There is a clear-cut difference between tax avoidance and tax evasion. One is legally acceptable and the other is an offense. Unfortunately however many consultants even in this country do not understand the difference between tax avoidance and tax evasion. Most of the planning aspects that have been suggested by these consultants often fall into the category of tax evasion (which is illegal) and so tends to put clients into a risky situation and also diminish the value of tax planning.

This may be one of the prime reasons where clients have lost faith in tax planning consultants as most of them have often suggested dubious systems which are clearly under the category of tax evasion.

In this chapter I provide some examples and case studies (including legal cases) of how tax evasion (often suggested by consultants purporting to be specialists in tax planning) is undertaken not only in this country but in many parts of the world. It is true that many people do not like to pay their hard-earned money to the government. However doing this in an
illegal manner such as by tax evasion is not the answer. Good tax planning involves tax avoidance or the reduction of the tax incidence. If this is done properly it can save substantial amounts of money in a legally acceptable way. This chapter also highlights some practical examples and case studies (including legal) of tax avoidance.

Why Governments Need Your Taxes (Basic Economic Arguments)

Income tax the biggest source of government funds today in most countries is a comparatively recent invention, probably because the notion of annual income is itself a modern concept. Governments preferred to tax things that were easy to measure and on which it was thus easy to calculate the liability. This is why early taxes concentrated on tangible items such as land and property, physical goods, commodities and ships, as well as things such as the number of windows or fireplaces in a building. In the 20th century, particularly the second half, governments around the world took a growing share of their country’s national income in tax, mainly to pay for increasingly more expensive defense efforts and for a modern welfare state. Indirect tax on consumption, such as value-added tax, has become increasingly important as direct taxation on income and wealth has become increasingly unpopular. But big differences among countries remain. One is the overall level of tax. For example, in United States tax revenue amounts to around one-third of its GDP (gross domestic product), whereas in Sweden it is closer to half.

Others are the preferred methods of collecting it (direct versus indirect), the rates at which it is levied and the definition of the tax base to which these rates are applied. Countries have different attitudes to progressive and regressive taxation. There are also big differences in the way responsibility for taxation is divided among different levels of government. Arguably according to the discipline of economics any tax is a bad tax. But public goods and other government activities have to be paid for somehow, and
economists often have strong views on which methods of taxation are more or less efficient. Most economists agree that the best tax is one that has as little impact as possible on people’s decisions about whether to undertake a productive economic activity. High rates of tax on labour may discourage people from working, and so result in lower tax revenue than there would be if the tax rate were lower, an idea captured in the Laffer curve in economics theory.

Certainly, the marginal rate of tax may have a bigger effect on incentives than the overall tax burden. Land tax is regarded as the most efficient by some economists and tax on expenditure by others, as it does all the taking after the wealth creation is done. Some economists favor a neutral tax system that does not influence the sorts of economic activities that take place. Others favor using tax, and tax breaks, to guide economic activity in ways they favor, such as to minimize pollution and to increase the attractiveness of employing people rather than capital. Some economists argue that the tax system should be characterized by both horizontal equity and vertical equity, because this is fair, and because when the tax system is fair people may find it harder to justify tax evasion or avoidance.

However, who ultimately pays (the tax incidence) may be different from who is initially charged, if that person can pass it on, say by adding the tax to the price he charges for his output. Taxes on companies, for example, are always paid in the end by humans, be they workers, customers or shareholders. You should note that taxation and its role in economics is a very wide subject and this book does not address the issues of taxation and economics but rather tax planning to improve your economic position. However if you are interested in understanding the role of taxation in economics you should consult a good book on economics which often talks about the impact of different types of taxation on the economic activities of a nation of society.
Tax Avoidance and Evasion

Tax avoidance can be summed as doing everything possible within the law to reduce your tax bill. Learned Hand, an American judge, once said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible as nobody owes any public duty to pay more than the law demands. On the other hand tax evasion can be defined as paying less tax than you are legally obliged to. There may be a thin line between the two, but as Denis Healey, a former British chancellor, once put it, “The difference between tax avoidance and tax evasion is the thickness of a prison wall.” The courts recognize the fact that no taxpayer is obliged to arrange his/her affairs so as to maximize the tax the government receives. Individuals and businesses are entitled to take all lawful steps to minimize their taxes.

