The Ethics of Tax Planning

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Any system of taxation depends on a substantial degree of compliance from the taxpayer. But do ethical considerations stop at obeying the letter of the tax law, or do they drive one to take a more critical and socially responsible attitude towards tax avoidance as well as evasion? Dr Alan Stainer is Head of Engineering Management at Middlesex University, Bounds Green Road, London N11 2NQ, and Founder Director of the International Society for Productivity & Quality Research; Lorice Stainer is Senior Lecturer in Business Ethics at the University of Hertfordshire Business School and a Business Ethics Consultant; and Alexandra Segal is a Chartered Accountant, Taxation Manager with Keelings Chartered Accountants, London, and a Taxation Consultant.

One of the most under-estimated and intriguing issues of modern business is that of the ethical dimensions of taxation and tax planning. This is because most businesses regard tax as their biggest headache. Surprisingly little has been written or researched on the subject so far, and yet it encompasses two major pillars of contemporary business: profitability and morality. Business excellence and business ethics should go together as exampled in the examination by Keogh (1988) which shows how the Business Roundtable, a group composed of the chief executive officers of the 100 largest US-headquartered organisations, concluded that there is a deep conviction that a good reputation for fair and honest business is a prime corporate asset which all employees should nurture with the greatest care.

Taxation ethics

Walters (1990) propounds this same ethos for the accounting profession. Regarding related ethical issues, and especially those of taxation, Dox (1992) believes that today’s tax practitioners must be agile tightrope-walkers, able to balance a host of divergent demands. They must deal with conflicting commands from the client and tax authorities and at the same time obey their own professional codes. The Institute of Chartered Accountants in England & Wales (ICAEW) (1995), in its publication “Professional Conduct in Relation to Taxation,” gives a set of ethical guidelines for the taxation practitioner. These deal largely with the question of how much needs to be disclosed to the tax authorities. They also take the standpoint that the tax adviser is an agent obliged to act in the best interests of the client and not for society as a whole. The implication is that the client’s tax liability should be minimised subject only to the constraints of honesty. Yet the word honesty is highly subjective and can mean different things to different people. Paradoxically, Hanson et al (1992) believe that minimising tax liability may not be fully compatible with following a code of professional conduct and ethics.

As Lynch (1995) correctly states, tax practice is no different from any other professional endeavour in that it should be conducted in accordance with the highest ethical standards, backed by the application of a considerable degree of skill, knowhow and competence. It is vital, when discussing moral issues, to ensure that the clearest possible definitions are used. This is because some writers can confuse the concerns through a lack of understanding of the strategic business processes.

Tax planning is designed to arrange an individual’s or an organisation’s affairs in order to maximise after-tax returns. Needless to say, businesses are substantially judged on their performance in relation to their earnings after tax and therefore gain respect within their environment by minimising their tax

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liability. When taxation and its planning are discussed the immediate interpretation of their meaning is that they relate to a degree of evasion or avoidance. By definition, evasion is illegal and hence unethical. In the main, avoidance is acceptable, as it reduces tax liability by whatever legal means possible and therefore is basically perceived as ethical. The former can lead to prosecution and imprisonment whilst the latter often reflects the client’s chagrin. But, as Lynch (1995) claims, life and certainly tax are not as simple as that. James and Nobes (1996) maintain that, on the one hand, there are degrees of culpability in tax evasion, whilst in tax avoidance there is sometimes a distinction to be made between the straightforward mitigation and the complex artificial schemes of minimising tax payments. The latter is frequently a disliked means of avoidance by clients. The hybrid word of ‘avision’ implies that both evasion and avoidance may in some circumstances be indistinguishable, hence there is not just a fine line between avoidance and evasion but a foggy grey area. The ultimate effect is the inevitable loss of revenue to the tax authorities and consequently to society at large.

Several of the ideas presented by Jackson (1996), in relation to ethics and taxation, can be challenged. She states that paying tax experts to advise on legal ways of cutting down on the tax liability is sound business strategy and ethically respectable. In this way there is no abuse of trust in a business paying no more than is legally required. She believes that, if there are legal loopholes overlooked by the legislators, it is their job to remove them and that there is no need for honest business people to feel any obligation to call attention to these loopholes. However, she advocates that considerations should be quite different if an organisation, through a loophole, legally discharges toxic waste, endangering the health and safety of society. However, as Stainer and Stainer (1993) claim, there needs to be in business a balance between the legal, profitable and ethical, where legal should be the lowest denominator of acceptable ethical behaviour. According to Macintosh (1995), it is the socially acceptable behaviour syndrome that is entwined with the so-called ethics of profit manipulation. Therefore, surely, basic ethical behaviour should be uniform whatever the circumstances, and social responsibility should not just relate to particular issues, such as health and safety, but to every aspect of business.

