THE EVOLVING (AND ELUSIVE CONCEPT) OF TAX AVOIDANCE: THE UK AND ITALIAN PERSPECTIVES

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1. Preliminary remarks

As the following paragraphs will attempt to illustrate, it is extremely difficult to define what precisely tax-avoidance is; or, better, it is hard to draw the boundaries of that concept and, hence, to determine where it begins, with respect to tax evasion, and where it ends, with respect to mitigation.

A realistic approach to the issue, therefore, may be that which seeks to define tax avoidance by first addressing the question of what may, fairly certainly, not be labeled as tax avoidance[1].

2. What tax-avoidance is not

2.1. Tax evasion

A useful way to look at the subject may be to highlight that -in terms of logical consequentiality- an "act of tax evasion" necessarily comes into play subsequent to the

[1] For the transnational dimension of the issue, P. BAKER, *Tax Avoidance, Tax Evasion & Tax Mitigation*, http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf. See also UK Tax Law Review Committee (IFS, London, 1997).

moment the relevant taxable event[2] has come into existence.

In other words, tax-evasion[3] consists of *concealing* or *disguising* a given taxable-event, but it will never have any impact on the event in itself.

This seems to mark a rather clear difference between tax evasion and tax avoidance, because the main feature of the latter is, indeed, its impact on taxable events in themselves[4]. In fact, the very consequence of tax avoidance, and hence the crucial problem that it poses to legislators and courts, is that, by structuring a transaction in one way rather than another, taxpayers may be able to manipulate the taxable event so as to trigger a lower tax burden than "it should have been". As we will see below, the whole gist of tax avoidance is to understand what the emphasized phrase actually means.

Going back to tax evasion, this may take place at two different levels:

i) At a purely tax-compliance level;

ii) At the level of the predicate legal transaction.

In the first instance, a tax-relevant transaction occurs and the taxpayer fails to declare it to the revenue authority and, thus, to fulfill the associated tax-payment obligations.

In the second instance, a tax-relevant transaction as documented, either in its subjective[5] or objective[6] features, is not in accordance with its legal reality (there is a discrepancy between intended and documented transaction): as a result, the legal features of the taxable event attached to the actual transaction are not affected by the tax-evasion-conduct; "simply", the taxpayer is pretending either that that taxable event has not taken place at all or that it has takes place in a way that diverges from its legal reality.

From this point of view, there seem to be strong similarities between the UK and Italian understandings of the issue.

In the UK legal system, courts have developed what is currently referred to as the "sham doctrine", the leading case thereon being *Snook* v. *London & West Riding Investments LTD*[7].

Applying the Court's reasoning in *Snook* (which was not a tax case) for tax purposes, a transaction may be regarded as sham when the parties have intended to give to the revenue authority the appearance of a transaction different from the actual transaction they intended to create.

The consequences of a transaction being recognized as sham are:

- For non-tax purposes, the transaction is void and no right or obligation stems from it;
- For tax purposes, the tax payer's liability is assessed with regard to the intended transaction (if any) rather than the documented one[8].

In the Italian legal system, a transaction that is not documented in accordance with the intention of the parties thereto is regarded as "simulated" and, pursuant to the civil code[9], is recognized as void for non-tax purposes. The revenue authorities, for their part, will levy taxes in accordance with the actual operation (if any) agreed upon by the parties.

As for sham, simulation is not a tax concept; hence, tax legislation makes no distinction according to whether or not a tax-relevant transaction is reported to the revenue authorities as a consequence of simulation: in any case, the actual taxable event is not being reported and this amounts to tax evasion.

However, tax legislation is evolving in the direction of shifting the burden of proof onto the taxpayer in a growing number of those situations where simulation is more likely to occur: mandatory rebuttable presumptions have thereby been introduced, for instance, with reference to bank remittances (which are deemed as earnings) and the proceeds from the sale of immovable property (which are deemed to amount to the fair market value of the property) etc..

For its relevance to marking the border between tax evasion and tax avoidance, it is worth mentioning a provision[10] engineered to ease the revenue authority's burden of proof with reference to schemes based on the fictitious interposition of an entity (or an individual) between the parties to a transaction. For many years, in the absence of an anti avoidance provision, the revenue authority has attempted to challenge interposition-based tax-avoidance

[2] To which tax law attaches the genesis of a tax obligation (to file a tax return, to pay a tax etc.)