A taxpayer may lawfully arrange her affairs to minimize taxes by such steps as deferring income from one year to the next. It is lawful to take all available tax deductions. It is also lawful to avoid taxes by making charitable contributions. Tax evasion, on the other hand, is a crime. Tax evasion typically involves failing to report income, or improperly claiming deductions that are not authorized. Examples of tax evasion include such actions as when a contractor “forgets” to report the LKR 1,000,000 cash he receives for building a pool, or when a business owner tries to deduct LKR 1,000,000 of personal expenses from his business taxes, or when a person falsely claims she made charitable contributions, or significantly overestimates the value of property donated to charity.

Similarly, if an estate is worth LKR 5,000,000 and the executor files a false tax return, improperly omitting property and claiming the estate is only worth LKR 100,000, thus owing much less in taxes. Tax evasion has an impact on our tax system. It causes a significant loss of revenue to the community that could be used for funding improvements in
health, education, and other government programs. Tax evasion also allows some businesses to gain an unfair advantage in a competitive market and some individuals to not meet their tax obligations. As a result, the burden of tax not paid by those who choose to evade tax falls on other law abiding taxpayers.

**Examples of tax evasion are:**
- Failing to declare assessable income
- Claiming deductions for expenses that were not incurred or are not legally deductible
- Claiming input credits for goods that Value Added Tax (VAT) has not been paid on
- Failing to pay the PAYE (pay as you earn a form of withholding tax) installments that have been deducted from a payment, for example tax taken out of a worker’s wages
- Failing to lodge tax returns in an attempt to avoid payment.

The following are some signs that a person or business may be evading tax:
- Not being registered for VAT despite clearly exceeding the threshold
- Not charging VAT at the correct rate
- Not wanting to issue a receipt
- Providing false invoices
- Using a false business name, address, or taxpayers identification number (TIN) and VAT registration number
- Keeping two sets of accounts, and
- Not providing staff with payment summaries

**Legal Aspects of Tax Avoidance and Tax Evasion**

Two general points can be made about tax avoidance and evasion. First, tax avoidance or evasion occurs across the tax spectrum and is not peculiar to any tax type such as import taxes, stamp duties, VAT, PAYE and income tax. Secondly, legislation that addresses avoidance or evasion must necessarily be imprecise. No prescriptive set of rules exists for determining when a particular arrangement amounts to tax avoidance or evasion. This lack of precision creates uncertainty and adds to compliance costs both to the Department of Inland Revenue and the tax payer.

**Definitions of Tax Mitigation Avoidance and Evasion**

It is impossible to express a precise test as to whether taxpayers have avoided, evaded or merely mitigated their tax...
obligations. As Baragwanath J said in Miller v CIR; McDougall v CIR: What is legitimate ‘mitigation'(meaning avoidance) and what is illegitimate ‘avoidance'(meaning evasion) is in the end to be decided by the Commissioner, the Taxation Review Authority and ultimately the courts, as a matter of judgment. Please note in the above statement the words are precisely as stated in judgment. However there is a mix-up of words which have been clarified by the words in the brackets by me. Tax Mitigation (Avoidance by Planning) Taxpayers are entitled to mitigate their liability to tax and will not be vulnerable to the general anti-avoidance rules in a statute. A description of tax mitigation was given by Lord Templeman in CIR v Challenge Corporate Ltd: Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability.

