

Can tax planning be criminal ?

Domestic and international perspective

Daniel Gutmann, Professor at the Sorbonne Law School (University Paris-1)

The question whether tax planning can entail criminal consequences is a relatively new topic in the academic sphere. Tax planning is indeed generally defined as a behavior which consists in setting up legal structures with a view to optimizing the tax burdens of individual or companies, without infringing the letter of the law. It is therefore paradoxical, at first sight, to wonder whether a perfectly licit behavior may nevertheless raise criminal issues. Besides, it should be observed that criminal law rarely interferes with taxation, except in extreme situations. Only where a taxpayer fails to file a tax return, conceals income or submits intentionally wrong statements to the tax administration, does criminal law provide for penalties or even imprisonment. This is justified by the deliberate intention of the taxpayer to escape taxation through fraudulent activities, but this has nothing to do with tax planning in the ordinary sense of this expression.

However, a theoretical approach is not sufficient, nowadays, to deal with this question. Practice indeed reveals a widespread feeling among tax managers that tax law is getting more and more “criminal”¹, i.e. that the failure to abide by all legal provisions creates a penal risk which did not exist to a comparable extent in the past. They wonder, for instance, whether the failure to declare the existence of a permanent establishment after a business restructuring may be considered, not only as a tax problem, but also as an event triggering criminal effects. A potential criminal dimension is also present in transfer pricing reassessments and, more generally, in all situations where tax arbitrage might be considered as fraudulent in the criminal sense. This trend towards more severe treatment of taxpayers has allegedly been strengthened since the 2008 financial crisis, which resulted in growing budgetary deficits and the subsequent pressure on state resources. It is also likely that the development of legal tools designed to fight money laundering has attracted more attention to the criminal dimension of numerous activities. Due to the disclosure obligations imposed on financial institutions, as well as legal professionals, it is now widely understood that tax-driven transactions must be situated within the broader perspective of criminal-oriented activities.

Against this background, it is of utmost importance to define the borderlines of tax law and criminal law and to distinguish clearly between sound tax optimization and aggressive tax planning. In other words, it is essential to understand why and to what extent there could (or should) be a connection between tax planning and criminal law (I). Assuming that such a connection is relevant in theory, it is then necessary to spell out the conditions which should be met in the event criminal law should extend its scope to tax planning situations (II).

¹ See D. Gutmann, « Towards a « Criminalization » of Tax Law? A French Approach », *European Taxation*, 2011 (Volume 51), No. 7, p. 271 et seq.

I- Why should there be a connection between tax planning and criminal law?

In theory, there are excellent reasons why tax planning may be seen as an evil to be fought by criminal law instruments. It is clear indeed that tax planning is a way to circumvent the “ordinary” tax burden, thereby harming the principle of equality between taxpayers. It also significantly affects tax revenues, thereby creating an important financial damage for the State.

One may object to these arguments that although tax planning is a financially harmful practice, it does not as such violate fundamental public interests such as human life, physical integrity or other basic value of developed societies (equality between genders and races, etc.). The degree to which the States’ interest is affected is therefore not comparable to situations which traditionally constitute the core scope of criminal law.

These objections are undoubtedly strong and may well suffice to discard the legitimacy of criminal legislation in tax planning matters. However, it is fair to observe that the values protected by criminal law are not immutable. The mere fact that tax planning was not “harmful enough” to justify specific criminal legislation in the past does not provide for a convincing argument that the same reasoning should prevail nowadays. With the globalization of the world economy, numerous possibilities of tax arbitrage have appeared and have been exploited by economic actors. In a context of scarcer budgetary resources, tax planning has become less acceptable than it used to be and the case for using new and more coercive counter-instruments has gotten stronger.

Besides, the relationship between citizens and tax law is also changing. While taxation has always been perceived as a way to provide monetary resources to the State and, more recently, as a way to provide incentives for economic policies, it is more and more understood as an essential tool to reach social justice. The current economic and social crisis has played a decisive role in this respect: while the differences between the poor and the well-off have so far been accepted – to a certain extent- as a structural consequence of liberalism, more and more voices now claim that liberalism should be controlled and that taxation should be a key element in providing for redistributive justice. “Solidarity” enters the realm of taxation. Tax planning is therefore under attack insofar as it may be seen as a breach to this fundamental value.

