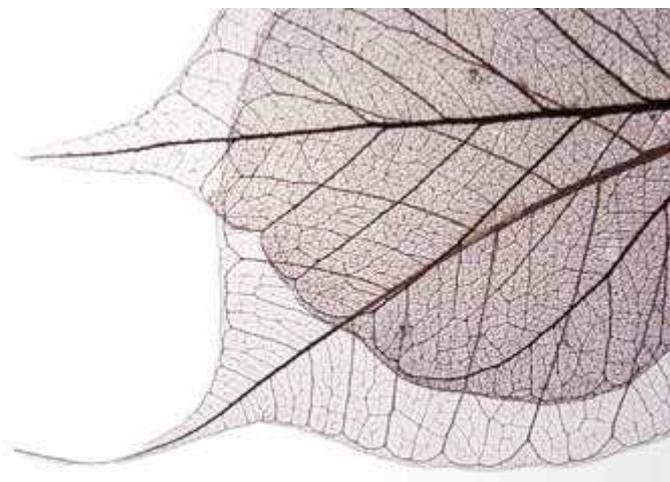


# TAX TRANSPARENCY: A BLURRED LINE IN THE SAND - AVOIDANCE



## Introduction

1. The Tax Gap is a way for HMRC to measure the difference between actual and anticipated tax revenues<sup>1</sup>. Part of the gap is down to non-compliance of various forms, including avoidance. There are a number of economic and policy reasons to care about non-compliance. It reduces the planned tax yield, potentially harming public services, and redistributes the tax burden on an ad hoc basis. Since not all taxpayers avoid or evade tax, it is both unfair and can undermine incentives that the Government intends to provide through the tax system. It can waste public and private resources, through capacity devoted to devising and, in Government, countering, avoidance/evasion schemes rather than creating wealth.

2. Fair competition is harmed by the distortions created via sophisticated legal and accounting techniques, making use of mismatches in taxing provisions across countries. Similarly, corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, can have difficulties competing with international businesses that have the ability to shift their revenues across borders to avoid or reduce tax.

3. HMRC's 2011/12 Tax Gap analysis identifies a number of areas of non-compliance<sup>2</sup>:

<b>Criminal attacks</b>	£4.7bn	13%
<b>Hidden economy</b>	£5.4bn	15%
<b>Evasion</b>	£5.1bn	15%
<b>Avoidance</b>	£4.0bn	11%
<b>Legal interpretation</b>	£4.3bn	12%
<b>Non-payment</b>	£4.4bn	12%
<b>Failure to take reasonable care</b>	£4.3bn	12%
<b>Error</b>	£2.9bn	8%

<sup>1</sup> See our separate paper on the UK Tax Gap.

<sup>2</sup> [www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf](http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf)

4. This short paper examines avoidance, one of the most contentious areas of non-compliance. It tries to give some of the main contentions, discuss how it matters for tax administrations and the public, and how it differs from evasion. It briefly discusses some of the possible remedies and the complexity of any solutions. The authors hope it removes some of the misunderstandings that have emerged and gives people who read it the chance to make up their own mind. It is written by a Trade Union from inside HMRC and was accepted by a diverse group of organisations and people involved in this public discussion.

## Tax and avoidance

5. Most people pay tax under PAYE and never even see the money that is paid over to HMRC. But for business, and people with more complex tax affairs, life is not so simple. There are accountancy principles and rules that convert a business's economic activity into accounts. This is done independently of HMRC and serves a number of purposes, e.g. to show the business if there is a profit or loss, often to show a lender if the business is making money and worth lending to, or to allow accounts for companies to be prepared for Companies House. Some businesses are also subject to an audit to make sure the numbers and rules have been applied correctly.

6. There is then an additional set of principles and rules applied that turns those accounts into ones that show the taxable profits. Generally, accountancy rules OK. But sometimes the law or the Courts may KO the accountancy! There can be special tax laws, or Court cases, that for tax purposes change the commercial accounts. These can increase or decrease the taxable profits; some allowances may apply to one size of company or type of activity but not another; others are time-limited; some can be in terms of percentages and others in terms of money. So it is probably true to say that calculating a taxable profit, or the tax bill, is not an exact science.

7. Taxation in most, probably all, countries arises through the operation of specific legislation and legal requirements. It is not a series of voluntary payments. Governments make choices on tax that set out what is to be taxed and the conditions under which this operates, such as rates or types of economic activity.

