

TAX AVOIDANCE, TAX EVASION & TAX MITIGATION

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The purpose of this short paper is to initiate a debate which (it is hoped) will spread and will reach - amongst others – to international bodies and governments. The fundamental thesis behind this paper is that key terms like “tax avoidance”, “tax evasion” and “tax mitigation” - which are some of the most important basic building blocks for discourse about domestic and international taxation - are not sufficiently clearly understood or defined, and that is wrong. We need to have these terms better understood and clearly defined, particularly at governmental and inter-governmental levels¹.

Increasingly these terms are appearing on the agenda of governments and inter-governmental agencies, but without any precise explanation of their meaning. The OECD’s attack on “harmful tax competition” is aimed at certain forms of tax avoidance or evasion². Aspects of the EU “tax package” – particularly the draft directive on savings income - are also aimed at cutting back on the opportunities for tax evasion. The underlying problem is seen to be the resident of one Member State who evades tax by depositing funds in a bank in another Member State where the interest is not taxed. Most recently, the ECOFIN Council has established an Ad Hoc Working Group on Tax Fraud³. To what extent are the concepts used in these initiatives clear or understood by those who launch them?

¹ One of the more recent attempts to define tax avoidance is the paper by the UK Tax Law Review Committee (IFS, London, 1997). Though the author does not agree with parts of the report, it is an excellent contribution to

The timing of the debate

A debate on the meaning of these concepts is timely for a number of reasons.

First, a very simple reason: taxpayers in all countries are entitled to know their legal position⁴. They are entitled to know what will be regarded as fraud, what will be regarded as avoidance, and what is acceptable mitigation. This is particularly true in the world of self-assessment where getting it wrong may be backed up by significant penalties or even by the criminal law.

There is a particular dimension to this in the application of constitutional guarantees or human rights conventions to taxation. Taxation is generally an interference with the right to enjoy property but that interference can be justified if it is in accordance with the law. But in order for it to be in accordance with the law, the law has to be clear and precise so that the taxpayer can know what they can do by way of legitimate mitigation and what would be regarded as abusive avoidance.

A second reason why these concepts need to be clarified is the growing view among governments that money laundering legislation should apply to fiscal offences, including foreign fiscal offences. If a professional advisor or a banker is to decide whether or not a potential client may have committed a foreign fiscal offence then they are entitled to require that governments state clearly what they

the debate.

² See *Harmful Tax Competition – An Emerging Global Issue* (OECD, Paris, 1998).

³ See conclusions of the ECOFIN Council of 31st May 2000.

⁴ See Ian Barlow, “Tax planning needs clarity”, *The Times*, September 9, 1999.

regard as being tax evasion or tax fraud. Only if there is a clear international understanding about tax fraud can one really accept that foreign fiscal offences should come within money laundering.

Finally - and this is the particularly worrying aspect - increasingly politicians and government officials (and this includes international bodies like the OECD) are confusing these concepts, particularly confusing avoidance and evasion. They are introducing provisions saying that they are countering “evasion” whereas really what they are really concerned with is actually avoidance⁵.

For all of these reasons the time seems right to initiate a debate on these concepts. The aim of the debate is to try to get international acceptance of bright line distinctions between the different concepts.

In the sections that follow an attempt is made to suggest some points which might be adopted in developing internationally recognised definitions of these terms.

Self-evident truths

I take these truths to be self-evident. First, any system of taxation will require taxpayers to supply a great deal of information to government. It is hard to think of any other area of law or administration that so depends upon information flowing to government authorities from the general public. Taxation will always rely upon a great deal of voluntary compliance and honesty, backed up by tax

⁵ Quite a good example is the Inland Revenue Press Release of 20th March 2000 on New Information Tax

investigation. In those circumstances the criminal law clearly has a role to play where there is a lack of honesty.

While the criminal law has a role, there is also a role for administrative sanctions – fines for non-compliance or negligent compliance. Tax law is likely, therefore, to have a criminal aspect and also an aspect which is not criminal but which is covered by administrative penalties.

There is then a second truth which is not necessarily accepted by all governments. Tax is a cost. That classic, 20th Century concept - the *homo economicus* - will always act to reduce costs. Tax goes straight to the bottom line and it is entirely rational behaviour to take all lawful and advisable steps to reduce that cost. This is particularly true, for example, for the managers of widely-owned public companies, one of whose duties is to act to reduce the costs in the company for the benefit of the shareholders.

