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Does an uncertain tax system encourage "aggressive tax planning"?

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ABSTRACT

"Aggressive tax planning" (ATP) is typically characterized as a tax scheme that reduces the effective tax rate of a particular type of income to a level below the one sought by fiscal policy for this income. One motivation often suggested for its use is the uncertainty in tax liabilities introduced by a complicated and ever changing tax system. In this paper, I examine the impact of an uncertainty on the use of such tax schemes; by implication, I also examine how a simpler and more stable tax system that reduced this uncertainty might affect ATP. In this analysis, I draw upon some of my own work on tax avoidance and tax evasion, and then I extend this work to the related but separate area of ATP. Importantly, I introduce and model both *individual* and *group* motivations, incorporating insights from behavioral economics in these new analyses. Taxpayers are clearly motivated in part by narrowly defined financial considerations as shaped by the tax, audit, and penalty rates that they face, all of which I classify as *individual motivations*. However, individuals are also often influenced by many other factors that go beyond self-interest and that have as their main foundation some aspects of social norms, morality, altruism, fairness, or the like. In their entirety, I lump these factors together as *group motivations*, and I argue that they are shaped by the dynamic social context in which, and the process by which, decisions emerge. My main conclusion is that there is much in theory to suggest that uncertainty leads to more use of ATP, especially when both individual and group motivations are considered.

1. Introduction

Individuals take a variety of actions to reduce their tax liabilities. Some are legal "tax avoidance" activities, such as income splitting, postponement of taxes, and tax arbitrage across income that faces different tax treatment. Others are illegal "tax evasion" actions (e.g., underreporting incomes, sales, or wealth; overstating deductions, exemptions, or credits; failing to file appropriate tax returns; by engaging in barter). There is widespread, if often imprecise, evidence that both tax avoidance and tax evasion activities are extensive and commonplace in nearly all countries.

The distinction between legal tax avoidance and illegal tax evasion may be clear in theory, but in practice the difference is more nuanced. "Aggressive tax planning" (ATP) is an example of such nuance. Although a precise and widely accepted

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definition of ATP is probably not available, ATP is often seen as a tax avoidance transaction that complies with the letter but not the spirit of the law; that is, ATP consists of a scheme that reduces the effective tax rate of a particular type of income to a level below the one intended by fiscal policy for this income (OECD, 2011). Such an ATP scheme is usually a sophisticated transaction that includes a number of steps and uses complex mechanisms. The economic justification of an ATP scheme is generally limited, even non-existent, and its true rationale consists entirely of reducing the effective tax rate by exploiting shortcomings, weaknesses, or ambiguities in tax laws, via the movements of funds, the construction of fictitious or shell companies, and/or the use of financial instruments or entities that are treated differently in different jurisdictions. As such, ATP may be considered a transaction that blends elements both of legal tax avoidance and illegal tax evasion.

A natural concern for policymakers is to search for strategies to reduce ATP. Devising such strategies depends critically upon understanding why individuals (and firms) utilize these schemes and on pursuing policies that are consistent with these motivating factors and the associated evidence. The clear underlying motivation for the use of ATP is to reduce the burden of taxation. However, there are other factors as well. One often suggested reason for ATP is said to be the uncertainty in tax liabilities introduced by a complex and ever-changing tax system, so that a simpler and more stable tax code would reduce the use of ATP (OECD, 2010; National Taxpayer Advocate, 2012). However, there is virtually no real support for this claim.

It is this issue that I examine here; that is, how does uncertain tax system affect ATP? By implication, I also examine a related issue: how would a simpler and more stable tax system that reduced this uncertainty affect ATP?

Uncertainty about tax policies can arise from many sources. One obvious source is the frequent, seemingly random changes in tax policies that make one's exact tax liabilities uncertain and subject to manipulation via complicated transactions. In fact, merely the discussion in government legislative bodies of potential tax changes introduces some element of risk into individual planning. Another reason sometimes suggested is the complicated tax laws that individuals and firms face. Difficulties in interpreting these tax laws introduce uncertainty.

Uncertain tax policies make individual choices in a variety of dimensions more difficult. Individuals who are planning their financial affairs need to know whether tax changes will alter the return on their tax shelters by changing such things as depreciation rules, investment tax credits, interest deductions, at-risk rules, or capital gains tax rates and holding periods. They also would like to know whether their itemized deductions will be allowed. Individuals do not know whether they will be audited by the authorities or how much unreported income will be discovered by government auditors. Actual and proposed changes in tax policies toward saving (e.g., the tax-exempt status of interest, the deductibility of contributions to retirement programs, the treatment of estate and gift taxes, the preferential treatment of capital gains) have increased the riskiness to saving. The tax rate schedule itself has been altered numerous times in the past. Uncertain tax policies affect virtually the entire range of individual choices.

There is an enormous theoretical and empirical literature that analyzes how individuals and firms respond to known, certain tax policies. There has also been much work on how agents behave in the presence of uncertainty. However, with some exceptions (Weiss, 1976; Stiglitz, 1982), there has been little analysis of how individuals act when it is tax policy that is uncertain.

In this paper, I examine the impact of an uncertain tax system on the use of ATP. In this analysis, I start with some of my own work on tax avoidance and tax evasion, and then I extend this work to the related but separate area of ATP. Importantly, I introduce and model both *individual* and *group* motivations, incorporating insights from behavioral economics in these new analyses (Alm, forthcoming). My main conclusions are that the impact of uncertainty on ATP is far from clear-cut in theory but that there is much in theory to suggest that uncertainty does in fact lead to more use of ATP, especially when the many and varied factors that affect taxpayer compliance are considered. In particular, taxpayers are clearly motivated in part by narrowly defined financial considerations as shaped by the tax, audit, and penalty rates that they face, all of which I classify as *individual motivations*. However, there is growing evidence that these individual motivations, while important, are not always decisive. Individuals are also often influenced by many other factors that go beyond narrowly defined self-interest and that have as their main foundation some aspects of social norms, morality, altruism, fairness, or the like. These factors are shaped by the dynamic social context in which, and the process by which, their decisions emerge. In their entirety, I lump together these factors broadly and no doubt imprecisely as *group motivations*. My main conclusion is that there is much in theory to suggest that uncertainty leads to more use of ATP, especially when both individual and group motivations are considered.

2. Uncertainty and ATP: individual motivations

In this section, I examine the ways in which the individual choice of aggressive tax planning is affected by uncertain tax policies. I focus here on *individual motivations*, or the ways in which uncertain tax policies alter the narrowly defined financial incentives facing a purely self-interested individual. These financial incentives are based upon the usual array of fiscal variables, all of which affect the "prices" of various individual activities: tax rates, audit rates, penalty rates, tax base definitions, compliance costs, and the like. Following but extending Alm (1988), I consider three basic types of risky tax policies. The first is called "tax base risk". Here the individual does not know with certainty whether the government will change the basic nature of the tax base. A second type of risk is called "tax rate risk", in which the tax rate applied to the (certain) base becomes riskier. A third type of risk is "enforcement risk", in which an individual facing an administrative audit does not know with certainty how much income will be discovered in the audit. For simplicity, I also focus on a single,