"ACCEPTABLE LIMITS OF TAX PLANNING: A REVENUE PERSPECTIVE"

Speech by Michael O'Grady, Revenue Commissioner

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INTRODUCTION

When Liam Grimes asked me to speak to you on this particular topic he remarked that it was a bit like the "how far can you go?" type of question that was popular with adolescents in the early days of what was then known as sex education. In my school, this question received two types of response: either a clip across the ear for being mischievous, or a lecture on the virtues of purity. Liam assured me that in asking the "how far can you go?" question in the context of tax you are not being mischievous and you would like a serious response from Revenue – and you will even put up with some lecturing on the virtues of purity.

So I am taking this as a licence to stray into the territory of social and corporate responsibility in tax matters. Two weeks ago I noticed Adrian Crawford's photograph in the Irish Times, along with a number of captains of Irish industry and commerce. The accompanying story said that KPMG, together with 22 other major Irish-based firms, had signed a Charter on Corporate Responsibility. The story didn't detail what was in this hefty sounding Charter, but I would guess it acknowledged that business had a responsibility to the wider community that went beyond just the interests of the owners and shareholders. I would like to pick up on this in a tax context by putting forward the view that socially responsible attitudes to tax planning should be influenced to a much greater extent by the policy behind the law – assuming that policy is clearly stated or is self-evident – instead of seeing tax law just as something to be tweaked and tailored to clients' interests, regardless of the underlying policy.

Many of you will be aware of recent, fairly heated debate on this topic in the US and UK. In America, tax shelters are increasingly regarded as "unpatriotic". Perhaps this is a post-9/11 or post-Enron reaction, but we have seen fairly radical legislation in that country, such as preventing US companies who reincorporate abroad for tax purposes from being eligible for government contracts. And in the UK, senior officials in the Inland Revenue and Customs have in recent times publicly slated tax professionals and business for colluding in abusive tax avoidance and for not doing enough to stop it.

While my comments today are designed to be a bit provocative, I should reassure you at the outset that I don't intend to make a US or UK-style attack on Irish tax professionals for any lack of ethics in tax planning. I think we need to have a somewhat less shrill debate about this important topic than we've seen in other countries. I noticed a recent article in the Financial Times written by Loughlin Hickey, KPMG's head of tax in the UK in which he appealed for a collaborative approach between Revenue, tax practitioners and business in addressing tax avoidance issues, as he feared a deteriorating relationship between Revenue and business/tax professionals on this issue could ultimately damage corporate investment in the UK.

Relationships in this country between Revenue and both the tax profession and the business community are by and large very good. And we want to keep it that way. But while we are on the same side in condemning evasion, we tend to have widely differing views on the boundaries of acceptable tax planning. From a Revenue standpoint tax avoidance is an issue that can easily lead to confrontation and lack of trust, and to consequential damage to relationships with business and tax advisers, such is the strength of feeling it provokes. So I think Mr. Loughlin Hickey's suggestion is valid also over here and I welcome this opportunity to try to articulate Revenue's views on the subject.

Many people would maintain that there is no clear red line between acceptable and unacceptable tax planning, or that there is always a clear distinction between unacceptable (but still legal) tax planning and tax evasion. The traditional Revenue response is that, like the elephant, we'll know unacceptable tax planning when we see it: it will depend on degrees of concealment, artificiality, and "aggressiveness" in the overall context of the intention of the Oireachtas when the tax laws were enacted.

While there can be little argument about concealment, the traditional tax practitioner view would be that artificiality is subjective and that, in any event, tax is a matter of law pure and simple, to be interpreted by the Courts – bringing underlying policy objectives into the picture makes the practitioner's role very difficult in advising clients.

I don't intend to draw any red lines here today – that might be too ambitious. Instead, I propose to step back a little from the definition issue by first of all explaining why, from a Revenue standpoint, unacceptable tax planning (however defined) undermines public confidence in the tax system and undermines our efforts at improving voluntary tax compliance. In this first part I will also elaborate a little on the type of "attitudes" to tax planning that Revenue find most objectionable.