Thirdly, it is undisputable that the States’ need of budgetary resources is more important than ever. As Michel Bouvier shows in his article on the impact of the crisis on tax systems², States have few options on the table: either they raise taxes, with a risk to jeopardize growth, or they cut public spending, with a risk not to be able to cope with the growing demands of the welfare State. A third option consists in enhancing tax “public-spiritedness” and focusing on tax compliance. No doubt, in this context, that “criminalizing” tax planning is a piece of a general policy directed towards a higher efficiency of the tax system as a whole. What are the functions of criminal law, after all? First, to deter from committing socially harmful actions. Second, to punish those who do not abide by the rule. In theory, nothing prevents this dual function to apply also in tax matters, as long as the assumption is that tax planning is to be fought.

² See this volume, to be completed.

This being said, the key issue is not so much whether criminal law and tax planning are incompatible in theory. It is rather to design a kind of criminal legislation which could adequately fight tax planning while remaining consistent with the fundamental principles of criminal law.

II- How to design a proper criminal legislation to fight tax planning?

Legislation design is hard work : it must take into account methodological issues as well as substantive principles. In the present case, the main requirements which must be borne in mind are :

- to define the boundaries of criminal law ;
- to distinguish between “ordinary” tax planning and criminal offences ;
- to apply the general principles of criminal law ;
- to think about the international context.

A- Define the boundaries of criminal law

Before having recourse to criminal law instruments, it is always necessary to make sure that this kind of legal tool is the most appropriate to reach the pursued goal, i.e. the avoidance of tax crime. It is necessary, in particular, to ensure that the enactment of criminal rules does not actually end up having the opposite effect, namely to make tax planning more subtle and elaborate than in the past. Empirical studies indeed show that the motivations underlying tax compliance are extremely complex³ and that tax morale is a complicated interaction between taxpayers and the Government. As a contractual relationship implies duties and rights for each contract party, tax compliance is increased by sticking to the fiscal exchange paradigm between citizens and the state⁴. It may therefore be argued that coercive measures against taxpayers are not always the good answer to tax compliance problems and that a more “taxpayer-friendly” enhancing the virtues of cooperation and mutual exchange, such as the “enhanced relationship” between taxpayers and tax authorities which is currently gaining strength in numerous countries, is a better tool to reach the goals pursued by the Government.

Defining the boundaries of criminal law also implies to assess whether administrative or criminal penalties are the most efficient. While the former are issued by the tax authorities, the second are issued by a judge. In practice, however, the distinction between the two kinds of penalties is often blurred by the repressive nature of administrative penalties, which explains why many States apply the fundamental principles governing criminal penalties (non-retroactivity, proportionality, etc.) to administrative sanctions⁵. The separation between administrative and criminal penalties should also not justify the addition to both kinds of penalties in the same situation. Although some legal systems admit the addition of administrative and criminal penalties – which is the case in France⁶, this is clearly inconsistent

³ S. Ekland-Olson, J. Lieb and L. Zurcher (1984) “The Paradoxical Impact of Criminal Sanctions: Some Microstructural Findings,” *Law & Society Review*, 1984 (18), p. 159 et seq. ; S. Klepper and D. Nagin (1989) “Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution” *Law & Society Review* 1989 (23), p. 209 et seq.

⁴ L. P. Feld and B. S. Frey, Tax Compliance as the Result of a Psychological Tax Contract : the Role of Incentives and Responsive Tax Regulation, *Law and Policy*, vol. 29, n° 1, 2007, p. 102 et seq.

⁵ See in this respect the position of the European Court of Human Rights in *Bendenoun v. France*, 24 Febr. 1994, Series A n° 284.

⁶ According to the French constitutional court, the principle of proportionality of criminal penalties only implies that the global amount of the penalties does not overcome the highest possible amount of one of them (see decision n° 97-395 DC of 30 Dec. 1997, § 41).

with the *non bis in idem* principle, according to which the same facts should not be punished twice⁷.

The scope of criminal law is also unclear due to the sometimes problematic difference between a penalty and a tax. Recent developments of French law in this field are interesting in this respect, insofar as specific “tax rates” have been introduced in order to fight certain schemes involving foreign structures. For instance, a 50% withholding tax applies to certain payments to residents of offshore jurisdictions which have not concluded tax treaties providing for exchange of information with France and are therefore considered as “non-cooperative”. A specific wealth tax rate also applies in the event a French resident owns assets through a foreign trust. Whether these provisions enact “penalties” or “taxes” is somewhat unclear and could raise interesting constitutional issues⁸. Let us observe, by the way, that this kind of problem is in no way specifically French and may be found in other countries as well⁹.

