Tax avoidance or tax evasion?
The difference between tax avoidance and tax evasion is the thickness of a prison wall
(Denis Healey)

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Abstract: This article seeks to distinguish clearly between tax avoidance and tax evasion. These concepts are not new to the field of taxation as they have been contested since 1900. Tax avoidance is a means by which tax payers reduce tax liability by planning their affairs so as to attract the least tax possible but still acting within the provisions of the Income Tax Act. Tax evasion is an illegal action as it constitutes a deed where the person is breaching the provisions found in the Income Tax Act. In response to tax avoidance and evasion, the legislator has introduced a number of anti-avoidance provisions which are both specific, tailor-made for certain articles, and also general. This paper shall discuss such provisions with the help of local and UK case law.

Keywords: tax avoidance, tax evasion, legislation

The principles of tax avoidance and evasion are no recent invention as the tales of Malta’s hate relationship with taxation are numerous and date back to the seventeenth century to the extent that it is said that some Maltese males became clerics exclusively to benefit from a tax exemption.1

The whole argument centres on the question posed ‘Is there anything wrong with tax avoidance?’ and the logical answer is ‘no’ as it is no criminal offence to make an effort to legitimately pay the least possible

1 Robert Attard, Principles of Maltese Tax Law (Malta, 2008).
tax. This situation is similar to the decision that a person takes to invest his money in the best possible manner. If the same question is posed with regard to tax evasion the answer is ‘yes’ as here the person is committing a criminal offence. This paper shall discuss these issues with the help of case law both from the local and UK scenarios.

To put the subject in perspective it is important to distinguish between the concepts of tax avoidance, tax evasion, and tax mitigation. Tax avoidance concerns arrangements that reduce tax liability in a manner contrary to the intention of parliament. Tax evasion is rather different, as it is a criminal offence normally constituting a dishonest submission of a tax return involving undeclared income. Tax mitigation reduces tax liability without tax avoidance.²

**Discussion**

The difference between tax avoidance and evasion was first noted in the UK in 1900 in the case of Bullivant v AG³ where it was stated that ‘the word ‘evade’ is ambiguous … there are two ways of constructing the word evade: one is that a person may go to a solicitor and ask him how to keep out of an Act of Parliament – how to do something that does not bring him within the scope of it. That is evading in one sense but there is nothing illegal in it. The other is when he goes to the solicitor and says, “Tell me how to escape from the consequences of the Act of Parliament, although I am brought within it.” This is an act of quite a different character.’

However, the distinction in the terms was recognized in the UK in the 1950s when the Radcliffe Commission (1955) distinguished between the two terms by stating ‘It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities, which are responsible for a person not paying tax that the existing law charges upon. Ex hypothesis he is in the wrong … By tax avoidance, on the

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³ TC (1901 ac196).
other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid for the arrangement.’

The clear articulation of the concept of tax mitigation dates back to 1970s and this concept originated from economists and not lawyers. C.T. Standford distinguishes between avoidance and mitigation by stating that it is reasonable to confine ‘avoidance’ to action which results in the would-be-avoiders substantially achieving the objective to which tax has become an obstacle, e.g. If a man ceases to buy cigarettes because of tobacco tax he has not achieved his pre-tax objective which is to smoke. Buying sweets instead of cigarettes is not tax avoidance.

Furthermore Lord Nolan, in the Willoughby case, distinguished between tax avoidance and tax mitigation by stating that the hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in tax liability. The hallmark of tax mitigation is that the taxpayer takes advantage of a fiscally attractive option offered to him by tax legislation and genuinely suffers economic consequences that Parliament intended to be suffered by those taking advantage of the option.

The basic correlation that no person is obliged to suffer more tax than is otherwise due can be summed up by Lord Tomlin’s widely quoted words: ‘Every man is entitled, if he can, to order his affairs so that the tax attaching ... is less than it otherwise would be’.

