

Evasion and Avoidance as Forms of Tax Non-Compliance: A Critical Review

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Abstract

Taxation is considered a veritable source of revenue for financing developmental as well as people oriented programs in virtually all countries, irrespective of whether they are classified as developed or developing economies. History has however shown that individuals often exhibit one form of tax reduction behavior or the other, with series of arguments on the legal, economic and moral consequences of these acts. This present study reviewed previous international literature regarding tax compliance and non-compliance behavior. The review of literature indicated that individual non-compliance can be intentional or unintentional, and intentional noncompliance usually takes the forms of evasion or avoidance. The study found that while tax evasion is universally acclaimed to be illegal and punishable, there still exist some lines of argument as to the (il)legality or permissibility of tax avoidance as a means of reducing tax burdens. The paper concludes that non-compliance with tax payments, by whatever form is undesirable as it ultimately reduces revenue accruing to the government and by extension, the entire economy. As such, governments and tax administrators should seek ways to improve compliance.

Keywords: Tax; taxation; compliance behavior; evasion; avoidance

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1.0 INTRODUCTION

Issues relating to taxation are considered very important by most people and governments because taxes represent a major source of revenue for financing developmental as well as people oriented programs in virtually all countries, irrespective of whether they are classified as developed or developing countries. Aside from being a major source of revenue to most nations, taxation also plays very significant roles in the promotion of social and economic welfare, provision of public goods, redistribution of income, promotion of economic stability, as well as regulation of economic activities and consumption of goods and services. Because of the aforementioned importance of taxation, developed economies have invested considerably on legislative tax reforms, taxpayer education, and development of new technologies to aid in evolving effective tax systems, and to boost tax collections.

Despite the emphasis on the importance of taxation and the efforts made at improving its efficiency, citizens' aversion to taxes have remained a problem that most tax authorities have to grapple with. This is because individuals will always look for a means –legal or otherwise–to reduce or even completely avoid paying taxes. This result in heavy revenue losses to governments and ultimately affects their ability to meet their obligations. This phenomenon is acclaimed to be a global one, but it is generally acknowledged to be higher among the less developed/developing countries of the world. In the United States of America for example, the IRS reported that the total amount of federal taxes that were either not paid voluntarily or on time were estimated at between \$312bn and \$353bn in the year 2002 (Alabede, Ariffin and Idris, 2012). While Cobham (2005) estimates that developing countries lose USD 285 billion per year due to tax evasion in the domestic shadow economy. It is also reported that half of sub-Saharan African countries mobilize less than 17% of their GDP in tax revenues, which is below the 20% minimum level considered by the UN as necessary to achieve the MDGs (Supporting the development, 2010). These facts underscore the extent of losses suffered by nations when individuals do not pay their taxes, and thus justify the attention the subject of tax compliance has generated over the years.

This present study reviews literature on the subject matter of tax compliance with particular attention on the dimensions of evasion and avoidance as forms of non-compliance. Attention is also paid to the discussions and arguments relating to the distinction between the two concepts as they affect tax revenue.

2.0 LITERATURE REVIEW/CONCEPTUAL CLARIFICATIONS

2.1 Taxes

Taxes are a compulsory contribution made by individuals and corporate bodies to the government of a given country with a view to complementing and/or providing income for the government (Buhari, 1991; Aguolu, 2002). Taxes are a form of compulsory levy imposed

by the government or other tax raising body, on income, expenditure, or capital assets for which the taxpayer receives nothing in return (Lymer and Oats, 2009; Anyaduba, 2006). The fact that the taxpayer may not receive anything in return for the tax payments differentiates taxes from other compulsory payments like charges, tolls, or other levies for which the payer expects specific and/or commensurate services (Ogbonna, n.d; Palil, 2010). The taxpayers only expect to have the benefit of living in a relatively educated, healthy and safe society (Fagbemi, *et al.*, 2010), like every other members of the same society, whether tax-paying or not.

2.2 Taxation

Taxation is defined by Ogundele (1999) as the process or machinery by which individuals, groups, or communities are made to contribute in some agreed quantum and method for the purposes of the administration and general development of the society they belong. It is the process or system of generating public revenue through the levying of various types of taxes (Anyaduba, 2006), and is often acclaimed as the oldest and ultimately the only sustainable source of development finance, especially for poor countries (Cobham, 2005).

A common feature observable with most definitions of taxes and taxation is that they are levied for the purpose of raising revenue for governments. This is not ultimately true, because taxation is embarked upon for several other reasons than public revenue generation (Olabisi, 2010). Among the several other reasons for imposition of taxes is that they provide a basis for the formulation of political, economic and social policies (Bakre, 2006); just as it serves as a means for controlling inflation, promoting economic growth and providing social amenities to the people; it builds legitimacy and consent by helping to create consensual, accountable and representative governments (McKerchar and Evans, 2009); and (most importantly for the poor or developing countries), it offers an antidote to the dependence on foreign aid (Supporting the development, 2011). Taxation thus serves a myriad of functions, and is such a powerful tool (of government), such that Lamont (1992) opined that of all powers of government, other than its authority to declare war, none bears so incisively upon the welfare of the citizens, both privately and in their economic enterprise, as does its power to tax.

