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Tightening the noose on Tax

By Robert Waruiru.

The difference between tax planning and tax avoidance is the thickness of a prison wall. That is a quote attributed to Denis Healey, a former Chancellor of the Exchequer speaking sometime when aggressive tax avoidance was still fashionable. Tax revenues are central to any government and it is easy to see why tax evasion has taken centre stage today. Sample this: Rwanda Revenue Authority exceeded its 2016/17 revenue collection target while Tanzania Revenue Authority marginally missed its target. Kenya Revenue Authority missed its target by an eye lash wide margin. Such sterling performances viewed against ever increasing tax revenue targets bring to the fore the debate on tax avoidance, a pet topic of the European Union (EU) as it turns up the heat on the “fight against tax evasion and avoidance, which are the cause of a major shortfall in tax revenues.”

Tax evasion is criminal. You know you have an obligation to pay your fair share of tax from profits but you deliberately fail to pay the tax. Some landlords might be caught up in this. There are enough examples of tax evasion but one which fascinates me to date is that of Italy where taxpayers who own limited edition Ferraris and Maseratis claim unemployment benefits!

Tax avoidance on the other hand is legal. At least I used to think it was the legal reduction of one’s tax liability. A good example of this is taking out an insurance policy and claiming the insurance relief available under the Income Tax Act. But Section 2 of the Tax Procedures Act, 2015, which defines tax avoidance as “a transaction or a scheme designed to avoid liability to pay tax under any tax law” has challenged my earlier beliefs about tax avoidance. The difference between tax avoidance and tax evasion is simple, right? Possibly. But that was before the seemingly ever expanding grey area of “tax mitigation, tax neutral schemes and aggressive tax planning”.

As early as 1985, India had experienced tax planning. In the McDowell and Co Ltd case, the Indian High Court frowned upon aggressive tax planning saying “tax planning should not degenerate into tax avoidance through subterfuges”.The EU appears to have a shared view, often characterizing tax avoidance as pushing the boundaries of aggressive tax planning, which explains the EU support for the latest base erosion and profit shifting initiatives. Yet, despite all the hue and cry about tax planning, there is no doubt about a taxpayer’s right to tax plan. The right to tax plan was asserted by the US Court of Appeal in Gregory vs Helvering (1928) in which the court held that “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

So how are countries responding to the challenge of tax planning? Two such responses are the enactment of General Anti Avoidance Rules (GAAR) and enforcement of the Principal Purpose Test (PPT). GAAR is an expansive topic but today we shall address the PPT.

Despite the words “tax avoidance” appearing 8 times in the Kenyan Tax Procedures Act, it is not clear how the Commissioner will rule that a transaction is a tax avoidance scheme. Given this lacuna, the PPT, should in my view, be a critical consideration in any transaction as this will likely be the basis for a tax avoidance ruling by the Commissioner.

The PPT, was first used in the Gregory vs Helvering case and looks at the real reason behind a particular action or transaction. If it can be proven that the transaction is legal but only serves to lower one's tax liability, the court will disregard that action or transaction, however legal it may be. This is also commonly referred to as the Ramsay Principle, after the celebrated 1982 case of Ramsay vs Inland Revenue Commissioner in which the highest court in the UK ruled that where a transaction is so arranged as to serve no other purpose other than to reduce the tax liability, the arrangement should be disregarded.

One must always consider the substance of the transaction and this substance must tie back to commercial rationale. Without the commercial rationale, the form of the transaction is likely to be disregarded.

There you have it. Tax planning is a fluid and ever-evolving concept. Whilst it is difficult to define what tax planning is, avoiding being in the taxman's crosshairs is a business imperative - being in the focus of the taxman isn't the cosiest of places to be. Thinking about the principal purpose of your commercial transactions should be a good starting point to avoid being in the taxman's sights!

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