This dictum has been echoed in various other judgements namely in IRC v Fishers Executors where Lord Sumner stated ‘the subject is entitled to arrange his affairs as not to attract taxes imposed by the crown’. Furthermore in the case of CIR v Newman, it was stated that

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6 1997, STC 995, 1004.
7 IRC v Duke of Westminster (1936), AC1 (HL).
8 IRC v Fisher’s Executors (1926).
9 159 F.2D 848 (2D CIR. 1947).
‘there is nothing sinister in so arranging one’s affairs so as to keep taxes as low as possible’.

Lord Nolan, in the case of IRC v Willoughby (1997), also described tax avoidance as a course of action designed to conflict with or defeat the evident intention of parliament.

Tax avoidance refers to types of transactions that result in the alteration of the incidence to taxation in a manner or in circumstances contrary to the purpose and policy of the relevant Revenue provisions. Consequently tax avoidance is related more with what the legislature did not specifically impose by way of taxation. ‘It covers instances where legislative intention and policy miscarried and failed to anticipate and reach the transaction under consideration.’

Tax avoidance has been described by reference to certain observable criteria and functional characteristics, which include:

- The extent to which the transaction was influenced or actuated by the prescribed taxation purpose;¹⁰
- Whether the transaction was artificial or contrived;¹¹
- Whether the transaction sought to exploit statutory loopholes or weaknesses;¹²
- Whether the transaction lacks economic reality.¹³

These attributes are arguably not unique to tax avoidance practices and are in themselves not sufficient and conclusive as to whether a sufficient tax advantage should be permitted or denied. Hence, a line cannot be cut clearly to decide the boundaries of permitting a tax advantage and it is the courts that decide after weighing the merits of each case.

An interesting local case that shed some light in this misty field was that of Grove Enterprises Ltd. vs. Frank Bowers et (case 526/2003).

¹⁰ N. Orow, General Anti-avoidance rules: A comparative international analysis (Bristol, 2000).
This concerned to some extent the concept of tax avoidance. Basically Grove had leased a house in Santa Maria Estate to Bowers and the agreement provided that rent had to be paid for the whole term. However, the payment due by the tenant was split in two, partly for the property rental and partly for the furniture in the villa. Bowers left before the expiration of the period and refused to pay rent on the grounds that the agreement involved an illicit clause on the grounds that no tax was paid by Grove on the rental of furniture to Bowers. The court held that this was a civil case and the element of tax planning was immaterial. The judgement, inter alia, stated

*L-ewwel nett ma jirriżultax jekk il-qasma tal-kirja, b’tant ghall-fond u tant ghall-ghamara kinetx forma ta’tax evasion li hu illegali jew tax avoidance li hu permissibli. Ma hemm xejn hażin li persuna tirranga s-sitwazzjoni finanzjarja taghha b’mod li tiği li thallas l-angas taxxa possibli. Sakemm dak li jkun jinqeda, b’mod leċitu, bl-ghodda li taghtih il-liġi, ma jkun qed jagħmel xejn hażin jekk juża dawk l-ghodda biex inaqqas l-impenn fiskali tiegħu.*

This case demonstrates that when a taxpayer arranges his affairs to pay the least tax possible, they are not breaching any article in the Income Tax Act.

**Types of anti-avoidance provisions**

In response to the continuing struggle between the legislator and the ingenious taxpayer and his advisors, tax authorities enacted provisions in both legislation and in subsidiary legislation to ensure the effective blockage of potential ‘loopholes’. The tools employed by the legislator consist of both specific and general anti-avoidance provisions.

