

**WHEN COMPLIANCE IS NOT THE
SOLUTION BUT THE PROBLEM:
FROM CHANGES IN LAW TO
CHANGES IN ATTITUDE**

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The Australian National University
Australian Taxation Office

Centre for Tax System Integrity



WORKING PAPER No 18
August 2001

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ISBN 0 642 76817 X

ISSN 1444-8211

WORKING PAPER No 18

August 2001

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Australian National University 2001*

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National Library of Australia
Cataloguing-in-Publication data:

McBarnet, D., 1947-.
When compliance is not the solution but the problem: From
changes in law to changes in attitude

Bibliography
ISBN 0 642 76817 X

1. Taxation – Australia – Public opinion. 2. Taxpayer
compliance – Australia. I. Murphy, Tina. II. Centre for
Tax System Integrity. III. Title. (Series: Working paper
(Centre for Tax System Integrity); no. 18).

*If you would like to make any comments on this working paper please contact the author
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THE CENTRE FOR TAX SYSTEM INTEGRITY WORKING PAPERS

The Centre for Tax System Integrity (CTSI) is a specialized research unit set up as a partnership between the Australian National University (ANU) and the Australian Taxation Office (Tax Office) to extend our understanding of how and why cooperation and contestation occur within the tax system.

This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Series Editor:
Tina Murphy

Abstract

The task of the Centre for Tax System Integrity is to extend understanding of how and why cooperation and contestation occur within the tax system. This goal presupposes a clear distinction between cooperation and contestation. In practice, however, this distinction may be open to creative management, demonstrated clearly in the practice of 'creative compliance'.

Taxpayer compliance with tax law may seem to fall, by definition, into the category of cooperation with the tax system. Indeed, securing compliance with the law is the driving force behind the compliance model of enforcement (Ayres & Braithwaite, 1992) which has been adopted by the Australian Taxation Office (Tax Office) and other regulatory agencies (Hawkins, 1984). Securing compliance is seen as the key, as the solution to the regulatory problem of making policy effective in practice.

Yet compliance with the law can in practice be used, and used very effectively, to *frustrate* tax policy. This working paper focuses on the issue of compliance, and on the Tax Office's compliance model of enforcement. It asks: what happens to the compliance model when compliance is not the solution but the problem?

When compliance is not the solution but the problem: From changes in law to changes in attitude

*Doreen McBarnet*¹

The Australian Taxation Office compliance model (ATO compliance model) focuses on the strategies adopted by those *enforcing* the law. They should be cooperative, understanding, focusing on fostering compliance rather than on leaping immediately to punishing non-compliance, with ‘big stick’ sanctions reserved for those recalcitrants who continue with non-compliance regardless (Ayres & Braithwaite, 1992). But choice of strategies is not the preserve of enforcement agencies. Different strategic responses can be adopted by those on the receiving end of the law too, and these translate into different approaches to compliance. Faced with a tax bill, people may choose to comply willingly. We might think of this as:

- *committed compliance.*

They may choose to comply unwillingly, complain but pay up nonetheless. We might think of this as:

- *capitulative compliance.*

They may invent false expenses, pack their cash in a suitcase and whisk it out of the country without declaring it, or simply operate in the cash economy, opting for:

- *non-compliance.*

Or, if they have the resources, they may set their lawyers to work² on the legal form of their activities to package or repackage them in ways they can claim fall beyond the ambit of *disadvantageous*, or within the ambit of *advantageous*, law. They can engage in:

- *creative compliance.*

¹ The sections on Australian tax policy and practice included in this analysis are based on research conducted as a visiting Research Fellow at the Centre for Tax System Integrity. My thanks to Director Valerie Braithwaite and all at the Centre.

² Or if they *are* lawyers, as in the celebrated recent cases of the bankrupt barristers, set themselves to work.

It is the essence of creative compliance that it can be defended as *not* non-compliance. Indeed, that is exactly how it is often presented, as ‘not illegal’, or more positively, in that well-worn phrase, as ‘perfectly legal’. Nonetheless, just like non-compliance, the essence of creative compliance is that it escapes the intended impact of the law. The creativity inherent in creative compliance involves finding ways to accomplish compliance with the letter of the law while totally undermining the policy behind the words. It is therefore when compliance takes the form of creative compliance that it becomes, for those vested with the task of enforcing policy, a problem not a solution.

Creative compliance devices abound in the area of tax, but are not confined to it. Far from it. Creative compliance will be found in any area of the law in which those subject to it have the motivation and the resources – in terms of money and/or know-how – to resist legal control *legally*.