What is really required in ethical business discussions is a stakeholder philosophy. The RSA Inquiry into Tomorrow’s Company (1995) supports this view and recommends the inclusive approach, which implies acknowledging the recognition of stakeholders and joint relationships. As Evers (1996) notes, such a recognition underpins much of the thinking in business ethics, promoting what Mahoney (1995) describes as the ethical quality of business. Moreover, Stainer and Stainer (1996) advocate a value-based approach to business performance through a Value Index for Business Excellence (VIBE). This index embraces five key elements for success: customer satisfaction, market effectiveness, resource effectiveness, social effectiveness and workplace satisfaction. This stakeholder methodology contrasts distinctly with that of Sternberg (1994) who, in discussing business objectives and business ethics, maintains that the major objective is the maximising of long-term owner value.

**Tax planning in context**

Fundamentally, taxation is merely the transfer of wealth from the people’s pockets to the public purse. The after-tax income is determined by both the level of the tax rate and the efficiency of the tax collection system. It is this income which regulates the standard of living for the individual and generates the opportunities and challenges for a business. Tax planning should be, therefore, viewed from a societal standpoint as well as one of self-interest.

Tax avoidance, which has an unfortunate connotation to it, is primarily the lawful manipulation of affairs. Tax evasion, defined by Tamari (1995) essentially in terms of “human greed”, is the illicit side of that manipulation. Accountants and tax practitioners refer to avoidance manoeuvring as tax planning or tax mitigation which emphasises its legality and hence its perceived ethical acceptance. However, Sandford (1973) stresses that the term “avoidance” should be used to mean something which is contrary to the spirit of the law and which accomplishes the pre-tax objectives. James and Nobes (1996) propound the view that there is little hard information about avoidance or evasion and that there are no accurate quantitative estimates of their importance. Yet the tax authorities are continually worried by this state of affairs and the search for loopholes by tax advisers is continuous. It appears that, if there is any reduction of avoidance, it is probably not due to any ethical restraint on the part of the taxpayers but is more likely a result of the development
and refinement of the Ramsay Principle (1982), which seeks the reality behind some “legal” arrangements which are so artificial that they might be seen as evasion.

There are many reasons why tax avoidance and tax evasion take place, including high tax rates, imprecise laws and lack of deterrents. With higher tax rates, organisations or individuals may find it worthwhile to spend more time and money on advice, perform more complex manoeuvres and take greater risks, in order to avoid or evade tax liabilities. Hence, one of the main fiscal arguments advocated is for government to lower tax rates so that avoidance or evasion become less attractive. In relation to imprecise laws, these will always exist, with the speed of finding loopholes often disturbing the legislators. The deterrents seem to consist of imposing relatively light penalties and charging interest, and these are often perceived as small in relation to the potential financial gains of non-compliance.

As Punch (1996) declares, tax evasion and tax avoidance by individuals and companies occur on a massive scale and are highly damaging to the state’s finances. Revenue services generally present examples of regulatory agencies possessing quite extensive powers which are nevertheless used most selectively and quite cautiously. In the United Kingdom the Inland Revenue rarely undertakes prosecutions unless the case is “serious” and where preliminary investigations have led only to persistent, uncooperative denials. The social penalty of getting caught, with the possible adverse publicity, could be the most powerful deterrent. The social stigma of tax evasions obviously varies from country to country. For example, in the United States of America they are regarded as a national sport and in Italy as a “moral” duty. Therefore, how can organisations meet tax demands in countries where tax evasion is rife? As Argandoña (1994) points out, managers of ethical businesses count on paying taxes from the outset and prepare their plans so that being fiscally correct is not a burden but an advantage. However, if the taxation process within a country is generally considered to be unfair or inefficient, this could lead to an increased desire to avoid or evade tax, thus making such activities more socially acceptable.

In recent years tax practitioners have been overwhelmed with many and complex changes in both standards and laws in relation to taxation. Moreover, the positive emphasis on ethical and societal issues has been gradually evolving. Today accountants need not only to nurture their technical and professional skills, but also to understand potential ethical issues. The challenges of business ethics are much too important to be overlooked or put to one side. Moral considerations should be inherent in the business culture. Organisations and individuals should have an obligation beyond that required by law or through economic efficiency.