[3] In our understanding, there are no qualitative differences between tax evasion and tax fraud. In those countries which make this distinction, for instance Switzerland and Italy, this has the limited scope of marking a higher degree of reproach that the law attaches to certain forms of tax evasion.

[4] Tax evasion is therefore an attempt not to pay tax owed, whereas avoidance is an attempt to "use" the law to reduce taxes owed.

[5] The parties of the transaction.

[6] The legal obligations that stem from the transaction.

[7] [1967] 2 QB 786 at 802, [1976] 1 All ER 518 at 528.

[8] As noted above, the actual taxable event or transaction is not affected by the taxpayer's actions.

[9] Art. 1414 and ff. of the Civil Code.

[10] Art. 37 (4), Presidential Decree nr. 600 of 1973

schemes (such as "dividend washing" or "dividend stripping" schemes) by means of that provision: the Court of Cassation[11] has firmly taken the position that, as long as the interposition of the purchaser of the shares cum dividend was actually intended, there was no room for invoking the provision under consideration, which has therefore been labeled as a purely anti-evasion provision[12].

Before moving ahead, it may be useful to test what has just been said on a specific case, and, in particular, on the facts of the Duke of Westminster landmark judgment[13].

The case concerned an arrangement whereby the Duke of Westminster, instead of paying (non-deductible) wages to some of his gardeners, entered into a deed of covenant under which, at the end of their employment, he would have paid to them a (deductible) annuity "in consideration of past services"; the reciprocal understanding of the parties being that the annuity would have substituted the accrued wages.

In the end, the Duke paid the same remuneration that he would have paid had he not conceived that scheme; however, the tax burden was different.

Inasmuch as the described transaction was real and the parties actually intended to make the arrangements as documented, there would have been no room to challenge the scheme on "sham" (or "simulation") grounds or, more generally, to claim it added up to tax evasion.

And indeed, as we shall see, that was not the finding of the House of Lords in the case under consideration.

2.2. Characterization of legal facts

As the foregoing should have made clear, in order to establish whether a certain conduct amounts to tax evasion, one has to interpret the legal facts that the parties to a transaction have actually put in place. In particular, an investigation is needed to ascertain what -in terms of legal rights and obligations- the parties have really agreed among themselves.

Legal facts, however, may also need to be interpreted at an entirely different level than that of ascertaining tax evasion: that is to say, for the purpose of establishing the correctness of a characterization that a taxpayer has given to a certain legal fact. Indeed, the parties' characterization of a transaction is not decisive with regard to its tax treatment.

In his dissenting speech to the Westminster judgment, Lord Atkin claimed that the Duke's characterization of the obligations that stemmed from the agreements entered into with his employees was not the stated one and that, consequently, the tax treatment thereof should have been reassessed accordingly.

It may be, however, that Lord Atkin, anticipating somewhat the subsequent development of anti-avoidance-driven jurisprudence, was more concerned with the *economic* facts of the case than with the *legal* ones; which is not, however, what we have just referred to as "characterization of legal facts".

The concept of characterization of legal facts, as opposed to tax evasion and tax avoidance, is clearly reflected in the Italian stamp duty code[14]; under the title "Interpretation of deeds", it states that transactions are to be interpreted according to their "intrinsic nature and legal effects", regardless of the name or form given thereto by the parties. The revenue authority, in a persistent endeavour to make up for the lack of anti avoidance provisions, has attempted to challenge tax avoidance schemes by invoking that provision. The Court of Cassation[15] has, so far, held, although less and less firmly, that this is neither an anti evasion nor an anti avoidance provision[16].

2.3. Tax mitigation

Although the Court may not have had this in mind at that time, the Westminster judgment could nowadays be interpreted as a tax mitigation case.

[11] Cass., 3 aprile 2000, n. 3979, in *Rass. trib.,* 2000, p. 917 and Cass., 7 marzo 2002, n. 3345, in *Foro it.,* I, c. 1702.

[12] We submit that the concept of "fictitious interposition" in the tax area is more a matter of academic discussion than anything else. Indeed, when interposition is tax-driven there is little doubt that the parties actually intend to enter into the predicate transaction (which is therefore a genuine transaction), with the result that such interposition may be relevant only from an anti-avoidance (and not anti-evasion) standpoint.

[13] *Duke of Westminster* v. *CIR* [1936] AC 1, 19 TC 490.

