Tax Avoidance Vs Tax Evasion

A Thin Line of Difference

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Definitions

- <u>Tax Evasion:-</u> An illegal practice where a person intentionally avoids paying his/her/its true tax liability. Those caught evading taxes are generally subject to criminal charges and substantial penalties. It is illegal.

- <u>Tax Avoidance:-</u> The art of dodging tax without breaking the law. It seems legal.

Definitions Cont….

- As per Oliver Wendell Holmes, as Justice Supreme court of USA.

When the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as evasion, what is meant is that it is on the wrong side of the line … *[Bullen v. Wisconsin (1916), 240. US. 625 at p. 630].*

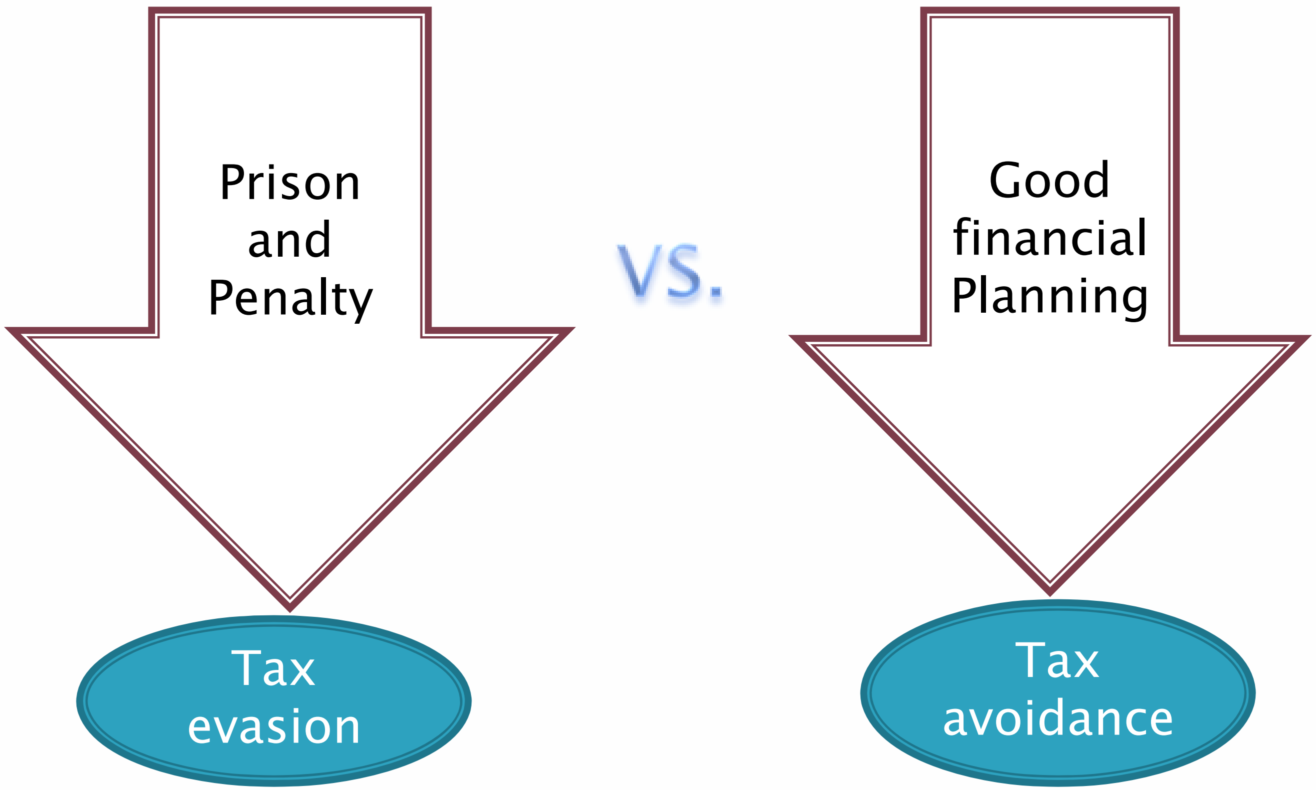
Definitions Cont….

- Former British chancellor of the exchequer "Denis Healey" said:

"The difference between tax evasion and tax avoidance is the thickness of the prison wall".

Definitions Cont….

- In simple words, the difference is;



Tax Evasion

- Tax evasion is an activity commonly associated with the underground economy and one measure of the extent of tax evasion is the amount of unreported income, namely the difference between the amount of income that should legally be reported to the tax authorities and the actual amount reported, which is also sometimes referred to as the tax gap.

Economics of Tax Evasion

- In 1968, Nobel laureate economist Gary Becker first theorized the *economics of crime*, on the basis of which Allingham and Sandmo produced in 1972 an economic model of tax evasion. It deals with the evasion of income tax, the main source of tax revenue in the developed countries. According to them, the level of evasion of income tax depends on the level of punishment provided by law.