I will follow this with a view on our existing anti-avoidance provisions. I will also speculate a little – and this is pure speculation – on what further legislative measures might be possible if tax avoidance continues to be a major problem. Finally, I will say something about how we tackle avoidance administratively within Revenue, with a particular focus on how we intend to experiment with the idea of "cooperative compliance frameworks", initially for those companies and high wealth individuals in our Large Cases Division. These frameworks will, among other things, attempt to agree boundaries for acceptable tax planning practices in the cases concerned, supported by open lines of communication with Revenue.

I should make it clear that I don't propose to deal with cross-border tax avoidance involving no loss of revenue to the Irish Exchequer. That's a topic that touches on much wider issues, including international treaty and other obligations.

EFFECT OF AVOIDANCE ON "VOLUNTARY" COMPLIANCE

For the past 15 years – since the introduction of self-assessment – Revenue's overall strategy in administering the tax system has been to encourage the highest possible level of "voluntary compliance". This sounds like a piece of Newspeak from Orwell's 1984, but the reality for any tax administration is that a good deal of tax compliance is in fact voluntary – notwithstanding the plethora of Revenue powers, deductions at source, reporting obligations, and the existence of audit and debt pursuit programmes with interest and penalty sanctions. The reasons why people comply with tax obligations are complex. They are not confined to fear of getting caught and of the resulting sanctions. If they were, tax evasion would be much higher than it is. The truth is that many people don't choose to take a free ride on tax even when the chances of being found out are very small.

We are about to commission some research into public attitudes to tax compliance in Ireland. We would be surprised if, in line with the results of similar research in other countries, our study didn't show that attitudes to tax compliance are heavily influenced by the perception of Revenue as a fair and effective administrator and enforcer of tax laws. At a personal level people will be influenced by how they are treated when they come into direct contact with Revenue. For example, are they treated respectfully and professionally or are they given the benefit of the doubt if they make a small mistake? But probably a more significant determinant of behaviour is public perception about how good Revenue is at protecting the honest taxpayer from the free rider. The public and the media tend to observe with great interest how Revenue flushes out tax evasion and how evaders are punished. (Perhaps we are deluding ourselves but we believe that the recent successes we have had in a number of high profile investigations, including the various offshore investigations, will in fact have a major overall impact in improving voluntary tax compliance.)

You might ask: what has this got to do with tax avoidance that is within the law? Well, apart altogether from Exchequer loss caused by avoidance, the problem for us as tax administrators is this: the "voluntary" element of voluntary compliance can also be badly eroded by the sight of people – usually those with significant income or capital – finding artificial ways, not intended by the legislature, of avoiding their tax bills. In our view "technical" compliance with tax law, which completely outflanks the policy behind the law, can be just as corrosive as evasion in terms of the overall impact on voluntary compliance. For example, a small businessman, who doesn't have the resources himself to pay for a pricey tax avoidance scheme, may see little enough difference between a person who illegally evades taxation and one of his bigger competitors who sets his accountants or lawyers to work aggressively on the legal form of his activities to package or repackage them in ways that clearly escape the intended impact of tax laws. While there is of course a difference between illegal evasion and legal avoidance, the reality is that many people don't appreciate that difference. They see avoidance as not paying a fair share. And Revenue has to deal with the real world effects of this.

TAX AVOIDANCE CREATES NOTHING OF VALUE: "DEADWEIGHT LOSS"

Tax avoidance is essentially about transferring resources to the avoider and away from everybody else. Consider an extreme example: if all taxpayers were clients of KPMG and all bought the same scheme which reduced their tax bills by the same percentage, Charlie McCreevy would have no choice but to increase tax rates for everyone in order to maintain the same revenue. Therefore we'd all be back where we started, except that we'd in fact be worse off because tax planning is very expensive. Economists have a very vivid term to describe this type of cost, which adds nothing of any value to the country as a whole: it's called a "deadweight loss".