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Specific anti-avoidance provisions

Specific anti-avoidance provisions are ‘tailor-made’ to cater for specific abuse, and contribute to control it in specific areas. However, although they are targeted at specific areas, sometimes, they still leave gaps which taxpayers can exploit. Consequently, they are supported by general anti-avoidance provisions that are general expressions of principle directed to a particular category of tax-significant transactions, that partake in the character of tax avoidance.¹⁵

The Income Tax Act (CAP 123 of the Laws of Malta) contains specific provisions that are inserted in articles throughout the Act. Thus specific anti-avoidance provisions may be found, for instance in the exemptions contained in article 12(1)(c), the group provisions (article 16–22), and the flat-rate foreign tax-credit provisions wherein the legislator is ensuring that the particular benefits are reaped by specific beneficiaries without benefiting unintended beneficiaries and structures. These provisions are accompanied by general provisions together with a clearance procedure, such as the general anti-avoidance provision contained in article 51 of the ITA.

General anti-avoidance provisions

Statutory anti-avoidance provisions of a general nature are often expressed and intended to impose a general overlay upon either the whole or specified parts of tax legislation. Furthermore, Arnold is of the opinion that any tax system requires some general anti-avoidance rule to ensure that taxpayers cannot avoid obligations that the law seeks to impose by engaging in transactions designed to avoid those obligations.

It is argued that where a general rule imposes a carte blanche operation to deny all taxation advantages that derive from transactions actuated by a prescribed tax avoidance purpose, then such a rule would frustrate rather than give effect to legislative intention and policy. It is

therefore critical that any anti-avoidance rule must contain a targeting mechanism that operates to permit or deny taxation advantages by reference to legislative policy. Furthermore statutory anti-avoidance provisions are not a panacea. Through their operation they can describe the arrangements that fall within the scope and those that fall outside the scope of their application.

General anti-avoidance provisions have been present in the ITA since its enactment in 1948. These provisions were based on UK tax legislation and must be treated with caution given that anti-avoidance legislation is a sensitive barometer of the relationship between the rights of taxpayers and the needs of the state.

The ITA includes a general anti-avoidance clause which empowers the commissioner to disregard artificial or fictitious transactions or schemes detailed simply to reduce the amount of tax payable by any person, even if such schemes are not finally put into effect or implemented. Where any scheme, which reduces the amount of tax payable by any person, is artificial or fictitious or is in fact not given effect to, the CIR shall disregard the scheme and the person concerned shall be assessable accordingly.

It can be argued that, given the absence of a definition of the terms ‘artificial and fictitious’ in the ITA, these terms are subject to interpretation. Moreover, these words appeared in the Finance Act (1915) in the UK which stated that a person shall not for the purpose of avoiding payment of tax on excess profits enter into fictitious or artificial transactions or carry out any fictitious or artificial operation. Inter alia, if a transaction is ‘fictitious’ it ought to be ignored without the aid of special legislation; and a transaction is not described as ‘artificial’ if it has valid legal consequences unless some standard can be set up to establish what is ‘natural’ for the same purpose.\(^{16}\)

A case (BSC case 21/62) involving article 51 of the Income Tax Act dealt with a loan made by a father to his children at a very low rate of interest (2 per cent) on 30 January 1956. Subsequently on 28 September 1956 the father loaned a further sum to his children at the same rate.

\(^{16}\) Board of Special Commissioners, case no. 1955.
All the money was then loaned to a third party at a much higher rate of interest, 6 per cent. The commissioner served the father with an assessment which included the full interest received from the third party.

The Board of Special Commissioners decision, subsequently confirmed by the Court of Appeal (1963), considered that the motive behind the first loan given to the children was genuine and could not be considered as being artificial or fictitious. *A contrario sensu* to these facts were the circumstances in which the second loan was given to the third party which were considered as being artificial and fictitious.

Article 51 (1) was in this case applicable and the father was taxed on the full amount of the interest on loan (6 per cent) subsequently given to the third party. This case sheds light upon the intention of the legislator who centres the argument upon the existence of a fictitious transaction.

