‘Risk-mining the Public Exchequer’

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RISK-MINING THE PUBLIC EXCHEQUER

Reflecting the realities of tax risk in the theory of tax avoidance

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Introduction

1. A self-assessed tax liability comes in at least three amounts. There is the amount the taxpayer assesses herself as being required to pay (i.e. the amount said to be payable in her “filing position”), there is the amount the taxpayer is required to pay in law (her “liability”), and there is the actual amount of tax paid after all real-world avenues of challenge, appeal or tax refund claim are exhausted.

2. Tax avoidance is often defined as “reducing tax by legal means” but the only reduction which necessarily results from tax avoidance is a reduction in the first of those three: the amount that is asserted to be payable in the taxpayer’s filing position. This is because some avoidance is challenged by the tax authority and found not to succeed, and in those cases the liability is greater than was claimed in the filing position. These are the instances referred to as “ineffective avoidance” in a paper called Tax Avoidance, issued by the Oxford University Centre for Business Taxation on 3 December 2012.1 I gratefully adopt that helpful label.

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3. It is tempting to suppose that “ineffective avoidance” is taxonomically distinct from “effective avoidance” because it has a different outcome, but in reality the position is not so simple. The only way for “ineffective avoidance” to be distinguished from effective avoidance is for the tax authority to mount a real-world challenge to the filing position. As at the point of filing (i.e. after the relevant taxpayer behaviour has taken place but before the outcome has eventuated) there is no way to determine whether or not the tax liability is understated. Considered as a category of taxpayer behaviour taking place in real time, rather than as a collection of fact-patterns in decided tax cases, there is therefore no difference between effective and ineffective avoidance. There is just tax avoidance and a risk that it will turn out to be ineffective.

4. The purpose of this paper is to explore the theoretical implications of analysing tax avoidance as a species of taxpayer behaviour not classified in hypothetical hindsight according to outcome, but incorporating instead the real-time element of risk as at filing position. Some of the implications of such an analysis are quite radical and surprising, and overturn widely accepted orthodoxies about tax avoidance. Those conclusions are summarised in bullet-point form at the end of the paper.

5. It should be noted that many tax justice advocates include within the meaning of the term “tax avoidance” deliberate tax expenditure by the state for the benefit of Capital, particularly where such expenditure arises from corporate capture of tax policy-making or from the existence of international tax competition. The active role of the state in that kind of tax avoidance takes it outside the scope of this paper, which only addresses tax avoidance insofar as it is understood exclusively as a taxpayer behaviour.

Modelling tax advice “risk space” in two dimensions

6. In the commercial world the structuring of transactions and the drafting of transaction documents is indeterminate while the parties to a transaction and their advisers develop a consensus about how they want to proceed. In all but the simplest transactions tax will be a factor affecting this process, and so the eventual transaction (even if it is perfectly innocent of any suggestion of tax abuse) will in such cases constitute an implementation of tax advice. That tax advice may be thought of as having led the transaction on a journey where the starting point is the form the transaction would have taken absent the tax advice and the end point is the actual transaction as implemented. That journey is treated in this paper as taking place through a two-dimensional space.

7. One axis defining that space has already been noted: it is the amount of tax asserted to be payable in the taxpayer's eventual filing position. Tax advice may serve to reduce that amount, as compared to a hypothetical version of the transaction entered into without the benefit of the tax advice. As already noted, conventional understandings of tax avoidance seek to define tax avoidance by reference to movements along that axis (while usually allowing on some basis or another that not all such movements constitute tax avoidance).
8. The other axis defining the space through which that journey is taken (and the axis which this paper seeks to introduce to the definitional analysis of tax avoidance) is risk. Once specific tax advice has been adopted and implemented a level of tax risk has been assumed by the taxpayer, and that risk subsists by reference to the strength of the resulting filing position – its likelihood of success in the event of tax authority challenge. The strength of the eventual filing position may be contrasted with the strength of the filing position had the transaction been entered into without implementing the tax advice, hence risk being the other axis of the space through which the transaction travels by virtue of that advice.

