benefits were notified to HMRC by the Department of Work and Pensions ("DWP") but this information was not always acted upon. These sorts of mistakes can easily add up to a thousand pounds or more of tax underpaid in each year and some of TaxAid's clients faced bills running into four or five thousand pounds or more. These underpayments were for the most part in themselves correct. There was no matter amenable to a legal appeal. Rather the taxpayer had to turn to one or both of two widely publicised routes to get some or all of the tax written off.

One was to show that there was some kind of error by the employer;[8] the other was to demonstrate that an Extra Statutory Concession - until then little known outside the tax profession – ESC A19[9] – could be applied. Both routes required the active co-operation of HMRC to resolve the issue and to agree not to collect the tax from the employee.

In the case of an alleged error by the employer, HMRC would need to initiate an enquiry with that employer. If the employer was no longer in existence that would be the end of the matter, since there was no-one from whom recovery could be made. In other instances, the employer might not respond to enquiries and HMRC might conclude, perfectly reasonably, that it was fruitless to continue to

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[6] See, e.g., David Gauke MP, 'PAYE Contributions' <http://www.davidgauke.com/content/paye-contributions>.
[7] The government conceded automatic application of ESC A19 to cases involving the state pension in a Ministerial statement on 11 January 2011.
<http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm110111/wmstext/110111m0001.htm>.
[8] Regulations governing the operation of PAYE are found at Statutory Instrument 2003/2682. Paragraph 72 addresses the situation where not enough tax had been deducted.
[9] The wording of the concession is reproduced at
<http://www.hmrc.gov.uk/manuals/pommanual/paye95005.htm>.

devote resources to getting a response. If the employer did engage with HMRC, they had only to show that they had taken reasonable care and acted in good faith[10] not to be held liable. The employee would not be party to any of this, only to the outcome as relayed by HMRC.

In the case of a claim by the taxpayer that their situation met the conditions of ESC A19, HMRC would consider the merits of the claim and advise the taxpayer of its conclusions. HMRC would also consider the application of the concession in instances where the taxpayer had not perhaps requested it specifically but it was clear that they wished to challenge the underpayment. Whilst some claims did result in the tax being written off, for others there were two particular conditions of the concession which proved problematical.

The first was the requirement to demonstrate that HMRC had failed to act on "information".[11] The concession itself does not define the term. HMRC as custodian of the concession could therefore define what it meant. Specifically, HMRC took the view that the regular returns by employers of employees' and pensioners' income at the end of the tax year were not to be considered information for the purpose of the concession,[12] even though these are the main source of information to HMRC about the income of employees and pensioners. Instead the taxpayer had to find an instance when they had contacted HMRC, or be able to show that some other third party (such as the DWP) had supplied information, or for the relevant information to have come to HMRC on form P45 or P46[13]. This in effect gave rise to a "retrospective" obligation on the employee to be checking their tax affairs to an extent they were unaware of at the time and which arguably does not exist in law.

The second was to demonstrate that they (the taxpayer) "reasonably" believed their tax affairs were in order. HMRC's guidance on this includes referring to such factors as whether the taxpayer had professional representation, whether HMRC actions had caused the case to be particularly muddled or confusing, the relative size of the arrears, the level of comprehension of the taxpayer given their age, background and so on.[14]

Whilst in most instances at TaxAid the lack of tax knowledge generally amongst our client base counted in their favour here, this was not always so. In one example we had at TaxAid, a client in the past had been advised by HMRC during a phone call that her personal allowance should be split across her two very low paid jobs. She had no real idea what this meant but since HMRC were suggesting it she assumed it was appropriate. When some time later she found herself making an ESC A19 claim, HMRC rejected the claim on the basis of reasonable belief. They took the view that the taxpayer must have initiated this suggestion to split the allowance and in so doing had shown

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[10] Income Tax (PAYE) Regulations 2003 Regulation 72 allows HMRC to recover from an employee tax not deducted by an employer only if: (1) The employer can satisfy them that they took reasonable care to comply with the regulations and that the error was made in good faith, or (2) HMRC believe the employee knew the employer was wilfully deducting the wrong amount of tax. Otherwise the employer is liable to make good the tax under-deducted.

[11] The wording of the concession can be found as indicated in footnote 9 above.

[12] See for example HMRC's own manuals at <http://www.hmrc.gov.uk/manuals/pommanual/paye95055.htm>. Keith Gordon has written extensively on this issue and highlighted the change of approach by HMRC over the years. See for example Keith M Gordon, "ESCapology" (2012) 170 (Issue 4376) Taxation, 24 October 2012 and the earlier articles referred to therein.

[13] When someone started a new employment they either needed to show the employer form P45 from the job they have left or complete form P46. The latter would dictate to the employer which tax code to use depending on which of 3 circumstances applied. These procedures are now evolving following the introduction of Real Time Information. See <http://www.hmrc.gov.uk/payerti/getting-started/paye-basics/rti.htm>.

[14] PAYE95081, 'Reconcile individual: HMRC delay: ESC A19: reasonable belief – factors' <http://www.hmrc.gov.uk/manuals/pommanual/paye95081.htm>.

sufficient knowledge of the tax system to understand that on other occasions her codes were incorrect. Since experience at TaxAid is that the majority of taxpayers, no matter what their background, struggle to understand complex tax codes this seemed a particularly hard decision and it was one that was overturned on referral to the Adjudicator.

The Adjudicator has seen many complaints involving the application of ESC A19 in recent years and the learning point taken from the experience of one of the two case studies currently on The Adjudicator's website[15] dealing with the concession states: "Staff should put themselves in the position of each individual taxpayer when considering the "reasonable belief" element of ESC A19".

Hitherto taxpayers had been encouraged down a route of entrusting the operation of PAYE either to their employer or to HMRC. Their reaction to being notified of an underpayment was, at least in the experience of TaxAid, that one of these two must have been at fault. It proved something of a rude awakening to be told that they were the ones who should have been checking tax codes (both on notices of coding and payslips) assiduously and contacting HMRC each and every time a source of income started or ceased. It transpired that taxpayers had obligations which had not perhaps been made as explicit to them as might have been expected and indeed which PAYE processes such as forms P45 and P46 were specifically set up to avoid.

There was a further dimension to this particular issue. Since there was no legal appeal route, the way to persist with a claim under ESC A19 or employer error was to engage HMRC's complaints mechanism. The experience at TaxAid was that it was essential to highlight in great detail the circumstances of the taxpayer and if at all possible pinpoint an instance of contact between taxpayer and HMRC during which one side could have mentioned or the other should have prompted disclosure of something amounting to "information". Tenacity undoubtedly paid off – several letters or even a referral to the Adjudicator might be required before HMRC might agree to write off the tax.

The Adjudicator's 2013 report[16] shows that the percentage of PAYE complaints upheld by it increased to 66%[17]. The report comments: "I am disappointed at the number of complaints HMRC customers feel they need to refer to me in order to get resolution. My role should be to consider the difficult exceptions, not handle routine matters that are well within the capability of departmental staff to resolve successfully."[18]

Whilst HMRC has a responsibility to be even handed in its approach to taxpayers, it is a moot point whether fairness should equate to giving way to the one who keeps arguing the longest. Persisting with a complaints process is a particular challenge for an unrepresented taxpayer who has limited literacy skills, does not speak English as a first language or suffers with a mental health condition that makes it difficult for them to engage with government departments such as HMRC.

It is also a cause for concern that HMRC should be the gatekeeper of interpretation of a concession, allowing for it to be applied in a way which is expedient to the Treasury rather than grounded in the

[15] Adjudicator's Office, 'Case Studies', case study 6, <http://www.adjudicatorsoffice.gov.uk/casestud.htm#5>.
[16] Adjudicator's Office, 'Annual Report 2013' <http://www.adjudicatorsoffice.gov.uk/pdf/report2013.pdf>.
[17] Ibid 12.
[18] Ibid Adjudicator's Foreword.

circumstances for which it was originally designed[19]. Whilst many concessions have been enacted following Wilkinson[20] there are always going to be some situations which are more effectively handled through some element of administrative discretion (and in such cases the ground rules for applying such discretion need to be made public whether through an extra statutory concession or otherwise). Currently the only legal "remedy" for failure to apply a concession is to seek judicial review, a remedy which is effectively inaccessible for the average taxpayer.

Employment and Self Employment

The dividing line between employment and self-employment must be one of the most litigated areas in personal tax. However in much of that litigation it has been the taxpayer who wants to demonstrate he or she is in self-employment. At TaxAid we more commonly encounter the reverse situation – the person who is told they must "pay their own tax" or who assumes their work is as an employee but has never had payslips or evidence of PAYE deductions. These cases are rarely at the margins – shop assistants, receptionists, bar staff and nannies who in most instances clearly meet the various tests of being an employee.