B- Distinguish between “ordinary” tax planning and criminal offence

In most countries, tax planning is usually tackled by specific anti-abuse tax rules which are tailored to fight specific schemes (CFC rules, thin capitalization rules etc.). It may however be the case that on top of these rules, a more general anti-avoidance rule (GAAR) exists in order to allow the tax authorities to disregard acts which constitute “fraus legis”, “abuse of law” etc. In France, for instance, the Tax procedure code¹⁰ provides that “abus de droit” requires :

-either that these acts have a fictitious character ;

-or that these acts exclusively seeked to circumvent the tax rules which should normally have applied, considering the taxpayer’s genuine situation or activities. In this event, it is also required that the taxpayer derived a tax gain by taking advantage of a discrepancy between the literal implementation of texts or decisions and the goals pursued by their authors.

The reason why it is distinguish between “abus de droit” and criminal fraud stems from the fact that next to this tax GAAR, the Tax code also provides for a “criminal GAAR”, the wording of which is not very far from that of the Tax procedure code. Criminal penalties apply to “whoever fraudulently escaped or tried to escape the total or partial establishment or payment of taxes laid down in this code, either by voluntarily omitting to file a return within the time limits provided by the law, or by voluntarily concealing taxable amounts, or (...) by any other fraudulent behavior”¹¹. This extremely broad definition of criminally punishable behavior explains why French criminal courts have already held that the failure to declare the

⁷ See in this respect the interesting evolution of the European Court of Human Rights which now holds that two sanctions may not be added, notwithstanding the different characterization provided by administrative and criminal law, when the same facts are at stake : see *Gradinger v. Austria*, 23 Oct. 1995, n° 15963/90 and more recently (in tax matters) *Ruotsalainen v. Finland*, 16 June 2009, n° 13079/03.

⁸ For a reflection on the topic, see D. Gutmann, Sanctions fiscales et Constitution, *Cahiers du Conseil constitutionnel*, Oct. 2011 (to be completed)

⁹ See for instance M. Zolt, Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions, *UCLA Law Review*, vol. 37, 1989, p. 343 et s. ; V. Morabito, Tax or Penalty ?, *Journal of Australian Taxation*, Nov-Déc. 1999, p. 391 et s. The problem is even very old in the U.S. (see the Supreme Court decision in *U.S. v. Sonzinsky*, 29 March 1937, 300 U.S. 306).

¹⁰ Article L64 of the Tax Procedure Code.

¹¹ Compare this expression with the Brazilian provision of Art. 2° Lei 8. 137/1990 : “empregar outra fraude para eximir-se, total ou parcialmente, de pagamento de tributo ».

existence of a permanent establishment¹² or a wrong tax transfer policy may give rise to criminal penalties¹³.

Against this background, it is of utmost practical importance – not to say anything about the challenging theoretical aspect of this problem – to draw the borderline between « abuse of law » (tax offence) and « tax fraud » (criminal offence). Although this article cannot go far into details, one may nevertheless make simple observations in this respect.

–first of all, it seems obvious that where a tax scheme may not be regarded as abuse of law, it should *a fortiori* not be regarded as tax fraud within the criminal law meaning. Although tax and criminal proceedings are independent in most legal systems – which is disputable in itself –, common sense leads to the conclusion that criminal penalties should not take place where tax law has not been infringed.

–second, it is obvious that there may be an overlap between the tax GAAR and the criminal GAAR in the case of fictitious or sham acts because, in this case, the taxpayer intends to conceal the existence of a taxable event to the administration ;

–the “hard case” rather occurs where a taxpayer sets up a complex scheme which is exclusively oriented towards a tax advantage. In this event, it seems reasonable to distinguish between two different situations : where a taxpayer is perfectly aware – or should be perfectly aware – of the legislator’s intent (because it is unambiguous and is expressly stated in the parliamentary work or in a draft bill), the intentional requirement of tax fraud is likely to be met and a scheme may be characterized both as abuse of law and as tax fraud ; where the taxpayer rather relies on the ambiguity of the law or takes advantage of a loophole in the law, not knowing exactly whether the borderline is crossed, it is objectively uncertain whether the conditions of abuse of law are met. In that case, the intentional element which must exist in any criminal offence is not present because there is no intention to infringe any clearly defined criminal prescription. One should therefore not forget the major importance of general principles of criminal law.

C- Apply the general principles of criminal law

The principle of legality of crimes, which means that no crime should be characterized in case the legal definition of the offence is unclear or vague, implies that no criminal penalty should take place where the legislator fails to describe accurately enough a tax planning scheme. This finding is confirmed by a survey of comparative law, which shows that many countries have refrained from establishing penalties for unclearly defined illegal behaviors, regardless of the financial damage suffered by the State¹⁴.