The ethical dimension

According to Prodhan (1994), ethics can be defined as a mode of human behaviour incorporating ends, norms, good, right and choice in dealing with others. Finance is often seen as a value-neutral positive discipline, promoting efficiency without regard to the social consequences which follow. Such a disregard is manifest, in general, in unethical behaviour in business. Boone and Kurtz (1987) believe that businesses face numerous ethical issues every day, and in relation to investors and the financial community there is probably no place where the public expects a greater level of business morality than in the arena of financial transactions. Executives are expected to exhibit the highest standards of ethical behaviour concerning financial practices in order to justify the public trust placed in them. As far as Hosmer (1991) is concerned, there must be a gradual climb up the hierarchical pyramid of managerial responsibilities from operational, to functional, technical, conceptual and ultimately to ethical.

The key to good business performance, according to Creelman (1996), is to discover how human, organisational and customer intellectual assets can be balanced so that they can combine to create value.

Tax planning, synonymous with tax avoidance, brings about different reactions in different individuals, even judges. Three judicial landmarks for tax planning, reflecting historical development, are as follows:

(1) The dictum of Lord Clyde (1929) that the taxpayer is “entitled to be astute to prevent so far as he honestly can the depletion of his means by the Revenue”.

(2) The statement of Lord Tomlin (1936) that “Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be”.

(3) The opinion given by Lord Simon of Glaisdale (1974) that “Disagreeable as it may seem that some taxpayers should escape what might appear to be their fair share of the general burden of national expenditure, it would be far
more disagreeable to substitute the rule of caprice for that of law”.

Thus it can be seen that ethics and tax planning are controversial matters, even in law. And in looking at the ethical issues in the performance of the practice of tax Dox (1992) contends that contemporary tax practitioners are faced with a myriad of conflicting demands as well as with a plethora of penalties from the tax authorities. The reason for these matters of contention is that some clients are more than willing to step into the grey areas. However, the tax practitioner must have an acceptable comfort level with both the tax strategy and the client response before recommending any tax planning opportunities.

The pathway is certainly not clear when it comes to artificial avoidance schemes. As Lynch (1995) indicates, accountants should advise on them and point out, as their duty, the associated risks and uncertainties, as well as possible law changes which may negate them, without promoting them or influencing the clients. This is because, if failure of schemes occurs, the relationship between client and accountant would be greatly affected adversely. As regards the morality of such schemes, this must be a question solely for the taxpayer rather than the tax adviser because of the subjectivity of what is or is not moral.

Several studies have been carried out in relation to ethical issues and their interaction with taxation from the point of view of both the tax adviser and the tax payer. In relation to the former, in their empirical results Finn et al (1988) learn that in the United States of America the most difficult ethical problems encountered by Certified Public Accountants (CPAs) are client requests to change tax returns and commit tax fraud and requests to alter financial statements as well as conflicts of interest and independence. In relation to the latter, Topolnicki (1994) reports a survey conducted by ICR Survey Research Group, also in the United States, which shows that nearly one-third of Americans would cheat on their income tax and that almost two out of five would be willing to use a shady commodity broker to earn extra dollars. Longenecker et al (1989A) communicate a nation-wide survey of managerial and professional business personnel regarding business ethics, with 2,156 respondents. One of the interesting conclusions was that the younger respondents, under the age of 40, were significantly more permissive in their views regarding ethics in a variety of situations. These include cases involving padding expense accounts and evading taxes, and yet the majority reported no pressure to act unethically. The same authors, Longenecker et al (1989B), look also at the difference in ethical behaviour between large and small businesses. The small company respondents express more stringent ethical views on topics such as faulty investment advice and misleading financial reporting. However, they tolerate the padding of expense accounts, tax evasion, collusion in bidding and insider trading more than do the large firms.

Reckers et al (1994) demonstrate that the development of tax decision-making models has focused on economic and behavioural factors affecting compliance, with tax ethical beliefs being an overlooked factor. The results indicate that tax ethics are highly significant in tax evasion decisions and may be one of the missing variables in tax decision-making models. In the same vein Erard and Feinstein (1994) declare that conventional models of tax compliance emphasise the fact that tax payers make strategic tax reports through under-reporting income to the extent that this behaviour is financially rewarded. In contrast to this view, their empirical evidence suggests that many taxpayers are inherently honest, reporting truthfully regardless of the incentive to cheat. A game-theoretic model is presented of tax compliance which includes honest and potentially dishonest taxpayers. To include the former alters the model which thus leads to much-improved empirical predictions and somewhat different and novel policy implications. The significant factors that may affect the decision to report in an honest manner are twofold: firstly, the taxpayer’s perceptions about the fairness of the tax system; and secondly, the taxpayer’s reactions to government activities, policies and personnel.