[14] Art 20 of Presidential Decree nr. 131 of 1986.

[15] Cass., 30 maggio 2005, n. 11457, in *Giur. it.,* 2006, I, p. 200; Cass., 23 novembre 2001, n. 14900, in *Giur. imp.,* 2002, p. 624; Cass., 25 febbraio 2002, n. 2713, in *Foro it.,* 2002, I, c. 3424; Cass., 7 luglio 2003, n. 10660, in *Giust. civ. mass.,* 2003, 7-8.

[16] In its latest decision (Cass., 30 maggio 2005, n. 11457) the Court has contributed to the uncertainties that afflict this area of law by regrettably recognizing that art. 20 is, "to a certain extent", an anti avoidance provision.

The Court held that the scheme put in place by the Duke was underpinned by a genuine transaction and that the claim according to which the annuities were, "in substance", wages could not be accepted: the only relevant substance, concluded the Court, is "that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles".

Evidently, the fact that the economic purpose of the legal arrangements under consideration was actually to pay for the employees' services and that the only justification for paying annuities, rather than ordinary wages, was that the former gave way to a different -and more convenient- fiscal treatment, were not regarded as relevant because they pertained to the economic, and not legal, substance of the transaction.

The Court did not say it, but one can readily deduce it from its reasoning, that it is up to the Parliament to amend tax legislation so as to prevent taxpayers from following the more tax efficient route to reach a certain economic effect, should one or more of those routes be perceived as at odds with the underlying rationales of the tax system: for instance, the legislator might well have made the deductibility of annuities contingent upon certain conditions devised to prevent any abuse thereof.

Tax mitigation, therefore, results from the fact that, as tax law stands at a given moment, a taxpayer is free to choose among legal forms in order to achieve a certain economic effect.

In Westminster, that effect was to pay the employees' services: and, under applicable tax law, there were no indications as to whether wages were more "suitable"[17] to serve such purpose than annuities. The economic outcome was the same, yet the legal facts were different, and the Court recognized that, according to the law, it had to concern itself only with the latter.

The reasoning in the Westminster case can be traced in the jurisprudence of the Italian tax courts. For instance, a similar understanding of the role of the judiciary with respect to tax avoidance can be observed in cases where the courts have held that certain off-the-peg tax avoidance schemes could not be challenged because they had taken place prior to the introduction by Parliament of the anti-avoidance provision which targeted them. In other words, the courts were absolutely aware of the absorbing tax-saving purpose of the (dividend stripping) transactions under consideration[18]; yet they concluded that -as the law stood at the moment the scheme was implemented- there were no indications that those transactions were to be taxed according to their economic, rather than legal, effects[19].

As a result, the courts have labeled the tax benefits of those transactions as tax mitigation or tax avoidance according to the time they had taken place.

3. Tax avoidance

This approach to tax avoidance schemes is more or less consistently reflected in the UK case law from Westminster up to the seventies, when courts started to approach tax avoidance by analyzing not just the legal effects of transactions but also the economic effects thereof[20].

The same may be said for the Italian jurisprudence up until recent years[21], although in this case the leap forward looks somehow more complex because it has occurred in a country that, ten years earlier, had adopted a semi-general anti avoidance rule[22] which covers vast areas of direct and indirect taxation.

What the Court of Cassation is in fact saying is that that rule, rather than simply entrusting the revenue authority with the power to re-characterize and disregard tax avoidance schemes when certain conditions are met, "gives evidence" of the existence in the tax system of an anti avoidance general *principle* (directly deriving from the "ability to pay" as a Constitutional principle[23]) that covers all areas of taxation.

As a result, this judicial GAAR can now be applied to all sorts of transactions, irrespective of the time they have taken place and of the type of tax that comes into consideration.

Before entering into more detail in the analysis of the foregoing, we should go back to what we stated at the outset: tax avoidance stands between

[17] Or, as we shall say below, a more "conventional" legal instrument with respect to the achievement of that economic result.

[18] Given that, as noted above, Parliament had already enacted anti-avoidance provisions which deprived the schemes of their fiscal attractiveness.

[19] *Inter alia*, CTR Friuli-Venezia Giulia, 26 giugno 2007, n. 45

[20] The change in the House of Lords understanding of its role with respect to anti-avoidance is generally situated in the early seventies, when the *Black Nominees* decision [1975] STC 372 was delivered.