Recognising this will help those concerned with tax to realise that creative compliance is not a *tax* issue but a much more general *law* issue, and a fundamental one at that. Recognising the issue goes beyond tax avoidance to law avoidance means we can try to learn from experience in other areas of law, in such areas, for example, as that first cousin of tax avoidance, creative accounting. Indeed, creative accounting is pertinent to tax not only as a parallel area of creative compliance, but as potentially integral to tax computation.³ In the analysis that follows I draw not only on my own research on tax avoidance in the UK⁴ and in Australia,⁵ but on joint research on creative accounting,⁶ to draw out the challenges posed for effective enforcement by creative compliance.

³ The more so where taxable profits and financial reporting profits substantially overlap. There is variability between jurisdictions as to how far this is the case. See, for example, Touche Ross (1989).

⁴ Funded by the Economic and Social Research Council. All of the projects listed in this paragraph were based on in-depth interviews with lawyers, accountants and regulators (including the Inland Revenue, Accounting Standards Board, Financial Reporting Review Panel, Tax Office), along with key players from business as relevant.

⁵ As a Visiting Fellow at the Centre for Tax System Integrity, researching the ATO compliance model of enforcement and issues posed for it by legal creativity.

⁶ With Christopher Whelan. Funded by the Jacob Burns Fund for Socio-Legal Studies and the European Commission. See McBarnet and Whelan (1999), on which this paper draws.

Creative compliance

Two factors contribute to the practice of creative compliance. One significant factor is the nature and operation of the law itself. The law-making process leads to lobbying and compromise, legislators cannot address every contingency that might arise, drafting is fallible. More fundamentally, it is in the nature of the law that it is open to different interpretations, and that its meaning and application are arguable.

Creative compliance, however, does not arise deterministically from the nature of the law. It also requires a particular *attitude to the law*, an attitude which, far from seeing the law as an authoritative and legitimate policy to be implemented, sees it as a *material to be worked on* (McBarnet, 1984), to be tailored, regardless of the policy behind it, to one's own or one's client's interests. And it requires *active legal work*.

The law is open to alternative interpretations. Innovations in practice can leave the law behind. But grey areas, alternative interpretations and innovative legal forms do not only arise 'naturally'. Rather, they may be motivated precisely by the desire to outflank the law. Creative compliance involves careful scrutiny of the law in order to seek out material for and actively construct alternative and innovative arguments and legal forms. Creative compliance involves seeking out:

- *gaps*: facilitating the 'where does it say I can't do that?' argument
- *the ex-files of law*: express exemptions, exceptions, exclusions, with practices then restructured to fit within them
- *rules*: the more prescriptive and rigid the definitions and thresholds involved, the better, with legal forms adopted to fit inside or outside their literal ambit – a practice of *working to rule*.

Regulators often express concern about uncertainties in the law being exploited,⁷ but creative compliance operates particularly effectively in the context of a rule-bound regime, where the words of the law can be treated as recipes for avoidance.

⁷ See for example, Australian Commissioner of Taxation's reference to 'tax arrangements which seek to exploit deficiencies or uncertainty in the law' (ATO, 1999, p xiii).

How this works in practice can be readily demonstrated from research. When it was proposed in the United Kingdom (UK) that value added tax (VAT – akin to the new Australian goods and services tax) should be levied on domestic fuel, hitherto exempt, there was extensive protest on the basis that the old and the poor would suffer. In the event, not everyone suffered. Some institutions, including university student residences, found a nice way to avoid the new costs involved in heating and hot water. They would sell their boilers, which of course remained exactly where they were in the institution's basement, to a separate company. The company would buy the fuel to heat the water. The company would have to pay VAT on the fuel but, as a commercial enterprise, could reclaim it. The company then sold the water to the institution. There is as yet no VAT on water so, hey presto, nobody pays any VAT. And the 'where does it say I can't do that?' argument, along with a quick referral to the rules, can be brought into play to justify it.

UK national insurance is currently being avoided in the North Sea oil industry by transferring UK staff to overseas agencies (*Scotsman*, 24 May 2001). Transnational tax avoidance by using tax havens or differential rules in different jurisdictions (for example the 'Delaware Link' device – McBarnet 1992) is common practice. But avoidance can also be readily accomplished within a jurisdiction simply by working to – or playing with – the rules. For example, to avoid UK national insurance contributions (national insurance contributions being paid by employer as well as employee), a practice developed in the financial sector of paying part of the salary in the form of large bonuses in shares. No national insurance contributions were payable on shares, though they had a clear monetary value and could be converted immediately into cash. To deal with this, the law was changed to impose national insurance on any payment in a 'traded commodity on a recognised exchange'. The result was a shift to payments in fine wine, also of clear monetary value, also amenable to immediate conversion to cash, but not traded on a recognised exchange.

