

# Tax Avoidance

## 1 Introduction

Tax avoidance is a topical issue. Government Ministers and civil servants within HM Revenue & Customs (HMRC) have both made clear their distaste for avoidance, and the fact that they regard this as a moral issue. They are not content with the words of Lord Tomlin in *IRC v Duke of Westminster* 1936, that "every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". This paper takes seriously the idea that there might be a moral case against avoidance, and then asks what that case might be. It concludes that if there is a moral case, its practical limits are narrower than Ministers and civil servants might like them to be.

One thorny issue is where to place the boundary between acceptable and unacceptable conduct by taxpayers. This paper explores that issue in relation to corporation tax. This tax has been chosen because it is a particularly challenging one. Large groups may be able to save large amounts through tax planning. Avoidance by groups of companies can be harder than much other avoidance to block with targeted legislation, often because it has an international component and the UK Parliament can only legislate for the UK. And the directors of companies are not employed to act in their own interests. If they do not reduce tax burdens then it is shareholders, employees, suppliers and customers who suffer.

This paper claims that there are two separate standpoints from which to view tax avoidance, the standpoint of the free market and the standpoint of responsibility to each other. Prudential arguments against tax avoidance have force from the first standpoint, but moral arguments could only have force from the second standpoint. Even that second standpoint would need to be characterised in a particular way, as a contract among citizens rather than as a contract between citizens and the state, in order to give the moral arguments force. The paper also argues that if there is a morally authoritative voice, then it has to be the voice of Parliament rather than the voice of the Government. That fact affects how one might establish the limits of acceptable tax avoidance.

## 2 The definition of avoidance

Tax avoidance is different from tax evasion. A company that enters a profit figure of £10m on a tax return when the true figure is £12m is engaged in evasion. Evasion is penalised and may lead to prosecution, and rightly so. A company that manages to use capital losses made in a different group against its own capital gains because it has discovered a chink in the armour of the legislation designed to stop that is engaged in avoidance.

There is an extreme type of avoidance, in which it is deliberately made difficult for HMRC to appreciate the details of transactions or to appreciate their overall effect. Several transactions in a series may take place in several different companies, and some of them may be overseas companies that do not file UK tax returns. Or a series of transactions may be such that each of them

would have a minimal effect on tax liabilities if undertaken alone, but that in combination they generate a large tax saving. This does not mean that every transaction which involves several companies, or which involves companies in several countries, or which is split into several smaller transactions, is dubious. Sometimes there are good commercial reasons to do business in that way. But complications may occasionally be introduced in order to make it hard for HMRC to see what is going on.

Another extreme is tax planning which is so obvious and so widely known that it can be accepted as a standard way of carrying on business. For example subsidiaries can be held in a diamond structure to ensure that if they are sold at a profit, the gain will be exempt from tax under the substantial shareholdings exemption but that if they are sold at a loss, the loss will be allowable against other gains, even though the general approach of the substantial shareholdings exemption is to make gains exempt and corresponding losses non-allowable. The Government knows all about this, but it has not proposed a change in the law to deal with it. Indeed tax planning at this elementary level can hardly be described as avoidance at all. It is a quirk in the system that might surprise someone who was new to the study of tax, but it simply means that there is a sensible way to conduct one's affairs and another, less sensible way.

This paper is concerned with avoidance that does not lie at either of these two extremes. It is concerned with avoidance in which HMRC are given access to all relevant facts, but in which the methods used to reduce tax liabilities are not ones that are standard practice for all reasonably well-informed companies, nor are they methods that are obvious from a cursory reading of statute.

The paper is also restricted to the UK context and to the saving of UK tax. A multinational group will have regard to its worldwide tax burden, but different countries have different tax laws and different constitutional arrangements for making and implementing those laws.

### 3 The existing legal position

HMRC may challenge attempted tax avoidance, on the basis that the company's interpretation of the law is incorrect or on the basis that the transactions are wholly artificial. If HMRC cannot reach agreement with the company the matter may go to court. The avoidance may succeed or it may fail. If it fails, the company will normally only have to pay the tax involved plus interest to reflect late payment.