8. When making choices Governments do (or should) consider what they hope to achieve and how it reflects the political choices they believe they are mandated to make. There are some basic factors they ought to bear in mind if they want their tax policies to achieve the effects they intend. Adam Smith wrote several centuries ago there were four underlying principles: equality of sacrifice, certainty, convenience, and economy. This is consistent with two other ways of considering policy - Horizontal equity, which implies that we give the same treatment to people in an identical situation; Vertical Equity, that people with higher incomes should pay more tax.

9. One outcome from Government decisions is to use the tax system to influence behaviour in ways they think are desirable - e.g. taxing goods like alcohol to regulate consumption, or encourage personal saving through an ISA, R&D through R&D incentives, or tax reliefs for charities to encourage charitable work. Other examples include allowing company losses in one year to reduce profits in other tax years, so that they are only taxed on overall economic activity. Such measures reduce tax payable but using any of these is not "taking advantage" or "avoidance". There are also occasions when policies have perverse effects, e.g. the decision to charge child benefit to higher rate tax by household results in some individuals paying more tax but no so for others (i.e. no horizontal equity).

10. It is often the way these policies are devised, their accompanying rules, and the way the Courts have interpreted them, which lead to avoidance or attempted avoidance. This can increasingly involve other legislation, such as that set out by the EU, for example on the Single Market and the difficulty treating EU businesses differently from domestic businesses.

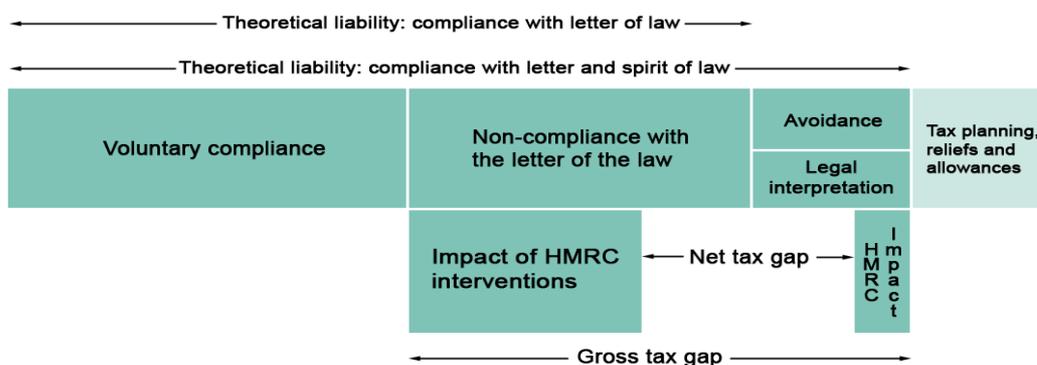
## Are there different kinds of ‘avoidance’?

11. It might be easier to say what avoidance is not, rather than try to say what it is. The debate on this subject is intense. It ranges from the claim that if not illegal then anything is permitted, that there is some boundary beyond which legitimate “tax planning” turns into unacceptable “artificial avoidance”, “aggressive avoidance”, or “abusive avoidance”, and even that avoidance and evasion demonstrate the same type of behaviours. Instead of “I brief, you spin and they leak”, we have “I plan, you avoid and they evade”.

12. As part of this debate there are also references to morality, or ‘tax morality’. An American Supreme Court judge once asserted that tax is the price we pay for a civilised society.<sup>3</sup> Tax avoidance is often seen as a refusal to pay the right price. Critics of “schemes” point to their often complex nature as proof that they are “artificial” and thus deserve to be ignored. There can be references to “freeloading”, an accusation made against taxpayers who have consciously arranged their affairs so as to pay amounts of tax that are low or very low compared to the theoretical amounts due. Critics say these “avoiders” benefit from skilled domestic workforces, infrastructure, legal systems, to which they do not contribute in fair measure, *“Moreover, corporates that dodge their tax liabilities by utilizing tax haven jurisdictions in countries where they are not actually operating (or have tax obligations) are, in effect, ‘free riders’. They benefit from public spending in their home country, or wherever they create taxable wealth and profits, yet avoid contributing to its financing.”*<sup>4</sup> These businesses may reply they are acting legally, bring employment and create business opportunities for others.

