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THE ETHICS OF TAX AVOIDANCE

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Abstract

The purpose of this paper is to examine the ethics of tax avoidance. Although tax avoidance is widely accepted as a legal way to reduce taxes, this arrangement does not represent an ethical conduct per se. On the contrary, the general feeling among people is that tax avoidance is an unethical behavior, mainly because it is used by large organizations and wealthy people to diminish the value of their tax liabilities by billions of dollars annually. To establish the ethics of tax avoidance, two ethical standards were applied: the Utilitarianism approach and the Deontology approach. The former approach states that ethics of tax avoidance cannot be determined theoretically because this evaluation depends, ultimately, on the quality of the government. The latter approach states that tax avoidance is an unethical behavior, since the result of this evaluation creates an irrational outcome. Despite the fact that the Utilitarianism and the Deontology approaches do not bring a unique result, this examination indicates that, in general, tax avoidance is unethical. The only possibility in which tax avoidance would be ethical is when the government is expected to spend the tax revenue in a not good way. Nevertheless, using additional evaluations with ethical standards, like Virtue Ethics and Common Good Ethics, this ethical analysis perhaps can go further.

"The tax each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid, ought all to be clear and plain to the contributor, and to ever other person."

"An Inquiry into the Nature and Causes of the Wealth of Nations"
Adam Smith

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1. INTRODUCTION

Judge Learned Hand, who served on the United States Court of Appeals for the Second Circuit, stated in 1934 in the famous case *Helvering v. Gregory* that: "*Any one 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.*"

Despite the strong ruling, the opinion that had prevailed in *Helvering v. Gregory* case in Supreme Court was diverse, and was the beginning of the discussion about tax avoidance. Since this case in the U.S., and almost at the same time in other countries, courts, jurists and legislators have been defining the nature and limits of tax avoidance – not without considerable disagreement. But from this long, expressive, and sometimes passionate debate, one point arises without too much disagreement: the understanding that tax avoidance is a legal kind of arrangement and that it does not violate the law.

However, although the legality of tax avoidance is well settled in both common law and civil law jurisdictions around the world, there is an essential debate that has been increasingly important in the last few years, which is the debate about the ethics of tax avoidance. In this field, apart from the legal aspects of this tax arrangement, the achievement is to determinate whether tax avoidance is morally right or wrong, in other words if someone that perpetrates this scheme is acting in an ethical or in an unethical manner.

According to *Bloomberg News*, in 2013 more than $200 billion of offshore profits were added to a total of $1.95 trillion accumulated abroad by U.S. multinational companies. As a result, Kimberly Clausing, a professor of economics at Reed College, estimated[1] that the U.S. lost almost $90 billion of tax revenue in 2008. Note that this amount is related only to this kind of tax avoidance, and just for United States.

[1] Clausing, Kimberly A., *The Revenue Effects of Multinational Firm Income Shifting* (March 11, 2011). Retrieved Sep 4, 2014, from SSRN: http://ssrn.com/abstract=2488860

On the other hand, in 2013, as reported by Organization for Economic Cooperation and Development (OECD)[2], the government deficit as a percentage of GDP was 3.2% in OECD countries. In the U.S. the 2013 deficit was 6.4%, in the U.K. it was 5.9%, and in Brazil it was 3.3%.

These data show that those States, like many others, have been facing serious difficulties in supporting their budget needs. Due to the recognized inefficacy of law enforcement to deal with tax avoidance, it ranks as one of the main causes to this budgetary constraint, since it reduces the total revenue collected by the States.

That said, as a main objective, this work intends to understand the ethical aspects of tax avoidance, to then determine whether the use of it is an ethical behavior or not. As a secondary objective, this work seeks to build conditions for the development of an ethical enforcement to be used by governments to reduce the use of tax avoidance.

The ethical analysis will use the Utilitarianism approach and the Deontology approach. Despite the existence of other relevant approaches on Ethics, these two represent the most studied and examined methods, which usually bring trustworthy results in an ethical investigation, and for this reason, they are appropriate to achieve the objectives of this paper.

The remainder of this paper will be organized in four parts. The second chapter will define and clarify the principal expressions and knowledge related to tax arrangements, will pinpoint the differences and similarities between tax avoidance and tax evasion, and will depict two recent cases of tax avoidance. The third chapter will present the most common models used by countries to deal with tax avoidance, and will show how some countries apply these models. The forth chapter will introduce the theory about Utilitarianism and Deontology, and will show the application of these approaches to tax avoidance. Finally, the last chapter will conclude this work, showing the results and distinct possibilities to handle the question presented here.

[2] http://www.oecd-ilibrary.org/economics/government-deficit_gov-dfct-table-en. Retrieved Sep 4, 2014.

2. TAX AVOIDANCE

The academic literature about tax avoidance usually uses different definitions for the same type of tax arrangements, what cause misunderstandings and imprecision in the study of this subject. To solve this inaccuracy, the first part of this chapter defines and explains the different types of tax arrangements. The second part studies the distinction between tax avoidance and tax evasion. The third part presents two tax avoidance cases to illustrate the analysis.

2.1 Tax Arrangements

Tax minimization, tax mitigation, tax avoidance and tax evasion are the expressions most commonly used to reference tax arrangements. Although these terms do not refer to the same situation, it is common to see the overlapped misuse of them. For this reason, defining these terms with precision is a requisite to understand their attributes and to point out the differences and similarities between them.

2.1.1 Tax Minimization

Tax minimization can be defined as an arrangement used to reduce the total amount of tax liability. This activity may be done within or outside legal borders, and also can be perpetrated by using specific schemes acceptable and stimulated by the government.

In fact this is the term which represents all kind of arrangements used by any person or organization to keep the amount of their pre-tax revenue. When a company or an individual uses some legal or illegal scheme to reduce the tax it should pay, this can be considered as a use of a tax minimization arrangement.

For the specific purpose of this work, it is relevant to establish the principle that tax minimization is not illegal or legal, moral or immoral. This arrangement is not under moral scrutiny, and there is not any action to be evaluated.

Therefore, tax minimization can be seen as a genus and tax mitigation, tax avoidance and tax evasion as species of this genus.

2.1.2 Tax Mitigation

The first species of tax minimization to be studied is tax mitigation. This type of tax arrangement is represented by all kinds of tax benefits or tax incentives created by the government to stimulate private sector investments or to incentivize particular people or companies to behave in a desirable way.

Zoe and John Pebble (2012, p. 706) have pointed out, that no one complains:

> "…if citizens contribute to tax-preferred pension plans. That is the government's whole point in offering the incentive. If people buy bigger holiday houses than they need, anticipating tax at preferred capital gains rates when they sell, or if they negotiate with their employers for more fringe benefits and lower salaries, it may not be very good for the economy, but no one objects from a legal or moral perspective."

As viewed, tax mitigation is an arrangement in which someone responds to incentives offered by the government, and the reduction in its tax liability is a desirable outcome of such.

Negi Mohita[3] stated, "*a moral judgment presupposes a subject who judges, an object that is judged, standard according to which an action is judged, and a faculty of judging or moral faculty.*"

Considering this framework, tax mitigation is not under a moral examination, since every moral judgment evaluates whether an action is right or wrong. The use of this scheme is implied right, as the action judged always follow the standard, which is a desirable incentive provided by government.

Hence, taxpayers respond to a specific kind of incentive, in which the government, representing society, considers a path to achieve a common good, social justice, or economic benefit.

Finally, despite the fact that tax mitigation is not under ethical scrutiny, this arrangement should be analyzed in its social and economic aspects, because the use

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[3] Mohita, Negi. Retrieved Sep 5, 2014, from http://www.yourarticlelibrary.com/philosophy/moral-judgement-distinguished-from-logical-judgement-and-aesthetic-judgement/10156/

of this tax structure tends to reduce government revenues and can create erroneous incentives to economic agents.

2.1.3 Tax Avoidance

Tax avoidance can be understood as a lawful scheme managed by an individual or by a company to reduce its tax liability. The Oxford Dictionary defines tax avoidance as "*the arrangement of one's financial affairs to minimize tax liability within the law.*"[4]

Assaf Likhovski (2008, p. 52) states that the starting point of the debate concerning tax avoidance was the 1873 case, *U.S. v. Isham*, in which the Supreme Court declared:

> "It is said that the transaction proved upon the trial in this case is a device to avoid the payment of a stamp duty, and that its operation is that of a fraud upon the revenue. This may by true, and if not true in fact in this case, it may well be true in other instances. To this objection there are two answers:
> 1st. That if the device is carried out by the means of legal forms, it is subject to no legal censure. To illustrate. The Stamp Act of 1862 imposed a duty of two cents upon a bank-check, when drawn for an amount not less than twenty dollars. A careful individual, having the amount of twenty dollars to pay, pays the same by handing to his creditor two checks of ten dollars each. He thus draws checks in payment of his debt to the amount of twenty dollars, and yet pays no stamp duty. This practice and this system he pursues habitually and persistently. While his operations deprive the government of the duties it might reasonably expect to receive, it is not perceived that the practice is open to the charge of fraud. He resorts to devices to avoid the payment of duties, but they are not illegal. He has the legal right to split up his evidences of payment and thus to avoid the tax. The device we are considering is of the same nature."

In this case the Supreme Court upheld the conception that activities that intend to avoid the payment of tax are not illegal *per se.* The Court decided that to define a given tax scheme as legal or not legal depends on the legality of the procedure, not only on the result of this procedure.

This notion delineates the boundaries of tax avoidance, which is the acceptance that this is a legal way to reduce tax payments; therefore it is a perfectly legal tax structure.

In the paper edited by The International Tax Compact[5], "Addressing tax evasion and tax avoidance In Developing Countries," tax avoidance is defined as an activity that:

[4] http://www.oxforddictionaries.com/definition/english/tax-avoidance. Retrieved Sep 5, 2014.