Creative compliance is pervasive in corporate practice in many areas of the law. Take an example from my research with Christopher Whelan on creative accounting, one we have frequently cited because it demonstrates so clearly the problems posed by creative compliance. Creative accounting has, over time, involved a vast array of techniques (for example, Griffiths 1986; 1995). This specific example, the 'orphan subsidiary', was

widely used in the 1980s to cosmetically enhance a corporate group's paper profits and assets, with knock-on effects for share prices, performance-related pay and borrowing capacity. A parent company must, under company law, produce accounts which include the profits/losses and assets/liabilities of its subsidiaries. The idea is that it should provide the full picture for all the companies it controls, and not hide away poor performances or liabilities in a separate entity whose details it does not disclose. But what if parent company A sets up a company B which it controls, but which is nonetheless carefully structured to fall outside the legal definitions of a subsidiary? In this 'orphan subsidiary' it would have the perfect vehicle to use in ventures which involved high risk or high borrowings – such as a highly leveraged acquisition – without the losses or liabilities appearing, detrimentally, in its group accounts.

The statutory definition of a subsidiary under section 736(1) of the *Companies Act 1985* involved two criteria. Company B was a subsidiary of company A if:

- A owned more than half B's equity capital, or
- A controlled the composition of B's board of directors.

With a little creativity, both criteria could be readily circumvented. There were many ways of achieving this, one of the simplest being to set up two types of shares, ordinary shares and preference shares, 50% of each. Company A would own the ordinary shares, while its bank would own the preference shares. Company A would not therefore own *more than* 50% of the equity capital. Company A and its bank would each appoint half the directors. Company A would not therefore control the *composition* of the board of directors. But the directors representing the ordinary shareholder (company A) would have two votes to the preference share directors' one. Company A would not control the composition of the board of directors, but it would control the board's votes.

These are typical examples of creative compliance at work, and they demonstrate how the material of the law is actively used to circumvent legal control. The constructs that emerge are backed with legal arguments and the opinions of leading counsel and, if challenged, a case can be produced (however 'bullish' – see ahead) to claim compliance with the law. And these are merely examples. Creative compliance is not a practice operating at the statistical margins, or at the margins of society. On the contrary, it is

pervasive, and pervasive among leading lights in the social and corporate world. The orphan subsidiary, for example, was just one of a vast range of creative accounting devices, used routinely in the UK by household name companies.

Creative compliance and non-compliance

That creative compliance *is* compliance is, of course, only a claim. Whether it is perfectly legal or not is an unanswerable question, until it has won or lost in court. Often it is a claim that succeeds simply because it is not contested. Even if it is successfully challenged, the fact that it is a case based on applying the law rather than ignoring it⁸ provides protection from the sanctions and stigma associated with simple non-compliance. A tax planning device may fail in court without being branded a tax fraud.⁹ It is an essential element – and attraction – of creative compliance that it can claim to be ‘not illegal’, to be quite distinct from non-compliance.

But the line between the two is not always so clear as that suggests (McBarnet, 1992). The Australian Commissioner of Taxation has recognised that aggressive tax planning can in practice slip over the line into evasion: ‘The competition in the market has also stretched the boundaries of arrangements, with some edging to the fraudulent’ (ATO, 2000b, p. 5).

What is more, creative compliance and non-compliance can intertwine. There has recently been a furore over Australian barristers going bankrupt with one creditor, the Tax Office, to whom they owed debts in unpaid taxes to the tune of millions of dollars (ATO, 2000b, pp. 6-7; *Sydney Morning Herald*, 26 February 2001). In this case the actual non-payment of tax would not appear to be a matter of creative compliance, but of simple non-compliance under tax law. But resort to a different branch of the law, bankruptcy, permitted escape from the sanctions of tax law. Of course no-one can go into bankruptcy unless they have run out of assets. But the reason for the furore was concern that assets remained in the family, accessible to and enjoyed by the bankrupt,

⁸ The Ralph Report distinguishes tax avoidance as a ‘misuse or abuse of law rather than a disregard for it’ (1999, p. 243).

⁹ I have elsewhere described one of the functions of creative compliance as ‘fraud insurance’ (McBarnet, 1991).

despite the bankruptcy and the protection it offered regarding the enforcement of tax law. In short, there was concern that bankruptcy law had been used creatively. Certainly, bankruptcy can be planned and creatively constructed. The ATO Auditor-General Audit Report of 1999–00 observed (on a broader base than the bankrupt barristers mentioned in the press) that the individuals concerned ‘are generally well prepared for bankruptcy’ (Auditor-General 1999, p.113).