9. Different advisers will calibrate tax risk differently. I propose to adopt a descriptive scale of filing position strength with the following three positions on it: (1) wrong about the tax, (2) more likely than not to succeed (or “>50%”), and (3) as right about the tax as it is possible to be in the circumstances (or “maximum certainty”). Naturally the scale may be graduated between these points to an arbitrary degree. The resulting two-dimensional tax advice risk space will look like this:
10. In order to produce a generic map of taxpayer behaviour in two-dimensional tax advice risk space, it is necessary to superimpose all possible journeys through that space onto a single curve. This curve (the “tax advice risk curve”) may be thought of as representing a notionally infinite number of positions in tax advice risk space ranging from a single maximally tax-problematic starting point through to a maximally tax-aggressive structuring option. In practice any individual commercial situation will have a starting point somewhere on the curve and a finite number of structuring options at various points further along it.

11. The maximally tax-problematic starting-point is a tax grey-area with no workaround. We are stuck at the zero-point in terms of tax savings and a filing position we are deeply uncertain about. That starting point is halfway up the filing position certainty axis and nowhere along the tax reduction axis, i.e. where the red blob is in the following diagram:
12. Let us now begin our tax-advice-led journey. Since the tax advice risk curve represents incrementally more tax-advantageous positions, the first steps are those which reduce tax risk but do not produce any tax savings. A simple example might be the clauses that are habitually inserted into a self-employed individual’s consultancy agreement because they are inimical to an employment relationship, so as to make sure that employment taxes do not apply. Assuming that on the facts it is probably a consultancy relationship we are dealing with anyway, inserting those clauses reduces risk but does not reduce tax. Here is the trajectory that the simple elimination of tax risk produces:

![Diagram]

13. Translating this trajectory into recognisable language, the advice that takes us in this initial direction would sound like this: “if you draft it like that, [employment taxes] could be said to apply – my advice is they don’t but there is still a risk – I recommend you draft it like this instead, then you should be fine”. The risk gradient emerges in the modalities of the verbs: the shift from “could” to “should” represents an increase in certainty.
14. Eventually we will exhaust all the things we can possibly do to reinforce our filing position. Our filing position will be at the maximum available certainty in the circumstances. All the grey areas have been side-stepped or worked around. From now on any incremental tax advantage must involve reducing tax. It is perfectly possible to do this without creating risk. For example we might pursue a specific category of investment, upon the recommendation of our tax adviser, because it attracts more favourable tax reliefs than other investment options in prospect. Indeed this is often taken as the paradigmatic example of “legitimate tax planning”. Since the filing position remains as strong however much of this stuff we do, the next stretch of our trajectory is horizontal, like this:
15. But there will come a point when our filing position starts to get weaker again. There are further tax savings to be obtained but they cannot be guaranteed, or at least they cannot be said to be as likely to succeed as the filing position we would have if we did not implement the advice. New tax risk factors are being introduced, and the relative certainty in the modalities of the verbs has reversed. It is now the tax advice which produces an analysis that “might” succeed, whereas if we do not implement the advice the tax “will” be payable. We are now on a section of the tax advice risk curve which is going in this direction:

16. As the advice gets more aggressive, the chances of success drop further. At some point it dips below the “more likely than not to be right about the tax” line. It is crucial to bear in mind that we are talking about strength of filing position, here, and not outcome. This is not the boundary between “effective avoidance” and “ineffective avoidance”. It is the boundary between a tax position which is likely to be effective and one which is likely to be ineffective.
17. Eventually the tax advice will be so aggressive that the chances of success upon tax authority challenge hit the bottom. The anti-avoidance law definitely applies, or the statutory interpretation relied upon cannot possibly be correct, or the commercial reality of the transaction is such that the formal analysis is hopelessly unsustainable, or the factual assertions are never going to withstand forensic scrutiny, or the accounting assumptions are false. Our filing position is, in effect, a lie. And if it is challenged it will fail. We are at the far end of our journey along the tax advice risk curve, down here:

18. The next step of the mapping process is to label the sections of the curve. I think it is clear that the initial vertical section of the curve represents an activity that could well be described as “elimination of tax risk”, and the section so labelled ends when the risk gradient turns through a right-angle at the top.
19. Once the gradient switches to horizontal, we are in the world of actual tax reduction, at least insofar as concerns filing position, and I think we can all agree that tax reduction starts off on the left with wholly innocent “legitimate tax planning”. Skipping the intervening section for the time being and going to the other end of the curve, there resides (and again this should not be controversial) avoidance of the most aggressive, egregious, and unconscionable kind. And so our tax advice risk curve, assuming just for the time being that “legitimate tax planning” merges indistinguishably into an as-yet-unmarked “avoidance” and then on into “aggressive avoidance”, looks like this:
Marking the boundary between “legitimate tax planning” and “avoidance”

20. Readers who have been paying attention will probably have already worked out where this is heading. The point I have been working towards is that, contrary to popular and even expert belief, there is in fact a clear dividing line between “legitimate tax planning” and “avoidance”. It is here:

21. It comes, in other words, where the risk gradient starts to go downwards in tax advice risk space; the point at which the tax advice starts to create risk, rather than reducing risk or being risk-neutral.

22. Admittedly at first the risk differential is small, but it is appreciable to a professional because pointing out tax risk, or (more accurately) identifying tax risk factors which are introduced by a given structuring option, is a tax adviser’s job. Indeed if a tax adviser fails to identify a tax risk factor which is introduced by a given structuring option and that risk eventuates, the adviser has in principle exposed herself or her firm to an action in professional negligence.
23. Why does risk-creation mark the dividing line between “legitimate tax planning” and “tax avoidance”? This is a key question. We understand there to be adverse moral overtones to the concept of “tax avoidance” which are absent with “legitimate tax planning” and so if a specific feature is said to distinguish “avoidance” from its morally neutral neighbour, we want to know what it is about that feature which legitimises the moral opprobrium. What, then, is so wrong with the deliberate creation of tax risk?

24. Before investigating this question, let us mark our newly distinguished tax advice risk curve sections:

25. I have retained the fingerpost on the curve, because it draws attention to an actual answer to two oft-asked but thought-to-be-rhetorical questions - “where do you ‘draw the line’ with tax avoidance?” , and “what is the ‘right’ amount of tax?” Broadly speaking the line between “legitimate tax planning” and tax avoidance is to be drawn at the point where implementing tax advice engages the adviser’s professional duty to advert to the fact that implementing it will introduce a new tax risk-factor, or otherwise create tax risk. The “‘right' amount of tax” is the amount of tax you pay if you implement tax advice which eliminates risk or is risk-neutral, but do not implement tax advice which actually creates tax risk.
What is so wrong with the deliberate creation of tax risk?

26. Deliberately creating tax risk is deliberately creating the possibility that your filing position understates your tax liability. Between not understating your tax liability (“legitimate tax planning”) and understating your tax liability (“evasion”) lies a category of behaviour which is deliberately bringing about the possibility that you might have understated your tax liability, and this is the category of behaviour which I propose to label “avoidance”.

27. We have already seen that perfectly innocent taxpayer behaviour can fall within a tax “grey area”. In other words the taxpayer can find herself burdened with tax risk. That tax risk corresponds to exchequer opportunity. If there is a chance you have fallen into a tax trap, that means there is a chance that the exchequer can successfully challenge your filing position and collect extra tax from you. But once you have passed over to the other side of the tax advice risk curve – once you have gone past the point of maximum filing position certainty and are now deliberately creating the possibility that your filing position understates your tax liability – the position is reversed: the risk where the filing position goes unchallenged is now for the exchequer, and the taxpayer has created an opportunity for herself.

28. And let us be clear about the nature of the taxpayer’s opportunity, because it throws into sharp relief the central contradiction in conventional conceptions of tax avoidance. Avoidance is usually defined as reducing tax payable by legal means, but in fact the opportunity that is increased as you head down the avoidance section of the tax advice risk curve is the opportunity to not pay tax which is legally payable. This is because wherever there is tax risk there is a chance that (a) the filing position is wrong and that extra tax is payable, and there is also a chance that (b) the filing position is not going to get challenged (or that the challenge fails for want of evidence, or fails for technical or procedural reasons).