13. Although fairness is a key part of debates on tax policies, there is no place in taxation law for any considerations of “fairness” or “equity” (i.e. the UK common law concept that the often competing rights and obligations of citizens have to be balanced). A Court does not consider if the outcome of a tax case produces a “fair” result. It looks to establish the true facts and then apply the law, as properly construed, to those facts. But there are some signs that this may be changing. The recent UK General Anti Abuse Rule specifically uses such words as “It therefore rejects the approach taken by the Courts in a number of old cases to the effect that taxpayers are free to use their ingenuity to reduce their tax bills by any lawful means.”<sup>5</sup>

14. HMRC uses the term as part of a spectrum of activity:



<sup>3</sup> Oliver Wendell Holmes (Compania General De Tabacos De Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100, dissenting; opinion (21 November 1927). [The words appear above the entrance to the IRS headquarters at 1111 Constitution Avenue.]

<sup>4</sup> See Oxfam, Business Among Friends,

<http://oxfamlibrary.openrepository.com/oxfam/bitstream/10546/316405/1/bp185-business-among-friends-corporate-tax-reform-020514-en.pdf>,

<sup>5</sup> GAAR, Advisory Guidance, April 2013, B2.1 and B2.2

15. This has aroused some criticism from people who argue that HMRC has no right to include in its definition the concept of the “spirit of the law”. But other tax professionals can see a place for the concept of the spirit of the law, even if it is hard to delineate.

16. A more academic analysis of “avoidance” divides it into:

- a. Ineffective avoidance (activity discovered and the action taken shows that legislation or treaties agreed, as construed by the courts, is effective to prevent the avoidance scheme from saving tax).
- b. Effective avoidance (defect in the legislation or other failure in the way the legislation is written that cannot be corrected by purposive interpretation).
- c. Using legislation or the international tax system to one’s advantage (domestic legislation and/or double taxation treaties together with the norms of international taxation result in taxpayers being able to take advantage of opportunities.)<sup>6</sup>

17. Other commentators (often from tax justice or campaigning groups) regard these sorts of definitions as too narrow and seek to broaden them. This can include cases where there seems to be a significant discrepancy between the statutory rate of tax and the rate a business pays, or where the commercial profits differ significantly from the taxable profits. Often this involves a business structuring itself and its activities in such a way as to produce low taxable profits in higher rate jurisdictions and high profits in lower rate jurisdictions.

### Approaches to ‘evasion’

18. It is easier to define evasion. The starting point is that ‘evasion’ is not legal. It does not involve an interpretation of the tax rules but a deliberate and conscious flouting of them<sup>7</sup>. Avoidance is not the same as the hidden economy (where what would otherwise be legitimate business activities are never disclosed to HMRC), or criminal attack (where the activities are never legitimate). But evasion can also cover business activities that are often concealed within legitimately reported activities and concealed from HMRC, either in whole or in part. (For example, cash sales may not be recorded but the purchases needed to generate the sales may be).

19. There can be “abusive” transactions where the dividing line between evasion and avoidance becomes thin. As Chancellor the Exchequer Dennis Healey is reported to have said in the 1960’s the difference between avoidance and evasion is the thickness of the prison wall<sup>8</sup>. Certain features may be common, including a failure to fully disclose positions or the existence of undisclosed additional stages in a process that may prevent a scheme from being effective. And there can be times when, to a layperson, it seems unclear why a scheme is regarded as “avoidance” and not “evasion”.

### Responses to avoidance

20. If we look back over the centuries there have been innumerable examples of people taking steps to avoid paying tax, lawfully or otherwise<sup>9</sup>. There are episodes like the attempt to tax wealth by taxing windows. One avoidance response was to simply remove the windows and brick up the space<sup>10</sup>.

21. In 1935 the House of Lords decided in favour of the Duke of Westminster in his attempt at tax avoidance. This decision has reverberated down the ages. It involved the decision by the Duke

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<sup>6</sup> [http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/TA\\_3\\_12\\_12.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/TA_3_12_12.pdf)

<sup>7</sup> There can be ‘innocent’ evasion (i.e. unintended evasion) but this paper only considers evasion where there is the intent to evade tax.

