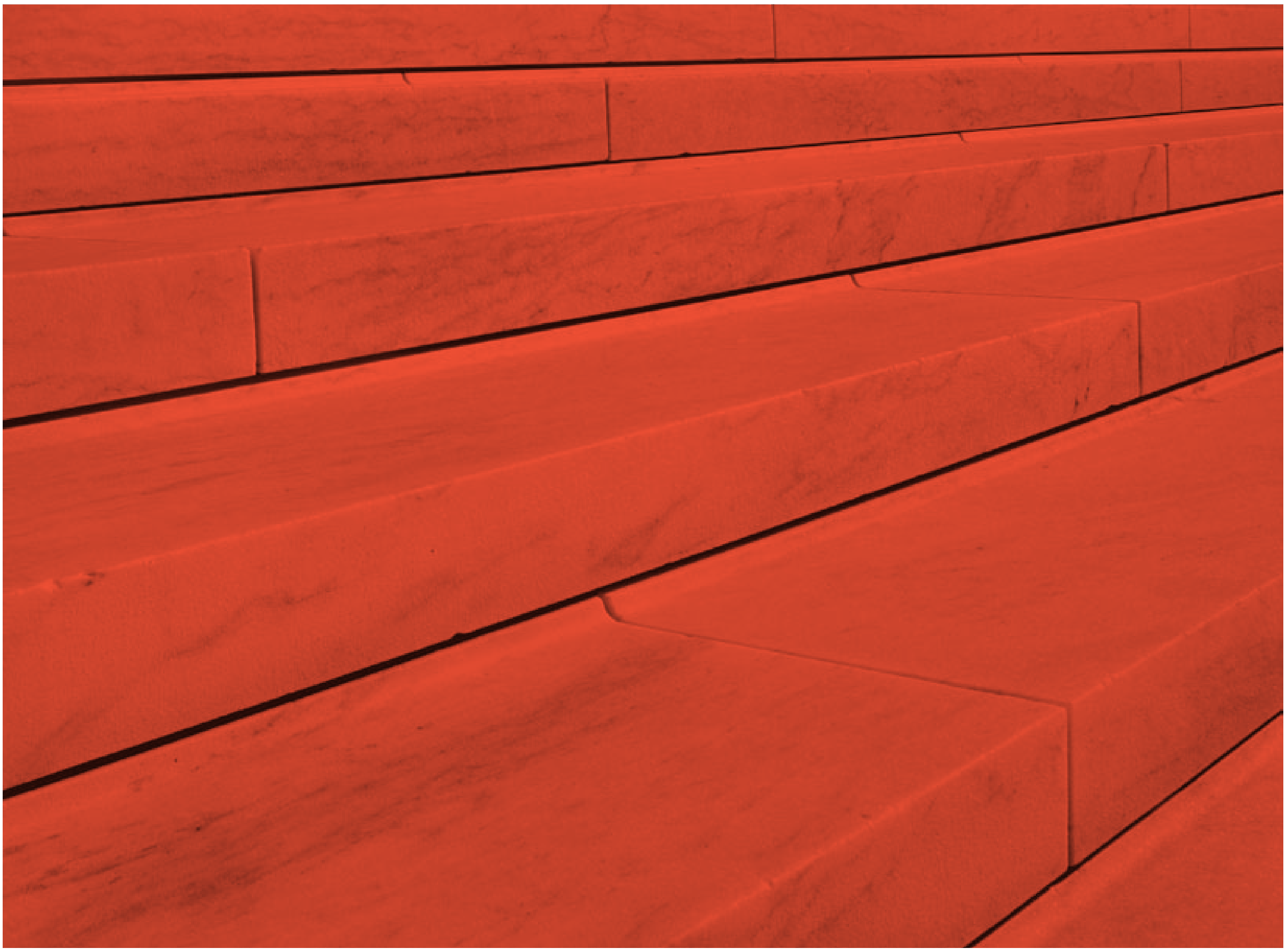
# Certainty in tax



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Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

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The ACCA Global Forum for Taxation reviews developments in tax policy and administration and develops ACCA's policy positions in relation to them. The Forum comprises a global network of experts and opinion formers who are all experienced in tax matters. The Forum's goals include reviewing what taxes do and how they should be administered, in the light of the widespread trend towards greater tax simplification and the increasing connection between tax and public policy on business and the environment.