Economics of Tax Evasion Cont….

- The literature's theoretical models are elegant in their efforts to identify the variables likely to affect non-compliant behaviors, however alternative specification yield conflicting results concerning both the signs and magnitudes of variables believed to affect tax evasion. As such , empirical work is required to resolve the theoretical ambiguities. Income tax evasion appears to be positively influenced by the tax rate, the unemployment rate, the level of income and dissatisfaction with government. The U.S. Tax Reform Act of 1986 appears to have reduced tax evasion in the U.S.

Smuggling

- Smuggling is importation or exportation of foreign products by unauthorized means.
- It is resorted to for total evasion of customs duties, as well as for the importation of contraband items.
- A smuggler does not have to pay any customs duty since the products are not routed through an authorized customs port, therefore are not subjected to declaration and payment of duties and taxes.

Government Response

- The level of evasion is depends upon the number of factors, one of them being fiscal equation.
- People's tendency to evade income tax declines when the return for due payment of taxes is not obvious.
- Evasion also depends on the efficiency of the tax administration.

Government Response Cont….

- Corruption by tax officials often render control of evasion difficult.
- Tax administrations resort to various means for plugging in scope of tax evasion and increasing the level of enforcement.
- These include, among others, privatization of tax enforcement, tax farming, and institution of Pre-shipment inspection agencies (PSI).
- In 2011, HMRC stated that it would continue to crack down on tax evasion, with a goal of collecting 18 billion pounds in revenue before 2015.

Corruption By Tax officials

- Corrupt tax official corporate with the tax payers who intend to evade taxes.
- When they detect instance of evasion, they refrain from reporting in return of illegal gratification or bribe.
- Corruption by tax officials is a serious problem for the tax administration in a huge number of undeveloped countries.

Level of Evasion and Punishment

- Tax evasion is a crime in almost all developed countries and subjects the guilty party to fines and/or imprisonment.
- There are so many countries which consider it a big crime because tax is main source of revenue especially for undeveloped countries like India.
- Developed nations also concentrate on this revenue, especially USA where "Government" give no scope of tax evasion and level of punishment is also very high.

Switzerland....an exception

- In Switzerland, many acts that would amount to criminal tax evasion in other countries are treated a civil matters.
- Dishonestly misreporting income in tax return is not considered as a crime.
- Such matters are considered in Swiss tax courts and not in criminal courts.
- In Switzerland, some tax misconduct is criminal, for example, deliberate falsification of records.

Exception continues....

- Moreover, civil tax transgressions may give rise to penalties.

- It is often considered that extent of evasion depends on the severity of punishment of evasion.

- Normally, higher the evaded amount, higher the degree of punishment.

Privatization of tax enforcement

- Professor Christopher Hood first suggested privatization of tax enforcement for overcoming limitations of government tax administration in controlling tax evasion.
- Some government resorted to privatization of tax enforcement to enhance the efficiency of tax system.
- The assumption is that leakage of revenue will lower under a privatized regime.

Tax Farming

- Tax farming is the old mean of collecting revenue when it is difficult to determine the leviable amount taxes with certainty.
- Governments lease out the collection system to private entity for a fixed amount, who then collects revenue and shoulders the risk of attempts at evasion by the tax payers.
- It has been suggested that tax farming may be the solution of tax evasion seen in developing countries.

Tax Farming Cont….

- Governments have historically turned to tax farming for quick cash.
- A “tax farmer” buys a “franchise” by making prepayment to the government.
- The “tax farmer” then invested, with the authority of the government, goes into the farm and begins extracting “taxes” from citizens.
- This is system destined to be abusive of “tax farmer” seek back their investment, plus profit and are themselves, unrestrained by “politics”.

Tax Avoidance/Tax Planning

- **Tax avoidance** is the legal utilization of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. The term tax mitigation is not however a synonym for tax avoidance. Its original use was by tax advisers as an alternative to the pejorative term tax avoidance.

Tax Avoidance Cont….

- The term has also been used in the tax regulations of some jurisdiction to distinguish tax avoidance foreseen by the legislators from tax avoidance which exploits some loopholes in the law.
- The United States of Supreme court stated that "the legal right of the individual to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted".

Methods of tax avoidance

- There are various methods i.e.

I. <u>Country of residence,</u>
II. <u>Double taxation,</u>
III. <u>Legal entities,</u>
IV. <u>Legal vagueness.</u>

Country of Residence

- Some countries tax persons on the income generated in the country, so in these case, tax can be avoided or reduced by transferring income-generating assets or activities to a country with no or lower income-tax.
- However, most countries tax on the income of residence on worldwide income, so simply transferring assets to another country usually has no effect on taxation. The country of residence of the individual or company is more relevant.