Of course I am not talking here about the hugely valuable job that tax advisers do in helping business to manage the complexity of tax law so as to come up with the solutions that drive commerce and investment. Some of our tax laws are running behind developments in the commercial world – this is particularly the case in the financial services area – and the tax profession has been very successful in facilitating new ways of doing business despite a tax code that is struggling to keep up to date. I would add in this context – and I don't intend this to sound patronising – that the role of tax professionals in solving problems and opening doors for inward investment to this country has, in my view, not been fully appreciated. This is tax planning of a highly constructive nature.

Neither am I talking here about people availing of "normal" tax shelters, although I acknowledge that, in the minds of the public, the distinction between the normal and the abnormal is not always appreciated. Earlier this year Revenue published the results of a study of effective tax rates for the top 400 income earners and the main types of deductions used to reduce effective tax rates. The vast bulk of tax shelters used by these people were very straightforward property-related allowances with no artificiality or "gymnastics" involved. But some of the debate that followed its publication tended to ignore this important fact. It seems to me impossible to argue that, so long as such straightforward shelters are available on the statute book, it is in some way wrong for high-income earners to avail of these types of incentives. Such reliefs, whether you agree with them or not, are intended to incentivise particular activities, and since tax reliefs depend on the taxable capacity of claimants, it can't come as any surprise that high-income individuals will use their increased capacity to absorb available reliefs. In any event, most of these types of "normal" shelter have been whittled away since 1998 and the property-based shelters are scheduled to end in December 2004.

"ATTITUDES" TO TAX PLANNING THAT REVENUE FIND OBJECTIONABLE

In broad terms, what is objectionable to Revenue is an attitude that regards the tax code as fair game to be combed through for gaps or unanticipated effects. I spent a number of years on the policy and legislation side of Revenue and I can attest to the fact that converting settled tax policy into legislation is not easy; legislative drafting is not infallible and it is not possible to address every contingency that might arise. If you spend your time seeking out loopholes or unintended opportunities in the tax code, you won't have to work too hard to come up with constructs that can be backed with finely argued legal points and opinions of senior counsel and, if challenged, you can at least present an arguable case to claim compliance with the law.

Doreen McBarnet of Oxford University has termed this type of activity "creative tax compliance". (She used this term not because she admired the creativity involved but because she sees it as a first cousin of creative accounting, which in recent years has done so much damage to trust in the capital markets.) The essence of creative tax compliance is that it is not non-compliance: securing technical compliance is seen as the key and the result is presented as "not illegal" or "perfectly legal" or "where does it say I can't do that?"

Essentially, under this general "attitude", a piece of tax legislation is not seen as an authoritative expression of legitimate policy arrived at via the democratic process; rather it is seen as material to be worked on, regardless of the policy behind it. (Of course I accept that the idea of using the law to frustrate the policy behind the law is not confined to tax; but you tend to see much more of it in the tax area.)

On the other hand, if the tax code is operating in a way that is harsh in particular circumstances, having regard to the underlying policy objectives, business and tax advisers would expect Revenue to exercise their care and management discretion to soften the application of the code in such a case. And, as you know, we sometimes do in appropriate circumstances. There is therefore an element of wanting the best of both worlds – a Revenue bound by the letter of the law when it operates to the (unintended) advantage of the taxpayer, but one which should also "do the right thing" and waive tax due when the law operates to the unintended disadvantage of the taxpayer.

It is clear also that a number of schemes are entered into in the hope that Revenue won't recognise the scheme in its totality, and therefore it is less likely to be contested. For example, pieces of a transaction may show up in different returns so that it is hard for Revenue to see the whole. And remarkably little use is made of the "declaration of doubt" procedure in tax planning situations. On the face of it, this is surprising, given the safe haven from interest/penalties afforded by that provision if the plan fails. But it seems clear that keeping the head down, in the hope of avoiding detection and challenge, is in many instances considered a better strategy than upfront disclosure. A second negative consequence is that a failure to challenge can be perceived (wrongly) as a Revenue endorsement by default, and the doubtful scheme can, as a consequence, be more widely sold or built upon on the basis of that failure to challenge.