Certainty, along with simplicity and stability, is one of the cornerstones of a good tax system: but why is it important? How can policymakers encourage certainty? Are there occasions when an uncertain outcome might be unavoidable, or even justified?

### FOR FURTHER INFORMATION

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## INTRODUCTION

Without certainty, neither governments nor taxpayers can effectively budget or plan for their future actions. Yet every system incorporates uncertainty to some degree, whether unavoidably or deliberately, and it may even be encouraged by governments. Which taxpayers are most affected by uncertainty, what could be done to reduce it, and what might be the other side effects of trying to make tax outcomes more predictable?

Certainty in the tax system is important for governments. If policymakers are to budget sensibly for their future spending, they must base their plans on a realistic estimate of the income they will receive and funds they will have available. Consumption taxes such as VAT are structurally important to government spending, and retrospective discovery that a widespread practice was wrong for years or even decades can have a significant effect upon national budgets as repayments (with interest) are made to hundreds or even thousands of businesses. The rise of global trade can have a similar impact; take, for example, the Indian government's approach to multinational businesses restructuring activities relevant to their jurisdiction.[1]

## CERTAINTY AND DECISION MAKERS

Certainty can affect taxpayers' wider decision making in three ways. First, if the taxpayer has a choice of transactions, accurate prediction of the different liabilities will aid a rational choice.

Second, even if there is no alternative transaction, uncertainty over the tax outcome can influence the decision about whether to proceed, particularly for businesses on narrow margins.

Finally, there may be a considerable time lag before the assessment of the tax position, whatever transaction takes place. Uncertainty over the tax outcome will have an opportunity cost, as the prudent taxpayer reserves funds against the potential liability, restricting alternative investments.

In every case, uncertainty of the outcome inevitably leaves scope for appeal if either the taxpayer or the tax authority disagrees with the assessed or submitted liability. The costs of dispute, both direct and indirect, can be considerable and are a waste of otherwise productive resource.

## WHY IS CERTAINTY AN ISSUE?

ACCA believes that certainty is a key requirement for the proper operation of a 'good' tax system but that this is an area in which systems in many jurisdictions fall short. Many tax systems call upon taxpayers to self-assess their liability to tax, yet the legislation may make it impossible for them to establish their liability accurately under the law.

For businesses, certainty is key to confident decision making. Plans based on incomplete assumptions introduce risk. Uncertainty about prospective tax receipts is equally concerning for government. Resolving uncertainty is a poor second best to avoiding it in the first place, especially for individuals and small businesses, which may not have the resources to deal with complexities in their tax affairs.

If certainty is so clearly desirable, how and why can uncertainty arise? Can it be reduced or avoided, and should it always be reduced or avoided?

Viewed mechanistically there should, in theory, be no issue. Identical economic activities should produce identical tax outcomes. The rules for calculating liability should be set out clearly in legislation and the taxpayer should simply apply the rules to the appropriate figures for income, profit, gain, etc to calculate the liability.

The outcome should be not so much predictable as inevitable. In practice, however, there is a stage before the completion of the tax return and associated tax calculation, at which the underlying information is generated. This relies upon the underlying factual matrix, which may be very, very complicated and subject to a wide range of influences.

1. *Wall Street journal* <http://blogs.wsj.com/indiarealtime/2014/10/21/global-firms-negotiate-for-protection-from-indias-tax-authorities>.

## SOME TYPICAL WAYS IN WHICH UNCERTAINTY CAN ARISE

Uncertainty can creep in at any stage in the tax-assessment cycle – identification of taxable transactions, valuation of them and application of the tax law to them. Perhaps the most potentially devastating form of uncertainty is that introduced by the threat of retrospective legislation. Most governments rightly follow the principle of avoiding such legislation save to counter clear abuse, but examples do exist, and the damage they do to taxpayer confidence in the system is considerable.

Corporation taxes are typically based on an adjusted value of published accounting profit, but that underlying published number may rely on subjective valuations such as provisions, accruals and prepayments.