> “takes place within the legal context of the tax system that is individuals or firms take advantage of the tax code and exploit ‘loopholes’, i.e. engage in activities that are legal but run counter to the purpose of the tax law. Usually, tax avoidance encompasses special activities with the sole purpose to reduce tax liabilities. An example for tax avoidance is strategic tax planning where financial affairs are arranged such in order to minimize tax liabilities by e.g. using tax deductions and taking advantage of tax credits.”

Hence, tax avoidance is considered as a misemployment of the law, and an abuse of the spirit of the tax legislation. In this sense, tax avoidance exploits the loopholes in the laws that were not expected by the legislators, regardless of the legal behavior of the tax-avoiders.

Despite the recognized legality of tax avoidance, governments of several countries have made serious efforts against the use of these loopholes in the laws. These efforts aim to reduce or eliminate the under tax payments, and are done by anti-avoidance instruments.

The general anti-avoidance rules, also known as GAARs, are the prescriptions created to avoid the use of loopholes and other mechanisms. Civil law countries like Brazil, France, China, and others, have provisions introduced under tax laws to tackle tax abuse.

The common law countries like the United States and United Kingdom also make use of anti-avoidance rules. In 2010, the United States implemented a codifying economic substance doctrine and the U.K. introduced, in 2013, legislation with a General Anti-Abuse Rule.

To deal with more peculiar schemes and prevent against some structured tax planning, governments make use of specific anti-avoidance rules, called as SAARs, or, less frequently, targeted anti-avoidance rules (TAARs).

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[5] The International Tax Compact. Retrieved Sep 5, 2014, from http://www.taxcompact.net/documents/2011-09-09_GTZ_Addressing-tax-evasion-and-avoidance.pdf

2.1.4 Tax Evasion

Tax evasion is an illegal practice whereby someone using unlawful means purposely reduces his or her tax liabilities. This arrangement is exposed to criminal punishment and fines, and is considered tax fraud.

Zoe and John Pebble (2012, p. 702) assert that:

> "Tax evasion is illegal. It consists in the willful violation or circumvention of applicable tax laws in order to minimize tax liability. Tax evasion generally involves either deliberate under-reporting or non-reporting of receipts, or false claims to deductions. This conduct is legally straightforward to identify; a taxpayer has committed tax evasion only if he or she has breached a relevant law. Indeed, evasion ordinarily involves criminal fraud."

Tax evasion can also be defined[6] as an illegal activity to escape taxation, and it may occur when all action happens in an informal manner or when there is a specific and isolated incident.

The U.S. Internal Revenue Code of 1986 - published as Title 26 of the United States Code - is the compilation of rules of jurisprudence that systemize all federal tax laws. In section 7201 of IRS Code, tax evasion is outlined as a felony (original text):

> "I.R.C. § 7201 - ATTEMPT TO EVADE OR DEFEAT TAX
> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution."

As delineated in this Code Section, even an attempt to evade taxes provided by law will be considered a felony. The person who did the action does not need to achieve the reduction of tax liability; the attempt alone is sufficient to cause the legal consequences.

Also, there is a discussion concerning whether ignorance of the law is an excuse to tax crimes. As a general rule, ignorance of law is not a valid defense, but with respect to

[6] http://www.taxcompact.net/documents/2011-09-09_GTZ_Addressing-tax-evasion-and-avoidance.pdf. Retrieved Sep 5, 2014.

tax evasion, as assertion by Mark Winings[7] commenting on the *United States v. Cheek* case, said, "*to consider a felony anyone should be conscious of this duty and that the defendant voluntarily and intentionally violated that duty.*"
In addition, this author concludes that:

> "In *United States v. Cheek*, the Supreme Court made it clear that the traditional maxim "ignorance of the law is no defense" does not apply to tax crimes. A taxpayer may behave outrageously, even to the point of not paying any taxes, without criminal penalty, as long as the taxpayer subjectively believes he is obeying the law."

In Brazil, Federal Law nº 8.137/1990 is the statute that defines and outlines tax crimes. This portion of the law related to tax crimes is divided into two segments dealing with crimes committed by a civil person and crimes committed by a civil servant.

Among others, the events considered crimes are: omitting material information to tax authorities; inserting inaccurate elements in as official document; forging or counterfeiting any fiscal document; and making false statement to tax authorities.

As seen above, tax evasion is an action taken against the rules, with the declared objective to reduce tax liabilities. This kind of arrangement is considered a felony and the committer is subjected to imprisonment and fines.

2.2 The Difference Between Tax Avoidance and Tax Evasion

The tax gap is the difference between the tax revenue the governments would raise in a perfect tax system and the revenue the governments actually collected. This amount is represented by all tax minimization arrangements. Although there are serious difficulties in determining the range of the tax gap, some studies estimates a sum of more than a trillion of dollars a year in developed countries.

Considering the huge amount of revenue countries had not been collecting, as represented by the tax gap, governments of several countries have been changing legislative, administrative and criminal procedures and rules to deal with this question. But before handling this matter, it is imperative to specify the difference between tax

[7] Winings, Mark. Retrieved Sep 6, 2014, from http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=6786&context=jclc

avoidance and tax evasion. Despite the same economic result of the utilization of these schemes, which in effect is the reduction of tax liabilities and decrease in government revenue, governmental approaches to each scheme must be different.

In Brazil, André Mendes Moreira[8] indicates the existence of two main criteria used to determine whether some activity can be considered tax avoidance or tax evasion. For this author, the first criterion to be evaluated is the chronological order, and the second criterion is the legality of the operation.

Taking the chronological order as a criterion, tax avoidance always occurs before the event that gives rise to the tax liability. This specific event is done in a way to avoid the existence of a tax liability, otherwise this would be a taxable event and would engender tax obligation.

The precondition to pay any tax is the occurrence of an event assigned by law; if this situation does not happened, like in the tax avoidance case, the tax obligation does not exist in legal terms.

Thus, from a chronological standpoint, the moment of the occurrence of the taxable event is the principal and unique evidence to determine the type of tax arrangement that occurs in the situation under review.

However, the same author indicates a shortcoming in this definition, because there have been situations in which tax evasion phenomena occur, but the taxable event has not happened yet. An example of this might be when a company issues a false commercial invoice and sells the product just after this erroneous operation.

The utilization of the second criteria attempts to fill the pointed out deficiency in the chronological criteria, introducing the analysis of legality of the operation. Alongside the chronological criteria, to determine whether some operation is a kind of tax evasion it has to verify whether the actions related with all operations are under the law or not.

[8] Moreira, André Mendes. Elisão e Evasão Fiscal – limites ao planejanemto tributário. Revista da Associação Basileira de Direito Tributário, Belo Horizonte, Vol. 21, mar.-abr. 2003, pp. 11-17.

The Brazilian author, André Mendes Moreira, defines the legality criteria used to identify tax evasion by the presence of at least one of three characteristics: dishonest tax reporting, fraud, or tax dissimulation.

Dishonest tax reporting arises when individuals, firms, or other entities do not properly inform tax authorities its income, profits or gains. The objective of this conduct is to evade the tax liabilities and it is done by illegal means.

Fraud is a widely used term, but specifically in this case it is related to the action of the misrepresentation of the state of some situation by counterfeiting or adulteration of documents, with the intention to reduce or eliminate the tax payment.

In tax dissimulation the agent forges the existence of some circumstance which in fact does not exist, or he falsifies the real affair through the use of different issues with the same aspects but with less taxable effects.

Based on the same assumptions, Professor John Pebble, from Victoria University of Wellington, asserts in Zoe and John Pebble (2012, p. 711) that:

> ""The law draws a line" between tax avoidance and tax evasion." This line may be fine, but it is supposed to be crisp, such that any set of facts will fall "on one side of it or the other." By definition, tax avoidance falls on the "safe side," whereas tax evasion is on the "wrong side" of the line. In practice, however, the line can become blurred in a way that definition alone does not suggest."

The excerpt between double quotation marks is from U.S. Supreme Court case, *Bullen v. Wisconsin* - 240 U.S. 625 (1916), in which Justice Oliver Wendell Holmes delivered the opinion of the Court stating that:

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy, if not by the mere letter, of the law."

Viewed as such, the attribute that differentiates tax avoidance and tax evasion is the legality of the operation. This legality is represented in the excerpt above by a line that separates the legal side and the illegal side. However, legislators seldom highlight this line, as it usually has some obscure areas in which events are not easily located.

These ambiguous cases demand strong efforts to determine the best classification of a tax event. In these situations, tax avoidance and tax evasion are not obviously settled.

In the article "Tax avoidance, Evasion, and Administration,"[9] Slemrod and Yitzhaki affirmed that:

> "(…) the distinguishing characteristic of evasion is illegality. In practice, of course, there are many gray areas where the dividing line is not clear, and sometimes the tax authorities may inappropriately characterize particular cases. One can draw a further distinction within the class of legal responses to taxation. At times we will refer to real substitution responses, or real responses for short, as those responses which come about because the tax law changes the relative price of different activities, and that induce taxpayers to respond by choosing a different consumption basket."

Therefore, although the existence and the characteristics of the line which separates tax avoidance and tax evasion is well known and established, the existence of a gray area where events are not simply assigned brings serious problems to the tax authorities and taxpayers alike in dealing with these specifics cases. In fact, these cases rest on the border of the two situations, and do not reflect the majority of situations and can be treated in separate when necessary.

2.3 Tax Avoidance Cases

To illustrate the characteristics of tax avoidance cases, as well as to demonstrate the amount of money involved in these operations, two recent and representative cases in the United States will be presented.

2.3.1 The Apple Case

Apple Inc. is considered to be one of the world's biggest information technology companies. The Permanent Subcommittee on Investigations of the U.S. Senate investigated Apple over allegations that reduced its U.S. corporate income tax by using tax avoidance schemes.