[21] The turning point being, in this instance, the decisions Cass., 21 ottobre 2005, n. 20398, in *Dir. e giust.*, 2005, 43, p. 21 and Cass. 14 novembre 2005, n. 22932, in *Giust. civ.*, 2006, 5, p. 1077.

[22] Art. 37-*bis* of Presidential Decree nr. 600 of 1973.

[23] Art. 53 of the Constitution.

tax evasion and tax mitigation. This means that we are confronted with a conduct that, on the one hand, is not contrary to the letter of the law (otherwise it would amount to tax evasion) and, on the other, is not an acceptable instrument (in terms of the reduced taxation that it attracts) to achieve a given economic result (otherwise it would constitute tax mitigation).

The Westminster case once again proves helpful: as we have seen, no case could have been made that the Duke was evading taxes or that the stated characterization of legal facts was wrong; and yet it is hard to deny the uneasiness one feels in accepting the conclusion that he was actually entitled to the deduction or, in other words, that that deduction really added up to tax mitigation, as the Court at that time implied.

The reason behind this uneasiness is easy to explain: paying the annuities had the same economic effects as paying wages; and the high street observer cannot help thinking that inasmuch as Parliament has for some reason prevented the deduction of the latter, that treatment should be *extended* to the former.

Now, there is not only one way to achieve that end.

The first is the amendment, by a democratically elected Parliament, of the relevant legislation. This solution, however, is not always viable, not least because taxpayers tend to be faster than parliaments and retroactive anti-avoidance provisions foster uncertainty and unpopularity.

The second, which is at the heart of current discussions on the subject, is the re-characterization for tax purposes of the legal facts of a given transaction according to their economic effects: in other words, if the Duke of Westminster arrangements were to be re-characterized, the payment of annuities would be deemed as a payment of wages for the purpose of deducting them from taxes[24].

Re-characterization may indeed take many forms, not least that of contending that a series of circular or linear transactions have, as whole, no economic effects at all and that, as such, no tax consequence should be attached to them.

This is exactly the line of thinking that underpinned the landmark *Ramsay*[25] and *Furniss*[26] House of Lords decisions, which are generally referred to as the two cases that epitomize the departure from the Westminster doctrine.

Although it has been held that that approach is a "principle of construction"[27], it is of the utmost importance to point out, to the contrary, that statute interpretation and re-characterization of legal facts are two very different things: whereas the purpose of the former is to ascertain "what Parliament meant by using the language of the statute"[28], the latter consists in determining the tax treatment of a transaction "by applying (not interpreting) statutory provisions (…) as though the parties had implemented a transaction different to the one which they in fact implemented"[29].

From a slightly different perspective, we might say that whereas interpretation has to do with tax evasion (in the sense that a tax scheme that fails to comply with the meaning of a provision, as resulting from an orthodox *interpretation* thereof, constitutes tax evasion), re-characterization has to do with tax avoidance (in the sense that a tax scheme which is liable to being re-characterized is a tax-avoidance scheme)[30].

Re-characterization poses two main, overlapping, issues:

- In the first place: are courts entitled to re-characterize the legal facts of a transaction in the absence of a legal provision (GAAR or semi-GAAR) allowing them to do so?
- In second place: under which conditions should re-characterization be carried out?

Let us address the second question first.

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[24] The Court of Justice [*Halifax* C-255/02, § 94] describes re-characterization as follows: "Where an abusive practice has been found to exist, the transactions involved must be *redefined* so as to re-establish the situation that would have prevailed in the absence of the transaction constituting that abusive practice" (italics added).

[25] [1982] A.C. 300 HL

[26] [1984] A.C. 474

[27] *Inland Revenue Commissioners v McGuckian* [1997] 1 WLR 991

[28] *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2003] 1 A.C. 311

[29] R. Ballard - P. Davidson, *Cahier de Droit Fiscal International*, 2002, 578.