There is an interesting example of this recently in a US tax case concerning Compaq Computers - subtitled “the ADR case”⁶. Compaq had realised a substantial capital gain. The managers were presented a capital gains tax saving scheme involving the purchase and resale of Royal Dutch ADRs, purchase *cum div*, sale *ex div*, a capital loss resulting but hopefully, because of the US-Netherlands tax treaty, no ultimate economic cost. Compaq bought into the scheme, but the US Tax Court struck it down on the grounds of a lack of business purpose (imposing, incidentally, substantial penalties on Compaq).

Agreements which uses the terms avoidance and evasion almost interchangeably.

⁶ United States Tax Court, 21 September 1999.

What is particularly intriguing about that case is to put oneself in the position of the Compaq managers to whom the presentation was made. Were they right to go ahead with this scheme which could have saved their shareholders many millions of dollars in capital gains taxation or should they have rejected that scheme out of hand? Perhaps we could all agree that they should have been able to tell at the outset whether the scheme failed as an exercise in tax avoidance or was a genuine form of tax mitigation.

That brings one to what seems still to be an open question. Are there any moral limits to the steps which one may take to reduce tax? (Moral limits as opposed to legal limits: there clearly are legal limits to the steps you may take). We are, after all, all of us taxpayers. We all benefit from well-funded government, so are there limits to what is legitimate tax mitigation in the moral sense? Again, a debate would be helpful to try to elucidate the moral limits, if any.

That leads to the last self-evident point. In many cases aggressive tax planning is self-defeating. The costs in dealing with an investigation, dealing with litigation, the emotional costs to the taxpayer concerned - particularly an individual taxpayer - may well outweigh the advantages of the tax planning. This is an issue partly for tax advisors, but also for the definitions of tax avoidance and tax mitigation.

The spectrum of conduct

Armed with these self-evident truths, it is helpful to approach this issue by considering a spectrum of conduct.

At the one end of the spectrum is the tax-disinterested taxpayer. The taxpayer who, through lack of inclination or lack of opportunity, takes no steps at all to mitigate or reduce his or her tax liability. This taxpayer represents no real issue, save that when considering the moral dimension there is a sense of discrimination against the salaried employee who has no scope for mitigating tax and in favour of the wealthy individual who can afford expensive advice to reduce his bill. On one view tax advisors destroy the planned progressivity in the tax system.

At the other extreme to the tax disinterested person lies the criminal dimension - tax fraud. Steps to reduce tax which overstep the mark and enter into the field of criminal law.

Between these two points on the spectrum are the key areas of tax mitigation and tax avoidance, and the most important point is to understand the borderlines between tax mitigation and tax avoidance on the one hand, and between tax avoidance and tax fraud on the other.

It has sometimes been said that the distinction between tax avoidance and tax fraud is as thin as the width of the prison walls. That is not good enough any longer. Everyone is entitled - particularly on this point - to a bright line distinction between what is and what is not criminal.

Tax fraud

It may be useful to start with some comments on tax fraud.

As part of this debate it might be helpful if there was a move away from the use of the term “tax avoidance” and towards using the term “tax fraud”. There are a number of reasons for this. First, all too easily evasion and avoidance are confused with one another; there is far less danger of a confusion between fraud and avoidance. There is a particular problem with the French terminology. In French, *evasion fiscale*, it is understood, means “avoidance” so there is a difficulty in discussing this concept if one uses evasion because it means avoidance in French. Finally, the term “tax fraud” is preferable because it emphasises that in the criminal area one is dealing with fraudulent conduct and there is much less danger of governments thinking that avoidance could be criminal.

Tax fraud – as a criminal matter - must involve intentional behaviour or actual knowledge of the wrongdoing. In some countries that is not necessarily the case. There should be an internationally accepted approach. Tax fraud must involve intentional behaviour or actual knowledge. The classic situations will be deliberately failing to put an item into a tax return or deliberately claiming a deduction to which a person knows he is not entitled. Also, deliberate omissions could be fraud, even where there is no duty to supply the information to the revenue authority⁷. Where a person knows that the revenue inspector has misunderstood the position, to fail to clarify the matter may be regarded as fraudulent.