Clearly the employer is legally obliged to operate PAYE on its employees. In principle if they fail to do so there are penalties to be paid as set out in the relevant regulations. Indeed being found to have failed to operate PAYE correctly can prove an extremely costly mistake for a business.

However, the existence of sanctions against the employer does not provide a satisfactory or timely remedy for the employee. There is no straightforward mechanism for them to enforce the legislation. They are not party to the enforcement of PAYE obligations as between the employer and HMRC (as I have noted above the same applies to the application of employer error). Yet it is the employee who then does not have a National Insurance record, is unclear what to do about their tax obligations, and does not know what action to take if they need to take on a second job or claim tax credits.

It is very difficult to advise a client in this situation. Should they happen otherwise to need to do a self-assessment tax return it might be prepared on the basis of the tax that ought to have been deducted. The client can contact HMRC but HMRC may simply note the information for when it next visits that particular business. HMRC has to have regard to its use of resources – it may not be able to look at the particular employer then and there in the depth needed to apply the relevant PAYE Regulations. Even when it does the position of an employee for past years may not be satisfactorily resolved.

It is not helpful to tell a low paid worker to walk away from a job or to seek legal advice as to remedies in employment law. In addition the definition of "employment" for employment law and rights is not the same as for tax, making a difficult situation even more complicated.

HMRC itself does not always understand the issues. In a recent case it took TaxAid three attempts via the complaints process over a period of nearly two years to get HMRC to understand that an

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[19] The online version of the article by Keith Gordon, above n 9, links to the original departmental guidance from 1971 which he obtained by a Freedom of Information request. The tone of that guidance – references to acting sympathetically and offering apologies – is rather different from the experience of those trying to claim the concession in 2010.

[20] *R v HM Commissioners of Inland Revenue ex p Wilkinson* [2005] UKHL 30.

employer had failed to operate PAYE correctly – which they eventually conceded that they had. Compensation was then paid to the client as well as a spurious tax demand being dropped.

There are refinements of this issue. The worker may be supplied via an agency or set up to work through some kind of corporate structure often referred to as an umbrella company. Such arrangements may be more difficult for HMRC to challenge. Either way it is the low paid worker who usually loses out. There has been no straightforward mechanism for them to enforce legislation from which they are the ones who stand to benefit. Tom Bingham's sixth[21] and seventh[22] principles address "expeditious and affordable resolution" of legal disputes and fairness of proceedings. The experience of dispute resolution for low paid workers whose "employers" do not follow the rules is that the principles are not being put into practice when it comes to resolving their tax problems.

Confusion over Remedies

There are two kinds of remedy for an aggrieved taxpayer – a complaint, which typically involves some kind of maladministration, and an appeal, where a right to and grounds for appeal will be set out in the relevant legislation. The nuances of the difference between the two remedies may be lost on the unrepresented taxpayer, potentially to their detriment. Going back to the PAYE underpayments issue outlined above, taxpayers might use the word "appeal" when bringing a claim either for employer error or the application of ESC A19. Some then went on to engage the appeals process as far as the First Tier Tribunal only to find that a striking out application from HMRC was upheld[23]. Because there was no matter amenable to appeal (since action was at HMRC's discretion), the only remedy was to engage the complaints process and be persistent[24].

At a separate level, unrepresented taxpayers may also have an imperfect understanding of different legal processes. They see all legal action as part of one process and expect each step to offer the same opportunity of dispute resolution. HMRC will pursue long outstanding debts by means of county court action. In many instances, the action goes uncontested and the taxpayer does not turn up. However, the taxpayer may see this as their opportunity to get an error in a tax bill rectified. They do not appreciate that county court proceedings are about recovery of a legally due debt from HMRC, not how it is arrived at. They do not understand that the options for challenging the quantum of the debt may require very different action than going to the county court or grasp that HMRC can legally pursue the collection of a tax bill which is not based on figures mutually agreed between HMRC and taxpayer as far as bankruptcy. More significantly, the mere act of turning up could close the door on an actual remedy. This is the situation with what is normally referred to as "special relief".[25]

The legislation relating to special relief replaced a concession known as "equitable liability". Special relief can be claimed when HMRC has made what are called "determinations"[26] in the absence of a tax return being sent back. Such determinations are legally due tax debts, bearing interest and surcharges, until such time as the taxpayer displaces them by making his self-assessment. However

[21] Tom Bingham, *The Rule of Law* (Penguin 2010) 85, 89.
[22] Ibid 90.
[23] *Prince et al v HMRC* [2012] UKFTT 157 (TC) where three striking out requests on this subject were heard together <http://www.financeandtaxtribunals.gov.uk/judgmentfiles/j6239/TC01852.pdf>.
[24] There might as suggested elsewhere be the possibility of judicial review but this is not a realistic option for most unrepresented taxpayers.
[25] Taxes Management Act ("TMA") 1970 Sch 1AB.
[26] TMA 1970 s 28C.

if no self-assessment is made within strict time limits the determination stands. The only recourse then if the determination is excessive is to try and claim special relief.

The problem here is that a taxpayer, who, in a misguided attempt to sort out a huge tax bill has attended a county court hearing, will have closed the door on such a claim because of the specific way in which the legislation is worded.[27] (It could be arguable that the wording does not bear the reading HMRC understand it to have but the point has yet to be tested). Indeed the suggested wording for a claim to special relief includes a statement to the effect that the taxpayer has not been present at court proceedings. We therefore have a situation where the taxpayer who faces a huge estimated bill which he has attempted to address by presenting himself at the county court has in effect ensured that the debt is no longer open to the remedy which might result in its reduction, whereas the one who ignored the county court proceedings still potentially has a remedy open. The taxpayer who makes some, if misguided, attempts to engage may be treated worse than the one who does nothing.

The confusion between the appeal process and proceedings to recover a debt can be illustrated by another case where advice was sought from TaxAid on behalf of a sick friend. In a complex VAT matter, HMRC had withdrawn from bankruptcy proceedings because the taxpayer was in poor health. The taxpayer had also appealed but assumed that the withdrawn bankruptcy proceedings were an end of the matter. TaxAid explained to the friend that, notwithstanding the withdrawal from bankruptcy proceedings, strictly the debt remained due unless the appeal was pursued and the quantum of the VAT debt reduced. Advice was given on how to do this. Sadly though it seems that the taxpayer remained convinced that this could not be right and did not pursue the appeal, leading to bankruptcy proceedings being reinstated.

It is not only TaxAid's clients who fail to appreciate the distinction between different lines of legal proceeding. Voluntary sector advisers who are not lawyers or specialists in tax often do the same. In training CAB and other voluntary sector advisers the thrust of the message TaxAid tries to get across is that tax debt is not set in stone. It may be possible to change it. But the way to do that is not through the debt recovery mechanisms. HMRC can pursue a debt based on determinations amounting to thousands of pounds as far as bankruptcy – but with the right advice that debt may be reducible to nil.

Even when it comes to the making of an appeal in an apparently clear cut matter - say a penalty for late filing of a self-assessment tax return – the position can be confusing for the unrepresented taxpayer. Penalties for late filing of such returns are now levied in several tranches depending on the tardiness of the return[28]. At the point of the initial £100 penalty, the taxpayer may be invited to put forward their reasonable excuse for late filing even when they may not yet have filed the return. They may offer a somewhat half-baked reason, thinking only £100 is at stake. The appeal is turned down and they take no further action, paying £100 in the belief that is an end of the matter. Some months later, they find a penalty of £900 and then perhaps a further £300 levied. Each part strictly is separately appealable but the earlier action may have prejudiced their case. They may also have failed to grasp that even if they pay the penalty the return must still be filed. In an example seen at TaxAid, a client's observation that he did not think he needed to do a return for a particular year was construed as an appeal and turned down. Subsequently the taxpayer was levied with the

[27] TMA 1970 Sch 1AB para 2(7).

[28] See Finance Act 2009 Sch 55 paras 3 to 6.

maximum penalty and came to TaxAid for help. TaxAid helped him to file the return and appealed the penalties on the grounds that the client had been homeless due to family breakdown and without access to any business records for his brief period of self-employment at the time the return was required to be filed. He also had mental health issues and problems with addiction. The appeal was declined on the basis it had already been considered and settled and these newly presented facts could not be taken into account. It was also by then the case that to take the appeal to the First Tier Tribunal would require permission to bring a late appeal.[29] HMRC very fairly will construe letters that are indicative of a desire to appeal as being an appeal even if the matter is not referred to explicitly. But some care is perhaps needed to be sure that in so doing they are not interpreting correspondence too widely and closing the door to the taxpayer's right to make out their case fully. Invitations to appeal at an early stage of a process should make clear the full extent of what is at stake and set out as clearly as possible rights, time limits and the next step needed, preferably with reference to external sources of help.