<sup>8</sup> The Thickness of a Prison Wall - When Does Tax Avoidance Become a Criminal Offence?  
[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1992652](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1992652)

<sup>9</sup> For recent UK experiences see the early chapters of R Brooks, *The Great Tax Robbery*, 2013.

<sup>10</sup> This tax lasted from 1696 to 1851, but was abolished, apparently on health grounds!

to pay staff via deeds of covenant, which gave the employer a significant cash saving. Although clearly artificial, a leading judgement set out an approach that was to last for nearly 50 years:

*“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”.*

22. One aspect of that view was not widely commented on but there are three key words, “if he can”. Increasingly tax avoidance schemes became ever more complex and reached an apogee in the 1970s. They often involved self-cancelling transactions that had no real legal effect except to change the apparent nature of a certain loss, gain or appropriation. A judicial revolution in a court case involving a Lincolnshire farmer produced a new look.

*“It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions intended to operate as such, it is the series or combination which may be regarded.”<sup>11</sup>*

23. Since then there have been a large number of important cases where the Inland Revenue (now HMRC) and the taxpayer fought it out in a wide variety of cases and involving a wide variety of schemes. Concepts such as whether a step or a transaction had no ‘commercial purpose’, or ‘commercial effect’, whether something was pre-ordained or merely likely, were and remain bones of contention. It is probably these sorts of arguments that give tax lawyers a reputation for geekiness!

24. What is less often understood is that until relatively recently there was no obligation on a taxpayer, or adviser, to tell the tax authorities that it had engaged in any avoidance scheme whatsoever. Often it took the intuition or careful examination of returns or accounts by tax inspectors for the Inland Revenue to extract the details that pointed to a less than ordinary transaction or series of transactions<sup>12</sup>. It was only through Finance Act 2004 that there was a legal obligation to notify avoidance schemes, either as a promoter or as a user.

25. Part of HMRC’s compliance response is the ability to charge penalties on tax that is “avoided” but subsequently found to be payable. The occasion and amount of a penalty depend on the circumstances of each case. Essentially the penalty varies with the behaviour and amount of tax involved. HMRC will charge a penalty if the error is:

- due to a lack of reasonable care, or
- deliberate - such as intentionally sending incorrect information, or
- deliberate and concealed - for example, intentionally sending incorrect information and taking steps to hide the error.

26. This means in practice that if a taxpayer has sought and considered professional tax (or legal) advice on a transaction or series of transactions, and disclosed the full facts in its return or claim, HMRC believes it is hard to impose a penalty. They believe it unlikely to be able to show a failure to take reasonable care, or any deliberate error, so penalties are not due. It is for this reason that many of the recent high profile “avoidance” cases are penalty free - something that many tax campaigners regard as “rewarding” avoidance. They think that HMRC needs to test these views before the Courts.

27. If we approach avoidance cases from the perspective of the possible HMRC compliance response, then the cases could be split between those which are “domestic”, i.e. within a country’s jurisdiction, and “non-domestic”, involving cross-border transactions and structures (i.e. as described in 16(c) above).

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<sup>11</sup> *WT Ramsay v. IRC* decision of the House of Lords, (1982) AC 300.

<sup>12</sup> For example, see *R v Inland Revenue Commissioners ex parte Matrix-Securities Ltd* [1994] 1 WLR 334

## ‘Domestic’ avoidance

28. For domestic avoidance HMRC will challenge when it believes that the law does not operate in the way the taxpayer believes, that the facts are not as the taxpayer has presented them, or a combination of the two. For ordinary ‘tax planning’ (described as ‘plain vanilla’)<sup>13</sup>, HMRC might challenge on the basis that otherwise acceptable planning was let down by the way the parties implemented it. For example, in the case of a theoretically lawful dividend paid instead of a salary it might be that the level of retained profits was too low to allow a legal dividend to be paid. One might speculate that the more complex the case, or “artificial” the avoidance, the greater the weight given to the true legal interpretation of the facts. For evasion the challenge is much more around establishing the (concealed) facts so that the law can be applied to them.

29. HMRC may consider if the General Anti Abuse rule applies, or seek to change the UK law, either by specific or targeted provisions. But any such changes would have to conform to any overriding EU laws or treaty provisions.