Beyond deliberately leaving items out of a return or deliberately claiming deductions to which a person is not entitled, there is scope for debate as to what other activities come within the scope of fraud. To take an example: suppose that

⁷ This was one of the issues in the recent case of *R. v. Dimsey and Allen* in the UK Court of Appeal.

a taxpayer transfers assets to an overseas trust. An element behind the transfer is that he knows that if he is liable to tax he will be able to show that he cannot pay the tax because the assets are in the trust. He knows, therefore, that he is likely to be able to negotiate a deal to settle the matter with the revenue authorities. Is an action like that tax fraud or not? Aiming at a “good” settlement - paying less tax than one might otherwise pay. This may be open for discussion but one simple test is to ask this: if these acts would have been fraudulent when committed with regard to a non-governmental victim, then they should equally be fraudulent and criminal when applied with regard to a government.

Tax fraud must surely involve a degree of knowledge; in particular, it must involve the absence of an honest belief that a person is not liable to the particular tax. If a taxpayer cannot show that he has an honest belief that he is not liable to the tax, that seems *prima facie* to fall within the scope of tax fraud.

Tax fraud should not extend to negligent conduct and - though this is perhaps debatable - it should not include reckless conduct (e.g. submitting a tax return with reckless disregard for the accurate position). That may be a matter dealt with by administrative fines, but should not be regarded as tax fraud. That is, perhaps, where the bright line should be drawn.

In some countries there are different degrees of tax fraud. In Switzerland, for example, there is a distinction between tax evasion and tax fraud. It is doubtful if these distinctions are very helpful. A State may want to have different levels of penalty dependent upon the degree of culpability, but simplicity suggests that the

essence should be a single offence of tax fraud and that offence should be statutory.

For those countries - like the UK - where we still have the offence of defrauding the Revenue as a common law offence based upon court decisions, this is no longer acceptable. Taxpayers are entitled to a clear, statutory definition of what is regarded as criminal conduct.

Tax mitigation

Moving from the concept of tax fraud – and jumping for a moment over tax avoidance – one comes to tax mitigation. The concept of tax mitigation has been recognised for some time. There is an encapsulation of it here in a Privy Council decision from New Zealand, *Challenge Corporation*. Lord Templeman said:

“The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax. In the oft-quoted words of Lord Tompkin, ‘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’”.

A more precise explanation - and this comes from the *Willoughby* case in the House of Lords:

“The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.”

Some comments on these statements about tax mitigation.

First, in this area it is far from clear that references to the intention of Parliament are at all helpful. It is not helpful to say that it is mitigation if you are within what Parliament intended but avoidance if you are outside of what Parliament intended. This involves difficult issues of what was the intention of Parliament when it enacted legislation possibly years ago. This also gives much too narrow a concept of tax mitigation.

There is the very obvious case where Parliament enacts a specific tax-exempt investment option - in the UK, ISAs for example. Those are very clearly tax exemptions created by Parliament. But it is trite to say that taking out an ISA is tax mitigation. Tax mitigation goes beyond that, and it is not helpful to seek the boundaries of mitigation by reference to the intention of Parliament. The really difficult issue is establishing the boundary between mitigation and avoidance, and looking at Parliamentary intention is not helpful for that.

One point which should be entirely clear is that merely taking tax into account in deciding whether or not to go ahead with a transaction or structuring a transaction should not be avoidance; that should still come within the category of mitigation. It goes back to *homo economicus*; taking account of tax does not automatically mean that one is involved in avoidance.

This brings one to “the choice doctrine” which is recognised in a number of countries. There is a good summary of it in the case of *Brebner v. IRC*.

“When the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out: one paying the maximum amount of tax, the other paying no or much less tax. It would be quite wrong as a necessary consequence to draw the inference that in adopting the

latter course one of the main objects is, for the purposes of the section, the avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved.”

That, one might say, is part of a choice doctrine and seems, again, a self-evident truth. Choosing between two alternatives - if one is carrying out a commercial or a family or an investment transaction, choosing the most tax-efficient - is not avoidance.

In this context there is an interesting recent example from Canada in the *Shell Canada* case⁸. Shell Canada had the need to borrow US\$100m. Rather than borrowing US dollars they took out a Kiwi loan. They borrowed New Zealand dollars, switched them into US dollars and then, when they had to repay the loan, switched it back. At the time, the New Zealand rate of interest was almost twice that on US dollars so they claimed almost twice as much interest deduction. When they switched back the currency, they made a capital gain because the New Zealand dollar had been deflating during the period of the loan. But the gain was not fully taxed. A classic situation of two ways of carrying out a commercial transaction, one of them more tax efficient. The Supreme Court of Canada, overruling the Federal Court, said that was not avoidance. That seems to be quite fundamental: choice doctrines should be regarded as indicating mitigation and not avoidance. What is disappointing is that Shell Canada had take their case to the Supreme Court of Canada to find out that choosing the more tax efficient was not tax avoidance (not to mention the potentially penalties one assumes they might have faced had the decision been to the contrary).