Conclusion

For those that can afford them, tax advisors play a crucial role as the interface between the tax system and taxpayers, interpreting and explaining its rules, ensuring the reliefs it wishes to grant are claimed, ensuring compliance and, where necessary, protecting the taxpayers' interests. But what of those who do not, for whatever reason, have access to this interface, who are unrepresented? If, as I have suggested, there are aspects of the system which effectively limit their access to justice, what can be done to alleviate this problem? Obviously, a charity like TaxAid is part of the answer. But it can only ever be a part. It is a small charity and inevitably resource constrained. Common sense suggests that the many people who find us and receive our help represent only a tiny fraction of those that need it.

An important part of the answer lies in the design and administration of the tax system itself. The issues I have identified are not sad but inevitable consequences of an efficient tax system. It is not, I believe, essential to an efficient and cost effective tax system to interpret ESC A19 in the way it has been interpreted, to restrict access to justice because of a fine legal distinction between complaint and appeal or to adopt a default opening position of refusing to admit a mistake when a complaint is made, such that access to justice becomes a function of persistence rather than merit per se. To a large extent these are self-inflicted wounds. We could do these things differently without sacrificing administrative efficiency or other policy objectives.

So if we want to improve access to justice for the poor and the vulnerable, I suggest that the people responsible for the tax system – the policy makers and the hard working and often over stretched members of HMRC who administer it- should always have this in mind as a key objective, and that those responsible for oversight and scrutiny of policy makers and administrators should treat it as key performance indicator. This really represents nothing more than recognition that the system has a special responsibility towards certain people. Indeed HMRC's Charter[30] clearly recognises that it has such a responsibility. The very first right contained therein is one of respect for the taxpayer, trying to understand their circumstances and making them aware of their rights. But HMRC needs support from policy makers and government to make this right real and effective.

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[29] I am pleased to say that since giving the talk this particular case was reviewed again by HMRC and all penalties withdrawn but TaxAid continue to encounter similar examples regularly.
[30] HMRC, 'Your Charter' <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/91888/charter.pdf>.

Since joining TaxAid, I have come across the assumption more than once that poor people cannot have tax problems. No one who has spent even a few hours in our offices listening in to our helpline or sitting alongside our volunteers as they meet with clients would maintain that view. Our tax system is complex. It impacts on rich and poor alike – indeed the impact on the latter is often proportionately greater, as a tax bill of a few thousand can make a very big difference indeed to their lives. I have referred earlier to some of Tom Bingham's eight principles for the rule of law.[31] One is that the law should apply equally to all.[32] Another is that it should not be accessible only to the rich.[33] Access to justice for the poorer and more vulnerable members of society is surely one of the touchstones of the extent to which the rule of law is embedded in our society. I hope that I have been able to highlight some of the issues in our tax system which need to be addressed if we are to move closer to that ideal.

[31] Tom Bingham, *The Rule of Law* (Penguin 2010) 37.
[32] Ibid 55.
[33] Ibid 88: "...denial of legal protection to the poor litigant who cannot afford to pay is one enemy of the rule of law…".

Selective Enforcement and Equal Treatment

Anthony Thomas, former President, Chartered Institute of Taxation and Chairman of the Low Incomes Tax Reform Group

For the UK tax system to operate efficiently and effectively there must be mutual trust between taxpayers, the tax profession and the fiscal authority. There must also be confidence that the law is applied equally to all sectors of society. Complex laws applied in an oppressive manner results in lower, not higher tax revenues and the US is probably a good example of that.

The rule of law is the foundation of everything we do in tax. In particular there are three of the Lord Bingham principles which apply.

Firstly, the laws of the land should apply equally to all save to the extent that objective differences justify differentiation.

Secondly, ministers and public officers at all levels must exercise the powers conferred upon them in good faith, fairly, for the purposes for which the powers were conferred without exceeding the limit of such powers and not unreasonably.

And thirdly, questions of legal right and liability should ordinarily be resolved by the application of the law and not by the exercise of some discretion of some official, in effect giving them quasi legislative powers.

It is clear that equality before the law is a cornerstone of our society. There cannot be one rule for the rich and powerful and another for the poor. There is, though, an important but related issue – inequality in administration gives rise to unequal treatment and hence unfairness. It is this which has to a large extent been the focus of much criticism of HMRC, their supposed "special relationship" with big business, the Public Accounts Committee, and much of the ill-informed and ill-considered media attention.

It is quite astonishing really that the unthinkable has actually happened. The world is in turmoil, I suppose the recent earthquake is a good example; there are more sex pests being unearthed every week; yet tax is topping the news agenda for the first time in living memory. The debate over how much an individual or company should pay in tax will rumble on for months. Companies cannot win. The trouble is the letter of the law has been replaced by the spirit of the law and big companies, and little ones for that matter do not know what to do about it. For a company to operate well within the law and minimise their tax liability has become as unacceptable as a banking boss pocketing a bonus that was earned legally under an incentive plan agreed some years earlier.

The "Starbucks" incident demonstrates that the tail is wagging the dog. What was presented as a climb-down by the coffee chain has only managed to inflame. By offering to pay £20m over two years to make up for a long period of rarely troubling HMRC is exactly the wrong way round. If we have not got a tax system fit for purpose it really is for the government to change it, not for foreign companies to offer a donation. I suppose it does not help that rather than taking a broader view HMRC is obsessive about the minutiae, as anyone who completes a self-assessment tax return knows.

It is not an organisation that has improved that much since it was created by the merger some years ago, although under its new leadership there are clear signs of some improvement.

Let us be perfectly clear, politicians and HMRC are a major part of the problem. For almost two decades each year they have enacted reams of badly worded and highly complex legislation with totally inadequate parliamentary scrutiny. No-one seriously believes that politicians understand the legislation they are enacting in anything more than a superficial way - they have neither the time nor training to do so. HMRC suggests the problem and then proposes the legislation that purports to solve it. Then when shortcomings inevitably appear, the fault is attributed to those who identify them and not those who conceive them.

The most important lesson coming out of the Goldman Sachs saga is that it is in political hands to allow the tax office to fulfil its mission. The seeming leniency of the deal and cosiness between HMRC and taxpayer caused controversy. It is hard to avoid the conclusion that HMRC let political face saving as well as merit count. This is a flaw in which HMRC work – an unholy trinity of an overly complex tax code, a desire for negotiated settlements, and good relationships with big business combined with a confidentiality that prevents public scrutiny. Running a fair and efficient tax system requires will and resource. Both have been lacking and HMRC's political masters are to blame. Policy makers have improved the situation in recent years and an overhaul of the tax system has closed many loopholes. It will be interesting to see how the GAAR helps but it will some while before its impact is capable of being assessed.

I will quote from a FT editorial dated 13 October 2013 which is telling. "Politicians of all parties also hound business to pay their fair share of tax, whatever that means. Lawmakers should set the legal framework while accepting that companies will always seek to pay no more tax than they can get away with – legally or in terms of reputation".[1] The editor went on to conclude: "Taxation should not be a question of moral exhortation".[2] How right – at least the editor of the FT "gets it" and it is very disappointing that other newspapers seem more interested in a memorable headline which does nothing for a better understanding of tax avoidance and the complexities of tax.

HMRC has moved to a more aggressive strategy of litigating as least as long as there is an even chance of winning. Settlements are now vetted by at least two Commissioners not involved in the negotiations who should at least not be susceptible to capture. HMRC needs resources and backing to fight big battles but it must be seen to be impartial when it negotiates. For citizens to trust that HMRC is impartial when it negotiates there must be transparency that big companies are not getting sweetheart deals, so lawmakers must find ways for settlements to be more open to public scrutiny and the first report of the Tax Assurance Commissioner is an excellent start.

Should you, though, get a better service because you pay more tax? It would be a novel way to encourage growth but not one that sits comfortably with the rule of law.

HMRC are responsible for the collection of tax and must apply the law correctly. The Commissioners should not move away from this position merely because the result seems unfair or unreasonable. To do so would be contrary to the will of parliament as interpreted by the courts. There may though be circumstances where applying discretion would result in better management and in such

[1] 'Britain in an age of uncertainty' *Financial Times* (London, 13 October 2013).
[2] Ibid.

circumstances the Commissioners can choose to apply discretion. The current public perception is a belief that big business and the wealthy have access to "corridors of power" not available to the poor and smaller business that gives them a better deal when interacting with HMRC. Government departments are entitled to make laws under powers delegated to them by Parliament, but laws sometimes conflict with one another. Where a regulation or a piece of tertiary legislation conflicts with the wider rule of law then clearly the latter must prevail. I will give an example:

Very recently the First-Tier Tribunal decided that HMRC had acted illegally when it issued a notice requiring three taxpayers to file their VAT returns online.[3] The judge found that HMRC has breached their human rights and acted unlawfully under EU law, because HMRC failed to make exemptions for the elderly, the disabled or persons living too remotely for reliable internet access.