Tax mitigation is, therefore, behavior which, without amounting to tax avoidance (by planning), serves to attract less liability than otherwise might have arisen. Tax Avoidance Tax evasion, as Lord Templeman has pointed out, is not mere mitigation. The term is described directly or indirectly by i?~ Altering the incidence of any income tax i?~ Relieving any person from liability to pay income tax i?~ Avoiding, reducing or postponing any liability to income tax On an excessively literal interpretation, this approach could conceivably apply to mere mitigation, for example, to an individual’s decision not to work overtime, because the additional income would attract a higher rate of tax. However, a better way of approaching tax avoidance is to regard it as an arrangement that, unlike mitigation, yields results that Parliament did not intend.

In Challenge Corporation Ltd v CIR, Cooke J described the effect of the general anti-avoidance rules in these terms: [It] nullifies against the Commissioner for income tax purposes any arrangement to the extent that it has a purpose
or effect of tax avoidance, unless that purpose or effect is merely incidental. Where an arrangement is void the Commissioner is given power to adjust the assessable income of any person affected by it, so as to counteract any tax advantage obtained by that person. Woodhouse J commented on the breadth of the general anti-avoidance rule in the Challenge Corporation case, noting that Parliament had taken: The deliberate decision that because the problem of definition in this elusive field cannot be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the judges.

Tax Evasion Mitigation and avoidance are concepts concerned with whether or not a tax liability has arisen. With evasion, the starting point is always that a liability has arisen. The question is whether that liability has been illegitimately, even criminally been left unsatisfied. In CIR v Challenge Corporation Ltd, Lord Templeman said: Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment.

The elements which can attract the criminal label to evasion were elaborated by Dickson J in Denver Chemical Manufacturing v Commissioner of Taxation (New South Wales): An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion. Not all evasion is fraudulent. It becomes fraudulent if it involves a deliberate attempt to cheat the revenue. On the other hand, evasion may exist, but may not be fraudulent, if it is the result of a genuine mistake. In order to prove the offence of evasion, the Commissioner must show intent to evade by the taxpayer. As with other offences, this intent may be inferred from the circumstances of the particular case. Tax avoidance and tax
mitigation are mutually exclusive. Tax avoidance and tax evasion are not: They may both arise out of the same situation. For example, a taxpayer files a tax return based on the effectiveness of a transaction which is known to be void against the Commissioner as a tax avoidance arrangement.

A senior United Kingdom tax official recently referred to this issue: If an ‘avoidance’ scheme relies on misrepresentation, deception and concealment of the full facts, then avoidance is a misnomer; the scheme would be more accurately described as fraud, and would fall to be dealt with as such. Where fraud is involved, it cannot be re-characterized as avoidance by cloaking the behavior with artificial structures, contrived transactions and esoteric arguments as to how the tax law should be applied to the structures and transactions. Tax Avoidance in a Policy Framework We now turn from the existing legal framework in the context of income tax to a possible policy framework for considering issues relating to tax avoidance generally. The questions considered relevant to a policy analysis of tax avoidance are: What is tax avoidance? Under what conditions is tax avoidance possible? When is tax avoidance a ‘policy problem? What is a sensible policy response to tax avoidance?

What is the value of, and what are the limitations of, general anti-avoidance rules? The first two questions are discussed below What is Tax Avoidance? Finance literature may offer some guidance to what is meant by tax avoidance in its definition of ‘arbitrage’. Arbitrage is a means of profiting from a mismatch in prices. An example is finding and exploiting price differences between New Zealand and Australia in shares in the same listed company. A real value can be found in such arbitrage activity, since it spreads information about prices. Demand for the low-priced goods increases and demand for the high-priced goods decreases, ensuring that goods and resources are put to their best use. Tax arbitrage is, therefore, a form of tax planning. It is an activity directed towards the
reduction of tax. It is this concept of tax arbitrage that seems to constitute generally accepted notions of what is tax avoidance. Activities such as giving money to charity or investing in tax-preferred sectors, would not fall into this definition of tax arbitrage, and thus would not be tax avoidance even if the action were motivated by tax considerations. It has been noted that financial arbitrage can have a useful economic function. The same may be true of tax arbitrage, presuming that differences in taxation are deliberate government policy furthering economic efficiency.