Tackling creative compliance: ‘Big powers’

How is creative compliance to be dealt with? In the ATO compliance model, if a taxpayer is not won over to compliance via gentle cooperative control, there is a next step – a shift of gear from gentle persuasion to legal force, from cooperation to sanctions. The ATO compliance model has two sides. It involves not just cooperation but ‘big sticks’. Despite the primary consensual approach, there is a need to remember ‘the power of the punch behind this velvet gloved approach’ (Clayton Utz, 1997). In the ATO compliance model, law and sanctions may be a matter of last resort, but they are there, and they are there to be used.

But what happens when it is the *taxpayer* who is resorting, as a matter of *first* resort, to the law, and using it, whatever the enforcement agency’s view, to claim compliance? Big sticks are for dealing with *non-compliance*. How do enforcers bring in legal sanctions to deal with what is claimed to be legal compliance? In this situation the issue is no longer a matter of enforcement style, of the agency choosing whether to bring in the big sticks or not. The enforcement agency *cannot* bring in the big sticks until it contests the claim to compliance. The issue, in short, is no longer one of enforcement, but one of *enforceability*. Before big sticks can be brought into play, the claim to compliance must first be contested.

To challenge the foundations of creative compliance, then, one first needs *big powers*. Big powers mean more than just new specific rules, which can result merely in a cat and mouse game of new creative compliance adapted to the new words of the new rule. Big powers need to be of a qualitatively different kind.

There have been attempts to produce big powers in a number of areas, including tax in the UK and Australia, and financial services and financial reporting regulation in the UK. In many ways the UK's new regime in accounting regulation, driven in particular by the wish to control creative accounting, has been at the cutting edge of the big power approach.

Key big power strategies have included:

- *A shift, in the form of regulations, from rules to principles*

Rigid detailed rules have been recognised as providing too fertile a soil for creative compliance. Where regulations involve rigidly defined categories, they can be too readily avoided by repackaging activities into a form that falls outside the clear delineations – though in substance it may remain effectively the same as defined by the regulation. The orphan subsidiary or the national insurance examples given above are classic examples. Hence the Accounting Standards Board's approach of trying to write its regulation for dealing with such matters as off-balance sheet financing (in the Accounting Standards Board's financial reporting standard known as FRS5) in terms of a simple general principle: companies should report the substance of their transactions. The Australian Review of Business Taxation (Ralph Report) has also advocated 'a system based on clearly enunciated principles' as the best way to 'ensure horizontal equity and to reduce tax avoidance and hence to improve the integrity of the system (Ralph Report, 1999, p. 15).

- *A focus on the substance of practice, not just its legal form*

FRS5 not only set out its regulation in the style of a principle not a rule, but it clearly stipulated that it was substance, not form, that counted. This notion of substance over form is also at the heart of the UK's 'new approach' to tax avoidance, introduced through judicial doctrine in the 1980s in the cases of *Ramsay (WT) Ltd v IRC [1982] AC300* and *Furniss v Dawson [1984] AC474*. The Australian Review of Business Taxation has also proposed a focus on 'economic substance rather than legal form', and

recommended that ‘transactions with similar economic substance should be taxed in a similar manner’ (Ralph Report, 1999, pp.14–15).

- *Taking a conceptual approach to the construction of definitions*

The orphan subsidiary was based on a very specific definition in the *Companies Act 1985*, as we have seen, including the criterion of ‘control of the composition of the board of directors.’ The *Companies Act 1989* changed that, by including a much broader definition that went for the essence of control regardless of its specific form. One ‘entity’ was the parent of another (its subsidiary) if it had a ‘participating interest’ in it, and ‘actually exercised dominant interest’ over it. This was seen as a ‘catchall’ definition that avoided the invitation in more specific rules to slip beyond the parameters they set.¹⁰

- *An emphasis on ‘super-principles’*

Another strategy is to set up ‘super-principles’ which cut through or override literal compliance with specific rules. Australia’s General Anti-Avoidance Rule can be seen as an example. The idea of substance overriding form can also be seen in this light. In the UK the epitome of the super-principle is the ‘overriding’ requirement in company law that accounts should give ‘a true and fair view’. There is also an express clause requiring directors to depart from, rather than comply with, specific rules, if following them will not result in a true and fair view – see sections 226(5) and 227(6) of the *Companies Act 1989*.

What all of these strategies are about is bringing into play big powers that undermine the material for, cut through, or override claims to compliance based on the *letter* of the law, rather than on what those producing or enforcing the law see as its *spirit*. But these big powers pose their own problems.