Two of the appellants had disabilities, all three ran businesses and filed their VAT returns on paper and on time for years and the third lived in a part of the country with no broadband. All three were aged and so learning to use a computer was difficult. Any decision as closely argued as this one must be persuasive and influential even if not technically binding. In essence what it says is that government departments cannot when exercising their functions simply disregard the laws of the land or the human rights of the taxpayer. They must obey the rule of law. Digital mandation was on the point of being forced through without regard for the needs of older or disabled people or those unable to access broadband. Fortunately in this country the courts provide a mechanism for correcting such abuses.

This case does though have lessons for us all, and not just HMRC, who I am hoping will sit around a table with the likes of LITRG and other interested parties to agree a sensible and workable solution and way forward. The alternative would be further expensive and hugely time consuming litigation the outcome of which would be uncertainty for a number of years.

Finally in the words of Edmund Burke "It is not what a lawyer tells me I may do; it is what humanity and reason and justice tell me I must do".[4]

[3] *LH Bishop Electrical Co Ltd AF Sheldon t/a Aztec Distributors v HMRC* [2013] UKFTT 522.
[4] Edmund Burke, Second Speech on Conciliation with America, The Thirteen Resolutions [1775].

POLICY AND DEBATE

The Perspective of HM Revenue & Customs

Anthony Inglese CB, General Counsel and Solicitor, HM Revenue & Customs

Introductory remarks

I am delighted to be able to speak again about the rule of law from the "official" perspective. Last March, I spoke about the rule of law in relation to how HMRC operates. I said a few words about the use of retrospective legislation, the use of guidance and the Commissioners' collection and management powers; I touched on the litigation and settlement strategy and finished with a few words about the General Anti-Abuse Rule, the GAAR.

For this session, I thought I would say more on the GAAR and then something about legitimate expectation from my perspective as the Head of HMRC's legal team.

The rule of law in the context of the GAAR

You are all very familiar with the background to the GAAR and with the controversy and discussion that the GAAR has elicited amongst tax lawyers. Since we last met, the GAAR has been enacted in this year's Finance Act and came into force on 17 July 2013. It is an element of the Government's approach to tackling tax avoidance and it is considered necessary to help protect the Exchequer and maintain fairness in the tax system.

Three years ago Graham [Aaronson] was asked to lead a study to consider whether a GAAR could deter and counter tax avoidance, whilst providing certainty, retaining a tax regime that is attractive to businesses, and minimising costs for businesses and HMRC. Graham recommended a narrowly focused GAAR: an anti-abuse rule than an anti-avoidance one.

The Finance Act GAAR is largely based on the principles developed in the GAAR Study Group Report, but with some material differences reflecting the results of the formal consultation process. The Act now provides for a GAAR which will counteract tax advantages arising from tax arrangements that are abusive and contains a schedule outlining the procedural requirements relevant to the application of the GAAR by HMRC.

I think we can all agree that the GAAR is a significant new development in UK tax legislation. Various Court decisions can be cited as providing legitimacy to even the most abusive tax avoidance schemes [for example the recent decision in Mayes about the SHIPS 2 scheme], and, of course, perhaps none more notably than:

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[1]

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[1] *IRC v Duke of Westminster* [1936] 19 TC 490.

In enacting the GAAR, Parliament can be said to have decisively rejected this approach, and to have imposed an overriding *outer* statutory limit on the extent to which taxpayers can go in trying to reduce their tax bill. In so doing, Parliament has had to enact an approach of general application and therefore one which necessarily needs to apply to a very wide range of fact patterns.

Some commentators have suggested that the GAAR may be at odds with the rule of law. The argument seems to run as follows. Tax law sets down precise rules governing taxation. For example, the relevant tax law may on its proper construction say that transaction X be charged to tax. However, if the policy intention behind the legislation was that transactions X and Y be taxed, the concern is that HMRC may employ the GAAR to seek a tribunal or court ruling clarifying that tax should also be charged on Y. The commentators may suggest that in such a case the technical tax law is clear in providing a particular outcome and, in some way contrary to the spirit that animates the rule of law, the GAAR has operated to overturn what is otherwise the result provided for by the legislation.

There are a number of responses I would make to that suggestion. First, the use of extraneous material to aid the interpretation of legislation is not a new thing. In cases of ambiguity, of which there are many in tax law, under the authority of *Pepper v Hart*,[2] the speeches of the relevant minister are often cited from Hansard. And, of course, in Government we produce numerous, we hope helpful, materials to accompany the legislation - explanatory notes, explanatory memoranda – all with an eye to aiding interpretation. In all of these cases, the extraneous material assists in a purposive construction of the legislation – and that, it seems to me, is consistent with the objective of the GAAR – to ensure that the purpose of the law is not defeated by abusive arrangements.

Secondly, the GAAR is a mechanism set down in primary legislation – it has been created by Parliament. A comparison may be made with the way that the Human Rights Act provides for the 'reading down' of other UK statutes which breach Convention rights. The effect which the GAAR can have on tax law has been approved by Parliament – seen in this way, it is perfectly in keeping with the rule of law.

Thirdly, the "rule of law" does not require that laws set out every circumstance in exact detail. The GAAR has been carefully designed to be balanced and to target only the most egregiously artificial and abusive tax avoidance arrangements on a just and reasonable basis. The Government has consulted widely and the majority agree that it is the right approach for the UK. A wider anti-avoidance rule could have generated considerable uncertainty, which could both lessen the attractiveness of the UK as a place to do business and also generate significant costs for taxpayers and HMRC; and more importantly, it could actually operate to undermine the rule of law because of the greater uncertainty created by a wide rule. The Government therefore accepted that a narrowly targeted GAAR is the right approach to tackle the persistent problem of abusive avoidance schemes.

Fourthly, the "rule of law" is also about procedures being fair. The Government accepted that tight controls are appropriate to ensure the GAAR is exercised in a consistent way along with appropriate safeguards to protect taxpayers which will reduce uncertainty about how the GAAR will operate in practice.

A number of safeguards are built into the GAAR rules. HMRC is required to establish that the arrangements are abusive (so that it is not up to the taxpayer to show that the arrangements are

[2] *Pepper v Hart* [1992] UKHL 3.

non-abusive). This helps to ensure that, in effect, the taxpayer is given the benefit of any reasonable doubt when a court is determining whether arrangements are abusive. In addition to stringent governance within HMRC before the GAAR is used (and I appreciate that this might seem like cold comfort to those on the receiving end of the GAAR), there will be the procedural safeguard of an advisory panel to bring an independent and non-HMRC perspective to the application of the GAAR. HMRC will be required to obtain the opinion of the independent advisory panel as to whether an arrangement constituted a reasonable course of action, before we can proceed to apply the GAAR. The introduction of an Advisory Panel is one of the key safeguards along with HMRC guidance, which itself needs to be approved by the Advisory Panel.

At its heart, the GAAR legislation is seeking to address the profound difficulty which lies in providing a general rule capable of differentiating between "acceptable" and "unacceptable" tax avoidance, which it does by the use of reasonableness tests. This requires HMRC to show that the arrangements "cannot reasonably be regarded as a reasonable course of action". The GAAR recognises that there are some arrangements which some people would regard as a reasonable course of action while others would not. The 'double reasonableness' test sets a high threshold by asking whether it would be reasonable to hold the view that the arrangement was a reasonable course of action.

The arrangement falls to be treated as abusive only if it would not be reasonable to hold such a view. I recognise that the role played by the concept of "reasonableness" in the GAAR may feel different from how we normally encounter the question of whether something is reasonable or not; but nevertheless Parliament has given more than enough material and clues to help us work out the answer.

Finally, it should also be noted that while the guidance and opinions of the Advisory Panel will assist the tribunals and courts in reaching their decisions on whether arrangements are considered abusive, ultimately the tribunals and courts will have the final decision in the same way as for any other part of tax law.

Tribunals and courts – courts for short – will still need to decide how to interpret and apply the GAAR legislation to cases before them. The Advisory Panel will be giving an opinion on whether particular arrangements are abusive. The courts will still have to form an opinion on that same issue. The courts have to "take into account" the Advisory Panel's opinion, meaning they must consider it carefully, and give it due weight. Similarly, the court must take into account the guidance approved by the Advisory Panel because the guidance might help it form a view as to whether the arrangements are abusive. However, the guidance and opinions of the Panel are only to assist the court in reaching its decision on whether arrangements are abusive.

Essentially therefore the GAAR is really no different from any other tax legislation. The Government has proposed legislation, Parliament has enacted it and it will be the court, where necessary, that interprets and applies it.

I want now to say a few words about guidance, following Judith [Freedman]'s session this morning.

The Use of Discretion and Guidance

An issue that frequently exercises my lawyers is the interaction of HMRC guidance with the doctrine of legitimate expectation… and, of course, the rule of law. This interaction is most marked when our guidance is found to be inconsistent with the law: on the one hand, the law provides for result or treatment 'X' and our guidance says the result or treatment is 'Y'. Taxpayers should, of course, be able to rely on our guidance in the ordinary run of things. But, if our guidance turns out to be wrong, is it right that taxpayers should benefit from a treatment or outcome that is not in accordance with substantive tax law? How can we reconcile that with the rule of law?