**Basis of anti-avoidance legislation**

J. Kessler suggests that the core of anti-avoidance legislation is based on two basic conditions that have to be satisfied these being:

- That the purpose of avoiding liability to tax was not the purpose or one of the purposes for which the transfer or associated operation or any of them were affected;
- That the transfers on any associated operation were commercial transactions and were not designed for the purpose of avoiding liability to tax.\(^{17}\)

\(^{17}\) Kessler.
Kessler argues that failing this test is synonymous with tax avoidance. A similar conclusion was arrived at by the Special Commissioners in the case of Carvill v IRC (2000) by stating that

one must ask whether the transfer was designed for the purpose of avoiding tax or not ... when it is clearly accepted that a transaction can be designed for more than one purpose the only way to categorize the design into one purpose is to look at the main purpose of the design.\textsuperscript{18}

It is interesting to analyse various decisions dealing with anti-avoidance schemes. Although these are not local cases, they are still relevant to the discussion as article 2(2) of the Income Tax Act suggests that

words and expressions used in the Act which are not known to the law of Malta but are known to the English Law, shall so far as may be necessary to give effect to this act and consistently with the provisions thereof, have the meaning assigned to them in the English law and be construed accordingly.

The attitude of the judiciary to the misty vision of avoidance schemes was clarified in the renowned case of WT Ramsay Ltd v CIR (1981). The case concerned a company that made a substantial gain from the sale of a farm and then carried out a number of share and loan transactions with the object of creating a large allowable loss at little cost to itself. A loss emerged of about £175,000 on shares it subscribed for in a company formed for the purpose of the scheme. The success of the scheme depended on its establishing that a loan to the same company sold at a profit of £173,000 was not debt on security falling within the Taxation of Capital Gains Act. The acceptance of the offer of the loan was given orally but evidenced by a statutory declaration by a director of the borrowing company. It was decided that the loan, being evidenced by a statutory declaration which represents a marketable security, was not a debt. The complex ‘circular’ avoidance scheme resulted in no betterment of the financial

\textsuperscript{18} \cite{1982} A.C. 300.
position of the parties but merely in the creation of a large loss for capital gains purposes. Additionally a series of preconceived transactions were entered into to avoid tax with a clear intention to proceed through all stages of completion once set in motion. In this case Lord Wilberforce held that, although the ‘Duke of Westminster principle’ prevented a court from looking behind a genuine document or transaction, it did not compel the court to view a document or transaction in blinkers isolated from any context to which it properly belongs.

Turning to the facts of the case it was clear that the purpose of the scheme was tax avoidance without any commercial justification and that it was the intention to proceed through all stages and to completion once set in motion.

A similar case involving facts of a similar nature was that of Eilbeck v Rawling (1981) where a chain of transactions were entered into with the object of creating a material allowable loss. The central feature of the scheme involved acquiring reversionary interests in two trust funds, one in Gibraltar and another in Jersey. Furthermore the Gibraltar trustees advanced £315,000 to the Jersey trustees. Both trusts were subsequently sold making a gain on the Jersey settlement which was exempt for capital gains tax purposes (1992) and a loss on the Gibraltar settlement was claimed as an allowable loss. The Inland Revenue issued an assessment on the Gibraltar gain and did not allow a deduction for the loss. The appeal of this case was comparable to that of WT Ramsay v CIR (1981) and was effectively dismissed for the same reason, namely that the scheme was to be looked at as a composite transaction under which there was neither a gain nor a loss but constituted merely a tax avoidance scheme without any commercial justification.

A case that extended the requirements and conditions of the Ramsay principle was that of Furniss v Dawson (1984) where shareholders in two family companies wished to dispose of their shares and found an unconnected company willing to acquire them at an agreed price. Prior to disposing of the shares, they exchanged them for shares in an intermediary company which in turn sold them to another company. The Inland Revenue issued the assessment as if shares had been disposed of directly to the company and the insertion of an intermediary company was designed to take advantage of the law with regards to company
reconstructions. Lord Brightman stated the classic requirement or condition for the application of the Ramsay principle by stating that this applies where there is a pre-ordained series of transactions and steps were inserted which had no commercial purpose apart from the avoidance of the liability to tax. If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes and the court must then look at the end result.