Besides, a sound legal framework should not contain disproportionate penalties. Unfortunately, this statement is too often contradicted by practice. In France, for instance, a 50% penalty applies in case a corporate taxpayer fails to declare the existence of distributions, either to resident or to non resident persons, on a specific form¹⁵. This penalty is very heavy and sometimes proves to be absurd where the tax authorities have been

¹² Cass. crim., 14 March 2007, n° 06-85.865 ; Cass. crim., 10 Sept. 2008, n° 07-88.433.

¹³ Cass. crim., 30 Oct. 1978 : Bull. crim. 1978, n° 290.

¹⁴ See notably, for reflections regarding Germany, Spain and Belgium, D. Gutmann, « Réflexions comparatistes sur la constitutionnalité de la répression de l’abus de droit », *Feuillet rapide Francis Lefebvre*, 56/08, p. 3 et s.

¹⁵ Art. 242 ter French tax code.

informed about a cross-border distribution which has triggered a withholding tax. *Ad hoc* penalties also apply where filing obligations concerning income derived by non-resident persons have not been properly executed. It should however be reminded a human rights approach should always be adopted in order to limit the state's powers in this field. Let us observe that the European Court of Human Rights held, in *Mamidakis v. Greece* of 11 January 2007¹⁶ that disproportionate sanctions infringe Article 1 of the first additional protocol to the European Convention of Human Rights¹⁷ which provides that « every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties". In *Mamidakis v. Greece*, the Court stated that a fine constitutes an interference with the right guaranteed by Article 1 because it deprives the taxpayer of an element of property, namely of the amount which he must pay. Although the principle of such interference is justified by the second paragraph of Article 1, the Court said very clearly that there must be a proportional relationship between the means used by the State and the goal pursued by the fine¹⁸. The judgment also holds that « accordingly, the financial obligation arising from the payment of a fine may infringe the guarantee enshrined in this provision, if it imposes upon the person an excessive burden or fundamentally alters its financial position »¹⁹.

D- Think about the international context

Criminal law is territorial by nature. Offences committed in a particular country may be punished only to the extent that the offender or his/her assets are located in that country. This leads to problematic situations when tax crimes are committed by non-resident persons : the tax authorities may then be deprived of any legal possibility to prosecute the offender.

In order to overcome this problem, the first possible path consists in establishing a system of mutual recognition of criminal judgments. A judgment against the offender in country A (where the offence was committed) will then be executed in country B, by virtue of an international instrument allowing the recognition of the former judgment. This mechanism exists in the European Union since the adoption of a Council framework decision of 6 October 2006 on the application of the principle of mutual recognition to confiscation orders²⁰. It facilitates cooperation between Member States as regards the mutual recognition and execution of orders to confiscate property so as to oblige a Member State to recognise and execute in its territory confiscation orders issued by a court competent in criminal matters of another Member State. Its Article 6 also provides that if the acts giving rise to the confiscation order constitute one or more of the following offences, as defined by the law of the issuing State, and are punishable in the issuing State by a custodial sentence of a maximum of at least three years, the confiscation order shall give rise to execution without verification of the double criminality of the acts where the latter constitute fraud. Article 7. 2, b) even goes as far

¹⁶ ECHR, 1st sect., 11 Jan. 2007, n° 35533/04, *Mamidakis v/ Grèce*.

¹⁷ Compare with ECJ, 12 July 2001, C-262/99, *Louloudaki, esp. § 70 and 71* : [2001] ECJ-I-5547.

¹⁸ § 44. Comp. with ECHR, 4th sect., 5 July. 2001, n° 41087/98, *Phillips v/ United Kingdom* : 2001-VII, § 51.

¹⁹ French wording of the decision (which is only available in French): « l'obligation financière née du paiement d'une amende peut léser la garantie consacrée par cette disposition, si elle impose à la personne en cause une charge excessive ou porte fondamentalement atteinte à sa situation financière (voir *Orion-Břeclav S.R.O. c. République tchèque* (déc.), n° 43783/98, 13 janvier 2004) ».

²⁰ Council framework decision 2006/783/JHA, OJEU, 24 Nov. 2006, L382/59 et seq.

as providing that in relation to taxes, duties, customs duties and exchange activities, execution of a confiscation order may not be refused on the ground that the law of the executing State does not impose the same kind of tax or duty or does not contain the same types of rules concerning taxes, duties, customs duties and exchange activities as the law of the issuing State²¹. It is therefore clear that the European framework aims at allowing an automatic circulation of judicial instruments in such areas as tax fraud.

The second – and much more far-reaching - way to overcome the territoriality principle could consist in promoting the adoption of international instruments of substantive criminal law. Common definitions of offences could be agreed upon, including specific tax crimes. Whether such a perspective belongs to a better or to a worse world however remains open to discussion...

²¹ Art. 695-9-18 of the Criminal Procedure Code.