First, to set the context. HMRC is under a general legal duty to collect and manage tax. As part of that duty we issue guidance, which is designed to help taxpayers navigate our processes and otherwise know where we are coming from, with the result that, all being well, tax should be simpler to pay and to collect. In an ideal world our guidance is usually correct and much appreciated. There are however a number of ways in which guidance may be incorrect or reflect a position which is ultra vires – beyond our legal powers:

- it misstates the law (which might become apparent only after a court holds that HMRC's position is wrong),[3]
- it is otherwise contrary to general public law or other legal principles,[4] e.g. it is irrational, discriminatory, to the extent that it could be successfully challenged as such on judicial review;
- it provides for a treatment which HMRC does not have the power to give.[5]

While ultra vires representations may, in certain circumstances, be capable of founding a legitimate expectation, the judicial authorities on this are not consistent, and the judicial dicta are mainly non-binding. Careful consideration of the facts of any particular case is needed before coming to the conclusion that HMRC ought to consider itself bound by ultra vires representations, or misstatements of the law, on the basis that they have given rise to a legitimate expectation.

The starting point should be that HMRC is not bound to give effect to guidance, rulings or representations (however made) where to do so would involve our acting beyond our powers or in a way that is contrary to the law. Put another way, the assessment of whether a statement creates a legitimate expectation does not (or does not solely) depend on whether or not it was "reasonable" for the department to have made the statement, or whether it would be "unfair" for it to be able to resile from it.

Starting from that position, in what circumstances can a public authority be said to be abusing its power or otherwise acting contrary to public law principles where it seeks to resile from particular promises or statements that are themselves contrary to the law? There is no short answer to this, but the hurdle for a claimant is high because of the powerful principle that law should not generally be overridden because the Executive has made a mistake.

This principle echoes the decision the Inner House of the Court of Session in *Al-Fayed v Advocate General for Scotland* in 2004[6] where it was found that 'forward tax agreements' were ultra vires the Commissioners' powers of care and management of the tax system and, as such, could not give rise to a legitimate expectation on the part of a taxpayer that any promises contained in them would be honoured. In particular, the court said that:

[3] This happened in *Oxfam v HMRC* [2009] EWHC 3078 (Ch).
[4] This describes the situation in *R v Attorney General ex parte* ICI [1987] 1 CMLR 72, see para 66.
[5] As was the case in *Al Fayed v Advocate General for Scotland* [2004] STC 745.
[6] *Al-Fayed v Advocate General for Scotland* [2004] STC 745.

> It is clear that the legitimacy of the expectation must be established before the court will be required to determine whether the alleged breach was so unfair as to constitute an abuse of power. In considering whether an expectation was legitimate the court must take into account the fact that a public authority, whose existence and powers are derived from statute, cannot validly act outside those powers. In the present case, the critical issue is whether the petitioners had a legitimate expectation that the respondents would continue to abide by the terms of the 1997 agreement once they were aware that it was ultra vires.[7]

The Court found that they did not.

As Lord Bingham put it in the *MFK* case in 1990: "The taxpayers' only legitimate expectation is, prima facie, that he will be taxed according to statute, not concession or a wrong view of the law."[8]

The Upper Tribunal very recently, in *HMRC v Noor*[9] approved HMRC's submissions, which cited Lord Justice Sedley's ruling in F&I Services, saying: "This [the ruling in F&I Services] is a robust indication that caution is necessary in concluding that advice given by HMRC which is wrong in law will create legitimate expectation, such that applying the law correctly amounts to an abuse of power", although the Tribunal pointed out that its comments on this were strictly obiter.

It is only where considerations of fairness provide a very heavy counterweight to the duty to apply substantive law correctly that the latter could be displaced, and I think this has to be the right way to try to resolve this issue if the rule of law is to be respected. Not entirely satisfactory perhaps, but if we are committed to making the rule of law a living principle in the real world, we need to grapple with points of tension like this, where competing arguments have their merits but are hard to reconcile (another classic example is the potential for tension between the rule of law and the democratic will). They do not permit clean, easy answers, but they do *require* answers.

Behaviour

I conclude by repeating the point with which I began my last talk. The rule of law is not, and should not be seen as, an impediment to effective action on the part of Governments, but it does provide a boundary which protects all of us from the related risks of arbitrary action and uncertainty. As a Government lawyer, I have to give "impartial, objective and frank advice", in the words of the Code which governs me, having "particular regard to the fact that it is a fundamental obligation of Government that it should itself act in accordance with, and subject to, law". The rule of law does not mean that Government always follows the safest legal option, but it does mean that Government will not deliberately follow unlawful options, however tempting this can sometimes be for Ministers.

Essentially, society can only function if there is a relationship of trust between the rule makers, the judiciary, the executive and the governed. That trust depends upon the law providing sufficient certainty and predictability that people can arrange their affairs knowing what they need to do to stay on the right side of the law and what the consequences would be if they do not. And the law, and the way it is administered, must not be arbitrary or breach accepted standards of fairness and justice.

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[7] Ibid para 118.
[8] *R v Inland Revenue Comrs ex parte MFK Underwriting Agents Ltd* [1990] 1 All ER 91, [1989] STC 873, [1990] 1 WLR 1545, at 1569.
[9] *HMRC v Noor* [2013] UKUT 071 (TCC).

Debate on the GAAR: Threat or Opportunity for the Rule of Law?

David Goldberg QC, Gray's Inn Tax Chambers
Graham Aaronson QC, Joseph Hage Aaronson[1]

David Goldberg QC

Our tax system is sick. Let me try to explain why I say that. A statute which imposes liability to tax can be short or long, simple or complicated, principled or unprincipled: it can try to influence human behaviour and economic decisions or it can attempt to be neutral so far as those matters are concerned.

Some tax systems just impose a charge to tax on profits and do not attempt to influence behaviour. The standard Imperial model of tax which this country bequeathed to its colonies and which was based largely on our 1918 Act is a tax system of that kind; and it seems to me that a tax system like that has at least four advantages over more complicated systems.

First, there is great and immediate clarity about what the subject matter of taxation is: the charge can be imposed in two or three lines made up of little words, so that a clear underlying principle emerges from the text of the legislation.

Secondly, the point by reference to which tax is imposed will, generally, be a point at which the taxpayer will, or should, have cash or liquid resources in hand, so that he can actually pay the tax due relatively painlessly.

Thirdly, a system which just taxes profits makes avoidance of tax relatively difficult: after all, the only way of lowering the taxes you pay in a system of that kind is not by playing games with law, but by attempting to change the facts, attempting, artificially, either to reduce receipts or to increase expenses; neither course is commercially attractive, neither is likely to survive judicial scrutiny and both can easily be prevented by short and clear legislation.

Fourthly, a system which does not seek to influence behaviour will not cause any economic or behavioural distortion.

Our tax system was once of that kind. It can, however, be argued that a tax system of this straightforward kind suffers from one significant disadvantage. The alleged disadvantage is that, upon analysis, the concept of "profit" turns out to be relatively imprecise. There are four points here.

First, although, in the end, disputes about tax have to be resolved in Court by lawyers, the lawyers have recognised that they do not know how to compute a profit and so they have left the field of computation to accountants. This results in a kind of split responsibility which can cause difficult issues to arise, as the second, third and fourth points illustrate.

[1] The piece by David Goldberg QC was as delivered at the conference. The piece by Graham Aaronson QC was a summary provided subsequently. At the conference both speakers presented for around 10 minutes.

Secondly, lawyers find it quite hard to understand the precise computation which accountants undertake and, indeed, there is considerable scope for misunderstanding about what the accountants are actually doing: indeed, I am not entirely sure that accountants understand what they are doing when they make a computation. The problem here can, however, be considerably ameliorated by recognising that the principle of law is not that you must adjust commercial accounts to arrive at a computation of profit but, rather, that you must build a computation from receipts and expenses, determining what the receipts and expenses are by reference to the ordinary principles of commercial accounting.

Thirdly, nowadays the accountants' techniques, of estimating when profits arise, change frequently; and the development of accounting standards often involves the abandonment of legal principle in favour of the doctrine of substance over form, which commonly means that an accountant computes a profit by reference to a transaction which the law does not recognise.

Lastly, lawyers have insisted that, although accountants do the computation of profit, lawyers have the last word as to the meaning of the word "profits" in tax legislation.

The result can be that the accountant has computed something which he calls a profit and which, indeed, may be a profit for company law purposes, but which is not a profit for tax purposes. I doubt if these points are really a serious disadvantage to a tax system: they are the kind of thing that will inevitably arise no matter how closely articulated a system appears to be. I have a suspicion that those who say that the uncertainty underlying the meaning of the word "profits" is a problem, are really saying no more than that they do not like the result obtained by giving the word "profit" its most natural meaning.