In deciding whether a piece of tax avoidance succeeds, the plain words of statute take precedence over everything else. But those who devise tax avoidance schemes that are not obvious from a cursory reading of statute are well aware of what is plain from statute. They do not propose schemes that would fall foul of unambiguous single provisions.

We therefore move on to tax avoidance that relies on the intricate interaction of provisions, or on debatable interpretations of key terms in statute. Intricate interactions do not in themselves take us beyond the plain words of statute. Once the interactions have been understood, the result can be just as plain as if only a single provision was at stake. It is however possible for the courts to strike down wholly artificial tax avoidance schemes, although they only rarely do so. Where schemes rely on debatable interpretations of key terms, it is just as hard to predict court decisions. (This frequent

lack of predictability is however partly an artefact of the system of tax administration. If the outcome of a possible court case were obvious, it is likely that HMRC and the taxpayer would reach an agreement - which would not be made public - rather than going to court.)

## 4 The free market standpoint

Participants in the free market seek to make good profits - or if they do not, it is by their own free choice because they have chosen other priorities. But within the free market, a choice to seek profits needs no justification. It is what makes the market work. The price mechanism automatically allocates resources to the uses in which they will generate good profits, because the suppliers of resources mostly seek profits themselves and therefore seek out the customers who will be prepared to pay good prices. And the relative profitabilities of the different possible uses of resources are determined automatically by consumers' preferences, because consumers will be most inclined to spend money on the things that they most want.

A profit-seeking participant in the free market naturally seeks to control costs. Mostly, this is unproblematic and contributes to the efficient allocation of resources. For example a business that really needs premises in central London and can make good use of them, will be prepared to pay handsomely. A business that has no real need for that prime location will find somewhere cheaper, in order to reduce its costs. The result is that expensive premises will be allocated to businesses that really need them and can make good use of them. A desire to control costs is therefore a virtue that helps the economy as a whole to work as well as it can.

The question is, should tax be viewed in the same light? A payment of tax is not a purchase of specific goods or services. Taxpayers separately have no choice over what their taxes are spent on, although individuals (but not companies) can express preferences collectively, at a very high level of generality, through Parliamentary elections. So if a business seeks to control tax like any other cost, it cannot claim the direct connection with the efficient functioning of the market that accompanies other efforts to control costs. The reduction of tax payments is most directly in the interests of the business's owners, employees, suppliers and customers, rather than in the interests of society as a whole. It is here that prudential arguments have force. A business would do its owners, employees, suppliers and customers no favours if it indulged in tax avoidance that led it to incur excessive legal fees, or that led officials to treat it with such suspicion that its relationship with HMRC became very difficult.

It is worth bearing in mind that employees, suppliers and customers as well as owners benefit from reductions in tax paid. If more tax is paid, the business must somehow recover the cost by reducing returns to owners, reducing pay rises for employees, seeking to pay less to suppliers and increasing prices to customers. In practice, the response will be a bit of each. And of course owners, and owners of suppliers and of business customers, are ultimately individuals, just like employees and private customers. The burden of all taxes is ultimately suffered by individuals. The range of individuals who ultimately bear the burden of taxes on a given business can be very wide, even if it is still considerably narrower than society as a whole.

The reduction of tax burdens might make an indirect contribution to economic efficiency. Tax-funded institutions that are not subject to the discipline of the free market can be very inefficient. Controlling

tax payments, keeping the state on a tight rein and keeping money in the private sector where it is more likely to be used efficiently, could in itself help the economy. The money so retained would not be distributed on an equitable basis. Most would be retained by those who hired the cleverest accountants and lawyers to do their tax planning. But those who retained the money would spend or invest it, diffusing the benefits throughout the economy.

One free market argument against tax avoidance is that it distorts competition. Those who engage in extensive tax avoidance pay less tax than those who do not, giving them an advantage. But it is open to any company to engage in tax avoidance if it so chooses. And while it is true that some businesses present more opportunities for avoidance than others - for example avoidance is much easier for financial institutions than it is for engineering firms - the fault lies with a tax system that may not be adequate to deal with financial instruments, rather than with individual financial institutions. Indeed opportunities to save tax allow those institutions to offer finance to industry on better terms than would otherwise be possible.