30. The recent UK case of Chris Moyles claiming to be a second hand car salesman illustrates domestic avoidance.. It was intended to take advantage of rules that give relief to legitimate businesses for the costs of raising finance. By a complex structure of transactions, assigning rights, and the use of a Jersey trust, the participants claimed they were running a used car business. The claimed finance costs were said to be c.£1mn but the interest charge was £63 and the income was c £4,000. The scheme had all the hallmarks described in an earlier House of Lords judgement “*every tax avoidance scheme involves a trick and a pretence. It is the task of the Inland Revenue to unravel the trick and the duty of the Court to ignore the pretence.*”<sup>14</sup>

## ‘Cross border avoidance’

31. Cross border cases would include the high profile cases of large international firms, where they explicitly use the tax rules to their advantage. The degree of “artificiality” is less than the Chris Moyles type schemes, although tax campaigners would argue the opposite, partly on the basis that the transaction could have been structured so as to give rise to UK tax. Here the UK challenge might be more on the implementation, not on the law itself. It is not possible for HMRC to simply set aside international rules, or to unilaterally change the laws

32. If we adopt this view then it is perhaps easier to see why there can be so much public unease on both the consequences of tax “planning” and on HMRC’s responses, especially across borders. People feel that it cannot be correct, and certainly not “fair”, to have a situation where large businesses can apparently with impunity set themselves up to enjoy low rates of tax in the countries where they have very significant sales or workforce. Nor can they understand why HMRC cannot simply “do something”, or “be more assertive”, like charge a penalty.

33. Governments and official bodies around the world have shared this concern, that profits are escaping tax, and that any change requires concerted international action. This approach is inherent in changes proposed under country by country reporting, and formulary apportionment (e.g. as in the European Commission with its common consolidated corporate tax base (CCCTB)). Both these ideas seek to make more information publicly available for citizens (and by implication tax authorities) on what businesses are doing, possibly forcing them to explain themselves more. There would be a formula to allocate profits across countries (e.g. an equal division using sales, profits and workforce).

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<sup>13</sup> This is not always clear. For example, if a company chooses to remunerate a Director by paying a (legal) dividend, some argue this is ‘avoiding’ the operation of PAYE on both Director and the company.

<sup>14</sup> Lord Templeman, R v Inland Revenue Commissioners ex parte Matrix-Securities Ltd [1994] 1 WLR 334

34. Opinions on this sort of radical change are divided. Representatives of the Big 4 firms of accountants told the House of Lords last summer that it posed real practical difficulties, especially if the formula left out intangibles that were increasingly part of profit calculations. A speaker from a law firm went so far as to say that “The thing you can say about apportionment is that it will produce a consistent answer but consistently the wrong answer.”<sup>15</sup> Speakers from the Tax Justice Network argued that “Instead of trying to treat them as if they were independent entities in different countries, the perspective should be to accept that they are unitary entities and build on that.”<sup>16</sup> The Lords committee were not persuaded that change was viable: “A unitary tax system treating multinational companies as single entities in a global economy is attractive in theory. But there would be formidable difficulty in reaching global agreement, or even within the EU, on a common tax base, let alone on the appropriate allocation.”<sup>17</sup>

35. Another radical response to the problems of avoidance involving international businesses would be to move to what is known as a destination based tax. The tax would be charged where goods and services are sold to a third party. Such a tax, involving the physical location of customers, is obviously much harder to avoid and there has been some interest in applying it<sup>18</sup>. But in the absence of any agreed international consensus it is hard to see any one country taking the first steps, especially the EU which has already produced its own CCCTB.

### Base Erosion and Profit Shifting (BEPS)

36. Another piece of work to try to tackle avoidance across borders is the OECD piece of work, summed up as BEPS<sup>19</sup>. This recognises that corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with international businesses that have the ability to shift their profits across borders to avoid or reduce tax. The OECD believes there is a real risk that profits may be increasingly untaxed as they are deemed to arise in lower tax jurisdictions, remote from the places where sales occur. The OECD and its members have supported a review and Action Plan that addresses these issues of base erosion and profits shifting. But changes to the international tax system are realistically only possible via international agreements and the UK government - and legislators - will have to work with their counterparts in Europe and across the world.

### Conclusion

37. This is an area where there seems little common ground across the range of views, other than it is an area that needs to be addressed, especially cross-border “avoidance”. One person’s legal tax planning is another’s unethical abuse of outdated international rules. Political and public understanding is restricted, with nobody setting out the range of issues and arguments that are needed before any more informed views can be reached. We hope this initial paper can begin to redress that imbalance, and perhaps start a wider programme of open discussion.

