Tax Avoidance: Rational Ignorance of Law[1]

Nigar Hashimzade[2]

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Abstract

Tax avoidance has traditionally been a subject of research in accounting and law. Past decade has witnessed growing interest to this subject in a range of other disciplines, from anthropology to psychology and sociology, and, not least, in economics. This was at least partly stimulated by politicians, mass media, and public focussing on tax avoidance, often conflated with tax evasion, in many countries after the global financial and economic crisis put a squeeze on private and public finances. Changing definitions, controversies in the interpretation of concepts, rules, and policies appear to have led to inconsistency in the assessment of legality of various tax avoidance schemes by legislators, tax authorities, tax advisors, and taxpayers. These controversies and inconsistencies suggest that either parties sometimes are not fully aware of tax law, or the law is ambiguous, or both.

Uncertainty or ambiguity in the tax law and the ensuing issue of intended or unintended non-compliance or over-compliance has been a topic of debate in the tax law literature for some time. An increasing complexity of the economic and financial environment has led to the emergence of new types of transactions and instruments whose tax treatment does not always fall into existing categories. A legislation aspiring to cover every contingency in detail becomes extremely complicated and may be prohibitively costly to learn in full. As an alternative, a simple general rule or a set of general rules allows for flexibility in covering the existing and evolving transaction, but is prone to wide interpretation and misinterpretation. Tax law is thus rendered uncertain, practically in the former case and fundamentally in the latter.

Individuals and businesses aiming to exploit preferential tax treatment of certain activities to their benefit face the possibility that their interpretation of the rules will be deemed unacceptable by the revenue authority. Disputes sometimes end up in the court of justice, where the judge decides based on the relative strength of evidence submitted by the parties. Acquiring evidence is costly and, based on the cost-benefit comparison, certainty in the outcome may be impractical for both parties, - or, indeed, may be fundamentally unachievable.

The paper presents a game-theoretic model of such a situation in the context of tax avoidance. This framework is used to address the following questions: (1) What influences the ruling of a tax authority on the legality of a tax avoidance scheme and the decision of a taxpayer on the involvement in a scheme? (2) Does more uncertainty in tax law encourage more avoidance?

In the model a taxpayer has an incentive to enter a tax-saving scheme without being fully certain of its legality, and the tax authority can either object, declare the scheme illegal and demand repayment of tax, or accept the scheme as legal, but is unable to commit to its ruling. The taxpayer can also disagree with the tax authority's decision on the illegality of the scheme. A dispute can be taken to the court, in which case the parties acquire costly information about the law (law discovery) and the specific case (fact discovery), - or hire tax specialists for this purpose.

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[2] Durham University, CESifo, and Institute for Fiscal Studies. Address: Department of Finance and Economics, Durham University, Mill Hill Lane, Durham, Co. Durham, DH1 3LB, United Kingdom. E-mail: nigar.hashimzade@durnam.ac.uk.

The outcome depends on the relative weight of evidence submitted to the judge and on the “bias” in the perception of the taxpayer’s case. When the bias is against the taxpayer the revenue authority declares the scheme illegal, or abusive, and the taxpayer accepts the ruling. Conversely, when the bias is sufficiently strong in the favour of the taxpayer the revenue authority rules the scheme acceptable. In an intermediate case an equilibrium is possible where a tax authority can declare a tax avoidance scheme legal or illegal at random, and both the taxpayer and the tax authority choose to be only partly informed about the tax law.

The bias in the model captures the social perceptions of tax planning activities which differ across countries and change over time. Thus, tax planning by an individual investor is less likely to be deemed abusive than a scheme pitched to a group; society in a European country is less forgivable of tax planning by wealthy individuals than society in the United States; in the wake of a financial crisis perception may turn against large corporate taxpayers seen as exploiting tax planning opportunities not available to ordinary individuals and small businesses, and thus not paying their “fair share” of taxes.

The baseline framework is intentionally simple and allows various extensions to investigate further positive and normative issues. One interesting extension would be to introduce risk aversion or loss aversion to describe an individual taxpayer. Loss aversion reduces the expected payoff from taking the dispute to the court. When bias is in the favour of taxpayer and the loss due to unsuccessful tax planning is substantial a loss-averse taxpayer acquires more information in equilibrium to increase their chance of winning in court, relative to the case without loss aversion; in response, the tax authority chooses to acquire less information. When loss is relatively small, the outcome depends on the combination of the degree of loss aversion and the magnitudes of the payoffs. Another possibility is to model the evolution of bias in a repeated setting; a repeated game will also allow introducing accumulation of information. The extent of the ambiguity in law could also be quantified, and the issue of optimal uncertainty could be investigated.

Rational ignorance and the value of information can be further analysed in a modified framework, with richer assumptions on the distribution of payoffs. In the simple framework, the ex-ante payoffs have effectively a rescaled Bernoulli distribution. Many disputes, however, are settled by negotiation, with the value of settlement up to the full amount of saved tax, with or without interest charge. The objective of the taxpayer and the tax authority can then be modelled as the choice of the distribution of the settlement conditional on the information, to maximize the expected payoff, under the capacity constraint on the amount of information. This capacity constraint reflects both the material cost of acquiring information and the limitation of the power of the players to process information that is, in principle, available.