[9] Slemrod, Joel and Yitzhaki, Shlomo. *Tax avoidance, Evasion, and Administration*. Handbook of Public Economics, Volume 3, Edited by A.J Auerbach and M. Feldstein. 2002 Elsevier Science B.

On May 21, 2013, the subcommittee held a hearing about "Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).[10]" According to the testimonies made at the hearing by Professor J. Richard Harvey, Jr., who participated as a tax expert, in 2011 Apple made use of a cost sharing agreement in which the rights to develop products outside of the U.S. were transferred to an Apple subsidiary in Ireland.

As a result of this tax structure, its Irish subsidiary recorded 64% of Apple's global pre-tax income, albeit just 4% of its employees and only 1% of its customers were located in this country. By comparison, 60% of Apple customers are located in other countries than the U.S. and Ireland, but just 6% of pre-tax income is recorded there.

Mark J. Mazur, Assistant Secretary for Tax Policy of the U.S. Department of the Treasury, and another witness in the hiring, said:

> "The Subpart F rules attempt to prevent the shifting of income, either from the United States or from the foreign country in which it was earned, into a low- or no-tax jurisdiction. Thus, Subpart F generally targets both passive and mobile income. The Subpart F rules discourage the shifting of these types of income by disallowing deferral of U.S. taxation for such income and requiring current taxation. (In related party transactions, the shifting of income may be achieved more easily because a commonly controlled group of corporations can direct the flow of income between entities in different jurisdictions.)"

So, according to this hearing, Apple made use of an international tax avoidance scheme to reduce its tax liability in the U.S. through use of subsidiary in Ireland in which the international pre-tax income was concentrated to take advantage of the special tax deal, transfer pricing, and other tax schemes.

To have a clear picture of the amount of tax avoided by Apple, Professor J. Richard Harvey, Jr.[11], summarized the case in these terms:

> "(…) by entering into the cost sharing agreement with its Ireland affiliates and negotiating a special tax deal with Ireland, Apple was able to shift approximately $22 billion of its 2011 pre-tax income out of the US into Ireland and incur an immaterial amount of Irish tax. If such income had been taxable in the US,

[10] The U.S. Senate. Retrieved Sep 7, 2014, from http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2

[11] Ibidem.

> Apple would have incurred approximately $22 billion x 35% = $7.7 billion of additional US federal tax."

2.3.2 The Caterpillar Case

Caterpillar Inc., a mining and construction equipment company, located in Peoria, Illinois, has more than 52,000 employees in the U.S. and more than 118,000 in the world. In 2013 Caterpillar generated sales and revenues of $55.7 billion, and invested $2 billion in research and development.[12]

Like in the Apple case, the Permanent Subcommittee on Investigations of the U.S. Senate investigated Caterpillar over allegations that the company avoided paying $2.4 billion in U.S. taxes from 1999 to 2012 as a result of moving taxable profits to a foreign affiliate in a tax haven.

Accordingly with the April 2014 Subcommittee report,[13] Caterpillar paid 55 million in tax consulting fees to PricewaterhouseCoopers (PWC) for this tax scheme. In addition, Caterpillar paid more than $200 million in auditing fees to PWC from 2000 to 2012.

In 1999, Caterpillar create a subsidiary in Switzerland, known as Caterpillar SARL, and designated this affiliate as its global purchaser. In the meantime, Caterpillar negotiated with Switzerland a reduction in its tax rates, resulting in an effective tax between 4% and 6%.

As part of the strategy, Caterpillar shifted its sales of manufactured replacements to Caterpillar SARL in Switzerland, recording this revenue under Switzerland's tax law without showing any U.S. revenue for these sales. The Caterpillar third party suppliers sold the manufactured replacements directly to Caterpillar SARL, thereafter selling these parts to Caterpillar dealers placed in the U.S. and rest of the world.

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[12] Caterpillar Report. Retrieved Sep 8, 2014, from http://reports.caterpillar.com/yir/performance_financial.html

[13] The U.S. Senate. Retrieved Sep 7, 2014, from http://www.hsgac.senate.gov/download/report-caterpillars-offshore-tax-strategy-april-1-2014

Before the beginning of this scheme, Caterpillar recorded and paid taxes in the U.S. of over 85% of its total revenues. Afterward, conversely, 85% of the total revenue went to Caterpillar SARL in Switzerland. Between 1999 and 2012 more than $8 billion of taxable revenue was transferred from the U.S. to Switzerland, avoiding payments of more than $2.4 billion in taxes.

The Caterpillar operation in manufactured replacements did not change as a result of this tax scheme. Caterpillar in the U.S. did all managerial decisions, as well as supply chain operations, with hardly any activity from the Switzerland affiliate. Furthermore, Caterpillar SARL did not have any warehouses in Switzerland or in any other country. As mentioned in the Subcommittee report, *the Swiss tax strategy lacked economic substance and had no business purpose other than tax avoidance*.

To conclude, the final report of the Subcommittee made some findings of facts, the most relevant being that all Caterpillar operations in manufactured replacements was managed and led from the United States; that Caterpillar used contradictory valuation when transferring operations from Caterpillar to the Caterpillar SARL and after to another marketing company; and that Caterpillar employed a Tax-Motivated "Virtual Inventory" without any business purpose but to reduce its tax.

3. ANTI-AVOIDANCE MODELS

Two main classes of anti-avoidance models are adopted by countries, and can be classified as: "General Anti-Avoidance Rules – GAAR"[14] and "Specific Anti-Avoidance Rules – SAAR," also known as "Targeted Anti-Avoidance Rules - TAAR".

General Anti-Avoidance Rules – GAAR—is a set of principles designed to tackle diverse kinds of tax avoidance schemes. These rules provide authorities with a set of resources to constrain all arrangements created to explore the loopholes of the law or the abusive use of the tax rules.

[14] In United Kingdom GAAR means "General Anti-Abuse Rule".

Specific Anti-Avoidance Rules – SAAR—is a specific rule made to deal with a restricted or particular arrangement in which tax payments are reduced by an avoidance structure.

Another categorization that must be distinguished is the Statutory Anti-Avoidance Rules from the Judicial Anti-Avoidance Doctrines. Generally speaking, the statutory rules are a set of codified legal codes made by a specific branch of the government, like parliament, congress, or even by the executive power. The use of Statutory Anti-Avoidance Rules is a consequence of the historical adoption of the legal system of Civil Law. Several countries in the world adopted this system, which has its grounds in Roman law, among them are France, Italy, Brazil, Mexico, China, Germany and Spain.

Among others, countries that adopted the Common Law legal tradition are the United States, United Kingdom and Australia. The Common Law tradition is normally not a codified system of law, which means that it relies on precedents of decisions that have been made in related incidents. The decision about which precedent will be used in a given case is done by the judge, who therefore has a very important role in determining the configuration of judicial system.

Notwithstanding the role that precedents play in Common Law countries to form their judicial decision-making, some of them have established statutory GAAR, like Australia, Canada, Hong Kong and New Zealand. And more recently the U.S. and the U.K.

Although almost all analyzed countries, in both judicial systems, embraced the use of Specific Anti-Avoidance Rules, this kind of anti-avoidance model is too restricted to be representative of countries' efforts to handle this issue. Due to this specificity and to accomplish the main objective of this work, this paper will focus only in General Anti-Avoidance Rules to explore the ethical implications of tax avoidance.

To illustrate the development of GAAR in a historical context, Australia was one of the first countries to make use of anti-avoidance, introducing in 1936 a provision into tax statute at Section 260. Although the text of Section 260 could have been applied to assorted situations, the development of the case law in this regard limited the use of this rule. To deal with this ineffectiveness of Section 260, in 1981 the Australian

Parliament passed relevant reforms in 1936 GAAR to become what is known as the Part IVA. After this adjustment in anti-avoidance rule, Australian courts expanded the range of GAAR to also reach commercial transactions.

In United States the anti-avoidance framework is usually considered to derive from the US Supreme Court decision in *Gregory v. Helvering* in 1935, in which a new corporation was created, dissolved and liquidated solely to the purpose of reducing the owner tax liability. In this case, the Supreme Court applied a business purpose test to determine whether the transaction had real meaning or was designed merely to avoid tax payment. As a result, the Supreme Court disregarded the whole operation done by the owner and charged the tax that he would have paid without all the company reorganization.

The root of the United Kingdom anti-avoidance doctrine was quite dissimilar. It was developed from the *IRC v Duke of Westminster* case from 1936, in which the House of Lords, in contrast to U.S. *Gregory v. Helvering* case, "*upheld the legal form of the transaction, notwithstanding the economic reality of the arrangement.*"[15]

As pointed out by Donald Korb and Aditi Banerjee[16]:

> "(…) the seminal Duke of Westminster decision stood for the proposition that the form of a transaction that a taxpayer chose must be respected, and a court cannot look behind it for some underlying substance, so long as the taxpayer had successfully satisfied the legal requirements of the chosen form. The Duke of Westminster approach has come to be seen as taking a more literal approach to the applicable statutory language, rather than a 'purposive' approach focusing on the legislative intent behind the statute."

Since the beginning of GAAR doctrines to today, several new dispositions were created by legislators and by courts. Due to this development in policies and as a result of a huge growth in the international trade and in international agreements in taxation, GAAR development in almost all countries has been moving forward in an almost uniform way, but at the same time keeping their local characteristics, which results in a very specific approach to tax avoidance in each country.

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[15] Korb, Donald & Banerjee, Aditi. Retrieved Jun 10, 2014, from http://www.sullcrom.com/siteFiles/Publications/Korb-Banerjee-Comparing%20US&UK%20anti-avoidance%20appraoches%20-%20Aug%202010.pdf

[16] Ibdem.