Another argument against tax avoidance is that tax should be paid because taxpayers benefit from the public services they receive. For example, businesses benefit from the existence of a workforce that has been educated in state schools and that receives medical care in state hospitals. This argument makes sense from a free market standpoint. Participants in a market pay for the goods and services that they enjoy.

There are two important differences. First, participants in a free market make their individual choices as to what to buy, and one participant's choices do not affect any other participant. State-provided services are chosen by a political process and the choices of the Government are, if approved by Parliament, binding on everyone. Second, the amount that a participant in a free market pays depends on the quantity consumed by that participant, and not on the participant's own means. By contrast, the amount that any one taxpayer pays for state-provided services is largely independent of that taxpayer's consumption, but it does depend on the taxpayer's means. However, these differences are not crucial to the debate about tax avoidance.

What is crucial is what follows from the idea that taxes are a fair price to pay for public services enjoyed. The obligation to pay taxes for services enjoyed is sometimes put by saying that there is an implicit contract between the state and the citizen, under which the state provides services and the citizen agrees to pay a fair price as defined by the spirit, as well as the letter, of tax legislation. But an argument that there was a contract would not support a view that anyone should comply with the spirit of the pricing mechanism. A party to a business contract is only obliged to pay the price determined in accordance with its terms, not some higher price. If we accept the characterisation in terms of a contract between state and citizen, that is not in itself an argument against tax avoidance. An argument against tax avoidance might however follow from a characterisation in terms of a contract between citizens that they would collectively provide services through the medium of a public sector. This argument is considered below.

The above points do not show that tax avoidance is praiseworthy. But they do suggest that from the point of view of the free market tax avoidance could be seen as morally neutral, and that no-one could complain if a business did act within the law to reduce its tax burden. It is going to be difficult to find solid grounds to condemn tax avoidance from the standpoint of a participant in the free market. It is time to consider a different standpoint.

## 5 The standpoint of responsibility to each other

This section considers the argument that we have an obligation to each other not to reduce our payments for public services, because if some pay less then others pay more. The implied contract is not between the state as provider and citizens, but among the citizens themselves.

As an argument against tax evasion, this looks strong. Tax evasion is not a victimless crime. It may seem to be so because it is not obvious who pays extra tax when someone evades payment, but victims who are not readily identifiable are still victims. Indeed equally strong arguments apply in the context of the private sector. We all have a responsibility to keep contracts and to avoid theft, not just because of the position of the obvious victims if we break the rules, but because breaking the rules would undermine the general levels of honesty and trust that are needed for a market to work properly.

As an argument against tax avoidance, it needs more examination. We must consider whether the argument stands up in principle, what the terms of any obligation to each other might be and how we might establish those terms.

### ○ The principle of the argument

The argument does appear to be reasonably strong in principle. To deny it we would have to deny that we had an obligation to look after each other as well as to look after ourselves. There are political arguments for no government, or for absolutely minimal government, and someone who took that sort of position would be able to dispute the idea that we have a responsibility to each other to pay our taxes. But that would be an extreme position, which will not be taken up in this paper. We should however recognise that our obligations to other citizens in general may be considerably less than our obligations to those who are closest to us. There may be nothing wrong with tax avoidance that is undertaken in order to be able to afford good provision for one's own family.

The argument that we should pay our taxes is not weakened in relation to companies by the mere fact that companies do not have votes. As mentioned already, all taxes are ultimately burdens on individuals. It is individuals who vote. Not all individuals vote in the countries where they suffer taxes, of course. For example a French investor in a UK company has no vote in the UK, but some of the burden of UK taxation ultimately falls on him. However, it is that investor's free choice to invest in a UK company. In contrast most citizens of a country have only a very limited prospect of moving to another country, so they have to bear the burden of their own country's taxes, but they do get a vote in their own country if it is a democracy.