Valuing a specific transaction may be easy in the case of a purchase of goods giving rise to a sales tax but less so in the provision of a one-off non-monetary benefit to an employee.

Typically, the sale of land or buildings would fall under a capital taxes regime, but if the entity is considered to be a property developer it could be a trading activity – and the tax treatment would be very different.

Tax depreciation claimed against the cost of an asset used in the business is typically available only from the date of delivery or actual use, rather than the date at which the asset was paid for, creating potential difficulties where assets are ordered near to year end.

Large groups transferring stock or assets between jurisdictions may find that different valuations apply in each jurisdiction. A single transaction may have different characteristics for different parties, or even for the same party in different jurisdictions.

Finally, there is the overriding uncertainty introduced by purposive interpretation of legislation, and its ultimate expression, the general anti-avoidance, or anti-abuse, rule. To some commentators this principles-based approach is an unforgivable departure from the requirements of certainty that should underpin fiscal legislation, while for others it is an essential component of the protection of society from the predations of unacceptable tax avoidance. The discretion that any such system confers upon the tax administration can itself be a risk to the state's income.

> Resolving uncertainty is a poor second best to avoiding it in the first place.

Policy designers need to be aware of each type of uncertainty, of how it can arise, whether it is acceptable, and what steps can be taken to reduce or eliminate it.

## ABUSE OF UNCERTAINTY

Uncertainty confers a discretion, first upon the tax return preparer, and then upon the inspecting official, within which the parties must try to establish the correct tax treatment. The risk to the exchequer posed by uncertainty is twofold – on the one hand, taxpayers may seek their own advantage through interpretation of uncertain provisions, and on the other there is potential for tax officials to seek an undue advantage, either for themselves or the state.

One of the most concerning aspects of uncertainty would be where it facilitates the corruption of tax officials, who could seek to exploit their perceived ability to impose excessive tax demands. Whether that individual's desired outcome is receipt of a bribe or enforcement of an unreasonable tax demand on a party too weak to resist, it is a feature that administrators and governments will (and already do) seek to eliminate.

The underlying issue in this instance is, of course, the dishonesty of the individual, but if the system allows such dishonesty to persist then it will reduce domestic confidence in the administration, and may discourage investment by businesses from other jurisdictions. It will be in the state's interest to reduce the scope for such developments.

There is a further risk to the system posed by extending discretion to the tax authorities, and that is in the field of undisclosed State aid. The scope to 'do a deal' with the tax administration will typically be limited to only the largest of multinational businesses or wealthiest of ultra-high-net-worth-individuals, but access to favourable rulings can confer a significant advantage on some taxpayers.

Elimination of the underlying uncertainties on which such deals are predicated would act for the benefit of all involved, and also of society more widely as the resultant disparities between effective tax rates for otherwise similar taxpayers is a distortion of what should be a level economic playing field. While allowing for such agreements (whether prospective or otherwise) creates certainty for the individual taxpayer, their existence creates uncertainty, and potential inequity, for other taxpayers who might not have access to them.

## DELIBERATE UNCERTAINTY

In some cases taxpayers seek to introduce uncertainty deliberately. The extreme example is an artificial and otherwise meritless avoidance scheme through which the taxpayer seeks personal advantage on the basis of a tenuous interpretation of law or facts. The outcome is deeply uncertain, but it is the taxpayer who has chosen to adopt a stance that may conflict with the apparent, or even explicit, intention of the legislator.

In practice, in most cases the uncertainty is simply a consequence of unclear mapping from reality into the tax and accounting position. The contention that in every case the taxpayer should eschew all uncertainty unless absolutely unavoidable assumes that in every case the tax authorities have a greater claim than the business to moneys that may or, in fact, may not be due in tax.

Quite apart from the moral doubts that many might have about such a contention, there is the additional legal difficulty for managers of a business that their duties to protect the interests of the owners and other direct stakeholders in the business may well exceed whatever legal duties they owe to wider society. There remain jurisdictions where a failure to protect the business owners' interest properly will leave the managers open to a legal challenge, and possibly even personal liability.