Double Taxation

- Most countries impose taxes on income earned or gains realized within that country regardless of the country of residence of the person or firm.
- Most countries have entered into bilateral double taxation treaties with many other countries to avoid taxing non-residence twice. India has now DTAA and TIEA with almost all countries and tax heavens.
- To avoid tax, it is usually not enough to simply move one's assets to a tax haven. One must also personally move to a tax haven to avoid tax.

Legal Entities

- Without changing country of residence (or, if a U.S. citizen, giving up one's citizenship), personal taxation may be legally avoided by the creation of a separate legal entity to which one's property is donated. The separate legal entity is often a company, trust, or foundation. These may also be located offshore, such as in the case of many private foundations.

Legal Entities Cont....

- Assets are transferred to the new company or trust so that gains may be realized, or income earned, within this legal entity rather than earned by the original owner.
- If assets are later transferred back to an individual, then capital gains taxes would apply on all profits.
- Also income tax would still be due on any salary or dividend drawn from the legal entity.

Legal Entities Cont….

- For settlor, to avoid tax there may be restrictions on the type, purpose and beneficiaries of the trust.
- For example, the settlor of the trust may not be allowed to be a trustee or even a beneficiary and may thus lose control of the assets transferred and/or may be unable to benefit from them.

Legal Vagueness

- Tax results depend on definitions of legal terms which are usually vague.
- For example, vagueness of the distinction between "business expenses" and "personal expenses" is of much concern for taxpayers and tax authorities.
- More generally, any term of tax law, has a vague penumbra, and is a potential source of tax avoidance.

Gems of Judiciary

English Law

IRC
Vs.
Duke of
Westminster

W.T. Ramsay Ltd.
Vs.
IRC

Gems of Judiciary Cont….

- *The English decision in "IRC V. Duke of Westminster" (1936) AC 1 (HL),*

Found that tax savings by planning for the same cannot be treated as impermissible tax avoidance.

Gems of Judiciary Cont….

"*W.T. Ramsay Ltd. Vs. IRC" (1981) 1 ALL E.R 865 (HL)*

Where a self-cancelling ready made device, artificial in nature without an independent business purpose was employed, it was treated as impermissible tax avoidance What is to be looked at is the legal nature, which does not rule out genuine strategic planning. The Revenue can't start with the question, whether there is any tax deferment or tax saving.

Gems of Judiciary Cont….

Indian Tax Pronouncements

McDowell Co. Ltd.
Vs.
Commercial Tax Officer

Azadi Bachao Andolan
Vs.
Union of India

Vodafone International holdings B.V.
Vs.
Union of India

Gems of Judiciary Cont….

- **McDowell Co. Ltd.**

  - Tax planning may be legitimate provided it is within the framework of the law.
  - Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by dubious methods.
  - It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.

Gems of Judiciary Cont….

- **McDowell Co. Ltd. (Cont..)**

  - There is behind taxation laws as much moral sanction as is behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation.
  - The proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally nor whether the transaction is not unreal and not prohibited by the statute,

Gems of Judiciary Cont….

- **<u>McDowell Co. Ltd. (Cont..)</u>**

  - but whether the transaction is a device to avoid tax and whether the transaction is such that the judicial process may accord its approval to it.
  - It is neither fair nor desirable to expect the Legislature to intervene and take care of every device and scheme to avoid taxation.
  - It is up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and to expose the devices for what they really are and to refuse to give judicial benediction.

Gems of Judiciary Cont….

- Azadi Bachao Andolan, *(2003), 263 ITR 706 (SC).*

Held that a citizen is free to carry on his business within the four corners of the law and that mere tax planning, without any motive to evade taxes through colourable devices is not frowned upon.

Gems of Judiciary Cont….

- *Vodafone International holdings B.V. Vs. Union of India & ANR."(2012 247 CTR (SC)1: 2012204 TAXMAN 408 : 2012 66 DTR 265 : 2012 341 ITR 1,SC)";*
  - Companies and other *entities are to be viewed as economic entities with legal independence vis-a-vis their shareholders/participants.*
  - *It is fairly well accepted that a subsidiary and its parent company are totally distinct taxpayers.*

Gems of Judiciary Cont….

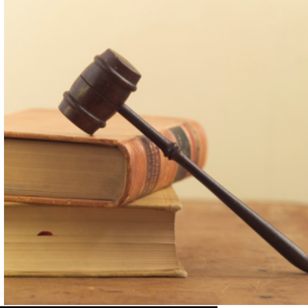
- *Vodafone International holdings B.V. Vs. Union of India & ANR."(Cont..)*

  - Whether a transaction is used principally as a colourable device for the distribution of earnings, profits and gains, is determined by a review of all the facts and circumstances surrounding the transaction.
  - While ascertaining the legal nature of the transaction the Revenue/Court has to look at the entire transaction as a whole and not to adopt a dissecting approach.