3.1 The Statutory GAAR Models

3.1.1 Brazilian Model

Before the introduction of GAAR in Brazil, the Brazilian Legislative Branch established specifics rules to tackle some kinds of avoidance schemes, mostly related to income tax. These rules, like Law nº 7.450/85 and Law nº 7.713/88, expanded and generalized the events considered to impose a tax liability.

In 2001, Brazilian GAAR was introduced by Complementary Law[17] nº 104, which included the sole paragraph of article 116 of the "National Tax Code."[18] As pointed out by Ricardo Lobo Torres (2006, p. 22) Brazilian GAAR was based in the French model, mostly in article nº 1.741 of General Tax Code and in section L 64, of the Book of Tax Procedures, which handles the dissimulation of the real aspects of a legal act or contract and with the power of tax authorities to disregard them.

In broad terms, the Brazilian GAAR provides that tax authorities could disregard transactions or operations that are realized solely to dissimulate the occurrence of the triggering events needed to impose tax liability, but it requires the introduction of a new law to regulate the procedures of this provision.[19]

Two problems arise from this rule and impose serious difficulties in applying Brazilian GAAR to tax avoidance cases. Firstly, the inexistence of a specific law to regulate the application of GAAR to real cases serves as an obstacle. Secondly, the discussion about the meaning of the word, "dissimulation," in the text of Complementary Law nº 104 also poses a similar issue.

Related to the first point and as seen before, Brazilian GAAR statutes call for another law to regulate its application to real cases. This is a typical kind of arrangement in the

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[17] Complementary Law in Brazil demands absolute majority of votes.

[18] Free translated from "Código Tributário Nacional", Lei nº 5.172, de 25 de outubro de 1966.

[19] "The administrative authority may disregard legal acts or transactions that are effected with the purpose of dissimulating the occurrence of a taxable event or of (dissimulating) the nature of the elements that trigger the tax obligation, under procedures to be established by ordinary law". Free translated by EYGM Limited. "GAAR rising - Mapping tax enforcement's evolution - February 2013", 2013 EYGM Limited., Retrieved Jun 17, 2014, from www.ey.com/tax, 2014

Brazilian legal system, in which an existence of a Complementary Law introduces general provisions and an Ordinary Law specifies how these provisions will be applied in the real world.

Although a relevant part of the Brazilian doctrine understands that the existence of this regulatory Ordinary Law is an ultimate condition, or that the lack of this rule prevents the application of Brazilian GAAR to real cases, the tax authorities have been applying this rule anyway and the Brazilian tribunals have been agreeing with such.

So, despite the lack of Ordinary Law to specify how Brazilian GAAR would be used, tax authorities have been making use of this statute to prevent tax avoidance arrangements.

Concerning the second difficulty in applying Brazilian GAAR, several tax law scholars discussed the meaning of the word "dissimulate"[20] in the GAAR legal context. One side defends the word by saying it means a wrong action in which someone acts against the law. So, if this word "dissimulate" refers to an illegal act, therefore, this provision should be treated as a rule created to deal with tax evasion and not with tax avoidance.

The other side of this debate contends that the word "dissimulate" has the meaning of an action taken by a taxpayer with the specific purpose of masking the occurrence of a taxable event. So, by this view, the Brazilian GAAR statute is not subject to any legal restriction by its text to be applied in tax avoidance cases.

In relation to the procedures in which GAAR is used, in general, tax authorities disregard the legal act or operation at the curse of the auditing processes, and the burden of proof is with the taxpayer, who needs to prove that the transaction in the analysis has real objectives and not only tax purposes.

[20] Free translated from "dissimilar" in Código Tributário Nacional", Lei nº 5.172, de 25 de outubro de 1966: "Art. 116. Salvo disposição de lei em contrário, considera-se ocorrido o fato gerador e existentes os seus efeitos: (…) Parágrafo único. A autoridade administrativa poderá desconsiderar atos ou negócios jurídicos praticados com a finalidade de dissimular a ocorrência do fato gerador do tributo ou a natureza dos elementos constitutivos da obrigação tributária, observados os procedimentos a serem estabelecidos em lei ordinária."

As observed, the utilization of Brazilian GAAR in real cases has some pitfalls. However, tax authorities have been systematically pushing the boundaries of this statute to deal with tax avoidance cases in Brazil. The final result of the behavior of authorities would be settled only by the Brazilian Supreme Court, in which an action against the Brazilian GAAR statute has been filed.

3.1.2 Germany Model

The first Germany rule related to tax avoidance was introduced in 1919 in the German Tax Code,[21] drafted by Enno Becker. It is considered one of the first Tax Codes in the Western countries. In 1931, this Code was modified, and in 1977, was introduced as a new German Tax Code, known as AO77.

The anti-avoidance rule in AO77 was introduced by section 42, in which:[22]

> "Any legal arrangement implying a treaty benefit can be disregarded for tax purposes if a taxpayer achieves such benefit through an "inappropriate" legal structure tax benefits that (i) would not have been achieved when using an "appropriate" structure, and (ii) the structure cannot be justified with significant non-tax (i.e., commercial) reasons."

In other words, this section provides that the taxpayers cannot circumvent the tax law by using some inappropriate structure that exists solely to reduce its tax liability. If this situation were to occur, a tax will be charged as though an appropriate, taxable structure had existed.

Apart from the GAAR, Germany has some specifics anti-abuse measures, like anti-treaty shopping rule, shareholder tests, business income tests, business purpose tests, and substance tests.

The burden of proof in anti-avoidance cases is shared between the taxpayer and authorities. As appointed in "GAAR Report:"[23] "*The authorities have to prove malpractice, but the taxpayer has to invalidate the charge*".

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[21] Reichsabgabenordnung (RAO)
[22] EYGM Limited. "GAAR rising - Mapping tax enforcement's evolution - February 2013", 2013 EYGM Limited., Retrieved Jun 17, 2014, from www.ey.com/tax, 2014
[23] EYGM Limited. "GAAR rising - Mapping tax enforcement's evolution - February 2013", 2013 EYGM Limited., Retrieved Jun 17, 2014, from www.ey.com/tax, 2014

The German GAAR is criticized and endorsed for the same aspect: its extensive application. On the one hand, its extensive judicial usage can embrace several types of structures that intend to avoid tax, but on the other hand, the lack of certainty creates insecurity in business and trades, which is not desirable.

Related to this question, Victor Thuronyi[24], Senior Counsel (Taxation) from International Monetary Fund, clearly explained these issues, as pointed out:

> "As can be seen from these examples, the German courts have felt it warranted to apply paragraph 42 to a broad range of cases, and have allowed the tax administration to use paragraph 42 to address many different types of tax avoidance in a flexible manner. This marks a contrast with most other countries, where specific anti-abuse provisions have had to be enacted to deal with the same or similar types of tax avoidance transactions. At the same time, the open-endedness of paragraph 42 means that it is not possible to predict with certainty in which cases the courts will be willing to apply this provision. The courts have not always applied it where the tax administration asked them to do so."

Another relevant aspect of German GAAR Model is the existence of a subjective element in the section 42 analyses that must be considered in judicial decisions. This subjective element is the taxpayer's intention to reduce his or her tax by using the tax structure under scrutiny.

In this way, authorities must prove that the taxpayer desired a tax reduction and chose the business structures only to attain this objective. The authorities have the burden of proof of an existence of intention by the taxpayer. However, the existence of intention and therefore the presence of subjective elements are presumed if authorities show that the following three other elements are presented (Prebble, 2008)[25]: an abuse of possible legal arrangements or an abuse of rights, the arrangement had the effect of reducing the tax, and if there are no important reasons to suggest that the inadequate legal arrangement is reasonable and justified by non-economic or other important considerations.

[24] Thuronyi, Victor. Retrieved July 10, 2014, from http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN017808.pdf

[25] Prebble, John. Retrieved July 10, 2014, from http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/working-papers/WP56.pdf

If authorities demonstrate that these three elements exist, the court will presume that the subjective element of intention is presented and will disregard the tax structure used to reduce tax liability.

3.2 The Judge-made GAAR Models

Two countries were chosen to represent the judge-made GAAR Models, the U.K. and the U.S. The U.K. model is not solely dependent on precedents, because the Parliaments have passed statutes to tackle tax avoidance. In the United States the GAAR system was developed based in decision precedents, but in 2010 the U.S. Tax Code was altered to include an anti-avoidance prescription.

Related to the connection between the codified U.S. Tax Code and the importance of judicial precedents, Joseph Bankman[26] pointed out that:

> "The federal income tax is, and always has been, based on statute. The economic substance doctrine, like the other common law tax doctrines, can thus perhaps best be thought of as a method of statutory interpretation. A related, though somewhat stronger, claim is that the legislature assumes that long-standing common law doctrines such as economic substance will be used to interpret the statutes it enacts. Under this claim, the doctrines have been implicitly adopted as part of the statute—at least where the statute does not indicate otherwise."

3.2.1 The United States Model

The Courts in the U.S. have long understood that tax statutes are subject to different interpretations, allowing taxpayers to act in diverse ways that were intended by the Congress and rulers. Among other reasons, to deal with this difficulty and misuse in interpreting the rules, courts have been making use of some tax avoidance doctrines.

As mentioned before, debate concerning tax avoidance in the U.S. can be traced to the 1864 case, *U.S. v. Isham*, in which the Supreme Court stated that if the case in question was carried out by the means of legal forms, it would be subject to no legal censure.

[26] Bankman, Joseph. Retrieved July 11, 2014, from http://www-bcf.usc.edu/~usclrev/pdf/074102.pdf

But the landmark decision that inaugurated the tax avoidance jurisprudence in The U.S. was *Gregory v. Helvering,* in 1935. In this case, Justice Sutherland delivered the opinion of the Court, in which he stated:

> "The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction, upon its face, lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

This case is considered one of the bases of the 'substance over form' doctrine and 'business purpose' doctrine. These two doctrines, alongside with the 'step transaction doctrine,' 'sham transaction doctrine,' and the 'economic substance doctrine,' are the principal rules developed by the U.S. Judiciary to deal with tax avoidance.