The treaty-based system of international tax, which follows legal form to allocate tax characteristics, has contributed to an environment where all international businesses will face some uncertainty, and in some cases managers (or owners) have chosen to try to exploit that uncertainty for their relative advantage.

The radical alternative of unitary taxation by formulary apportionment, which is discussed further below, would introduce different uncertainties and require a fundamental shift in approach from both business and government to implement.

Tax systems should be designed so as to reduce the possible incidence of such dilemmas by allowing business to pursue comfortably the course that offers the greatest overall benefit to society.

## CERTAINTY, CONSISTENCY AND SUBJECTIVE JUDGEMENTS

Moral judgement and administrative discretion are not constants, either at a given point in time or across time. In the UK case of *Jones v Garnett*[2] one striking feature of the wider regulatory landscape was that at the very time that the Revenue department was challenging the effectiveness of shared dividend structures, the sister department for Business, Industry and Skills was actively promoting such structures for small businesses via its website. Government itself appeared uncertain as to the correct response to the interaction of tax and company law.

The vast majority of uncertainties in the tax system are internally generated – that is, it is the provisions of the tax system itself that create the uncertainty, regardless of whether the details of transactions and economic or book values are known. As soon as the calculation of the tax liability is affected by a subjective condition, such as the classification for tax purposes of the asset as 'personal' or 'business' property, then uncertainty can arise.

Brevity in tax law, while aiding simplicity, can reduce certainty as it opens the gate for subjective interpretations in the absence of detailed definitions.

Certainty, meanwhile, can equate to volume and complexity, with a corresponding cost for every taxpayer or adviser expected to familiarise themselves with the provisions.

Purposive laws and interpretations tip tax systems from complex (which while difficult may still be susceptible to resolution) to complicated, as external factors come into play. The more extrinsic factors that can be adduced as evidence then the wider the range of possible outcomes, and the more difficult it will be to predict what will occur.

The more the reliance on subjective factors, such as the perceived intention of the legislature, or the intentions of the taxpayer at the time the transaction was entered into, the less confidence taxpayers will be able to have in their prediction of the outcome. Such certainty as can be adduced must come from extra-statutory material – case law, official guidance and the like.

Any objectively certain tax regime would have to contemplate every possible transaction and interaction and this would make it irredeemably complex and unwieldy. Attempts to create such a regime reactively exist and are not widely regarded as successful. And in a complex and changing world, the system will need a 'backstop' for unenvisaged circumstances.

Tax systems should be designed so as to reduce the possible incidence of such dilemmas by allowing business to pursue comfortably the course that offers the greatest overall benefit to society.

An immediate issue with that will be that taxpayers want the default position to be tax-free, while authorities want to capture the revenue. The practical impact will be that those businesses that seek to manage their tax exposure actively will divert resource to ensuring they are within a defined exclusion.

From the perspective of government, once it is clear that there will be some 'circumstance-based' uncertainty that it

2. [2007] UKHL 35, popularly known as Arctic Systems, on the effect for tax purposes of spousal joint ownership of a personal service company.

cannot eliminate there may be a temptation to extend the boundaries of uncertainty deliberately, on the basis that a prudent taxpayer will wish to avoid tax risk, and thus will pay more tax in order to be sure of escaping challenge.

While the deliberate creation by taxpayers of what has been termed 'exchequer risk', that is, an uncertain filing position in which less tax is paid than would have been in a more certain position, is open to censure, the deliberate creation by the exchequer of 'taxpayer risk' is perhaps equally open to criticism, as it will introduce unnecessary costs for society.

The fourth of Adam Smith's Four Canons of Taxation, efficiency, comes into play, as the wider economic costs of uncertainty start to have an impact.

> Limiting the damage done by uncertainty should be a primary objective of tax system designers.

## WHAT CAN BE DONE, IF ANYTHING?

Where uncertainty depends on factors extrinsic to the tax system the only option is to reduce or remove reliance on those factors. In practice, however, the accounts upon which most business taxes are based have the advantages of comparability and consistency across businesses, in many cases further assured by independent audit, and cannot easily be replaced by alternative measures to which the tax provisions could be applied.