¹⁰ Drawn from European law. See McBarnet and Whelan (1991).

Problems

A number of problems arise where big powers involve basing regulation on principles rather than on specific detailed rules. One problem is how to *sustain* principles and prevent them from being converted or reduced to rules, which can then be used once again as material for creative compliance.

Sustaining principles

This kind of reduction can happen in a number of ways. It may occur through demands for guidance on how principles will be applied in specific contexts. FRS5, the Accounting Standards Board's regulation requiring the reporting of the substance of transactions, not just their legal form, took nine years to reach the standards book, and demands for guidance produced detailed examples which, some have certainly looked to as new rules and potential material for creative compliance (McBarnet & Whelan, 1999, chapter 10). What happens in effect is that we get rules about how principles can be used.

Lobbying may result in negotiated curtailment behind the scenes of what look in the books to be big powers. After the 'new approach' in UK tax, for example, the Inland Revenue responded to lobbying and met with legal and accounting professional bodies to negotiate the parameters within which they would apply the new approach in practice.

Something similar can be found in the Australian context in the Ralph Report. Australia's big power is the General Anti-Avoidance Rule (GAAR), but the Ralph Report has sought a clear statement that 'the GAAR will not apply to the mere use in a straightforward and ordinary manner of structural features of the law to best advantage'. A 'statement of policy should confirm the circumstances in which the GAAR could be applied and reduce the perception that valid business practices could unintentionally be subject to the application of the GAAR.' It has recommended that there should be a board to review the application of the General Anti-Avoidance Rule, including rulings on whether or not a practice is caught by the rule. It has argued the need for producing clarity without mapping the minefield (Ralph Report, 1999, pp. 241–244). This

unfortunately is not a solution but a restatement of the problem – just *how* to produce the clarity requested without mapping the minefield. There is a real danger that in pursuit of ‘clarity’, the big power of the General Anti-Avoidance Rule may be limited to narrower parameters, and reduced to rules, undermining its capacity to override rule-based avoidance.

This narrowing can also be produced through the courts, not just through the enforcement agency losing but through the process of decisions, whoever wins or loses, being made, reasoning being set out, and new material being provided for those bent on creative compliance to exploit.

In the context of the new approach to tax avoidance in the UK, new ‘rules’, and therefore material for creative compliance, were found by scrutinising the arguments used by the judges, even in the *Ramsay* case, which introduced the anti-avoidance principle of looking through form to substance.

The *Ramsay* case comprised a circle of ‘self-cancelling’ transactions used to create an artificial loss, not unlike the recent Australian ‘investment schemes’,¹¹ though more complex. The transactions required two companies and a subsidiary controlled by the taxpayer, two companies controlled by the scheme promoters (the Rossminster group). It involved two loans, one share issue, the exercise of options on interest levels (the interest rate on one loan was changed from 11% to 22%, on the other from 11% to zero), the sale of the 22% loan to a company controlled by the scheme promoter, which then sold the loan to the subsidiary of taxpayer company B, two liquidations, loan repayments, and exchange of shares for loanstock in another promoter-controlled company. Yet it was, as the judges observed, ‘all over by lunch’. What is more, these multiple deals had ‘no business purpose’. These observations were seized upon and steps taken in subsequent tax avoidance schemes to factor in a business purpose (with ‘careful minuting’, as one interviewee put it, to record it) to build in gaps and contingencies, and to change the timescale.

¹¹ Interviews, and as referred to in the Senate economics committee inquiry and surrounding publicity, *Australian Financial Review*, 9 November 2000.

Even without resort to courts, precedents build up. In the context of rulings on the application of the Australian General Anti-Avoidance Rule, it has been observed that ‘an important body of case law is building up’ (Clayton Utz, 1999). Rulings or clearances may be sought informally whether there is a statutory right to them or not, and interviews with UK tax officials and accountants indicated frequent requests to the Technical Office of the Inland Revenue for informal advice on ‘hypothetical’ or ‘no-names’ transactions. Tax officials had an ambivalent attitude to such requests, preferring to avoid rulings on such a basis but finding the requests a valuable source of information on the latest creative thinking. Potential new material for creative compliance is also produced every time there is a decision on the part of the agency on how a principle should apply to a specific situation. Even a simple failure to challenge a practice can be treated as endorsement by default, and built upon.