However, it is important to mention that in addition to these general rules, the U.S. Tax Code allows the Internal Revenue Service (IRS) to tackle numerous specific situations related to tax avoidance, like § 1.701–2 (2) Anti-abuse rule, in which it is stated that, "*The form of each partnership transaction must be respected under substance over form principles.*"

The doctrines mentioned above, as pointed out by Varma & West,[27] are not consistently applied by courts and, at times, overlap with each other in a decision. In the same way, Patricia Lampreave[28] asserts that courts commonly use more than one of these doctrines to deal with anti-avoidance cases in allowing or disallowing the tax benefit taken into consideration.

Another aspect to consider is that courts have been applying two different approaches related to the application of these doctrines: conjunctive tests and disjunctive tests.
In conjunctive tests, courts demand that taxpayers prove a presence of economic substance and business purpose in the transaction in order to not consider it as an illegal act. The lack of any one of these tests is sufficient to prevent the expected tax effects of the transaction. In disjunctive tests, only one of these two tests is required to keep the tax effects of the transaction. This is a more flexible approach, in which the

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[27] Varma, Amanda & West, Philip. *Tax treaties and tax avoidance: application of anti-avoidance provisions*. Cahirs de droit fiscal international. Volume 95a. 2010. Rome.
[28] Lampreave, Patricia. Retrieved July 11, 2014, from http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2026120_code1596806.pdf?abstractid=2026120&mirid=1

taxpayer should prove only the existence of economic substance or business purpose in the transaction.

To better clarify the U.S. Judge-made GAAR Model, its relevant to first explain the doctrines mentioned above.

3.2.1.1 Substance-Over-Form Doctrine

The Substance-Over-Form Doctrine, or substance-over-form principle, is the doctrine in which the substance—not the form—of a transaction is taken into consideration for tax purposes.

By using this principle, courts consider the event in its substance, disregarding the form presented by the taxpayer to achieve the elements that configure the real operation. In this case, the taxpayer has to prove that the substance of event is the same as the form presented; otherwise the substance will be adopted for tax incidence matters.

J. Bruce Donaldson[29] asserted that:

> "To permit the true nature of a transaction to be disguised by mere formalism which exist solely to alter tax liabilities would seriously impair the effective administration of the tax policies of Congress. In this sense and context, the doctrine of substance-over-form serves a high purpose. It is a search for the essential reality, seeking to uncover the economic substance in order to allow the tax burden to fall with the exact weight which Congress intended."

This author also stated that the beginning of this doctrine could be traced to the Supreme Court's decision in *Weiss v. Stearn* (1924). In this decision, Justice McReynolds delivered the opinion of the Court and Justice Holmes and Justice Brandeis dissented. Justice McReynolds stated that:

> "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and, when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder, we must regard matters of substance, and not mere form."

[29] Donaldson, J. Bruce. *When Substance-over-Form Argument is Available to the Taxpayer*, 48 Marq. L. Rev. (1964). Retrieved July 14, 2014, from http://scholarship.law.marquette.edu/mulr/vol48/iss1/4

Another important decision was made in *Commissioner v. Court Holding Co.* (1945), in which Supreme Court stated that:

> “The incidence of taxation depends upon the substance of a transaction. The tax consequences, which arise from gains from a sale of property, are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms which exist solely to alter tax liabilities would seriously impair the effective administration of the tax policies of Congress.”

One relevant fact is that the taxpayer cannot take advantage of the Substance-Over-Form Doctrine. The form chosen for the transaction cannot be changed to reduce its tax liability, even if it proves that the substance of transaction delivers less tax liability than the form presented.

3.2.1.2 Business Purpose Doctrine

The development of the Business Purpose Doctrine also relays on the Supreme Court decision in *Gregory v. Helvering* (1935), as well as in *Bazley v. Commissioner* (1947), and *Knetsch v. Commissioner* (1960). In this doctrine taxpayer must prove that the transaction has a business reason or a commercial sense other than only to avoid tax payments.

Related to this subject, J. Bruce Donaldson[30] stated that:

> “(…) the business purpose cases represent a separate strain of substance cases. Here usually the Court is confronted, as in the Gregory case, with a fact situation in which all the legal forms are present to bring the transaction technically within certain advantageous aspects of the Code structure. The carefully prearranged form, however, covers and disguises the genuine underlying transaction, the essential substance of which is fundamentally different from the form. The courts read into the Code the judicial requirement that a transaction must have some "business purpose" in order to comply with the overriding intention of the Code provision.”

[30] Donaldson, J. Bruce. *When Substance-over-Form Argument is Available to the Taxpayer*, 48 Marq. L. Rev. (1964). Retrieved July 14, 2014, from http://scholarship.law.marquette.edu/mulr/vol48/iss1/4

To support the transaction, taxpayers must present a valid business purpose to the transaction, demonstrating that the operation was done with real intention to improve operational profits, to reduce costs, to restructure the operational activities, to increase revenue, to raise capital for company business, among others.

Patricia Lampreave[31] pointed out that this doctrine does not require an existence of tax avoidance purpose, just the lack of business purpose in the transaction:

> "It is important to note that the test examines whether or not there is a lack of any business purpose to be carried out by a company. The doctrine does not examine whether the purpose of a certain arrangement is tax avoidance, but, rather, whether the arrangement is made in the absence of an intention to develop an activity."

Other important matter is that this doctrine does not rely on the form of the transaction. All the formal characteristics of the operation could be within the law, but the commercial or business purpose must be demonstrated to validate the arrangement.

3.2.1.3 Step Transaction Doctrine

Step Transaction Doctrine can be considered as an extension of Substance Over Form Doctrine. Both pursue the real substance of the transaction, disregarding the form presented by the taxpayer to access the genuine and undercover objective.

Step Transaction Doctrine would be utilized only if the form differs from the substance of the transaction. This doctrine states that for tax purposes, separated steps of a transaction can be considered as a single one.

In *Del Commercial Properties, Inc. v. Commissioner*, the District of Columbia Circuit stated that:

> "Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. (…) The Internal Revenue Service - and the courts - will ignore a

[31] Lampreave, Patricia. Retrieved July 11, 2014, from http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2026120_code1596806.pdf?abstractid=2026120&mirid=1

> step in a series of transactions if that step does not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax."

In other words, a taxpayer might make use of the three steps, A, B and C, to achieve some business objective, but this same objective could be reached by using just steps A, B or C alone; by using just two of these three steps; or by applying these steps in a different order. Simply put, the IRS and courts can disregard one or two of these steps, or change the order of them, to fit the result in the condition described by law that is connected with a tax duty.

In the development of the Step Transaction Doctrine, three tests were used to determine whether a Step Transaction Doctrine should be applied or not. These tests were well described in *True v. United State,* in which a judgment made about tax avoidance by the Tenth Circuit stated:

> "Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment. (…) More than one test might be appropriate under any given set of circumstances; however, the circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate."

In this case, the Tenth Circuit asserted that if one of the three tests were satisfied, the Step Transaction Doctrine should be applied. This is the standard method used by courts and by the IRS to apply the doctrine, however is important to observe that there are other decisions in which the courts and even the Supreme Court demanded the fulfillment of two or all three tests to apply the Step Transaction Doctrine.

Under the End Result Test the separated events will be considered together as one if courts or IRS demonstrate that intent of the taxpayer using these steps was to achieve a particular result. The subjective intent of a taxpayer is an important element of this test, which relies on its prior intention to use more than one step to reach a specific outcome.

The Interdependence Test, also known as the Mutual Interdependence Test, examines whether or not one specific step in a transaction has a proper meaning or if it has significance only when analyzed together with the other steps. This test examines the existence of interdependence between the steps of a transaction.

In discussing this topic, Yoram Keinan[32] pointed out that:

> "The court must, therefore, examine whether the individual steps or events have independent significance or merely have meaning as part of the larger transaction. Accordingly, if the steps have "reasoned economic justification standing alone," then applying the mutual interdependence test is inappropriate. By contrast, when "it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts…step transaction treatment may be deemed appropriate."

It should be noted that the End Result Test focus on the final result, and that this is the element under scrutiny, but in the Interdependence Test, the principal element is the connection between the events, not the result. In the End Result Test the concern relies on the subjective intent of the taxpayer to achieve the final result. In contrast, in the Interdependence Test, the objective relationship among the steps is the principal element. Notwithstanding these different approaches, the End Result and Interdependence tests can be considered as complimentary tests.

The Binding Commitment Test examines whether or not at the time the first step taken it made a commitment to complete the remaining steps. The steps would be considered as one step only if this commitment between the steps was demonstrated. This test is commonly used when a long period of this has passed between the two steps.

In general, this test is considered as the least effective of the three tests. The difficulty in applying this examination relies on the need to determine what was the subjective intent of the taxpayer. The most common situation in which this is applicable occurs when a document describing the taxpayer's intent is exhibited in cases.

3.2.1.4 Sham Transaction Doctrine

As mentioned before, the doctrines traditionally used by courts to deal with tax avoidance arrangements are overlapped by each other or applied at the same time.

[32] Keinan, Yoram. Retrieved July 17, 2014, from *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*. Akron Tax Journal. 2007.

In this sense, the Sham Transaction Doctrine is commonly employed simultaneously with the Economic Substance and Business Purpose Doctrines. In fact these two doctrines are used to determine whether Sham Transaction occurs or not. To do so, the Economic Substance is utilized as an objective examination and Business Purpose as a subjective examination.