This is an issue which we have to face quite often in the practice of tax law: the legislation, read in its most natural and ordinary sense, produces a result which is not the result a commentator thinks is right. Instead of expressing the true state of affairs, which is to say "I do not like that result" the commentator, who is, of course, sometimes a judge or an academic or a business person, will dress what is a personal prejudice in the language of reason and objectivity: an example appears in The Times today, where there is an Op Ed piece criticizing the supposed tax benefits given to "non doms".

This habit which, in truth, involves a pretence, makes it hard to distinguish between conclusions reached on the basis of subjective emotion and conclusions reached on the basis of objective reason: even though it may be the case that a result is reached purely on the basis of subjectivity, no judge will ever say that that is the basis for his decision; as Lawrence M Solan pointed out in his brilliant book *The Language of Judges*, no judge ever says "This is a difficult question which I could just as easily decide the other way, but I am upholding the death penalty imposed on you".[2]
The rule of law, of course, requires that decisions are made on an objective rational basis and, in considering whether our tax system is rule of law compliant, it is necessary constantly to question whether there is truly an objectively valid basis for any view formed or any decision reached.

Whether I am right or wrong about the reason for it, the views which gained favour in this country were, first, that greater certainty was needed, as to the subject matter in respect of which tax was to be levied, than is to be obtained from a simple straightforward tax system which just taxes profits and, secondly, that we wanted to use the tax system to influence behaviour.

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[2] Lawrence M Solan, *The Language of Judges* (Chicago Series in Law and Society 1993).

Now it must, of course, be the case that a move from a simpler to a more complicated tax system for the purpose of creating greater certainty can only improve things if it actually does achieve the greater certainty which it is intended to bring. And a move from a neutral tax system to a behaviour inducing system can only improve things if the induced changes are beneficial.

So the question has to be whether our no longer simple tax code is an improvement on the original model: does it provide greater certainty than the original? Does it provide a basis for taking decisions which is objectively valid? Does it encourage desirable things or things which distort behaviour for bad reasons?

We have one of the longest – perhaps the longest – tax code in the world and there are essentially two reasons for that.

First, because we have a relatively high rate system, we create lots of reliefs which are both intended to be behaviour changing and are, effectively, rules that, in computing profits, you are to deduct, from certain specified amounts, sums which would not be deductible from those amounts in accordance with any natural or accounting view of the matter.

Secondly, in an attempt to create greater certainty, we now have a mass of special codes which are intended to prescribe both when (that is on what events) and how profit is to be computed in particular cases; loan relationships, derivatives and intellectual property are just three examples, each of which presently contains different – even if only slightly different – rules. The patent box is another example. And, standing apart from these special codes, there are further rules designed to deal with special situations: the structured finance rules are one example. The list is more or less endless: we could add the arbitrage provisions and the worldwide debt cap.

The result is an incoherent mess: there is too much legislation; it is too complex, there is a lack of consistency and the certainty which it was intended to create is, as a consequence, illusory. That is why our tax system is sick: there is no longer a single unifying principle which underlies the whole of our direct tax legislation; and the problem is made worse by a contradiction between, on the one hand, the reason which underlies the desire for greater and more specific codification and, on the other, the way in which Courts approach the interpretation of the Taxing Acts.

The point of rules which prescribe when, and define how, you are to calculate a profit – the reason for having and the purpose of rules of that kind - is that they are intended to do exactly that: they are intended to define exactly when and precisely how to compute a profit, and they are, accordingly, intended to be prescriptive. However, these rules have been imposed upon a system which permits of purposive construction, which is a device for interpreting a statute to mean what it does not say. The result is that the certainty which the profit defining rules are intended to create is more apparent than real, since the clarity of the rule may be – and has frequently been – destroyed by so called purposive construction.

It might help to give a relatively straightforward example of how the combination of prescriptive rules and purposive construction precludes objective rationality and opens the door to subjective emotion. Let me do that by reference to the facts of *Furniss* v *Dawson*.[3] The rule that a paper for

[3] *Furniss (Inspector of Taxes) v Dawson DER* [1984] AC 474, [1984] 2 WLR 226.

paper exchange does not give rise to an immediate liability for capital gains tax can be seen as a rule which defines when a profit does not arise. And the rule has a fairly obvious purpose: the idea behind it is that, until a taxpayer has free cash, he is not to be called on actually to pay tax. I use the expression free cash because it is obvious that, if the Dawson family had sold their company to the ultimate purchaser for loan notes and had then borrowed the value of the loan notes from a bank, they would not have been liable to pay capital gains tax: they would not have had free cash, because they would have had a liability to give the cash back to the bank.

Now, I accept that the Dawson family did not borrow from a bank: they borrowed from their own creature company, Greenjacket, which was not a bank. However, in a certain sense, they did not end up with free cash: they ended up with shares in Greenjacket and borrowed money. And while that is different from borrowing from a bank, it is not immediately apparent to me that it is so radically different that the purpose of the legislation was necessarily to impose a tax charge on what they did: what is the objectively logical basis, in terms of our tax code, which tells me that there should be a tax charge in the one situation but not in the other?

I recognise, of course, that there is room for argument about that, but the point which can validly be made is that, once the rule engaged by any particular set of facts is seen to be a profit defining rule, purposive construction of it to make it mean something which it does not say must be of doubtful validity: it seems to me likely to flout, rather than to fulfil, the true purpose of the legislation; and any decision based upon a construction of that kind is more likely to be subjective rather than objective.

In my view there is no truly objective basis for the decision in *Furniss* v *Dawson*:[4] instead there is a range of subjective views which can be used to justify different results, but the result cannot be keyed in to some underlying and logical principle in such a way as to be regarded as wholly objective.

In any event, a tax system which allegedly suffers from some lack of certainty as to the meaning of the word "profits" is not improved by adding to it a mass of apparently profit defining provisions which either, when analysed, are so badly drafted that they do not provide any certainty at all or which, although apparently clear, have their certainty taken away by a rule of purposive construction.

The basic idea, behind our early tax system, which was that we taxed a profit determined by reference entirely to commercial concepts only at a time when it was relatively easy to pay the tax, has been swamped by a mass of detailed and apparently prescriptive legislation. Now, it seems to me that this has not improved the position as compared to a simpler tax system: our tax code is now so top heavy with detail that we need to ask whether it is still based upon any sound and coherent principle. The answer is "No": it does not provide greater certainty than the original model and the absence of principle means that it does not provide an objectively valid basis for taking decisions.

There are, moreover, other concerns about the system. I saw, in the paper yesterday, a report, by PwC, that the lowering of our corporation tax rate has made this country the most attractive in Europe in which to start a business. That is good news, but I wonder if it is true for everybody, or only for those who can afford a big four adviser and are able to negotiate with HMRC in advance of doing a deal. I also wonder if it really matters given the figures published at the weekend, which show that companies pay only 7% of the total national tax take in the form of corporation tax. Those

[4] Ibid.

figures also show that 31% of the national tax take is paid by 1% of the individual taxpayers in the country, and they need to be coupled with the point that our tax system imposes a very heavy burden on relatively low earners who, taking account of N.I. contributions, start paying tax on a relatively small sum of income at 32%. To my mind, figures of this sort suggest that there is something wrong with the focus and structure of our tax system.

There is also a widespread concern, less well articulated because it is not a simple matter of figures and there are reasons for not expressing it, that there are difficulties in the actual operation of the tax system, both at the administrative and legal levels, which are compounded rather than alleviated by the activities of the Public Accounts Committee.

On top of this, two initiatives, which are presently under discussion between taxpayers and HMRC, should cause further concern about the health of our tax system. First, HMRC have been giving thought to re-writing the profit defining rules of the loan relationships and derivatives regimes. My guess is that the profit defining rules will end up significantly longer but less defining than the present regime, so that there will be a host of apparently specific rules but, also, an overriding rule that the profits offered up for taxation must "fairly represent" the profits arising from loan relationships and derivatives. I am not sure that legislation of that kind is useful: if the special rules are not going to be prescriptive, but wishy-washy and general in nature, what is the point of a special rule? We might just as well tax profits without defining what we mean: we would be better doing that than enacting a host of words which appear to be rules but aren't.

A rather broader issue arises from the Banking Code which is intended to be a "voluntary" code of behaviour for banks: the idea is that they are to be on good behaviour so far as tax is concerned. Although the code is voluntary and non-statutory, it is to be backed up by a statutory power to "name and shame" any bank which does not adhere to the so-called principles set out in it. The idea of a non-statutory code of behaviour supported by a statutory power is, in any event odd, but it also raises the question of what the role of law is in the tax system. If we are to be told by statute to pay tax on a sum which fairly represents our profit and we are to be compelled to behave in a certain way by a non-statutory code, is there really a need for 17,600 odd pages of legislation? What purpose does the legislation serve?