Application

Big powers are only as big as their application, and application may in practice be curtailed by a range of factors. These can be illustrated by looking at the record of enforcement in the new UK accounting regime.¹² The body responsible for enforcement is the Financial Reporting Review Panel, which came into being in 1991, armed with the extensive new powers listed above – *and* with a big stick sanction in the background in the judicial power to make directors *personally* liable for all the costs of revising and reissuing accounts which were successfully challenged by the panel, along with legal costs. The panel announced that it would use the true and fair super-principle to stop creative compliance:

‘Where we are firmly of the view that accounts are not true and fair, we will not be deterred from taking action by the fact that there is room for forensic argument as to technical compliance with the particular FRS [accounting standard]’ (Financial Reporting Council, 1992, p. 24).

In other words the panel would use the true and fair principle to override what it saw as creative compliance.

¹² This section draws on analysis based on joint research with C Whelan (McBarnet & Whelan, 1999).

But to date this power has *never* been used for this purpose. Rather, the panel has monitored those situations where *companies* have invoked the true and fair principle to override compliance with specific rules. Indeed, it has tended to require companies to adhere to the rules even where there is strong opinion that following the rules does not produce true and fair accounts. In doing so the panel may indeed be damaging its big powers. It may be setting a precedent that following the rules is more important than following the principle of a potentially clashing true and fair view.

The big power of FRS5, requiring companies to report substance not just legal form, has been used only once against a small company. No directors have had to face personal liability costs, because no cases have gone to court.

It could be argued, of course, that all this tells us is that creative compliance has died off in the face of the new regime. But there are still many instances of practices that others see as ‘bullish’, or ‘sailing close to the wind’ (for examples see McBarnet & Whelan, 1999; Griffiths, 1995), and there is some danger that by not addressing them the panel is in fact legitimising them.

Why then has the panel been so circumspect in its use of its big powers? For, although the panel has big powers in the books, our interpretation of what was happening was that a kind of ‘self-regulation’ was taking place, in the sense that the enforcers themselves were limiting their invocation of the powers at their disposal. Indeed, reflecting on the position of the panel, or any agency in the same position – the Tax Office with its General Anti-Avoidance Rule, for example – the fact is that putting big powers into practice is not as straightforward as it might seem. Indeed, there are risks in using big powers which can foster caution.

There is a risk of ‘winning but losing’ in court with decisions and reasoning used in unforeseen but very damaging ways. In the accounting context, the *Argyll* case in 1981¹³ involved successful prosecution of company directors for including in their group accounts a company they had not yet fully acquired, although, they argued, they effectively controlled it, it was in substance a subsidiary, and including it would result

¹³ Unreported magistrates’ court case, but very influential. Reported unofficially in Ashton (1986).

in true and fair accounts. The Department of Trade followed the case with a statement, underlining the message that specific definitions in the law had to be strictly adhered to. The unintended consequence was the highly damaging device of the orphan subsidiary, with the case and the statement pointed to as a powerful basis for arguing not only that the practice was not illegal, but that directors had no legal alternative but to keep a company that did not meet the specific definitions of a subsidiary out of their group accounts.

More generally, going to court means losing control to the judges who may, whether in ways favourable to the enforcement agency or not, come up with approaches with complex implications for other instances. And of course there is a risk of losing, not only opening the floodgates to copycat cases of the same type, but encouraging avoidance more generally. ‘A daft judge can kill a standard’, as one of our UK accounting regulators put it (McBarnet & Whelan, 1999, p. 88). The Tax Office has had experience of this in the past in terms of judicial treatment of the General Anti-Avoidance Rule. After the new approach cases in UK tax, the Inland Revenue required tax inspectors not to invoke the *Ramsay* ruling without getting central clearance to do so. Inland Revenue did not want taxpayers challenging them in court on the reach of the new doctrine in the context of just any case; the new doctrine of ‘substance over form’ was too important not to keep it carefully controlled.

Small wonder then if the pragmatic approach is to avoid confrontation in court. Indeed, big powers may be stronger for not testing them in court. The (until recently) chairman of the Accounting Standards Board, David Tweedie, observed of the new principle-based regime:

‘We’re like a cross-eyed javelin thrower competing at the Olympic Games: we may not win but we’ll keep the crowd on the edge of its seats.’¹⁴

He was reflecting on the (continuing) uncertainty surrounding how effective the new regime can really be. But the comment also captures the *power* of uncertainty. Uncertainty over where the regulatory javelin will fall – both because the regime is new

¹⁴ Hence the ‘cross-eyed javelin thrower’ of our book.

and because it is based on principles – may make for greater caution among the regulated in embarking in creative compliance.