### ○ The terms of the obligation

The basic obligation is to pay taxes in accordance with the words of legislation, as interpreted by court decisions that have the force of precedent. That much is uncontentious, subject to the legislation being compatible with the European Community Treaty. (A taxpayer who feels that the legislation is not compatible with the Treaty can raise the matter with HMRC and invite HMRC to litigate or concede the point.)

The question is, does our obligation to each other to pay our taxes go any further than that? Is there any moral obligation on a taxpayer not to use tax avoidance?

It is plausible to think that there is such an obligation, at some level. It would be difficult to see any merit in a transaction that was, for example, entered into solely to generate a loss which was not a real commercial loss but which could be set against profits that would otherwise be taxable.

Starting with such extreme transactions, there is then a scale reaching up to clearly unproblematic transactions such as a decision to buy a company and then take care to delay any major changes to its trade until its losses brought forward have been used up, because a major change can block the carry-forward of losses. In between are transactions that a taxpayer was going to undertake for commercial reasons anyway, and in the execution of which varying degrees of tax planning are incorporated.

The existence of an obligation to each other not to engage in extreme forms of tax avoidance would not however mean that taxpayers should never do so. Moral obligations often come in twos and threes, rather than singly, and different obligations can easily conflict. The obvious conflict for a company's directors trying to decide on the appropriate level of tax avoidance is that as well as the duties that members of a community owe to each other, they have a duty to their shareholders to secure a good post-tax return on investment. That return needs to be as good as can be obtained elsewhere in the global market for businesses with comparable levels of risk, otherwise capital will no longer be available to the company. That would suggest that they should engage in tax avoidance, subject only to the prudential considerations that they should not incur excessive legal fees or make the company's working relationship with HMRC too difficult.

The conflict of duties that is involved here is not of the same type as conflicts that can arise for an individual, who may for example be torn between loyalty to a friend and an obligation to tell the authorities about some wrong-doing by his friend. In that type of conflict, the person on whom the duties fall is the person who has to decide what to do. That can be the position with an owner-directed company, but it is not the position with a large group where the shareholders and the directors are different people. The directors have to take decisions on behalf of the shareholders. The shareholders might have a straightforward obligation not to engage in extreme tax avoidance, and if they were making the decision themselves they might have no conflicting obligations. But as will be shown below, the terms of our obligation to each other are hard to determine. This means that we must all decide for ourselves how far our obligations go. If a shareholder were taking decisions about tax avoidance in relation to his or her personal financial affairs, he or she might legitimately decide on extensive tax avoidance.

It is therefore not up to the directors to assume that they know what the shareholders ought to see as their obligations. The directors face a clash of obligations. On the one hand they have an obligation to make a reasonable estimate of the shareholders' obligations to society. On the other hand they have an obligation as directors to generate good returns for shareholders. It is impossible to lay down general rules determining what the directors should do. Sometimes it will be perfectly reasonable for them to decide that on balance they should refrain from imposing on the shareholders a level of obligation to other citizens which those shareholders might reasonably dispute that they had. Then a fair amount of tax avoidance might be appropriate.

## ○ Establishing the terms of the obligation

The argument above relies on the difficulty of determining the level of our obligation to each other. The next stage is to show that it is in fact difficult to determine the level of our obligation. This will be done by trying to identify a body that could determine our obligation, and showing the limits on the ability of the only plausible candidate to do so. Unless there is a practical way to determine what that obligation is, or a body that can authoritatively decide the level of the obligation, there is nothing for it but to leave the decision up to each taxpayer. Those decisions can usefully be informed by discussions of principles and examples, but in the last resort no-one would be able to tell others that their informed decisions were wrong.

In this context, the obligation to abide by the letter of the law as interpreted by precedent-making courts can be seen as a practical and unambiguous one. At that basic level of compliance, it is possible to determine obligations by consulting the legislation and judicial precedents. In cases of dispute there is an authority, the judiciary, which can decide the level of our obligation. But who can be the voice of authority when we move beyond such relatively easy cases?