However, in Craven v White (1988) the House of Lords indicated that, for the Ramsay principle to apply, all transactions have to be pre-ordained with such a degree of certainty that at the time of the earlier transactions there is no practical likelihood that the transaction would not take place. In this case Lord Jauncey (1988) considered that a step in a linear transaction which has no business purpose apart the avoidance or deferment of tax liability would be treated as forming part of a pre-ordained series of transactions or of a single composite transaction.

Lord Nicholls (2001) stated that the phrase ‘the Ramsay principle’ is potentially misleading and asserts that in Ramsay the House did not enunciate any new legal principle. What the House of Lords did was to highlight that when confronted with new and sophisticated tax avoidance devices the duty of the court is to determine the legal nature of the transaction in question and then relate them to fiscal legislation.

A recent case (2001) involving a complex and artificial tax avoidance scheme was that of Hitch and others v Stone. The case concerned the Hitch family who wanted to dispose of a farm without paying capital gains tax or development land tax and devised a scheme to achieve this end.

The Inland Revenue mounted a successful challenge on the grounds that the agreements on which it was based constituted a ‘sham’. The concept ‘sham’ was defined as ‘acts done or documents executed by the parties thereto which were intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations which the parties intended to create’.

Furthermore, in this case the documentation to carry into effect the tax avoidance scheme possessed little or no commercial reality. It was what the judge called a ‘highly artificial scheme’.
In essence, when a person utilizes a scheme with the sole or main purpose of avoiding, reducing, or postponing tax liability as a direct or indirect result of the scheme, the Commissioner of Inland Revenue (CIR) is empowered to determine such person’s tax liability so as to ‘nullify or modify such scheme and its consequent advantage’.

Article 51 (5) of the ITA defines a scheme as including any disposition, agreement, arrangement, trust, grant, covenant, transfer of assets, and alienation of property whatsoever irrespectively of the date on which such scheme was made, entered into, or set up. This definition delineates the parameters of a scheme.

This paper encapsulates a blanket provision with the aim of eradicating schemes set up with the intention of reducing the liability to tax. The sole or main purpose of the scheme must be tax avoidance. One may argue, a contrario sensu, that if the intention and scope of the scheme was not tax avoidance but was a purely bona fide commercial purpose, it is acceptable even if tax savings result as an incident of the scheme. On the other hand, if the sole or main purpose of the scheme is tax avoidance and the transactions would not have taken place for an ulterior reason the scheme is unacceptable. Through the enactment of this article the legislator has attempted to design a ‘catch all’ clause that affects not only persons who set up schemes but also persons who are in a position of obtaining such an advantage.

In the event that the commissioner agrees that the sole objective of the scheme is tax avoidance he may ‘nullify or modify the scheme and the consequent avoidance’. It is worth analysing the different courses of action that the CIR has in article 51 (1) and 51 (2). In article 51(1), the CIR is obliged to (‘shall’) disregard the scheme as if it did not take place, whereas in article 51 (2) he can nullify or modify such a scheme.

Conclusion

Anti-avoidance measures can be perceived as a sieve that prevents the reduction of the liability to tax. Specific measures engrained in the articles serve as effective control measures that can tighten the tax net or deter the avoidance of tax by taxpayers. General anti-avoidance
measures serve their purpose as a barrier that further filters transactions and schemes which are set up for the avoidance of tax, particularly those having a fictitious or artificial purpose.

Consequently, although the taxpayer cannot be said to be presumed to be in bad faith, if the Inland Revenue perceives an unusual or dubious modus operandi the taxpayer must be in a position to prove that his actions had commercial scope and relevance beyond the sole or main purpose of annulling, deferring, or reducing the tax liability.

It is difficult to envisage a tax law without anti-avoidance provisions but it is also expected that the duty of the legislator in designing such provisions is to strike a proper balance between the rights of the individual to organize his affairs as he best deems suitable and the public interest in avoiding the circumvention of tax laws.

It is only when that balance is reasonably struck that provisions achieve their true purpose and do not unduly hamper economic activity and enterprise.