For my own part, I find these two developments disturbing in the sense that they seem, at the least, to lack respect for the rule of law.

My analysis is, accordingly, that we have created problems in our tax system both by pursuing a wrong philosophy of taxation and by aiming our legislation at targets which are not necessarily right. The question which then arises is whether the problem is treated by a GAAR. Does that help to restore health to our tax system?

My own diagnosis is that the tax system is so overburdened by rules and so burdensome for taxpayers that it is more or less moribund. Of course, it still appears to be functioning but it certainly cannot go on growing at its present rate or it will die from overweight.

The GAAR does not cure this problem, but adds to the weight of the system. What good does it do? It is supposed to stop abuse of the tax system. I am not at all sure that that is a good – it depends what is meant by abuse and whether it is truly possible to distinguish between good and bad avoidance – but, even assuming it to be a good, a question which arises is whether the good is purchased at the price of a harm. In my view the answer is that the GAAR does do harm: I consider it to be unclear and a threat to the rule of law. To my way of thinking, there are at least three features of the GAAR which undermine the rule of law.

First, the GAAR is not adequately certain: in particular, the concept of reasonableness, which plays such a prominent role in the GAAR, is not sufficiently well defined. What are the limits on the ability of the administrator or the judge to say that something is unreasonable? Whose standard is to be applied in determining reasonableness? In other areas of law there is a designated standard – for example, the man on the Clapham Omnibus. Presumably, that is not the standard here but if it is not, is the standard that of the Public Accounts Committee? And if not, why not? In the end, the application of all provisions like this one depends upon the subjective view of the decision maker that a course of conduct is acceptable or not acceptable.

If that view were inevitably founded on some sound principle, it would be unobjectionable – and I recognise, of course, that the GAAR assumes that our tax legislation contains express or implied principles which tax arrangements might seek to avoid. But if I am right that many of our rules are intended to be prescriptive profit defining rules, on what basis can it be said that it is not reasonable to seek to apply those rules? What is the principle behind rules of that kind except to prescribe how to work out a profit?

It is not an answer to say that the idea behind the rules is to tax some general idea of profit: if that were the case, there would not need to be and would not be 17,600 pages of legislation. Nor is it an answer (although the GAAR legislation assumes it is) to say that the idea is to tax an economic profit: tax is not (apart from the GAAR) levied on economic profit and, in any event, the concept is vague.

These points are particularly acute because the GAAR is applied only when the taxpayer would, despite purposive construction, get a tax advantage. In other words, the GAAR applies to take away a tax advantage which, even on a purposive construction of the legislation, is available, apart from the GAAR, to a taxpayer. Apparently, it can be unreasonable to do something which gives you an advantage which it was the purpose of the legislation to give to you. That sounds, at the least, odd.

The second feature of the GAAR which, in my view, undermines the rule of law is the concept of seeking to exploit a shortcoming in the legislation. No doubt the idea of shortcomings in legislation goes some way to explaining why the GAAR can apply to deprive a person of a tax advantage which the legislation was, even on a purposive construction, intended to give him.

If the legislation gives an advantage in circumstances where the decision maker thinks the taxpayer should not have it, that is, in the decision maker's mind, no doubt, due to a shortcoming in the legislation. But what is the concept here? How is it that, in relation to tax, which is an entirely man made conception, there can be a shortcoming just because the decision maker thinks that the taxpayer should not get the benefit the legislation stipulates he should get.

What is the foundation for the decision maker's thought? It reminds me of the story of the little old lady and Professor Einstein. The little old lady attended a lecture given by Professor Einstein on gravity, in the course of which he explained that the earth was held in orbit around the sun by the force of gravity. When the lecture was over, the little old lady went to the professor and told him that she was surprised to hear all this stuff about gravity because she thought everybody knew that the earth was held up on the back of an elephant which was standing on a turtle. "Ah", said the professor "that is very interesting but what is the turtle standing on?" The little old lady replied "You cannot catch me that way. It is elephants and turtles all the way down".

What is the underlying principle which means there is a shortcoming in the legislation on which Mr Mayes relied, but no shortcoming in legislation which gives me relief for charitable donations? And why, by the way, is the concept of shortcoming a one way street in favour of HMRC?

There are many things that I consider to be shortcomings in the legislation – many of the restrictions on the ability to use losses are, for example, fundamentally obnoxious to sound economic theory. In one sense, it is certainly right to describe that type of legislation as having a shortcoming: it is economically illiterate.

I recognise, however, that it would be wholly absurd to legislate that a taxpayer should get a relief if his failure to get it were due to some shortcoming in the legislation. But if that is absurd, why is it less absurd to impose tax by reference to a shortcoming in the legislation?

And there is one other point here which I think worth making though I recognise that many will disagree with it. If we were to compute profit on a cash basis, many of the difficulties and uncertainties inherent in tax law would disappear: legislation could be very simple. Now, of course, most people here will say that a cash basis of taxation is hopelessly unsophisticated and that has been recognised since the 16th century. However, every other method of computing profit is based on an estimate and accountants recognise that. For my own part, I regard it as a shortcoming of the legislation that we impose tax by reference to any form of estimate. The point is that the concept of shortcoming is again ephemeral and ill defined.

The third feature of the GAAR which undermines the rule of law is that the GAAR undoubtedly gives the administrator a law making power. The administrator has power to counteract a tax advantage by creating law especially to impose tax. It seems to me wrong in principle that an administrator should be given a power of that kind. So I have some specific concerns about the form of our GAAR and the way in which it has been enacted, and I also have a more general concern about it which is derived from the Australian experience. The Australian experience is that, while Courts do, for a time, accept and apply the GAAR with some enthusiasm and vigour, every so often they react against it and start limiting its effect.

That has happened recently in Australia where the Court has found, in a number of cases, that there was no tax benefit. Under the present Australian law, the existence of a tax benefit is key to the operation of the GAAR and is found by comparing, on the one hand, the claimed tax consequences of the transaction which actually took place and, on the other, the tax consequences of the most natural transaction. If the actual transaction produces a better tax result than the hypothetical comparator, there is a tax benefit which can be counteracted. However, Australian Courts have recently been astute to say that the most natural transaction would have been to do nothing.

Since doing nothing can attract no tax consequence, the result is that there is no tax benefit and Part IV A of the Australian Act – the Australian GAAR - cannot apply. In turn, the Australian revenue has reacted to what the Courts have done and has proposed that the question of tax benefit should no longer be a central feature of the legislation: instead, the question is, it seems, to be whether the scheme or arrangement in issue had some tax aspect, in which case the authority can impose the tax which it believes the taxpayer should have to pay rather than the tax which the law mandates.

Given the form of our GAAR which, to my mind, already in some circumstances allows HMRC to impose the tax which it thinks should be paid rather than the tax for which the law, apart from the GAAR, provides, I doubt if we shall need to follow up our GAAR with amending legislation of the Australian kind. But I do believe that the governmental thinking behind the proposed amendment to the Australian GAAR – which seems to be that once tax is concerned in a transaction there should, more or less, be a discretionary element which allows the taxing authority to collect as much tax as it thinks it should – is, to an extent, reflected in the developments which are occurring here, in the proposed amendment to the loan relationships and derivatives codes, in the Banking Code and in the GAAR and are, indeed, encouraged by the very existence of a GAAR which enshrines the false view that there is an automatic answer to any tax question which is independent of the words of the statute.

All of these developments seem to me, first, to undermine the certainty which our legislation not only should, but is clearly intended (even if not very successfully) to, give us and, secondly, to be designed to encourage those who have sufficient influence to obtain access to HMRC to agree a tax treatment with them before implementing any transaction. I doubt if that is desirable.

In place of developments of that kind, we need some fundamental and radical thinking about our tax system, about what we want it to do, about why we want it to do what it does and about how it is to do it. The GAAR was not thinking of that kind.

Yesterday was the 150th anniversary of the delivery of the Gettysburg address in which the late President Lincoln dedicated the American people anew to the proposition that all men are created equal. It might seem rather overblown to compare the small corner of the field which is tax law to such a high purpose. But, though the corner be small, the effect is large and impacts on nearly every person who resides or does business here. It is important that the rule of law is maintained in tax and there is no room to be smug here: the tendency in tax law, in the attitude of government, in the attitude of politicians generally, in the attitude of administrators and, to some extent, in the attitude of tribunals and Courts is to undermine it. We here today should highly resolve to protect it, not run with the crowd.