29. It is for this reason that aggressive tax avoiders and commercial promoters of tax avoidance schemes shop around for tax advice which takes an unrealistically optimistic view of tax-motivated transactions: the more aggressive the filing position, the greater the opportunity to not pay tax which is legally payable. But in fact any deliberate creation of tax risk, however small its shortfall as compared with maximum filing position certainty, is a deliberately-created opportunity to not pay tax which is legally payable. That opportunity is created at the expense of taxpayers generally, and is therefore anti-social conduct deserving of the opprobrium attaching to the phrase “tax avoidance”.

30. This risk game that tax avoiders play with what is potentially public money is set out in the flow-chart on the next page. The innovative feature of this apparently simple flow-chart is that I put the questions in the correct order. The mistake invariably made in this context is to treat the process of tax authority challenge as itself determinative of whether or not a liability to pay additional tax arises. This treatment reflects a fundamental error of analysis. Except in the very rare case of retrospective anti-avoidance legislation, the liability is anterior to the processes of enforcement.
31. To non-lawyers this may appear to be a controversial or philosophical point but it is not. It is trite law (in the UK at least and no doubt elsewhere) that in the case of ineffective avoidance the tax charge is treated as already having arisen ab initio in accordance with the charging provisions that are found to have applied. Accordingly, my flow chart asks whether or not the avoidance has the intended effect in terms of tax liability before it introduces the possibility of challenge:

- **taxpayer deliberately creates tax risk**
- **taxpayer adopts consequent uncertain filing position**
- **is the filing position correct as a matter of law?**
  - **Yes**
  - **is the filing position challenged?**
    - **Yes**: “effective avoidance”: no additional tax is payable
    - **No**: “ineffective avoidance”: more tax is collected
  - **No**: taxpayer pockets funds even though legally they are payable into the public exchequer as tax
32. It is because of that outflow at the bottom of the flow-chart, where public funds remain in private hands as a result of the taxpayer behaviour at the top of the flow-chart, that the deliberate creation of tax risk is an anti-social behaviour and society is right to object to it. A policy of deliberate tax-risk-creation over time should be treated as a kind of risk-mining, which extracts value from the public exchequer by seeking to withhold money, some of which should as a matter of law be paid into it.

33. It should be emphasised that we are talking here about tax risk that has been deliberately created *qua* tax risk, and not tax risk which has arisen as a result of deliberate but non-tax-motivated behaviour. If you do something in pursuit of your commercial objectives and it gives rise to tax risk, you are not in the “avoidance” zone. You are over on the left of the curve in the zone where you want tax advice to eliminate tax risk, not create it. If you have an uncertain filing position over in that zone and it is not challenged you cannot be reproached for any loss to the public exchequer. The difference is in the risk gradient at the end point that the tax advice is taking you to. There is no “blurred boundary” or difficulty in “drawing the line” between on the one hand eliminating and on the other hand introducing tax risk factors, and advice which fails to identify itself as doing one or the other would be very incompetent indeed. To distinguish deliberately-created tax risk, which is better thought of as risk for the public exchequer rather than for the taxpayer (for whom it is really an opportunity) I propose to label it “exchequer risk”.

**Safe “open-cast” exchequer-risk-mining in the enforcement-free zone**

34. Clearly any given “more likely than not to succeed” filing position is by definition more likely than not to be correct, but that does not mean that every such filing position is correct. In the same way, a single roll of a six-sided die is unlikely to result in a six, but an arbitrarily large number of rolls will result in roughly 16.67% of them being sixes. Likewise with the deliberate creation of exchequer risk, even where the risk is small. If exchequer risk is being deliberately created an arbitrarily large number of times, and not all filing positions are being challenged, an inevitable result will be tax not paid which is legally payable. It is for this reason that a policy of deliberate exchequer-risk-creation over time should be treated as the risk-mining of value out of the public exchequer, *even where the filing positions are “more likely than not to succeed”*.

35. Indeed, counter-intuitively, exchequer-risk-mining with only moderate increases in risk is more likely to extract value from the public exchequer than tunnelling deep seams of exchequer risk with filing positions that are likely to fail upon challenge. The reason for this apparent paradox is quite simple; tax authorities will almost always want to challenge aggressive avoidance but they will not want to waste resources challenging filing positions which are relatively strong. A policy of challenging deliberately-created exchequer risk where the filing positions are nonetheless more likely than not to succeed would create a gigantic public-sector industry of largely fruitless tax litigation. Even if tax authorities wanted this and had the resources to bring it about, it could not conceivably be politically acceptable because of the corresponding waste of taxpayer resources in resisting these tax authority challenges.