Under the Sham Transaction Doctrine, a transaction can be disregarded for tax purpose if courts or the IRS demonstrate that the transaction presented by the taxpayer does not exist; if this transaction occurs in a different way than declared; or if the transaction does not have economic substance or business purpose. In all these situations, the transaction would be disregard for the tax purpose, and authorities can impose a tax liability as if an effective economical transaction had happened.

For this reason, as pointed out by Brion D. Graber,[33] the type of Sham Transaction can be two-fold. In one sense, factual shams are when transactions declared do not actually happen. An economic sham, in another sense, is when the purpose of the transaction has no other meaning than to obtain tax benefits. In the former, both the subjective analysis of economic substance and the objective analysis of the business purpose of a transaction will be taken in consideration to determine the existence of a sham transaction.

In almost the same way, Marilyn A. Wethekam[34] by referring to *United Parcel v. Commissioner* case affirmed that there are two kinds of sham transactions—'sham in fact,' when a transaction existed only in paper but never occurred, and 'sham in substance,' when a form presented for a transaction differs from its economic substance.

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[33] Graber, D. Brion. *Can the Battle Be Won? Compaq, the Sham Transaction Doctrine, And a Critique of Proposals to Combat the Corporate Tax Shelter Dragon*. University of Pensylvania Law Revew. Vol.14

[34] Wethekam, Marilyn A. *A Critique of Current State Tax Shelter Laws*. Retrieved July 18, 2014, from http://www.hmblaw.com/media/12618/a_critique_of_current_state_tax_shelter_laws.pdf

3.2.1.5 Economic Substance Doctrine

Under the Economic Substance Doctrine a transaction can be disregarded for tax purposes if it lacks economic substance, in this case any tax benefits will be disallowed and would be subjected to penalty. Note that a fundamental requirement to apply this doctrine is the transaction under scrutiny meeting the tax statutory criteria.

Concerning this point, Patricia Lampreave[35] stated that:

> "The economic substance doctrine has generally been applied to transactions where a taxpayer has technically met statutory and regulatory requirements, but has met these requirements in such a way that the specific result of the transaction or series of transactions is unlikely to have been foreseen by Congress or regulators."

This doctrine, among the others previously analyzed, has its ground in court decisions like *Gregory v. Helvering (1935), Frank Lyon Co. v. United States (1978), Knetsch v. United States (1960), and more recently in ACM Partnership v. Commissioner, (3d Cir. 1998)*.

Over the years, to establish a practical way to apply this doctrine, courts have developed a test to determine whether a transaction has economic substance or not. This test is known as "two pronged test" and, as mentioned in *ACM Partnership v. Commissioner,* two factors are analyzed in its framework. These are the "subjective business motivation" and the "objective economic substance of the transactions.

These two factors are evaluated by applying objective and subjective tests. The objective test focuses on the existence of practical economic effects in a transaction other than tax benefits. This test aims to identify if a transaction had some economic meaning, like improvement in profits, reduction in costs, or if this transaction had as a purpose only to reduce the tax liability of the taxpayer.

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[35] Lampreave, Patricia. Retrieved July 11, 2014, from http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2026120_code1596806.pdf?abstractid=2026120&mirid=1

The subjective test looks at the motivations of taxpayers, and what is expected before accomplishing the transaction. This test is analogous to the business purpose test, and is also knows as ‘business purpose requirement of economic substance doctrine.’

As stated in *ACM Partnership v. Commissioner* the aim of subjective tests is to identify the intention of taxpayers, and if it planned to carry out a transaction “*rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and economic situation*.”

In 2010, the Economic Substance Doctrine was codified through Health Care and Education Reconciliation Act to answer the undesirable, different ways courts had been applying the subjective and objective tests, among other reasons. The Health Care and Education Reconciliation Act included a new subsection in the Internal Revenue Code, and defined this very doctrine. The Act also included a strict penalty provision in the Code, which is applicable to a transaction that lacks economic substance.

The new subsection “7701(o) Clarification of economic substance doctrine“ was included in the Title 26 - Internal Revenue Code of U.S. Code, specifically in the Subtitle F - Procedure and Administration (§§ 6001–7874). This subsection is comprised of rules related to the application of the doctrine, some other special rules, and definitions.

With regard to the application of doctrine, the legal text shows that the subjective and objective tests must be undertaken and the transaction would be considered as having economic substance only if both of them demonstrate the existence of practical economic effects and the business purpose.[36]

In the Definitions portion, for purposes of the subsection in the analysis, the Economic Substance Doctrine is defined as *“the common law doctrine under which tax benefits under subtitle A (Income Taxes) with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”*

[36] IRS Code. 7701(o). (1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Finally, concerning the penalty provision, the Health Care and Education Reconciliation Act included in the U.S. Code provisions related to transactions that lack economic substance. The inclusion of these provisions can be seen as exposed in the Joint Committee on Taxation[37] report as an attempt "*to give economic substance factors greater weight in taxpayers' decision-making prior to entering transactions and prior to reporting transactions for tax purposes."*

3.2.2 The United Kingdom Model

As stated before, the genesis of the United Kingdom anti-avoidance doctrine can be grounded in *IRC v Duke of Westminster* case from 1936. In this case,[38] the House of Lords rejected the Economic Substance doctrine, adjusting the understanding that the statute can apply only if the taxpayer acts exactly as described in the text. It also denied the application of the Business Purpose test, allowing taxpayers to arrange their businesses with the declared purpose of only reducing tax liabilities.

Note that the *IRC v Duke of Westminster* in the U.K. is quite concomitant with in *Gregory v. Helvering* case from 1935 in the U.S., but the direction given by the House of Lords was very much divergent from what the U.S. Supreme Court had established.

In 1982, the House of Lords changed the judicial interpretation of tax avoidance in the *Ramsay v Commissioners* case. In this case, it was stated that courts are not confined to literal interpretation of tax statues, and that they should consider for tax reasons the context, the scheme and the purpose of an act. There was also the establishment that, if needed, the nature of a transaction for tax purposes can be determined by a combination of more them one transaction.

On this subject, in *Astall & Anor v Revenue and Customs (2009)* Lady Justice Arden stated that:

[37] https://www.jct.gov/publications.html?func=startdown&id=3576. *Description Of Revenue Provisions Contained In The President's Fiscal Year 2010 Budget Proposal Part Two: Business Tax Provisions.* September 09, 2009. Retrieved July 21, 2014.

[38] http://saf.uwaterloo.ca/mtax/documents/MTAXResearchPaperbyAlexanderChan.pdf. Retrieved July 18, 2014.

> "The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of the statute, upon its true construction, applies to the facts as found."

In 2010 the Government established a study group[39] led by Graham Aaronson, "*to consider whether a general anti-avoidance rule should be introduced into the UK tax system.* The result of this group was a report with a recommendation to the Government, which led to U.K. General Anti-Abuse Rule – GAAR published in 2013.

The U.K. GAAR focuses on abusive tax arrangements, which can be understood as an arrangement in which the tax result is not the same as the Parliament had expected, or an arrangement not viewed as reasonable. The rule, among others, is applied to income tax, corporation tax, capital gains tax, and inheritance tax.

When defining abusive tax arrangements, the section 207[40] of U.K. Finance Act 2013 stated that, "*arrangements are "tax arrangements" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements".* Further, *"Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances."*

Alongside section 207 that introduced U.K. GAAR, Schedule 43 of U.K. Finance Act 2013 also introduced an Advisory Panel. This rule imposes that authorities must consult the Advisory Panel before applying to U.K. GAAR. If as a result the arrangement is not subjected to U.K. GAAR, by way of the Panel's opinion, the authorities must have coherent and convincing elements to maintain the procedures against the tax benefits.

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[39] http://webarchive.nationalarchives.gov.uk/20130321041222/http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf. Retrieved July 23, 2014.

[40] http://www.legislation.gov.uk/ukpga/2013/29/part/5/enacted. Retrieved July 23, 2014.

4. ETHICS OF TAX AVOIDANCE

The philosophical definitions of ethics is vast and variable, but there has been some agreement that defines ethics as twofold, as a discipline that study system of moral principles and as an investigation of standards of human behavior that indicates what is right or wrong. The focus in this work is in the second branch of ethics, the study of what is right or wrong.

Human beings make several decisions every day, and many of these impose the need to choose between the right and the wrong thing to do. They can opt to decide something in a way that is morally wrong, or rather opt to decide something in a way that is morally right. Their chosen option rests only on their consciences. In fact, even if they know that some action is wrong, they can choose to take the wrong path and to live with this decision.

But, before deciding whether an act is right or wrong, human beings have to discover what it even means to be right or wrong, to behave in a particular situation they have to determine in advance the ethical aspects of their options. To support this investigation, about what is right and what is wrong, ancient Greek philosophers developed sources of ethical standards to determine how human beings ought to act when faced with specifics situations.

Despite this long development in ethical standards, there have not been significant agreements about the definition of these standards and about which of them ought to be applied in a given situation.

4.1 Ethical Standards

To deal with the main question of this work, two of the most studied and applied sources of ethical standards will be considered: Utilitarian Approach and Deontological Approach. Both of these sources of ethical standards are within the branch of Normative Ethics, and they try to answer the same question – what is the right or the wrong thing to do in a particular situation?

4.1.1 Utilitarian Approach

Consequentialism is the field of Normative Ethics in which the normative properties depend on the consequence of the act. In other words, within Consequentialism the outcome of an action is the core from which the action will be valued. As a corollary, the means employed to achieve this end does not count in this analysis, simply the result.

Consequentialism, also known as teleological ethics, encompasses several theories, like Utilitarianism, Hedonism, Egoism, Asceticism, and others. Among these theories, the more developed and encompassing is Utilitarianism.