Tax avoidance

The situation is simplified if one takes the view advocated here that between the tax-indifferent on the one hand and tax fraud on the other there are only two categories of behaviour: tax avoidance and tax mitigation. Tax avoidance comes between tax mitigation and tax fraud. Anything that is not tax avoidance should be regarded as tax mitigation.

Logically one can then define tax avoidance by demarcating the boundaries of tax fraud and tax mitigation. Alternatively, one can define tax mitigation by defining the limits of tax avoidance. It seems more straight-forward to proceed by defining tax avoidance. Everything that is not criminal and is not avoidance is then tax mitigation.

Many statutory provisions use a purpose test to define tax avoidance. They say that it is avoidance if your dominant purpose - or your sole purpose - was to reduce or eliminate tax liability. That involves difficult issues of the intentions of a person and the weight given to different intentions. Purpose tests are not helpful. It is more helpful to identify tax avoidance by recognising a number of sub-categories of avoidance; if you have identified these sub-categories, all else should be regarded as mitigation.

One suggestion is that there are three categories of tax avoidance which provide an exhaustive definition.

First, “countered tax avoidance”. Where particular schemes have been countered by either specific or general legislation then it seems quite clear that the law now provides that those transactions constitute tax avoidance. To carry out

⁸ Supreme Court of Canada, 15 October 1999.

those transactions can no longer be regarded as mitigation. This is obvious, particularly with specific countering legislation but also with regard to general anti-avoidance provisions⁹ or court-based doctrines. Where a scheme has been countered and will no longer work, then even if it is not criminal, it is avoidance.

Beyond that, there is much to be said for the concept of “abusive tax avoidance”, sometimes referred to as “taking an abusive position”. This derives in part from legislation in New Zealand in 1995 which introduced the concept of abusive tax avoidance¹⁰. Where a taxpayer enters into an arrangement which is not criminal, but the taxpayer has an inadequate belief that the arrangement is effective, then that is abusive. Having an inadequate belief that one has no liability to tax is avoidance and is abusive. The New Zealand legislation talks about “taking an abusive tax position” which is a position where the taxpayer does not have a reasonably arguable position that there is no tax due. A reasonably arguable position is defined as a position where the taxpayer is more likely to be correct than not. If one enters into an arrangement where one cannot say that he is more likely to be correct than the revenue authority, that could be termed abusive tax avoidance and is no longer in the category of tax mitigation. The way the New Zealand authorities have approached the matter through the concept of abusive tax avoidance has much to commend it.

⁹ General anti-avoidance rules – or GAARs – create some of the greatest difficulties for drawing a bright line between avoidance and mitigation. In fact, revenue authorities may even encourage this lack of clarity to deter taxpayers from sailing too close to the wind. In theory GAARs should be clear and capable of precise application. In practice, they have nearly always led to a spate of legislation in the country concerned which has done little to make the law clear. For that reason they are nearly always accompanied by an advance ruling system to give the taxpayer the certainty which he is entitled to demand from all law.

¹⁰ On this see Adrian Sawyer, “Blurring the Distinction between Avoidance and Evasion – the Abusive Tax Position” [1996] *British Tax Review* 483-504.

To this one might add a third category: “ill-advised tax avoidance”. This encompasses schemes which technically work, but when one looks at the costs, the risks, the emotional costs, they are ill-advised and they are no longer within the category of tax mitigation.

All of this leads to a fairly simple approach. If one can identify tax avoidance which has been countered or which is abusive or which is ill-advised, all else can be regarded as tax mitigation, and should not be regarded as in any way subject to any counter-action by governments.

Conclusions

There is a real and pressing need for a debate on the precise meaning of key terms such as “tax avoidance”, “tax evasion” and “tax mitigation”. The purpose of this short article has been to suggest a possible – and, hopefully, relatively simple - approach to these terms based upon a spectrum of conduct and boundaries to be drawn between tax fraud, tax avoidance and tax mitigation.

It seems perfectly reasonable, if these concepts are to remain on the international agenda (which seems likely), that the bodies which use them should take steps towards developing internationally accepted definitions of the concepts. Given the amount of other work on taxation in which the OECD is engaged, perhaps that body is best placed to work towards internationally accepted and clear definitions of these concepts based upon bright line distinctions. It seems quite reasonable to expect the OECD to clarify these terms before it proceeds further with initiatives such as that on harmful tax competition.