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36. It follows that enforcement against “more likely than not to succeed” filing positions is unlikely, and that value extraction in this region of tax risk space can therefore be pursued more-or-less with impunity. If you get your risk level right (and of course the biggest and best-resourced tax avoiders generally do), the amount of tax that you potentially pocket is huge, and the prospect of it being found to be owing through the machinery of enforcement is negligible. Operating in what is effectively a rule-of-law no-fly zone, you can quarry away at the the public exchequer until it is a wasteland of holes and nothing will be done to stop you.

37. Much of the corporate tax avoidance publicised in recent times has been this safe kind of “open-cast” exchequer-risk-mining. Activists and journalists draw attention to it and the public is scandalised, but the perpetrators describe it as legal and the tax authority impliedly endorses the perpetrators' narrative by doing nothing, notwithstanding that huge amounts of money might be being lost to the public purse. There is no way to estimate the amount that is being lost in this way because it is not treated as tax avoidance by tax authorities and so it does not feature in "tax gap" figures. The inclusion of this rule-of-law-free “safe zone” in tax advice risk space, where open-cast value-extraction from the public exchequer takes place, completes our diagram:
38. Some might say that there is nothing “morally” wrong with creating low levels of exchequer risk, but the burden should probably be on those who advance that proposition to substantiate it. Generally-speaking the creation of risk for others is the very definition of what constitutes irresponsible behaviour. Why should tax be a unique sphere in which there is no moral dimension to irresponsible conduct? Further, opportunities to create exchequer risk increase as the complexity of one’s business affairs increases, and so such opportunities tend to accrue to wealthier taxpayers. It seems grossly inequitable (and therefore morally wrong) that the social cost of exchequer risk-mining should be disproportionately visited upon less wealthy taxpayers – that indirect taxes paid by the very poorest in society and employment taxes deducted from the salaries of workers are risk-mined back out of the public exchequer by the wealthy.

**Exchequer-risk-creation as the essential feature of abusive tax conduct generally**

39. This paper began with the observation that, in view of the role played by risk, it is misconceived to define tax avoidance (as a taxpayer behaviour) by reference to outcome. A key point to recognise as we approach its conclusions is that it is equally misconceived to define tax avoidance by reference to method.

40. For example, it is often said that tax avoidance involves complying with the letter but not the spirit of the law, or relying on formalities which do not correspond to economic reality. It is true that taxpayers, acting on tax advice, sometimes structure transactional formalities so as to seek to benefit from “literal” interpretations of tax legislation in circumstances where there is a possibility that a court might apply a more purposive interpretation of the law, or a more realistic view of the facts, so as to deny the taxpayer her fiscal advantage. Structuring a transaction in this way constitutes the deliberate creation of tax risk, and so the behaviour does indeed constitute tax avoidance.

41. But to define avoidance by reference to these particular methods of exchequer-risk-creation is a little like defining paint by reference to the colours it comes in. From a definitional perspective it does not matter how the risk to the exchequer is created. There are many ways to do it (including methods that have nothing to do with the “spirit” or purpose of tax legislation), but whatever method is adopted, what it does is create a fiscal opportunity at the expense of the public exchequer.

42. Stepping back from both method and outcome, it becomes clear that we should treat exchequer-risk-creation, not as an analysis of the thing we are talking about when we talk about “tax avoidance”, but as its essential defining feature as a category of taxpayer behaviour. There is nothing wrong with reducing your tax liabilities by implementing lawful commercial options upon the recommendation of a tax adviser, or by deliberately structuring your transaction so as to obtain the benefit of some tax legislation literally interpreted, but there is something wrong with these things if they serve to create the possibility (however small) that you are underdeclaring your tax.
43. Exchequer-risk-creation is fundamental to tax evasion too. Evasion is a specific subcategory of exchequer-risk-creation where the method (underdeclaring your tax) is itself unlawful, and the filing position is definitely (rather than possibly) wrong. But deliberately underdeclaring your tax, as with only creating the possibility that you have underdeclared your tax, throws an enforcement burden onto the tax authority which, depending on whether or not a successful tax authority challenge takes place, may result in your not paying tax which is legally payable. And to that extent evasion and avoidance are the same thing.