Despite the global importance attached to taxation as an instrument of development, and the power of states to enforce tax payments, the general success of income tax rests primarily upon the honesty of taxpayers (Adams, 1921) and their willingness to comply with reporting and making actual/correct payments. The issue of compliance has thus, over the years formed the basis for discussions by academics and tax practitioners/regulators alike, with several definitions and dimensions introduced into its meaning. In order to gain an insight into compliance behavior therefore, it is important to get a clearer understanding of the meaning of (tax) compliance.

2.3 Compliance

In its simplest form, compliance is considered as a term which describes the taxpayers' willingness to pay their taxes (Kirchler, 2007). Tax compliance is however a much wider concept than just the willingness to pay. It is a term that has come to be viewed from many perspectives including economics, legal, and also psychological (Palil, 2010), as encapsulated in broader definitions of the concept, some of which are considered here.

According to Roth *et al.*, (1989), tax compliance means that the taxpayer files all required tax returns at the proper time, and that the returns accurately report tax liabilities in accordance with the internal revenue code, regulations and court decisions applicable at the time the return is filed. To Fagbemi *et al.*, (2010), tax compliance is when a person seeks to comply with the tax law by full disclosure of all relevant information on all tax claims, and also (seeks) to pay the right amount, at the right time and place required by the law. It therefore means that compliance requires that the taxpayer complies with the laws, by declaring the correct income, claiming the correct deductions, reliefs and rebates and then paying all taxes on time (Palil, 2010), without having to wait for follow-up (enforcement) actions from an authority (Singh, 2003).

The above definitions identify the three important requirements of compliance, which Sour (2004:45) identified to be "...adequate record keeping, timely and accurate filling of tax returns, and the payment of all taxes owed". These are also in line with the three types of voluntary compliance recognized by the Internal Revenue Services (IRS) Plumley (1996), via: filing compliance (the timely filing of any required return); reporting compliance (the accurate reporting of income and tax liability); and payment compliance (the timely payment of all tax obligations).

From the foregoing therefore, it is obvious that compliance with tax regulation is not limited to the actual payments of the tax liabilities alone. It rather begins with registering and filing and subsequently reporting all income and tax liabilities. A comprehensive list of the obligations required of a compliant taxpayer is given by McKerchar and Evans (2009) to include:

- registering with the revenue authority as required;
- filing the required returns on time;
- accurately reporting tax liability (in the required returns) in accordance with the prevailing legislation, rulings, return instructions and court decisions;
- paying any outstanding taxes as they fall due; and
- maintaining all records as required.

Failure to satisfy any one or more of these obligations results in non-compliance and is considered as posing a risk to revenue collection (McKerchar and Evans, 2009).

2.4 Non-compliance

Non-compliance is the direct opposite of compliance, and can be generally seen as taxpayers' failure to remit the proper amount of tax (Palil, 2010). Comprehensively, it can be defined as the failure on the part of a taxpayer to correctly file returns, report actual income, claim the correct deductions, reliefs and rebates and remit the actual amount of tax payable to the authority on time (Kirchler, 2007, Palil, 2010). This act of non-compliance may either be intentional or unintentional (Sour, 2004; McKerchar and Evans, 2009). As pointed out by Sour (2004), a taxpayer's failure to comply may occur either because he/she made an honest mistake when filling his tax forms, or because he/she intended to evade his tax liabilities right from the onset. Sour expatiated further that non-compliance is not limited to situations

where individuals underpaid (under report) only, but also includes situations where individuals overpaid (over report) their taxes. Furthermore, there is almost a general consensus that unintentional non-compliance could result from such factors as complexity, contradictions, and imprecise nature of tax legislations or tax procedure (Jackson and Millirun, 1986; Kesselman, 1994; James and Alley, 2004; GAO, 2011). Intentional non-compliance on the other hand, are usually discussed under the terminologies/concepts of tax evasion and tax avoidance, which have enjoyed wide attention in almost all studies bothering on taxation, and are strongly regarded as activities that are unfavorable to a state's tax laws (Fjeldstad, Schulz-Herzenberg and Sjrnsen, 2012).

■3.0 THE EVASION-AVOIDANCE DISCOURSE

The dual concepts of tax evasion and tax avoidance have been severally defined and distinguished mainly on the basis of (il)legality (Sour, 2004; Slemrod and Yitzhaki, 2002, Sandmo, 2005). However, almost all authorities in taxation –including lawyers and tax authorities – have consented to the fact that there exists many areas that still remain ambiguous to all stakeholders in the taxation process (Sour, 2004), as far as the dividing line between the two concepts is concerned. A brief explanation on the two concepts, along with the associated discussions is presented below.