[30] Our opinion is, therefore, that the attempt to reconcile *Westminster* and *Ramsay* devised in *Westmoreland* (above) is not a convincing one. The Court held that in the *Ramsay* case, rather than re-characterizing the transactions, it had recognized "that the statutory language was intended to refer to commercial concepts, so that in the case of a concept such as a "disposal", the court was required to take a view of the facts which transcended the juristic individuality of the various parts of a preplanned series of transactions". Indeed, if this were actually the case, *Ramsay* should be labeled as a tax evasion case in which the taxpayer had failed to comply with the law. In fact, there is no dichotomy between the law and its interpretation: the law *is* as it is interpreted. As a result, it makes no difference as to whether the law refers to a commercial or juristic concept. *Contra,* L. Hoffmann, *Tax Avoidance,* BTR, 2005, 197.
In any event, the *Westmoreland* reconstruction has also proved unworkable: see *BMF v. Mawson* [2003] STC 66

Ramsay itself and the case law that followed on it made the application of its doctrine contingent essentially on two conditions: the existence of a "pre-ordained series of transactions" (or of a single composite transaction) and that of "steps inserted which have no commercial purpose apart from the avoidance of a liability to tax"[31].

It is interesting to note that these conditions are mirrored in the aforementioned Italian semi-general anti avoidance rule promulgated in 1997.

The reason for this similarity between judiciary and statute-based anti-avoidance approaches is that they are targeting exactly the same thing: an "unconventional" combination of transactions through which the taxpayer achieves an economic effect that he could have achieved with a "conventional", yet more fiscally burdensome, transaction[32].

To that end, the crucial test to establish whether a transaction is "conventional" or "unconventional" lies in the commercial purpose of each of its steps: indeed, there is no room for re-characterization wherever the taxpayer gives evidence that the "inserted step" that makes the transaction apparently "unconventional" is actually instrumental to achieving a verifiable economic effect which is *different* to the one that may be accomplished by way of the "conventional" transaction.

The Italian provision is indeed devised in such a way that, prior to any tax assessment based thereon, the taxpayer is entitled to provide evidence that the transaction has led to an economic result that could not otherwise be achieved (that is: that could not be achieved by means of the "conventional" transaction): and, once it is ascertained that that purpose is actual and verifiable, the transaction may not be re-characterized.

The answer to the first question is, in our opinion, implicit in how the courts tend to justify their re-characterization decisions in the absence of an anti-avoidance provision: they either say that they are actually interpreting the relevant statute (indeed, in the post *Ramsay* line of cases the House of Lords has consistently pretended that *Westminster* had not been reversed[33]) or that their prerogatives have been conferred at a constitutional level (it is the case of the decisions handed out by the Court of Cassation during the last three years).

As we have seen, the re-characterization of legal facts of a transaction entails that the applicable provision is not actually applied because *it is assumed* that those facts are different: this is a mechanism that, manifestly, operates at the level of the applicability (and not interpretation) of the law and, as such, must itself be provided for by the law[34].

4. Conclusions

At present, it looks as though the UK and Italy are going in opposite directions: whereas the latest decisions of the House of Lords seem to have substantially reconsidered the viability of a purely judicial approach to tax avoidance and recognized the limits to statute interpretation[35], the Court of Cassation has substantially overtaken Parliament by claiming that, pursuant to the "ability to pay" principle, courts are entitled to re-characterize a transactions whenever, in light of its economic effects and of the absence of a business purpose, it adds up to an "abuse of law"[36]: despite the terminology, the concept collimates with tax avoidance, as described above.

Not surprisingly, like the House of Lords before it, the Court of Cassation would have us believe that this approach to the issue is nothing more than a (now constitutionally oriented) interpretation of tax statutes.

[31] Lord Brightman in *Dowson* 55 TC 324 at 401.

[32] References to adjectives as "normal", which we have dubbed with "conventional", may be found in the Court of Justice's *Cadbury Schweppes* decision (case C-196/04, § 55) where it refers to "wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax *normally* due on the profits generated by activities carried out on national territory" (italics added).

[33] Lord Hofmann in *Westmoreland* [2001] STC 237 at 247.

[34] See J. FREEDMAN, *Defining Taxpayer Responsibility: In Support of a General Anti Avoidance Principle,* BTR, 2004, 332 ff.; J. FREEDMAN – G. LOOMER – J. VELLA, *Corporate Tax Risk and Tax Avoidance: New Approaches,* BTR, 2009, 1, 74-116.

[35] *Barclays Mercantile Business Finance Ltd v. Mawson* [2005] STC 1.

[36] Cass., sez. un., 23 dicembre 2008, n. 30055-30056-30057; Cass., 21 gennaio 2009, n. 1465, in *Giust. civ. mass.,* 2009, 1.