From the perspective of the regulators we can use another metaphor, and think of the benefits of the ‘Oz factor’ – ‘Oz’ not as in a pommie’s Australia, but as in the Wonderful Wizard. The power of the Wizard of Oz lay in projecting big powers without exposing the mere mortal behind the image. For enforcement agencies, the image of big powers, never used, may be more effective in securing control than actually using them and taking the risk that they may be revealed as less powerful in practice than the image suggests.

This becomes in fact, an argument for the compliance strategy of enforcement, albeit on a very different grounding from that propounded by the Tax Office. But that has its dangers too, since a big power never used can soon lose its deterrent effect, and the failure to invoke big powers, may be taken as tacit admission that there are doubts on their reach.

There are other restraints on the use of big powers: concerns over the possibility of compensation demands if, for example, the agency loses a case and a regulated company attributes to it damage to reputation and loss of share value. Since, as the Tax Office explicitly acknowledges, there is always room for ‘disagreements or different views on the law and compliance’ (ATO, 2000a, p. 6), this is always a possibility – the more so where the practical application of broad untested principles is concerned.

There can also be a real concern that the powers are just too big. The then chairman of the Financial Reporting Review Panel, which actually enforces the new regime in accounting, described the powers available to the panel as ‘draconian’. If the big powers were little used for cutting through creative compliance, it reflected a concern on the part of the enforcement body itself, that, for example, the ‘true and fair’ principle is too ‘blunt’ an instrument, and indeed that it should not be used to counter something ‘which Parliament, rightly or wrongly, wrote in’ (McBarnet & Whelan, 1999, p. 226). An agency dealing with such powers may see itself as structurally vulnerable to judicial review, or these days in the UK, litigation under the Human Rights Act.

A regime based on big powers is always vulnerable to lobbying on the basis of a rule of law critique. Big power regulation – based on principles, on a capacity to override literal compliance with specific rules by invoking broader purposes, or on a general anti-avoidance rule – can readily be presented as too uncertain, as involving retrospectivity, as giving regulators too much power, or as opening the way to arbitrary decision-making. All of these points were made in the wake of the UK’s new approach to tax avoidance, notably in a booklet published by a joint committee of solicitors and accounting professional bodies, the Special Committee of Tax Law Consultancy Bodies 1998.

The Ralph Committee’s concern about uncertainty in the reach of the Australian General Anti-Avoidance Rule, has already been noted. The committee’s general terms of reference included assessment of how far current arrangements ‘meet the aims of’, among other things, ‘certainty of taxation treatment’ and ‘clarity of law’ (Ralph Report, 1999, overview p. vi). The Tax Office has also experienced direct criticism of its recent attack on artificial investment schemes (for examples see McBarnet & Whelan, 1999; Griffiths, 1995) on the basis of retrospectivity.¹⁵ The Accounting Standards Board’s FRS5 took nine years and four drafts because of vociferous criticisms that the principled approach was too vague, too uncertain, and too impractical.¹⁶ The big power response to creative compliance can only too readily be presented as ‘creative control’ (McBarnet & Whelan, 1999, p. 272).

Small wonder that enforcement bodies are inclined to be circumspect with big powers. It is precisely because they are regulating or ‘taxing democracy’ with all its inherent tensions between due process and effective control.

¹⁵ Interviews at the Tax Office.

¹⁶ See McBarnet & Whelan (1991) for a deeper analysis of ‘the discourse of resistance’ in relation to both tax and accounting regulation changes.

Attitude

Finally, big powers, far from destroying creative compliance, may still fall prey to it. Even big powers can be treated as ‘material to work on’. We have already seen how the judicial reasoning in the UK’s new approach tax cases was mined for ‘rules’ which could be used to argue new tax avoidance schemes lay beyond the reach of the new approach.

Regulations, even regulations geared to principles or anti-avoidance doctrines, have to be expressed in words, and even the words expressing the big powers to curb creative compliance can be subjected to the creative and advantageous interpretation on which creative compliance is based.

Consider the orphan subsidiary. We saw earlier how it was based on careful scrutiny of and adaptation to very specific definitions in company law. We also saw how the law was changed. Definitions of a subsidiary under new legislation included the ‘catchall’ requirement to include an ‘entity’ in group accounts if the parent company had ‘a participating interest’ in it (a far cry from ‘more than half the equity capital’) and ‘actually exercised control’ over it (much wider than ‘controlled the composition of the board of directors’). Legislators set out definitions of a broader, more abstract nature, and refused to define them further, precisely (and they were quite explicit about this) in order to stop feeding creative compliance.

Yet creative compliance continued. Even big powers have exemptions and exceptions – ‘ex-file’ clauses – which were sought out and used. But more significantly still, the words in the catchall definition were themselves scrutinised and responded to with the ‘deadlocked joint venture’. This involved two companies forming a 50-50 joint venture in which, it was claimed, neither ‘actually exercised control’, so that it remained off the accounts of both.