EXISTING ANTI-AVOIDANCE MEASURES: "CAT AND MOUSE"

I want to move on to comment on existing statutory responses to unacceptable tax planning. In my view over the past twenty years or so this has been a sort of "cat and mouse" game, which has not been very satisfactory. When a particular scheme is identified, the usual response is to use a "sniper" legislative approach to outlaw it in a narrow and focussed way – because of the reasonable fear of causing collateral damage to legitimate business if the anti-avoidance provision had been broader in scope. However, it has often been possible for tax advisers to construct a more complicated, if less efficient, variation of the scheme that has a similar effect. A further set of anti-avoidance provisions follows, with slightly greater success but also greater complexity. In some instances this can go on for some time. The limited partnership legislation, which started with Alan Dukes in 1986, is a case in point: this legislation was modified and tweaked many times since it was first introduced, in order to close off more and more variants of the original. The final exasperated outcome might be a wide-ranging "shotgun" approach which of necessity is vague and may well create difficulties for those who have no thought of tax avoidance.

Part of this sequence can involve a press announcement by the Minister for Finance to the effect that a loophole is to be closed in a future Finance Bill and that, when enacted, the law will effectively be backdated to the date of the announcement. Retroactive legislation is of course undesirable and creates uncertainty – the wording of the press release is necessarily much less detailed than draft legislation and it may be difficult to advise clients of the full implications. But clearly if there is a large actual or potential leakage in tax receipts as a result of a scheme, the Minister has no option but to close it off immediately, rather than waiting until the next Finance Bill which may be many months away.

As you know, we also have a general anti-avoidance provision (section 811) that was introduced back in 1989 following the McGrath Supreme Court decision. Continuing on in the same vein as the "sniper" and "shotgun" images, this could be described as a "landmine" approach. We warn you that you're entering a minefield if your transaction is undertaken primarily to gain a tax advantage. But we don't map the minefield for you and you're never sure if you're going to get through in one piece if Revenue decides to take you on.

Even after 14 years, the full scope of section 811 has yet to be tested in the Irish Courts. However the uncertainty as to its scope is in itself an element of its success as an "in terrorem" deterrent. Tax advisers would no doubt like a much more prescriptive and detailed set of rules in the interests of certainty. But from our standpoint detailed rules are grist to the mill of tax avoidance: the more you spell out the rules and rigidly define categories, the more easily they can be avoided by repackaging activities into a form that falls outside the clear delineations. The best description I have heard about section 811 is that looking at its potential effects is a bit like watching a cross-eyed javelin thrower competing in the Olympics: he may not win but everybody watching will be on the edge of their seats.

It has been suggested that section 811 can be more powerful as a deterrent if rarely used and never tested in the courts. There is an element of truth in this, but the difficulty is that a power never used can soon lose its deterrent effect: the reluctance to use the power may be seen as a tacit admission that there are doubts about its reach. Section 811 has in fact been invoked in a number of cases in recent years and a case may soon be coming before the High Court. We are confident that the section will stand up to judicial scrutiny. But if it doesn't, there is only one inevitable consequence: a bigger and better section 811.

I just want to mention here also a significant (non-statutory) anti-avoidance measure that affects State bodies and, by inference, other State-funded agencies and institutions such as local authorities, hospitals and universities. The man in the street may find this surprising, but these bodies and institutions have been very active customers of some of the more aggressive tax schemes being sold in recent years, particularly in the VAT area. In October 2001 the Government endorsed a "Code of Practice for the Governance of State Bodies" which contains the following statement: "State bodies … should not engage in 'offensive' tax avoidance transactions. In broad terms tax avoidance is offensive if it involves the use of the tax code for a purpose other than that intended by the Oireachtas (including an unintended use of a tax incentive) with a view to reducing the amount of tax to be paid by the State body or some other party to a transaction in which the State body participates." From a Revenue standpoint that is a very important statement of principle. If State bodies and State-funded institutions are engaged in tax avoidance, it sends out the worst possible signal to the rest of the community.