It is possible that tax arbitrage directs resources into activities with low tax rates, as intended by government policy. It is also likely to ensure that investors in tax-preferred areas are those who can benefit most from the tax concessions, namely, those facing the highest marginal tax rates. If government policy objectives are better achieved, tax arbitrage is in accordance with the government’s policy intent. Tax avoidance, then, can be viewed as a form of tax arbitrage that is contrary to legislative or policy intent.

What Makes Tax Avoidance Possible? The basic ingredients of tax arbitrage are the notion of arbitrage, and the possibilities of profiting from differentials that the notion of arbitrage implies. This definition leads to the view that three conditions need to be present for tax avoidance to exist. A difference in the effective marginal tax rates on economic income is required. For arbitrage to exist, there must be a price differential and, in tax arbitrage, this is a tax differential. Such tax differences can arise because of a variable rate structure, such as a progressive rate scale, or rate differences applying to different taxpayers, such as tax-exempt bodies or tax loss companies.

Alternatively it can arise because the tax base is less than comprehensive, for example, because not all economic income is subject to income tax.

An ability to exploit the difference in tax by converting
high-tax activity into low-tax activity is required. If there are differences in tax rates, but no ability to move from high to low-tax, no arbitrage is possible.

- Even if these two conditions are met, this does not make tax arbitrage and avoidance possible. The tax system may mix high and low-rate taxpayers. The high-rate taxpayer may be able to divert income to a low-rate taxpayer or convert highly-taxed income into a lowly-taxed form. But this is pointless unless the high-rate taxpayer can be recompensed in a lowly-taxed form for diverting or converting his or her income into a low-tax category. The income must come back in a low-tax form. The benefit must also exceed the transaction costs. This is the third necessary condition for tax arbitrage.

- Since all tax systems have tax bases (The thing or amount to which a tax rate applies.

To collect income tax, for example, you need a meaningful definition of income. Definitions of the tax base can vary enormously, over time and among countries, especially when tax breaks are taken into account. As a result, a country with a comparatively high tax rate may not have a high tax burden (Total tax paid in a period as a proportion of total income in that period. It can refer to personal, corporate or national income. ) if it has a more narrowly defined tax base than other countries. In recent years, the political unpopularity of high tax rates has lead many governments to lower rates and at the same time broaden the tax base, often leaving the tax burden unchanged. )that are less than comprehensive because of the impossibility of defining and measuring all economic income, tax arbitrage and avoidance is inherent in tax systems. Examples of Tax Arbitrage/Avoidance The simplest form of arbitrage involves a family unit or a single taxpayer. If that family unit or taxpayer faces differences in tax rates (condition 1 above), and condition 2 above applies, then the third condition automatically holds.

This conclusion follows because people can always compensate
themselves for converting or diverting income to a low tax rate. An example of such simple tax arbitrage involving a family unit is income splitting through, for example, the use of family trust. An example of simple tax arbitrage involving a single taxpayer is a straddle whereby a dealer in financial assets brings forward losses on, say shares, and defers gains while retaining an economic interest in the shares through use of options. Transfer pricing and thin capitalization practices through which non-residents minimize their tax liabilities are more sophisticated examples of the same principles. Multi-party arbitrage is more complex; the complexity is made necessary by the need to meet condition 3 above, that is, to ensure a net gain accrues to the high-rate taxpayer. In the simpler cases of multi-party income tax arbitrage, this process normally involves a tax-exempt (or tax-loss or tax-haven) entity and a taxpaying entity. Income is diverted to the tax-exempt entity and expenses are diverted to the taxpaying entity. Finally, the taxpaying entity is compensated for diverting income and assuming expenses by receiving non-taxable income or a non-taxable benefit, such as a capital gain.