Gems of Judiciary Cont….

- ***<u>Vodafone International holdings B.V. Vs. Union of India & ANR.”(Cont..)</u>***
  - Corporate business purpose of a transaction is evidence of the fact that the transaction is not undertaken as a colourable or artificial device.
  - Stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device.

Cases on Tax Avoidance



- *"CIT Vs. Vallabh leasing & Finance Co. (P) Ltd." (2004,187 CTR 20:2004, 265 ITR 1:2004 134 TAXMAN 770, Madhya Pradesh)*

Provisions of sub-ss. (1) and (2) of s. 94 were not attracted to one time transaction of transfer of shares by assessee-company to its director at face value; there being no systematic effort by assessee to avoid tax, transaction comes within the ambit of s. 94(3)(b).

Cases on Tax Avoidance Cont….

- *"CIT v. Punjab State Electricity Board" [2010] 320 ITR 469 (P&H)*

Held that a sale and lease back transaction could not be dismissed as sham. It has legal effect. The fact that it reduces tax burden cannot by itself justify the inference, that it is a colourable device. It is not every case of tax planning, that is illegal/ illegitimate.

Cases on Tax Avoidance Cont....

- *"CIT v. Bihariji Construction (India) Ltd." [2007] 289 ITR 303 (Gauhati).*

Held that reduction in tax burden is not an offence, unless the transactions were not genuine and were contrary to the provisions of income-tax law.

Cases on Tax Avoidance Cont….

- *"CIT v. Sri Abhayananda Rath Family Benefit Trust" 255 ITR 436 (Orissa HC)*

"Evading payment of tax" is quite different from "tax planning". A person may plan his finances in such a manner, strictly within the four corners of the taxing statute that his tax liability is minimised or made nil. If this is done and as observed strictly in accordance with and taking advantage of the provisions contained in the Act, by no stretch of imagination can it be said that payment of tax has been evaded. In the context of payment of tax, "evasion" necessarily means, "to try illegally to avoid paying tax".

Differences

- Tax avoidance is generally a legal exploitation of the tax regime to one's own advantage.
- Tax evasion is the general term for efforts by persons to evade the payment of taxes by illegal means.
- In case of tax avoidance, person try to reduce liability of tax payable by means that are within the law whilst making a full disclosure of the material information to the tax authorities.

Differences Cont....

- Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability.

- Examples of tax avoidance involve using tax deductions, changing one's business structure through incorporation or establishing an offshore company in a tax haven.

Differences Cont….

- Examples of tax evasion, includes dishonest tax reporting i.e. under declaring income, profits/gains or overstating deductions.

- Tax avoidance may be considered either amoral dodging of one's duties to society, part of a strategy of not supporting violent activities or just the right of every citizen to find all the legal ways to avoid paying too much tax.

Differences Cont….

- Tax evasion, on the other hand, is a crime in almost all countries and subjects the guilty party to fines or even imprisonment.

- Switzerland is one notable exception: tax fraud (forging documents, for example) is considered a crime, tax evasion (like under declaring assets) is not.

Differences Cont….

- **Tax avoidance** involves using whatever **legal** means you choose to reduce your current or future tax liabilities.

- Tax evasion means doing illegal things to avoid paying taxes. It's the <u>Alphonse Capone</u> path to financial freedom.

Differences Cont....

- Tax avoidance looks like a tax planning and it is done before the tax liability arises.

- Tax evasion is blatant fraud and is done after the tax liability has arisen.

Conscientious reasons for not paying tax [Western World]

- Some tax evaders see their efforts to evade taxation as based upon novel legal theories, these individuals and groups are sometimes called tax protesters. U.S. tax protesters are an example of this kind of approach to tax evasion that has generally ended in failure for those making such claims.
- Tax resistance is the refusal to pay the tax for conscientious reasons (because they do not want to support the government or some of its activities), sometimes breaking the law to do so.

Conscientious reasons Cont….

- Some donate their unpaid taxes to charity, while others (at least in the US) take creative "deductions" such as not paying a percentage of tax equal to the defense budget.

TO SUMMARISE

Tax Planning (Avoidance) entails mitigating your tax liability morally and within the four corners of the Law.

Tax Evasion is use of ‘colorable/sham devices’ for reduction in tax liability.

Tax Evasion begins, where Tax Planning Ends.

Thank you

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Disclaimer :- These are purely personal and professional views of the author and based on appreciation of the law and judicial pronouncements. What is or what is not 'tax planning' is a very factual question to be seen and examined by the regulator in the specific factual matrix and a general presumption/Rule cannot be laid/made out.