The Utilitarian Approach, called Utilitarianism, or Utilitarian Ethics, is a kind of Consequentialism, and considers the result of a specific behavior, the result of which should be measured and evaluated. The Utilitarianism theory was systematically developed by Jeremy Bentham in his 1780 work "Introduction to the Principles of Morals and Legislation." The most important theorist of Utilitarianism that followed Bentham, however, was John Stuart Mill, in his 1863 work "Utilitarianism."

Jeremy Bentham developed his theory of Utilitarianism centered in the criminal system of the United Kingdom in the eighteenth-century. His aim was to create a rational and steady system to deal with criminal punishment, which was based in those bygone days predominantly in retribution.[41] Bentham developed his Utilitarianism based in the sensations of pain and pleasure, his ethical system thus relying on the idea that an action ought to be considered right if the resulting level of pleasure outweighs the pain.

In his work "Introduction to the Principles of Morals and Legislation", he stated that:

> "Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne… The principle of utility is the foundation of the present work: it will be proper therefore at the outset to give an explicit and determinate account of what is meant by it. By the principle of utility is meant that principle which approves or disapproves of every action whatsoever… By utility is meant that

[41] Hooker, J. N. *Three Kinds of Ethics.* Carnegie Mellon University, Pittsburgh, 1996.

> property in any object, whereby it tends to produce benefit, advantage, pleasure, good, or happiness, (all this in the present case comes to the same thing) or (what comes again to the same thing) to prevent the happening of mischief, pain, evil, or unhappiness to the party whose interest is considered: if that party be the community in general, then the happiness of the community: if a particular individual, then the happiness of that individual."

Note that the utility depends on whose interests are considered, but Bentham also pointed out that principles of utility should consider not only the individuals but the community, so any behavior must be evaluated by taking the happiness and the harms of all aspects of community into consideration. Bentham also enumerates circumstances - like intensity, duration, certainty or uncertainty - that should be evaluated to determine the value of pleasure or pain, and therefore the utility of an action.

Bentham Utilitarianism is based in quantitative criteria, which depends on the maximization of pleasure and the minimization of pain. The ethical decision is directly determined by the difference between pleasure and pain, in Bentham[42] words:

> "Pleasures then, and the avoidance of pains, are the ends that the legislator has in view; it behoves him therefore to understand their value. Pleasures and pains are the instruments he has to work with: it behoves him therefore to understand their force, which is again, in other words, their value."

John Stuart Mill, an England philosopher and economist, was a follower of Bentham. He had an education based in Utilitarianism principles, and mastered fields like logic, law, economics and several other humanities. His close relation and admiration for Bentham have not necessarily minimized his disagreement with some aspects of Bentham Utilitarianism, which is what ultimately led him to modify and expand Bentham's work.

Mill's principal work in this area was "Utilitarianism," published in 1863. In this work he had stated that the nature of pleasure is also relevant to measuring its utility, not simply the intensity and the duration. For him, pleasure has a qualitative nature, and for this reason there are different kinds of pleasures[43]:

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[42] Bentham, Jeremy. *An Introduction to the Principles of Morals and Legislation.* Chapter IV, VALUE OF A LOT OF PLEASURE OR PAIN, HOW TO BE MEASURED, IV.1. Retrieved July 31, 2014, from http://www.econlib.org/library/Bentham/bnthPML4.html

[43] Stuart Mill, John. *Utilitarianism.* 1863. Chapter 2. What Utilitarianism Is. Retrieved Aug 1, 2014, from http://www.utilitarianism.com/mill2.htm

> "It is quite compatible with the principle of utility to recognize the fact, that some kinds of pleasure are more desirable and more valuable than others. It would be absurd that while, in estimating all other things, quality is considered as well as quantity, the estimation of pleasures should be supposed to depend on quantity alone."

In this sense, John Stuart Mill classified pleasures by higher pleasures and lower pleasures. Higher pleasures are intellectual and moral pleasures, and lower pleasures are physical pleasures.

Mill, like Bentham, considered the common good of society as more important than that of individuals, and uses the notion of the "Greatest Happiness Principle" to measure the difference between pleasure and pain. With regard to this topic he stated that:

> "According to the Greatest Happiness Principle, as above explained, the ultimate end, with reference to and for the sake of which all other things are desirable (whether we are considering our own good or that of other people), is an existence exempt as far as possible from pain, and as rich as possible in enjoyments, both in point of quantity and quality; the test of quality, and the rule for measuring it against quantity, being the preference felt by those who in their opportunities of experience, to which must be added their habits of self-consciousness and self-observation, are best furnished with the means of comparison. This, being, according to the utilitarian opinion, the end of human action, is necessarily also the standard of morality; which may accordingly be defined, the rules and precepts for human conduct, by the observance of which an existence such as has been described might be, to the greatest extent possible, secured to all mankind; and not to them only, but, so far as the nature of things admits, to the whole sentient creation."

4.1.2 Deontological Approach

Deontology, also known as Deontological Ethics or Duty-Based Ethics, is a category of Normative Ethics in which the ethical analysis of an act depends not on its consequences, like in Consequentialism and Utilitarianism, but on whether this act followed a moral norm or not.

This moral norm ought to be observed before executing an action. The individual ought to act in accordance with the moral norm. The relevant point is the agent's intention, not the consequence of its act. In any decision there is a duty to be observed and this duty is based in a moral norm that does not depend on the result or consequence of the action, but instead on a moral law.

As Bentham and Stuart Mill are central to the Utilitarianism, the German philosopher Immanuel Kant (1724- 1804) is the essential figurehead for Deontology. Kant built his ethical philosophy based on reason, and considered that morality derives from such, for only reason can determine whether some act is good or not, moral or immoral.

Moral rules or moral law ought to be "categorical imperatives," or the fundamental principle from which all duties and obligations have theirs grounds. As stated by Muel Kaptein and Johan Wempe[44]:

> "Kant developed a powerful theory in which moral rules are based in pure reasoning instead of intuition, our conscience, or the consequences of action. His theory can be characterized as a monistic, rule-deontological theory. That is to say, Kant does not subject incidental actions but rather types of actions (such as lying, keeping promises) to moral judgment. All moral rules can be traced back to a general rule: the categorical imperative."

The categorical imperative appeared in Kant's work, "The Groundwork for the Metaphysics of Morals," with different formulations, and, as discussed since the publication of the work, with different meanings. Three of the categorical imperatives include the constructs of Universal Law, the Law of Nature, and Humanity as an End in Itself. Kant's formulations of the Moral Law are:

> "Act only in accordance with that maxim through which you can at the same time will that it become a universal law.
>
> So act as if the maxim of your action were to become through your will a universal law of nature."
>
> Act so that you use humanity, as much in your own person as in the person of every other, always at the same time as end and never merely as means."

These formulations of Kantian moral law are centered in the idea that these general rules can be used to analyze whether an action is moral or not. In Kant's ethics, all actions are judged as a rule of action, known as a maxim. As pointed out by Muel Kaptein and Johan Wempe[45]:

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[44] Kaptein, Muel and Wempe, Johan. *Three General Theories of Ethics and the Integrative Role of Integrity Theory*. Retrieved Aug 7, 2014, from http://ssrn.com/abstract=1940393
[45] Ibidem.

> "A maxim is morally neutral. It is a rule that categorizes an action into a group of actions. The fact that every action is driven by a maxim is the crucial difference between behavior and action. Beings that are not able to act are not able to develop guidelines for their actions and cannot be judged in moral terms. This applies to animals and the mentally disabled. A maxim describes actions and they are formulated on a descriptive level. The aim is to find the right criterion on the basis of which it can be asserted which maxims should or should not be followed. The term "should" suggests the normative nature of this endeavor."

As viewed, the maxim describes the action in a neutral term, and from this description the action is analyzed by the moral rules. If the maxims represent a rational behavior, it denotes a moral action. On the other hand, if the maxims do not represent a rational behavior, consequently the action is not a moral action. Therefore, morality or immorality of an action depends on its rationality, and only what is rational is moral.

4.2 The Application of Ethical Standards to Tax Avoidance

As seen before, tax avoidance is a kind of arrangement through which some organization or individual reduces their tax liabilities by legal means. Note that there has not been any serious questioning about the notion that tax avoidance is a legal scheme: It is tax evasion that is the illegal means to reduce tax.

Nonetheless, determining whether some conduct is legal or not does not imply that the conduct is correct or incorrect, right or wrong. Courts cannot define the moral aspects of an action, it only can decide about the legality of an action, not about the ethics behind the action.

So, in order to establish whether tax avoidance is a kind of conduct considered ethically right or wrong, it is necessary to make use of the ethical approaches. For the purpose of this work, as indicated above, the Utilitarianism and the Deontology approaches will be applied to tax avoidance.

4.2.1 The Utilitarian Approach to Tax Avoidance

As defined by Bentham, the criteria by what some conduct ought to be measured using the Utilitarian approach is the difference between the pleasure and the pain generated by the conduct under analysis, or, in the other words, the maximization of utility of the action.

In analyzing the Utilitarian ethics of tax avoidance, the means used to attempt the tax reduction is not taken in consideration. All taxpayer motivations and concerns are not contemplated; the only thing that will be evaluated is the result that a scheme would produce.

Hence, to determine whether tax avoidance is a kind of conduct ethically right or wrong, it is necessary to evaluate the amount of utility or disutility it brings to the taxpayer, the State, or the society. A preliminary approach is possible to consider the taxpayer as a winner, and the State, representing the society, as a loser.

Following the framework presented, the first duty is to evaluate the gain or loss of utility for taxpayers who undertook a tax avoidance arrangement. For this matter, it is necessary to assume that, for the taxpayer, less tax is always desirable. Thus for the taxpayer there is an inverse relation between its amount of tax liability and its perceived utility.