Over the years many have indulged in numerous examples of such tax arbitrage using elements in the legislation at the time. Examples are finance leasing, non-recourse lending, tax-haven (a country or designated zone that has low or no taxes, or highly secretive banks and often a warm climate and sandy beaches, which make it attractive to foreigners bent on tax avoidance and evasion) ‘investments’ and redeemable preference shares. Low-tax policies pursued by some countries in the hope of attracting international businesses and capital is called tax competition which can provide a rich ground for arbitrage. Economists usually favour competition in any form. But some say that tax competition is often a beggar-thy-neighbor policy, which can reduce another country’s tax base, or force it to change its mix of taxes, or stop it taxing in the way it would like.
Economists who favour tax competition often cite a 1956 article by Charles Tiebout (1924-68) entitled “A Pure Theory of Local Expenditures”. In it he argued that, faced with a choice of different combinations of tax and government services, taxpayers will choose to locate where they get closest to the mixture they want. Variations in tax rates among different countries are good, because they give taxpayers more choice and thus more chance of being satisfied. This also puts pressure on governments to be efficient. Thus measures to harmonize taxes are a bad idea. There is at least one big caveat to this theory. Tiebout assumed, crucially, that taxpayers are highly mobile and able to move to wherever their preferred combination of taxes and benefits is on offer.

Tax competition may make it harder to redistribute from rich to poor through the tax system by allowing the rich to move to where taxes are not redistributive. Tactics Used by Tax Evaders Moonlighting Tax evasion at its simplest level merely involves staying out of the tax system altogether. The Revenue deploys small teams of volunteer officers to carry out surveillance to track down moonlighters. Early success was followed up by the deployment of compliance officers in virtually every tax office. Revenue Investigation Officers routinely scan advertisements in local newspapers or shop windows and even before the advent of the modern personal computer they frequently had access to reverse telephone directories to track down moonlighters from bare telephone number details. They also study bank and other financial institutions deposit and loans databases, customs records, and star class hotel bookings for private functions and ceremonies to identify rich individuals who maybe evading taxes.

Non Extractive Fraud Alternatively it can arise because the tax base is less than comprehensive, for example, because not all economic income is subject to income tax. An ability to exploit the difference in tax by converting high-tax activity into low-tax activity is required. If there are
differences in tax rates, but no ability to move from high to low-tax, no arbitrage is possible. Even if these two conditions are met, this does not make tax arbitrage and avoidance possible. The tax system may mix high and low-rate taxpayers. The high-rate taxpayer may be able to divert income to a low-rate taxpayer or convert highly-taxed income into a lowly-taxed form. But this is pointless unless the high-rate taxpayer can be recompensed in a lowly-taxed form for diverting or converting his or her income into a low-tax category. The income must come back in a low-tax form. The benefit must also exceed the transaction costs. This is the third necessary condition for tax arbitrage. Since all tax systems have bases that are less than comprehensive because of the impossibility of defining and measuring all economic income, tax arbitrage and avoidance is inherent in tax systems. This involves profit switches or timing differences, for example:

- Post dating Receipts
- Ante dating Expenditure
- Hidden Reserves
- Incorrect accounting of transactions such as showing an income as a payable.
- Stock manipulation Perhaps the most common place method seen in practice is the manipulation of stock to produce the desired “profit”.

It is not unknown for the evaders’ Accountant to be involved – putting at risk the livelihood and, if the amount involved is significant, personal liberty! The most blatant case of this kind is where the Accountant virtually treated this as year end tax planning. Based upon the formal disclosures made by the evader under the Hansard procedure to the Inland Revenue (in which he implicated the Accountant and in connection with an account in a false name also his Bank Manager), the following scene can be recreated: “Studying the draft accounts the Accountant did a quick calculation to work out what range
of figures could be used for closing stock in hand without giving rise to suspicion. He then apparently discussed with the client the impact on net profit of reducing Closing Stock.