FURTHER ANTI-AVOIDANCE MEASURES? – SOME POSSIBILITIES

It seems to me that if tax avoidance continues to be a major problem, with significant Exchequer leakage, it is inevitable that there will be some ratcheting up of both legislative and administrative counter measures. I thought it might be interesting to list a couple of possibilities on the legislative front. I hasten to add that this is pure speculation – any policy decisions in this area are of course a matter for the Minister for Finance and the Government. And neither of these is original; they are based on approaches adopted in other jurisdictions.

The first possibility I would like to mention is automatic disclosure to Revenue by both promoters and users of certain defined categories of "tax shelter". Many of you will be aware that the US have a disclosure system of this nature: if a transaction displays a minimum number of pre-defined characteristics, then full details of a transaction must be reported to the IRS. This of course has shades of the old section 153 debate about it: turning the tax adviser into a Revenue snitch. (You may recall the controversy in the mid 1990s about the Beef Tribunal Report recommendation that auditors should report tax evasion to Revenue.) But the reality for Revenue is that catching up with avoidance in an audit, possibly years after transactions have taken place, is not a good strategy. And that's where an avoidance scheme has been detected in returns; as I said earlier, there is increasing evidence of doubtful transactions being camouflaged so as to evade the Revenue detection radar.

If there is major Exchequer leakage involved – as there is in many of these cases – Revenue and the Minister for Finance need to know about it quickly so as to deal with it before the "virus" spreads. As regards the "snitch" argument, I would quote the response of Mark Weinberger, US Assistant Secretary for Tax Policy: "If a taxpayer is comfortable entering into a transaction, a promoter is comfortable selling it, and an advisor is comfortable blessing it, they should all be comfortable disclosing it to the IRS." I would suggest that this "comfort" test – whether the parties involved are relaxed about putting their cards on the table for Revenue to see – is one of the indicators as to whether a red line between acceptable and unacceptable tax planning has been crossed.

The second possibility is civil penalties (and criminal sanctions) for taking "an abusive tax position". This type of penalty is part of the New Zealand tax code and is aimed at preventing spurious claims of legality in the context of tax avoidance. The New Zealand provision requires an interpretation to be "as likely as not" to be the correct tax position. It looks at objective chances of success: in broad terms, if they are less than 50% compared with alternative interpretations, the position adopted will be considered abusive. The rationale for a provision of this nature goes back to what I said earlier about failed tax planning being defended on the basis that it is not non-compliance, and therefore not constituting neglect or fraud within our existing penalty provisions. I have seen some instances where avoidance schemes were sold on the basis of advice on interpretation that was hugely questionable. Anybody can produce an arguable case, but where the objective chances of the argument being sustained are no more than, say, 20% or 30%, the question arises: is this not abuse and does it not warrant sanctions in the form of penalties and publication? (Those of you who are familiar with Revenue's Code of Practice for Auditors will be aware that auditors are already instructed to apply the "likely as not to be correct" test in determining whether a wrong interpretation should attract a penalty.)

One further measure I should mention here is one that is already in the legislative pipeline: the Interpretation Bill 2000, which has recently been passed by Dáil Éireann and is currently before the Seanad. In 1999, the Irish Law Reform Commission recommended that our Interpretation Act should be amended to require the Courts to interpret legislation purposively – that is to have regard to the purpose or object underlying a statute instead of just the literal words. However, the Commission eventually recommended the retention of the "literal rule" of interpretation but with the important modification that where a literal interpretation would fail to reflect the "plain intention" of an Act, preference would be given to the intention of the Oireachtas, where that intention can be ascertained from the Act as a whole. This is now contained section 5 of the Interpretation Bill 2000, which is likely to become law very shortly.

If and when the Bill becomes law, I think you will see greater use of "purpose" clauses in future Finance Act provisions. And you will certainly see section 5 being used by Revenue to challenge avoidance schemes that rely excessively on a literal interpretation that flies in the face of parliamentary intent.