For example, there have been calls to replace the current system with a unitary tax model. Instead of taxing each company's locally accounted profits, the system would tax a proportion of the whole (global) business's profits on the basis of the proportion of its sales, assets and labour recorded for that jurisdiction.

Such apportionments could introduce significant uncertainty at an entity level within groups, as each business unit would need to predict not only the overall group profits but also the share of those profits on which it would be taxed, calculated not on its own staffing and investment levels but as a proportion of the group results as a whole.

Accordingly, a successful territory within a rapidly expanding group could see its tax charge falling against the background of 'loss making start-ups' elsewhere around the planet. Likewise, a struggling element of a group which has just divested itself of other 'loss-making' entities could in fact see its tax charge go up despite a decline in local receipts, purely as a result of the change in its relative importance to the group rather than to its local economic environment.

Given that the majority of business decisions are based upon a consideration of the actual cash return on a particular investment, rather than its proportional importance to the owner's other investments, the addition of this extra layer of complication to the local business decision-making process would increase uncertainty.

The difficulties of allocating transactions to the correct territory would remain, albeit at one remove, as calculating the proportion of turnover in a territory would still involve identifying the location of transactions. The difficulties of taxing the digital economy have come to the forefront in recent years, but physical goods can pose similar problems where ownership of goods changes hands in transit.

The conventions governing physical trading have grown over many years; digital trade has grown in volume and complexity far more rapidly, and poses potentially greater challenges and opportunities for both businesses and exchequers around the world.

> Agreeing consistent treatments for cross-border transactions is key to confident international trade.

Another factor will be how far the system relies upon judicial interpretation in addition to the underlying words of the tax code. Since the tax law should have been drafted on a prospective general basis, so as to apply to as wide a range of circumstances as possible, taxpayers ought to be able to predict the outcome of transactions accurately, just from the law.

Legislation is typically subject to at least some degree of consultation and debate, and enacted following published timetables. Judicial precedent by contrast is, by its nature, focused upon a single case, will be subject to little or no debate, and can change overnight and without warning.

The judiciary should, of course, recognise the wider impacts of their judgments, but cannot influence the timing. The existence of appellate courts, overlapping jurisdictions and multiple opinions in any given case can add to the confusion in taxpayers' minds as to what may or may not be the outcome of given provisions in the light of judicial interpretation.

Even where the legal position is clear, the key element is the factual basis. The financial accounts that the tax system relies on are no more than a geographically and chronologically artificial breakdown of the monetary values ascribed to various real-world transactions. Businesses have a wide discretion to shape their accounts ahead of time: more perhaps than the legislation can cope with, or than governments are prepared to concede.

## CONCLUSIONS

So what, then, are the conclusions for policy designers?

Certainty is undoubtedly a desirable feature of tax systems, and indeed for economies generally, both for governments and taxpayers, but policymakers must keep in mind the tension between simplicity and certainty. The interests of larger business are better served by certainty, while for individual taxpayers simplicity will be paramount. Across the range of smaller businesses, the relative importance of the two will depend upon the aims, activities and resources of each individual business.

Tax systems should be designed so as to minimise unfair outcomes – but if the 'fairness' of tax certainty led to economic stagnation then that would be too high a price to pay. The boundaries of uncertainty should be as clearly defined as possible, and where governments do use administrative or judicial discretion as a design feature of the system, it should be illuminated by clear guidance. Tax should exist to create benefits for society, not be a burden upon it.

Given the comparatively small number and greater sophistication of large businesses, transparent clearance mechanisms allowing taxpayers to discuss proposed transactions in advance might be an appropriate response to the uncertainties of simple legislation. Regular and constructive dialogue with the authorities should in any event be a feature of a healthy relationship between business and state. Formalising the outcome of discussions, and even publishing the salient features of individual clearances centrally, could aid certainty and transparency for business and tax officials alike, forming a part of the clear guidance advocated above.

From the practical perspective of the policymaker, it is clear that a compromise will have to be reached between the conflicting needs of different taxpayers. Clear communication of the aims of each measure will help taxpayers recognise what is expected of them, although this imposes on the policymakers the burden of actually understanding what they want to do and how they are trying to achieve it.

Tax should exist to create benefits for society, not be a burden upon it.

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