Graham Aaronson QC

I entirely agree with David Goldberg that a sufficiently clear, concise and coherent tax system would not need the protection of a GAAR. However, we do not have a clear, concise and coherent tax system, and there is not the slightest chance of having one in the foreseeable future. Precisely because of this existing state of affairs, the traditional method of preventing tax professionals and taxpayers from exploiting deficiencies or obscurities in the tax rules has been to surround the substantive tax provisions with countless specific anti-avoidance rules. The result is a process which leads to ever-increasing complexity and obscurity in the tax legislation. One of the main purposes of a sensible GAAR is to make it unnecessary for this process to be continued, while at the same time signalling to tax advisers and taxpayers that there is simply no point trying to devise ever more complex and sophisticated schemes designed to exploit tax rules for purposes for which they were never intended.

As David Goldberg correctly notes, every type of GAAR inevitably involves an element of subjective judgment. The General Anti-Abuse Rule recommended by the UK's GAAR Study, and adopted by the Government in FA 2013, recognises this inevitable fact, and ensures that the subjective discretion to strike down an abusive tax scheme can be applied only in cases where it is beyond reasonable doubt that the scheme does indeed abusively exploit the substantive tax rules. It does not matter whether David Goldberg or other tax professionals consider that taxpayers should be permitted to exploit the tax code in a clearly abusive way; the plain fact is that this view is not shared by the public or, critically since 2013, by Parliament either, and the UK's GAAR will put a stop to it.

Graham Aaronson QC, Joseph Hage Aaronson

Graham Aaronson is a founder partner in Joseph Hage Aaronson, and is head of its tax litigation team. He started practice at the bar in leading commercial law chambers (Essex Court Chambers). Having decided to specialise in tax law he moved to the leading tax chambers, Pump Court Tax Chambers, where he dealt with the whole range of UK taxation, but with a particular emphasis on tax litigation. For five years he left his practice to be the CEO of a quoted (on the London Stock Exchange) plastics engineering company. He returned to practice and shortly after, at the age of 37, he was appointed Queens Counsel. As a QC he specialised in commercial taxation, with particular sub-specialities in transfer pricing, oil and gas taxation, life assurance office taxation and structured finance; and he has advised or represented most of the major corporations carrying on business in the UK. He initiated the EU law challenges to the UK corporation tax regime in the landmark Hoechst case, and since then he has been the lead counsel in most of the group litigation actions dealing with various aspects of corporation tax. He was appointed in 2010 by the UK Treasury as leader of a study to determine whether a general anti-avoidance rule should be introduced into the UK's tax regime. His report recommending a general anti-abuse rule ("the GAAR") was accepted by the Government, and the proposed legislation has now been enacted in the Finance Act 2013. He was appointed in 2012 as the initial chairman of the Advisory Panel which oversees the GAAR, and was the architect of the Guidance Notes which govern the practical application of the GAAR.

David Goldberg QC, Gray's Inn Tax Chambers

David Goldberg is a lawyer and a lawyer's son. He was born in Plymouth, to which town his family, leaving the line of Napoleon's retreat from Moscow, had come in 1813 in time to see the French Emperor a prisoner on The Bellerophon in the Sound, all of which explains his occasional references on cold days to frozen Frenchmen. Plymouth provided formative influences: Drake; connections with the Military (he served in the Plymouth College Combined Cadet Force); the guns of the Royal Citadel, which point over the town and not out to sea to subdue the pro-Parliament citizens. From all this, he obtained a dislike for foreign dictators, a distrust of overbearing executive bureaucracies, the knowledge that you can finish the game and beat the revenue too and a valuable aphorism which he never seeks to use as a weapon but bears in mind whenever anyone speaks to him in jargon.

He has two children who no longer have homework for him to help with; but, when they did, he found that his ability to factorise quadratic equations was just the same as it was when he, himself, had homework. As a lawyer, his primary interests are planning transactions in the most efficient manner, helping in what Mrs Thatcher (as she then was) once described in a letter to him as "the battle against the Inland Revenue", the control of executive action and litigation, both on technical tax issues and at the interface of revenue and administrative law. Outside the law, he has too many interests to mention: he once took strenuous exercise but gave it up after meeting a doctor who told him that we are all born with a definite but limited number of heartbeats, none of which should be wasted in the gym; and he now models himself more on Mycroft than on Sherlock Holmes. His published works include books and articles on legal topics and, when he feels strongly enough, letters to the newspapers.

Anthony Inglese CB, General Counsel and Solicitor, HM Revenue & Customs

Anthony Inglese is the General Counsel and Solicitor, HMRC since March 2008. He heads a 400-strong office and is responsible for all legal services to HMRC. This includes advice, legislation and litigation. His Office has just been named In House Public Sector Team of the Year by both The Lawyer Magazine and The Legal 500. Anthony leads for the Government Legal Service on Professionalism and Ethics and induction training. He has over 35 years' experience as a Government lawyer, including as a head lawyer of several Government Departments. He was called to the Bar at Gray's Inn in 1976, he became a Bencher in 2002. He was also a Member of the Bar Standards Board between 2008 and 2011. Anthony will be leaving HMRC in January 2014.

Michael Llamas QC, Chief Legal Advisor to HM Government of Gibraltar

Michael Llamas read Law with French at Sussex University, LLM in European Law at King's College London and DEA in European Environmental Law at La Sorbonne. He was called to the Bar England and Wales in 1990, and to the Paris Bar and the Gibraltar Bar in 1994. He acted as EU Legal Counsel to Gibraltar in Brussels from 1997 to 2007. He moved back to Gibraltar in 2007 and has been Chief Legal Advisor to the Gibraltar Government since then. He heads the Gibraltar Government's EU and International Department. His responsibilities include advising the Government on all EU matters, overseeing the transposition of EU measures in Gibraltar and conducting all of the Government's EU litigation. He has appeared regularly before the Luxembourg and Strasbourg Courts. Appointed Silk for Gibraltar in 2012.

Sir Stephen Oliver QC, Pump Court Tax Chambers and former President of the First-Tier Tax Chamber

Sir Stephen practiced at the "Revenue" bar from 1964 until 1991, at Pump Court Tax Chambers. As advocate and adviser he represented businesses and private clients, dealing with the entire range of taxes. Then, and until the reorganisation of the tribunals in 2009 that followed the Tribunals, Courts and Enforcement Act 2007, he was Presiding Special Commissioner (covering direct tax appeals), President of the VAT and Duties Tribunals, and President of the Financial Services and Markets Tribunal. After the reorganisation, he became President of the First-Tier Tribunal (Tax Chamber) until 2011 and a judge of the Upper Tribunal until 2013.

William Redgrave, Jersey Advocate, Baker and Partners

William Redgrave is a Jersey Advocate and English Barrister. His work now covers a wide range of Jersey litigation, including fraud and trust disputes, and Jersey Law Society disciplinary proceedings. He was appointed as a Crown Advocate in 2012. He practised at the English Bar for 13 years before moving to work in Jersey in 2008. In England, William appeared in high-profile criminal cases, and prosecuted police corruption. In Jersey he has advised financial services businesses and the regulator on a variety of regulatory matters, including AML laws and procedures, sanctions and tax information exchange. He has conducted investigations on behalf of regulated businesses and the regulator.

Harish Salve, Former Solicitor General of India

Harish Salve is a senior counsel practicing in the Supreme Court of India. He is a qualified chartered accountant who started work in taxation in 1978 and then enrolled as an advocate in 1980. He set up his independent chambers in 1986. He was designated as Senior Advocate in 1992. He held the office of the Solicitor General of India from 1999 until November 2002. He has handled some of the most important cases in decides by the Indian Supreme Court in the last three decades. He has argued a number of important tax cases in the Supreme Court, the best known amongst them being the Vodafone Case. He has been active in the field of arbitration, both as counsel as well as an arbitrator. He enrolled as a barrister in 2013, and is now a non-resident tenant of Blackstone Chambers.

Jane Shillaker, Outreach Manager, TaxAid

Jane has 32 years' experience of working in taxation, with HMRC and in the private and charitable sectors. She started volunteering for TaxAid in 2007 and joined the staff in 2010 as Outreach Manager, responsible for delivery and development of TaxAid's assistance to clients outside London. She represents TaxAid on HMRC's Disabled Customers' Consultation Group and its Mental Health Forum. She is a Chartered Tax Advisor and a lay member of the Tax Chamber of the First Tier Tribunal.

Anthony Thomas, Former President, Chartered Institute of Taxation and Chairman of the Low Incomes Tax Reform Group

Anthony Thomas has been in tax practice in Coventry for more than 30 years as a chartered tax advisor and accountant with an interest in the SME sector and professions. He is currently chairman of the Low Income Tax Reform Group (LITRG) which aims to give a voice to the most vulnerable sectors of society. Anthony has been President of the Chartered Institute of Taxation (CIOT), Association of Taxation Technicians (ATT) and is also a member of the General Assembly of the Confédération Fiscale Européenne (CFE).

Charles Clore House
17 Russell Square
London WC1B 5JP

T 020 7862 5151
F 020 7862 5152
E binghamcentre@biicl.org

www.binghamcentre.biicl.org

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