### Further information can be found in the following publications

Action Aid paper on Tax Responsibility for Investors (<http://www.actionaid.org.uk/news-and-views/actionaid-releases-new-tax-responsibility-guide-for-ftse-investors>)

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<sup>15</sup> Steve Edge, Slaughter & May, Para 105, Tackling corporate tax avoidance in a global economy: is a new approach needed? Published 31 July 2013

<sup>16</sup> Professor Sol Picciotto, Para 99

<sup>17</sup> Para 102,

<sup>18</sup> See Designing and implementing a destination based corporate tax, 13 May 2013, [http://www.ceps.be/system/files/events/2013/04/P4\\_RitadelaFeria.pdf](http://www.ceps.be/system/files/events/2013/04/P4_RitadelaFeria.pdf)

<sup>19</sup> OECD Action Plan on Base Erosion and Profit Shifting, <http://www.oecd.org/ctp/BEPSActionPlan.pdf>

ARC, 2013 Budget Submission, <http://www.fda.org.uk/Media/Tax-gap-is-closing-but-further-8-billion-could-be-recouped-by-HMRC-providing-an-alternative-to-cuts-or-tax-increases-says-ARC-Budget-submission.aspx>

R Brooks, The Great Tax Robbery, 2013.

CBI Papers on Tax and Business [http://www.cbi.org.uk/media/2145560/making\\_the\\_case\\_-\\_july\\_2013.pdf](http://www.cbi.org.uk/media/2145560/making_the_case_-_july_2013.pdf)

HMRC Factsheets:

- Levelling The Playing Field, Compliance (<http://www.hmrc.gov.uk/about/briefings/tax-compliance.pdf>)
- Tax Evasion (<http://www.hmrc.gov.uk/about/briefings/campaign-tax-evasion.pdf>)
- Tackling the Profits of Multinational businesses,  
(<http://www.hmrc.gov.uk/about/briefings/profits-multinationals.pdf>)

House of Commons debate, 5 February 2013, HMRC capacity and resources, <http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm130205/halltext/130205h0001.htm>

House of Lords, Report on Tackling Corporate Tax Avoidance in a Global Economy, The 58pp executive summary (<http://www.publications.parliament.uk/pa/ld201314/ldselect/ldconaf/48/48.pdf>)

Institute of Fiscal Studies, Green Budget, February 2013, Chapter 10, Corporate tax, revenues and avoidance, <http://www.ifs.org.uk/budgets/gb2013/gb2013.pdf>

OECD Action Plan on Base Erosion and Profit Shifting (<http://www.oecd.org/ctp/BEPSActionPlan.pdf>)

Oxfam paper on Tax Havens ([http://www.taxjustice.net/cms/upload/pdf/oxfam\\_paper\\_-\\_final\\_version\\_06\\_00.pdf](http://www.taxjustice.net/cms/upload/pdf/oxfam_paper_-_final_version_06_00.pdf))

Oxfam paper, Business Among Friends, May 2014. <http://oxfamilibrary.openrepository.com/oxfam/bitstream/10546/316405/1/bp185-business-among-friends-corporate-tax-reform-020514-en.pdf>

Oxford Business School Report for the NAO on Tax Avoidance [http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/TA\\_3\\_12\\_12.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/reports/TA_3_12_12.pdf)

Parliamentary Accounts Committee:

- 19 February 2013, Tax Avoidance - Tackling Marketed Avoidance Schemes, <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpublic/788/788.pdf>
- 15 April 2013, Tax Avoidance - The role of large accountancy firms, <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpublic/870/870.pdf>
- 13 June 2013, Tax Avoidance - Google, <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpublic/112/112.pdf>

Tax Research, [http://www.taxjustice.net/cms/upload/pdf/Mind\\_the\\_Tax\\_Gap\\_-\\_final\\_-\\_15\\_Jan\\_2006.pdf](http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf)

<http://www.taxresearch.org.uk/Documents/PCSTaxGap.pdf> and

<http://www.taxresearch.org.uk/Documents/Intheshade.pdf>

Treasury Select Committee, 6 March 2012, Closing the Tax Gap: HMRC's record at ensuring compliance,  
<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1371/1371.pdf>