Tax *evasion* is typically considered as any intentional, illegal reduction of tax payments, which usually takes the form of underreporting income, sales or wealth, or overstating deductions (Schneider, Braithwaite & Reinhart 2001), including failure to file appropriate tax returns (Alm, 1999). *Avoidance* on the other hand, is considered as the reduction in tax burden by means of practices that take full advantage of the tax code (Alm, 1999) or exploiting the loopholes in the tax laws to reduce tax liabilities by arranging ones tax affairs using tax shelters in the tax law, and avoiding the tax traps in the tax laws (Soyode and Kajola, 2006). It generally entails getting around the law, without necessarily breaking it (Gilak, 2012). Thus, when it comes to avoidance, it is not what you do that matters, but rather how you do it (McBarnet, 1992). Tax avoidance usually takes the form of such actions as income splitting, postponement of taxes, and arbitrage across incomes that face different tax treatments (Alm, 1999), and/or hiring of a tax professional to alert one of the tax deductibility of activities already taken (Sour, 2004).

The foregoing definitions thus imply that the tax evader is a criminal, who breaks the law in the efforts to reduce his/her tax liabilities, and thus needs to worry about possible detection (Sandmo, 2005), and the likely penalties, which ranges from conviction to a prison sentence, a fine, or a combination of the two—as in the United States of America (Slemrod, 2007). The avoider on the other hand, is considered as just a smart taxpayer who exploits the loopholes in the tax laws to reduce his/her tax liabilities (Olabisi, 2010), and does not have to worry about possible detection (Sandmo, 2005). Despite the almost general consensus that the dividing line between tax evasion and avoidance is the illegality of the former, there exists pockets of arguments as to whether avoidance should be permitted (or even tolerated) at all. In general, two divergent shades of opinions have been expressed in this regards.

At one extreme is the opinion of those who view avoidance as permissible (acceptable) since it does not break the law, but is "...a rather legal strategy to escape from tax payments" (Torgler, 2005:134). According to Duru (2009), citizens have the right to reduce the amounts of taxes due of them, in as much as it is by legal terms. To those who hold this view, the tax avoider is simply considered as being sensible (Kiabel and Nwokah (2009)), smart (Olabisi, 2010), and creative (Kasipillai, Aripin and Amran, 2003) in exploiting the loopholes in the tax laws to his advantage, and it should be acceptable to the tax administrators. Holders of this opinion find explicit support in the pronouncements of Lord Clyde in the case between *Ayrshire Pullman Motor Services and David M. Ritchin Vs Commissioner of Inland Revenue*, cited in Kiabel and Nwokah (2009), when the Lord President, Lord Clyde held that:

No man in this country is under the smallest obligation moral or otherwise so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow and quite rightly to take every advantage, which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is in like manner entitled to be astute to prevent so far as he honestly can the depletion of his means by the Revenue. (p.53)

While it can be deduced that the above views are based on the legal definitions of avoidance and evasion, which declares the former as legal and the later illegal, a directly opposing view is expressed by authors based on the economic, social, and (sometimes) moral consequences of the two acts. Thus, as opposed to the legal definitions of the two concepts, evasion and avoidance are said to have strong similarities as far as economics function is concerned, and are sometimes hardly distinguished (Franzoni, 1999). They both comprise activities that negatively affect the state's revenue mobilization, and the entire tax system. On this view, Seldon (1979) opined that on economic grounds, there is virtually no distinction between avoidance and evasion because their causes and their consequences are basically the same. He further argued that there are no clear lessons to be drawn about the morality of these who evade taxes (violate the law) or those who merely avoid (do not violate the law), but nevertheless appear to defy the spirit of the law. Expounding further on the issue of immorality of the two acts (evasion and avoidance), Sandmo (2005), buttressed his argument with the following example:

The house painter who does a bit of extra work in the black economy violates the law, while the wealthy investor who engages a tax lawyer to look for tax havens does not. However, from a moral point of view their ways of behaviour may not seem to be all that different. (p. 646)

The above views, especially those of Sandmo (2005) are in line with the views of James, Murphy and Reinhart (2005) that compliance might better be defined in terms of complying with, not just the letter of the law, but also the spirit and purpose of the law. These views are based on the premise that avoidance, like evasion, also deprives the state of taxable revenue. Furthermore, when an individual or taxpaying body overdoes avoidance, it becomes evasion (Soyode and Kajola, 2006).

■4.0 CONCLUSION

Issues bothering on taxation are of great importance to the people and government of any society. Taxation generally aids governments in raising revenue required to fund developmental programs. It also has the potentials of giving the citizens a sense of patriotism and satisfaction of performing a civic duty when they pay their taxes. However, like every other human endeavor, it is natural to expect that some people will voluntarily comply with tax payments, while others will not. In attempting to reduce tax burdens, individuals tend to find justification for their actions by searching for ‘escape routes’ that are perceived as ‘not breaking the law’. It is however important to note that in reducing tax burdens, either by evasion or avoidance, the revenue accruing to the economy is affected, which may ultimately be detrimental to the entire economy.

The natural question that comes to mind is that ‘should individuals not be entitled to legally reduce their tax liabilities? An obviously suitable answer is provided by Sandmo (2005), that any taxpayer, who desires a reduction in taxes, should make a detailed statement about his/her transactions entitling him to such reductions, and thus, by so doing, comply with not only the letters of the law, but the spirit and purpose of the law.

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