Arrangements were then made for the audit to take place and in the meantime some stock was moved off site! “The Accountant and Bank Manager who assisted the evader are both guilty of conspiracy to defraud – it matters not that they made no financial gain themselves. Extractive Fraud This might take the form of Suppressed receipts or inflated outgoings: Suppressed Receipts Typically these involve defected mainstream takings and often an undisclosed bank account. However the more resourceful evader may take advantage of special arrangements or unexpected receipts: Where the proprietor or director personally deals with some customers it may be possible for cheques to be made out in a manner which facilitates diversion. Alternatively cheque substitution may be used, such that the otherwise “off record sale” cheque is banked and an equivalent amount of “on record cash” is extracted.

It is not unknown for late cash payment of credit sales to bypass the bookkeeping system with the debt subsequently being written off as bad. Unexpected receipts always present a good opportunity for deflection. For example:

1. Scrap sales
2. Insurance or bad debt recoveries
3. Refunds, rebates or discounts
4. Returned goods sold for cash, disposal of fully written down assets and windfalls in general.

The evader may take advantage of a new business opportunity, which remains hidden, and off record. Examples of this seen in practice include:

1. the dentist with three practices of which only two were discloses
2. the off record sale of hitherto obsolete car parts to the burgeoning classic car market

Inflated Purchases & Expenses

Where the ability to deflect receipts is too difficult the evader might draw cash from the business bank account and disguise such withdrawals as some form of legitimate business expense. In practice this often involves the use of “ghost” employees or fictitious outgoings to cover such extractions. Fictitious outgoings have to employ the use of false invoices. These might take the form of altered invoices, photocopied or even scanned “blanked” versions of genuine invoices, completely bogus invoices or even blank invoices supplied by an associate.

Another approach seen in practice involved the use of a seemingly unconnected off shore company to raise invoices for fictitious services. To hide the true ownership of the off shore company the evader uses a “black hole” trust to hold the shares. Essentially this involved a compliant non-resident trustee and “dummy” settler – the trustee providing “stooge” directors as part of the arrangements.

**Employment Tax Evasion Schemes**

Employment tax evasion schemes can take a variety of forms. Some of the more prevalent methods of evasion include pyramiding, employee leasing, paying employees in cash, filing false payroll tax returns or failing to file payroll tax returns. Pyramiding “Pyramiding” of employment taxes is a fraudulent practice where a business withholds taxes from its employees but intentionally fails to remit them to the relevant departments. Businesses involved in pyramiding frequently file for bankruptcy to discharge the liabilities accrued and then start a new business under a different name and begin a new scheme. Employment Leasing Employee leasing is another legal business practice, which is sometimes subject to abuse.

Employee leasing is the practice of contracting with outside businesses to handle all administrative, personnel, and payroll concerns for employees. In some instances, employee-
leasing companies fail to pay over to the authorities any portion of the collected employment taxes. These taxes are often spent by the owners on business or personal expenses. Often the company dissolves, leaving millions in employment taxes unpaid. Paying Employees in Cash Paying employees in whole or partially in cash is a common method of evading income and employment taxes resulting in lost tax revenue to the government and the loss or reduction of future social benefits. Filing False Payroll Tax Returns or Failing to File Payroll Tax Returns Preparing false payroll tax returns understating the amount of wages on which taxes are owed, or failing to file employment tax returns are methods commonly used to evade employment taxes. Payments of Benefits These include free benefits such as personal entertainment, excessive allowances for foreign travel, provision of educational schemes (foreign education) to only preferred employees, car and driver paid by company etc are simple examples.

Conclusion

I hope that I have made clear the difference between doing things right and legitimately and in a fraudulent manner. Whether you are a taxpayer or a consultant it is important to make sure that you understand the nuances of good tax planning. Whilst it is understood that tax planning is becoming more difficult and there is only a thin line between what is right and wrong it obviously requires the expert to do the needful. However be careful not to be tricked by those who claim to be experts in tax planning when they are mere computational experts.

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