AN ADMINISTRATIVE RESPONSE TO AVOIDANCE

Since the mid-1980s Revenue have had a specialist unit dealing with anti-avoidance. This unit has had some very significant successes over the years. Under our new structure we have decided to expand this specialist area into two anti-avoidance units – separating direct and indirect tax – to be located within our Large Cases Division. Our new Regions will also have an anti-avoidance function in their own areas – the central units will take on the more complex cases and will provide advice and support to the Regions. This type of work is resource intensive, involving a lot of detailed scrutiny of transactions and documentation, but we are committing whatever resources are considered necessary to be effective.

But what I want to talk mainly about under this heading is our new approach of encouraging cooperative and self-regulatory frameworks and how we intend to go about this in the first instance with our large corporates and high wealth individuals. This is a crucial part of our strategy because we are convinced that the compliance behaviour of those at the top of the taxpayer scale impacts significantly on how the general body of taxpayers view the whole tax system. Within the past two weeks we have written out to all of the companies to be dealt with in our Large Cases Division. The letters make it clear that our primary objective is on building a positive professional relationship with large business and we're very much selling the cooperative model as a potential win-win situation.

Our main focus is on managing risk. If Revenue is satisfied that there is a strong commitment to self-regulated tax compliance, including a non-aggressive attitude to tax planning, then a case will be risk-rated accordingly and the level of audit and enforcement activity will be scaled to match the perceived risk. We are very aware that standards in this regard can be influenced by what the competition is doing. That's why our Large Case Division is organised on business sector lines, and we will do everything possible to ensure that tax does not become a source of competitive advantage in any sector. On the other hand, if there is an uncooperative, confrontational attitude, or a pattern of aggressive tax planning, or little evidence of high-level commitment to self-regulated tax compliance, the case will be put on top of the risk scale and can expect a large measure of Revenue scrutiny – with all of the risk for the company that that entails, including reputational risk if a monetary settlement falls within the publication criteria.

We believe these cooperative frameworks have a good chance of success. Corporate responsibility is increasingly being taken more seriously and many large companies – and many high wealth individuals – see the reputational risks involved in being associated with "close to the wind" avoidance schemes as not worth it. We want to work cooperatively with these companies and individuals to be clearer as to what we would both be comfortable with and what we can live with – and we want to encourage them to limit their creativity to those comfort zones. For our part we'll do our best to deal with the free rider problem and ensure that responsible tax behaviour does not of itself create a competitive disadvantage. I should mention that we intend to extend the cooperative framework approach in due course to our "second-tier" districts in Dublin and the South West Region – these districts deal with the next layer down in terms of case size.

CONCLUSION

Finally, just a few general comments:

- Our whole strategy as tax administrators is built around the idea of voluntary compliance – of increasing the stock of "social capital" that prompts people to comply with their tax obligations even when they're unlikely to be found out if they don't. Apart from the revenue loss involved, our main problem with tax avoidance is its contagion effect, as voluntary compliance is eroded by the sight of individuals and companies – usually those with high income or high capital – reducing their tax bills in ways that were never intended by the Oireachtas.

- We would, of course, like to see a change of attitude among tax advisers and their clients in relation to tax avoidance. We feel that if corporate and social responsibility means anything, it means working within the spirit as well as the letter of our tax laws. We will be working hard to shift attitudes in this direction, in the first instance by encouraging the largest companies and highest wealth individuals to operate within the "cooperative frameworks" I outlined above, and in due course extending the approach to second tier cases.

- But if it is wishful thinking to believe that aggressive tax avoidance can be moderated by this approach, then it seems inevitable that there will be an ongoing escalation in both legislative and administrative counter-measures.

- However, getting back to Loughlin Hickey's proposal, I believe that more engagement and debate between Revenue and tax practitioners on this issue would be very worthwhile. The Revenue perspective you just heard is, I fully admit, not the full story. There is, I'm sure, another side to this story and Revenue is prepared to listen to it. Good tax behaviour is not the sole responsibility of taxpayers and their advisers. If the whole tax system is to work properly, we also need coherent tax legislation and a Revenue administration that enforces the law fairly and with common sense.

Thank you for listening.

ENDS