### *The Crown*

One candidate to consider is the Crown. We should start by looking at the Crown as a continuing entity rather than the Government of the day, because taxpayers have dealings with the Crown. When a company claims that a specific piece of tax avoidance is legitimate, it has any discussions with an inspector, a servant of the Crown rather than of the Government. (The conditions of employment of civil servants state that a civil servant owes a duty of loyalty to the Crown, and that "that duty is for all practical purposes owed to the Government of the day", but those words obscure the important distinction between the Crown and its temporary directors, the Government.) So perhaps an individual inspector, acting in accordance with instructions issued by officials at the top of HMRC, would be in a position to say whether or not a specific piece of tax avoidance was acceptable.

However, the Crown cannot just assert any such authority. Officials do not normally have the power to decide what conduct is or is not acceptable, although it is perfectly proper for officials to decide whether to litigate and then let the courts settle a dispute. We must therefore consider possible sources for any authority that the Crown might have.

The Crown might be thought to derive authority from the fact that it is under the direction of Ministers, who are members of a government that is in power because of the result of a general election. But it is not at all clear that the Crown would derive authority from this source. We can compare the Crown to a company, and the Government to its board of directors. A company is under the direction of people elected by the shareholders, but that does not give the company any authority over the shareholders. And it would not have any such authority even if each person in the country held just one share, and all participated equally in the election of the board of directors. It is also worth noting that Ministers take no part in decisions on how to treat specific taxpayers. Any authority that officials might derive from working under the general direction of Ministers would therefore be somewhat indirect, although the mere fact of indirectness would not necessarily diminish the weight of any such authority.

Another possible source of moral authority of the Crown would lie in its history. While the Monarch as an individual plays no party political role, the UK remains a monarchy and it is not clear that all vestiges of the old view that the Crown has its authority naturally have been eliminated. However in relation to tax law, the fact that the Bill of Rights of 1689 put the power to tax firmly in the hands of Parliament would be a serious obstacle to any such argument, even if sufficiently substantial vestiges could be identified.

### Ministers

The next possessors of authority we might consider would be Ministers. They form the Government, which emerges from a democratic process. They are the ones who decide what tax laws to propose to Parliament in the form of the annual finance bill. They also take finance bills through Parliament, arguing the case for specific proposals and responding to MPs' questions. Ministers' statements can even be used in court to interpret the law, but only where the words of an act are ambiguous or obscure or lead to an absurdity (*Pepper v Hart* 1993).

However the role of Ministers in the legislative process would not support any authority that they might have to tell us how we should or should not respond to tax legislation. Someone who decides upon a proposal and then advocates it is no sound judge of the worth of the proposal. Likewise, Ministers who have decided that we should be taxed in a certain way have no authority to ask us to comply with their intentions. Of course they think that their own ideas are good ideas, and that the legislation which embodies their ideas should be interpreted in line with their intentions. That is human nature.

### Parliament

If there is any body with the authority to indicate the extent to which our responsibilities to each other mean that we should limit our use of tax avoidance, it is likely to be Parliament. For the purposes of taxation that means the House of Commons. The House of Lords has a debate on each finance bill, but it can make no changes.

This is fitting because the House of Commons is the nearest thing we have to a representative of the entire community. We can take it as standing for all of us. It is also fitting because the Bill of Rights of 1689 placed the power to levy taxes in the hands of Parliament, and there it has stayed. We can see this in the preambles to finance acts, which include the phrase "... the Commons ... have freely and voluntarily resolved to give and to grant unto Your Majesty the several duties hereinafter mentioned". It is up to Parliament to decide whether there are any taxes at all, so it makes sense to look to Parliament for guidance on the extent of taxpayers' obligations. There is also no presumption that Parliament is biased in favour of satisfaction of the Crown's demands for money, a bias that might incline it against tax avoidance. A vital role of Parliament is to control the ambition of governments to collect more and more money.

A key fact about the House of Commons is that it is not the Government. A government emerges following a general election by virtue of the composition of the House, but the fact that a specific government emerges does not limit the political diversity of the House. The House includes members of all of the opposition parties and non-Government members of the governing party, as well as most members of the Government itself. This mixed composition means that Ministers cannot claim to speak for the House. Nor can any limited group of MPs claim to speak for the House.