On the European scene, Sorell and Hendry (1994) describe an example of Italian taxation practice where act utilitarianism seems to work better than rule utilitarianism. By convention, businesses in Italy under-declare their liabilities to tax and the negotiations then take place, resulting in businesses agreeing to pay more tax. A multinational enterprise that was new to Italy, calculating its tax liabilities correctly and honestly the first time, fell foul of this arrangement, as it was taken to be under-declaring and hence was required to pay a tax bill higher than it should have. Act utilitarianism might have recommended compliance with accepted Italian practice rather than with the rule of telling the truth. But rule utilitarianism comes into its own when what is in question is the claim of utilitarianism to be a moral theory.
Argandoña (1994) observes that in 1991 a number of large organisations in Spain were accused of using false invoices to avoid payment of value-added tax (VAT). In consequence, several companies were discovered whose principal, and even only, business was to write out those false invoices, charging a price for this so-called “service”. The ethical problem arose in that the main motivation of the accused companies was not VAT evasion but the need to justify important payments that could not be otherwise justified before the auditors. This was because these payments were made to political parties in order to win public work and public procurement contracts. The ethical dilemma lay in the fact that the companies had to pay a certain percentage of the amount of the public contract to the political party, not for im morally winning a contract by illegal means, but just for being awarded a contract which they won fairly. It was then a case of extortion, but a very special one, in that it was an indirect contribution to public, semi-official corruption.

In the United Kingdom, tax avoidance practices of dubious ethical standing are often generally accepted. Such cases include bonuses being paid by businesses in kind rather than cash, to reduce extra national insurance contribution - a loophole partially closed – and the “bed-and-breakfast” practice for reducing capital gains. There has been considerable criticism that the United Kingdom tax system is becoming increasingly regressive, as reported by the Institute of Fiscal Studies (IFS) (1997). To alleviate regressiveness organisations should be paying more tax and spend less effort on tax avoidance schemes. A regressive tax is where the marginal rate of tax is less than the average rate, so that the proportion of income taken in tax falls as income rises. A salient example was the poll tax – the ultimate regressive tax – which was abandoned eventually because of its perceived unfairness. Heady (1993) points out that any suggestion for tax reform, such as the poll tax, is often judged by economists in terms of economic efficiency versus fairness. Other examples of regressive tax comprise that levied on tobacco and beer, where the poor and the rich consumers pay the same tax for the goods. However, it is the poor who spend a greater proportion of their income on such items. This syndrome contrasts with what Adam Smith proposed over two hundred years ago, that people’s tax payments should be in proportion to their income.

Conclusion

According to The Economist (1997), anyone interested in power tends to be interested in tax, and the bureaucrats who run the European Union (EU) are no exception. Their efforts in the past to harmonise taxes have had little success, chiefly because they require unanimous approval of EU members who remain jealous of their fiscal sovereignty. But tax is firmly back on the EU’s agenda and the new cry, heard from Germany, France, Italy and Belgium, is for an end to what they call “unfair” tax competition. Such competition is exampled by Luxembourg, enticing German savers with the lure of tax-free interest income. Mario Monti, the current single-market commissioner, would like to see a “code of good conduct” to stop harmful tax competition. However, who decides what is harmful? It seems that the ethics of tax and its planning is being taken seriously by the European politicians and consequently could have an impact on the European business culture.

Clarke (1990) correctly argues that in any country the tax authorities are dependent on a substantial degree of willing compliance from the taxpayer in order for the system to function effectively. Furthermore, the system would involve grotesquely expensive operations if it were to have resources for comprehensive rather than selective enforcement. In effect, even control agencies with substantial powers may use them cautiously because they perceive their role as revenue collectors. They believe that severe sanctions in a democracy are not an effective deterrent, and that negotiation and settlement, rather than prosecution, are a more effective way of eliciting compliance. It seems that the
bottom line as far as tax planning is concerned is honesty. In the United Kingdom, the importance of ethics of tax is likely to accelerate in the future, especially with the introduction of the self-assessment approach to tax collection.

Tax planning must be exercised in an atmosphere of integrity, mutual trust and, above all, a good ethical climate. Tax practitioners must be objective in their approach to tax planning, as well as perform their task in a professional way, in order not to tarnish their own reputation and principles. As the Financial Times (1995) observes, “it is part of a civilised society that people, inside and outside business, act morally. No more and no less.” This must be the lesson for the next millennium.

References