44. Indeed if we isolate the deliberate creation of exchequer risk from scenario-specific contingencies like method and outcome, and simply treat it as the essential and defining feature of abusive tax conduct generally, it also makes it much easier to understand some of the international variants of tax abuse, which do not fall into conventional definitions.

45. Abusive intra-group cross-border pricing, for example, sits uncomfortably within ordinary definitions of abusive tax conduct, because it is quite hard to identify at what point a tax-driven pricing exercise becomes a species of dishonesty, and indeed the multinational enterprises that indulge in it will always assert that the prices are within the defensible range that could lawfully have been adopted for the purposes of each jurisdiction.

46. But it is the deliberate use of a tax haven conduit or “hub” entity that constitutes the key abusive conduct in this kind of scenario, rather than the subsequent pricing exercise, because the use of the tax haven entity creates exchequer risk in the jurisdictions at both ends of the supply chain without a corresponding taxpayer risk in the middle. The tax haven entity can buy as cheaply as possible and sell as expensively as possible, reducing taxable profits in its in-group counterparties, but creating corresponding profits for itself which do not suffer tax. The effect of introducing the tax haven entity is therefore a deliberate net increase in overall exchequer risk among the three jurisdictions.

47. Looking at the untaxed profits of the tax haven entity, conventional definitions would struggle to identify them as the proceeds of tax avoidance; still less as the proceeds of tax evasion. But they are manifestly the proceeds of exchequer-risk-creation and as such they are the proceeds of abusive tax behaviour. In circumstances where the pricing is not so aggressive as to attract challenge in either of the jurisdictions where corporate profits are actually taxed, the profits in the tax haven entity will be the proceeds of what I have described above as “open-cast” exchequer-risk-mining, value-extraction in the safe zone where tax authority challenge is unlikely.

**Summary of conclusions**

48. In summary, then, the deliberate creation of exchequer risk:

- is an essential feature of abusive taxpayer conduct generally, being shared by both “tax avoidance” and “tax evasion”;
• is the essential defining characteristic of what has hitherto been labelled “tax avoidance”, distinguishing it from “legitimate tax planning”;

• can result in the loss of tax actually legally payable;

• inevitably results in the loss of tax actually legally payable if pursued as a matter of sustained policy, which is the practice of most large corporate taxpayers;

• can (depending on the degree of exchequer risk created) take place outside the effective purview of the rule of law because of the practical unlikelihood and political unacceptability of tax authority challenge in cases where the filing position is more likely than not to succeed;

• constitutes the source of certain abusive international financial flows;

• can in every instance be objectively identified by the taxpayer’s advisers before it is even implemented, and indeed should be so identified in accordance with those advisers’ existing professional obligations.

49. There is a widespread perception that the law provides a clear line of minimum tax payable, that prudent persons push their tax liabilities down to that minimum, and that the idea of “tax avoidance” as a discrete species of anti-social behaviour is therefore misconceived. This is a plausible-seeming narrative which is happily promulgated by the tax industry but it is deeply misleading. In fact, as we have seen, the creation of exchequer risk is an objective threshold which a taxpayer chooses to cross under advisement, and once over that threshold the taxpayer is playing a deliberate risk game with what may be public money.

50. There are some who say that the paramount factor where tax avoidance is concerned is the rule of law, and that the solution to tax avoidance is better legislation and better enforcement. As I hope emerges from the analysis in this paper, that approach is only ever going to be able to tackle the aggressive avoidance at the far end of the risk curve. A more sophisticated perspective which recognises the role played by risk is required in order to arrive at a proper understanding of the problem, and hence to develop solutions which render the public exchequer resistant not just to the more dramatic forms of tax avoidance that are widely acknowledged but also to the systematic value-extraction that I have characterised in this paper as risk-mining.

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August 2014