This diversity of opinion within the House of Commons makes it hard to determine the will of Parliament, except by consulting the acts that Parliament passes. It might seem that we would be back to being able to say no more than that people should obey the letter of the law as interpreted by the courts. In fact we may be able to go a bit further, but we must take care to limit how much further we go.

Suppose that there are ten loopholes in the legislation that prevents tax losses being sold from one group to another. The Government proposes, and Parliament passes, legislation to block eight of those loopholes. The other two, which are on much the same lines as the first eight, are left open because the Government is unaware of them or cannot work out how to close them. If a company then starts to exploit one of the two remaining loopholes, it cannot reasonably argue that Parliament intended to leave them open. Parliament surely would have closed them if given the opportunity. One might therefore argue that the company would be breaching its duty to the rest of us by exploiting one of the remaining loopholes.

This argument would however be limited to cases where the remaining loophole was of the same type as the closed loopholes. "Of the same type" is a vague condition, and attempts to make it more precise are not likely to succeed. But it should probably be applied fairly strictly so that only a small range of unclosed loopholes would be made subject to the presumption that they should not be used. One possible level of strictness would be to limit the presumption to loopholes that would have been covered, under the *ejusdem generis* rule of interpretation, if the statute had listed the loopholes closed and had ended with the words "and other loopholes of the same type are also closed".

This does not mean that legislation should actually be drafted in such a style. That would lead to considerable uncertainty for taxpayers. It also does not mean that taxpayers should be bound to follow the guidance that might be derived from such an approach, because an obligation to follow it would be equivalent to passing legislation to that effect. Binding taxpayers to follow the guidance would amount to requiring taxpayers to repair defects in specific legislation, when the onus should be on the Government to get the legislation right. The sort of guidance that might be derived from Parliament's likely intention should therefore be purely persuasive.

Taxpayer uncertainty and the limits to any obligation on taxpayers to repair the defects in legislation also mean that a company should not be subject to any penalty for exploiting a loophole that had been left open. (There would not be any penalty at the moment.) It does not even follow that a company's use of a loophole of the sort described should be blocked, at least not until legislation to close the loophole for the future was announced. It is important that taxpayers can, if they wish, rely on the strict letter of the law. It is not worth abandoning the rule of law in order to safeguard a bit of tax revenue.

The foregoing argument about the role of Parliament does take it that we should see Parliament as effectively making decisions on whether the Government's proposals for taxation should be accepted or rejected. In practice pressure of time, the complexity of legislation and a shortage of technical expertise among MPs all limit the effectiveness of scrutiny. And secondary legislation, which can be very significant, does not generally get debated at all. However these facts would not in any way enhance the moral authority of Ministers to say how we should respond to tax legislation, even though Ministers are backed up by an army of technical experts in the Treasury and in HMRC.

## 6 Ways forward

There is plenty of scope for a debate on what is or is not acceptable avoidance, if we take the view that we do have duties to each other. Both general principles and specific examples have their place in that debate. The Government has every right to participate, but it will do so as an equal of all the other parties to the debate, not as an authoritative source of answers.

While such a debate is worth having, because it will lead to the decisions of taxpayers on tax avoidance being better-informed, it will not take those decisions out of the hands of the taxpayers concerned. It is most unlikely that the debate would reach conclusions that were sufficiently widely shared to sustain a claim that they should be binding on all taxpayers.

This leaves open the somewhat depressing prospect of continuing in the current style, with taxpayers finding ever more contrived ways round anti-avoidance legislation and the Government proposing ever more complex legislation in response. But there is a better way.

The key is to re-design the tax system so that it does not draw artificial boundaries between things that are close commercial substitutes. Any such boundaries create pressures when there is less tax to pay on one side of the boundary than on the other. Tax avoidance schemes are created to exploit the boundaries.

Reforming the tax system along these lines would not be an easy task. It would mean some drastic changes. For example many transactions are commercially equivalent to the borrowing of money at interest, but only some receive the same tax treatment as borrowing at interest. The decisive elimination of the boundary between transactions which do receive that treatment and those which do not would demand extensive re-working of the legislation in that area, and of legislation in related areas. But tasks of that nature may still be worth undertaking. The current approach is leading to an impossibly complex tax system.

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