The power to override compliance with specific rules in order to require compliance with the overarching principle of producing true and fair accounts has itself been scrutinised and resisted on the basis that it is complied with if companies give the ‘true and fair’ version of their accounts in the *notes* but leave the *numbers*, in the same

accounts, based on literal compliance with specific rules – *even though* it is accepted that compliance at this level does not give a true and fair view.¹⁷ The numbers of course, are more important than the notes, not only because the significance of the notes may be lost on the less expert reader, but because the numbers are what are used in calculating market ratios such as leverage or gearing. These ratios, in turn, are what are used by analysts in assessing share value, by banks in lending covenants to stop excessive additional borrowing by management, or which, when they reach a certain level, oblige management to consult shareholders. The numbers are, in other words, the basis of legal controls on a number of fronts.

In short, even big powers designed to counter creative compliance may themselves be vulnerable to it if they meet with the same attitude to the law – an attitude that treats the law as merely a material to work on. It is not only how big powers are applied that determines their impact, but how they are received.

A change of attitude

Creative compliance, I suggested earlier, is the product of two factors: the nature of the law and the attitude taken to it. The application of the law *is* problematic, given to grey areas and alternative interpretations. But the problem posed by creative compliance depends on those on the receiving end of the law actively working on and taking advantage of those intrinsic problems. The enhanced uncertainty associated with principles and general anti-avoidance rules is a genuine concern. Yet the resort to such measures is itself a response to active abuse of more specific rules. The drift of principles to rules I have designated a ‘problem’, but it would not be a problem if those rules were not likely to be actively seized on and used to escape legal control, and if there were not a culture which treated the law as fair game for such activity.

What this suggests is that changes in the law, however sweeping, are unlikely, alone, to eliminate creative compliance and the problems it poses for law and enforcement. The second factor, the attitude to the law, needs to change too.

¹⁷ There was a controversial debate over this in the 1980s between accountants David Tweedie and James Kellas on the one hand, and Ralph Aldwinckle of the Law Society, on the other. Even after a change of statutory wording, the debate continues. See McBarnet and Whelan (1999, chapter 15) for a detailed analysis.

The Tax Office, and the ATO compliance model of law enforcement itself, recognise the need to foster a cooperative taxpaying culture, and indeed recognise that it is not just the law that has to change, but attitude:

‘Changing attitudes to our tax system is the remaining element that can give a major impetus to achieving a genuine new tax system in its fullest sense’ (ATO, 1999, p.xiii).

The Tax Office is currently working to counter non-compliance by fostering an image of tax as a positive contribution, not as a negative imposition. It seeks to relate tax payment to the provision of public services:

‘Our tax system is important to our community. It is about education, health treatment, support for those in need and roads and other community assets’ (ATO, 2000b, p. 8; ATO, 2000c).

The Tax Office, in effect, is appealing for tax compliance as a mark of responsible citizenship. The UK’s Inland Revenue has announced a similar approach. It will be promoting the payment of tax as a ‘badge of good citizenship’, ‘explicitly linked to public goods.’¹⁸

But this paper, and the larger bodies of work on which it draws, indicates that tackling the attitude to non-compliance, appealing for compliance, is not enough. Whether compliance is enough depends on *how* people are complying. Compliance can itself be a creative construct, and a mark of resistance to tax policy, not cooperation with it. In aiming to construct a culture of compliance, then, the aim must be not just a culture of compliance as opposed to *non*-compliance, but a culture of compliance with the *spirit* of the law, rather than creative compliance with its letter.

¹⁸ *Financial Times* weekend 20–21 January, 2001, quoting Nick Montagu, chairman of the Inland Revenue, who also argued that a similar approach had ‘worked in the Netherlands’.

Creative compliance is not just a tax problem but a law problem. The Tax Office is working to change the general attitude towards *tax*. But if a change of attitude is required, it is not just in the attitude to tax, but in the attitude taken to the law, policy and compliance. This is true not just for taxpayers, but for their professional advisers – the lawyers and accountants whose creative work lies at the heart of creative compliance. What needs to be fostered is a change of attitude to the law, in which it is seen not as a game of words, a material to be worked on to one's own or one's client's advantage, but as an instrument of legitimate policy to be *respected*, with the policy, not just the words, looked to as the measure of compliance. That, I know, is itself problematic in many ways. But without some shift in that direction, the concern must be that compliance will remain not a solution but a problem for tax policy and tax enforcement, and, indeed, for legal policy and legal control in general.

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