Taken this assumption, and considering no other consequences, when a taxpayer makes use of a tax avoidance arrangement his utility grows considerably compared with his former situation. Therefore, taking the Utilitarianism criteria, for this taxpayer, the use of tax avoidance is an advantageous action and the right thing to do.

After establishing that the tax avoidance arrangement increases the taxpayer's utility, then it is necessary to investigate whether this scheme also increases the utilities of the State and society. In this case, the State results should be considered as society results, since the tax collected by states is assumed to be appropriate by the entire society, and, as a result, a good for the State is a good for the society.

Tax avoidance arrangements - as defined in this work - reduce taxpayer liabilities and, therefore, reduce State revenue. States are expected to use revenue to pay their current obligations, but also to invest in State equipment to provide better lives to its citizens. However, there not have been any guarantees that the amount of revenue States collect will indeed be used in a desired way for society. In this case, the quality of public administration and state politics are the keys of the utility measure.

So to define if tax avoidance creates more or less utility for the society, it is necessary to evaluate whether this supplementary revenue (that which is paid by the taxpayer in the event he or she does not use the tax avoidance scheme) is expected to have a good use or not. It is not possible to define whether tax avoidance increases the society's utility without defining in advance if the resources obtained will be well spent by the government.

As a matter of conclusion, it is possible to settle on the fact that the reduction in State revenue due to the use of tax avoidance schemes led to a reduction in societal utility. Although it is not possible to determine how governments would use the portion of tax avoided, even a little part of the supplementary money received by the State can be applied in a good way, bringing some marginal benefit to the society. So, according to this reasoning, tax avoidance has a disutility to society, but the extent of its disutility will depend on the specific case analyzed.

The question at this point is to weigh the benefit created by a tax avoidance arrangement to the taxpayer, versus the loss it brings to the society, hence determining whether tax avoidance in ethically right or wrong based in a Utilitarianism view.

As seen above, the taxpayer views tax avoidance as creating utility and ought to be the right thing to do, but for the society the ethical judgment over tax avoidance relies on the expected quality of the State, and the effective return the revenue can bring to society. Consequently, it is not possible to define in a Utilitarianism view whether tax avoidance is ethically right or wrong, since the consequence of this conduct cannot be applied to all cases, but merely in specific cases under analysis.

In short, using the Utilitarianism approach, the ethics of tax avoidance depend on the specific State where tax avoidance is supposed to happen. If the State tends to perform well with the tax revenue, tax avoidance is wrong, because this revenue will bring more utility to the society, even though the taxpayer will lose some utility. On the other hand, if the State manages tax revenue in an undesirable way, the utility created for the taxpayer will overcome the little disutility generated to the society. Using this arrangement will result in the presence of more utility, and therefore an ethical behavior.

4.2.2 The Deontological Approach to Tax Avoidance

Deontological ethics, or Kantian ethics, points out that an individual ought to observe a moral norm before executing any action. Under this viewpoint, the intention of the individual ought to be in accordance with a moral norm, regardless of the expected and the effective consequences of this act.

To apply the Kantian ethics is necessary to transform the situation under analysis in a maxim, and then this maxim should be evaluated as if it is a categorical imperative. As showed before, there are three formulations for the categorical imperative, but to analyze this kind of question, only the first formulation has adequacy to the characteristics of the maxim derived to the taxpayer's behavior.

This first formulation is one in which Kant pointed out that: "Act only in accordance with that maxim through which you can at the same time will that it become a universal law." From this formulation, a given situation has to be transformed into a maxim, and this maxim has to be examined in such a way that the subject of maxim would desire that all actors would apply the conduct described in the maxim as a natural and universal law.

Thus to value the ethics of tax avoidance, a maxim must be defined. This maxim should represent the conduct of a taxpayer while using this arrangement, and has to be a general statement that could be used in any situation, not only in the specific case.

As previously observed, the use of a tax avoidance arrangement is the legal use of the loopholes or the methods not expected by the legislator to reduce taxpayer liabilities. This scheme is broadly considered within the law, nevertheless it is not a desirable scheme for the States due to the reduction in States revenue and for its anticompetitive consequences.

In light of these issues, the maxim related to the use of tax avoidance by taxpayers could be defined as: *taxpayers always make use of tax avoidance arrangements in order to reduce its tax liabilities*.

This maxim generalized the taxpayers' behavior as if it is a natural law to be applied to all possible actors. It is now necessary to test this maxim faced with the first categorical imperative formulation: "Act only in accordance with that maxim through which you can at the same time will that it become a universal law."

Under this first formulation, the tax avoidance maxim should be analyzed as if a taxpayer would desire that all others taxpayers in an economy make use of tax avoidance arrangements as a natural law. So, from the standpoint of the taxpayer it is necessary to evaluate if will be it desirable that all others taxpayers use the tax avoidance arrangement in the same way it is using the scheme.

As a result, in examining this formulation, this maxim is an undesirable situation, because if all taxpayers reduce their tax liabilities by using a tax avoidance scheme, the total revenue received by a State will decline significantly, forcing the State to act harshly against this situation. For instance, this response can go from increasing the existent tax amounts to creating new taxes to support the obligations. Apart from this consequence, if all taxpayers reduce their liabilities, no one will have a competitive advantage, demonstrating that the scheme fails in benefiting any market participant.

Therefore, the widespread use of tax avoidance arrangements will reduce State revenues to an insufficient level, leading to efforts to somehow increase their revenues, the most common way being elevating the amount collected by the existing tax or to create new taxes altogether.

As a result, applying categorical imperatives over the tax avoidance maxim brings the particular taxpayer and others to a situation equal or inferior than before, which denotes that this is not a rational maxim and thus not an ethical action.

5. CONCLUSION

Since the beginning of the twentieth century, societies around the world have been demanding more goods and service from states. Aside from demands in goods and services, demands for health care, transportation facilities, energy supply, among others, can also be observed. Also as an important issue, there has been a large and constant claim for more welfare spending.

Notwithstanding these demands, people in general refuse to pay more taxes to fund this increasing spending by States: They want more from the State but want to avoid paying for the higher presence of States in their lives. But to refuse to pay these taxes is, as a rule, an illegal act. Although people and organizations do not like to pay taxes, they pay in order to be within the law.

As demonstrated in this work, tax avoidance is a kind of arrangement in which someone can reduce his or her tax liability in a legal way. For this reason, this arrangement has become increasingly common, resulting in very impressive amounts of tax avoidance, and resulting in a reduction in States revenues.

In view of these questions, States have been fighting against tax avoidance with real persistence but have not been very effective, mostly because taxpayers tend to have tax specialists ready to take advantage of an inevitable new tax rule that tries to combat tax avoidance. Even when States are truly efficient in setting a tax framework, taxpayers are usually more efficient than States.

The most common methodology used by States to tackle tax avoidance is called GAAR, or General Anti Avoidance Rules. As viewed, almost all capitalist countries have some kind of GAAR to deal with the taxpayers who intend to make use of tax avoidance schemes.

In this regard, the U.S. anti avoidance system is based in judicial decisions that constructed a framework of tests and theories applied to situations in which illegal tax avoidance is supposed to be perpetrated. In Brazilian cases, although there is not a totally operational legal framework, the federal and local tax authorities have been using this law structure to fight against these arrangements.

Hence, from the legal standpoint, there are not any remaining and relevant questions related to the legality of tax avoidance arrangements. It is recognized by the doctrines and judicial systems that tax avoidance arrangements are within the law. Nevertheless, from the ethical viewpoint, there has been different opinion about the ethics of tax avoidance, namely that it is unethical.

Society, in general, tends to consider tax avoidance as an unethical conduct, mainly when confronted with cases related to companies like Apple and Caterpillar, both studied in this work. However, Ethics as a subdivision of Philosophy has methodologies to deal with these kinds of questions. These methodologies are known as Ethical Standards, and among the Ethical Standards there are two that represent the strongest fields in the history of Ethics: the Utilitarianism and the Deontology approaches.

In short, Utilitarianism tries to evaluate the ethics of an action by measuring the result of this action, while Deontology is concerned with the intent of the actor not with the result of its action. So, to analyze the ethics of tax avoidance, these two approaches were applied to this kind of tax arrangement. This work found an inconclusive answer using the Utilitarianism approach, but a conclusive answer when using Deontology.

By employing the Utilitarianism approach, tax avoidance ethics will depend on the expected quality of the government. The arrangement will be considered ethical if the revenue that the State did not collect would not be used in a good and responsible way. On the other hand, if this revenue that the State did not collect was expected to be used wisely by the government, the use of tax avoidance arrangement by taxpayers will be unethical, morally reprehensive.

Using the Deontology approach, after applying the categorical imperative to the maxim related to tax avoidance, the result is that tax avoidance is an unethical action. This is considered unethical because its use is not a rational behavior, since the final result does not bring any advantage for this taxpayer and probably results in cost without any return.

As stated above, the ethical analysis using the framework developed by Utilitarianism and Deontology philosophers offered an answer to the question asked in the beginning of this work, but this answer was not consistent. These ambiguous results, however, do not invalidate the objectives of this research; they in fact emphasize the necessity to consider both approaches together in other to have a deeper perspective of the question at hand.

Despite the differences in the results for countries where the government has a good historical use of the revenue obtained from taxation, both methodologies deny the use of tax avoidance, declaring that this is an unethical behavior. Only in the countries where the government has a bad historical use of the revenue obtained from taxation prompts the Utilitarianism approach to indicate that tax avoidance is an ethical action, but even in this case from a standpoint of Deontology, tax avoidance is still not ethical.

The use of different ethical approaches can, as in this case, result in different ethical viewpoints, but, more importantly, the reasoning for this result can clarify the question under scrutiny.

Another possibility to better deal with these questions is to extend this work by using others kinds of ethical approaches, like Virtue Ethics and Common Good Ethics. These two approaches, by using distinct methodology and theories, can exam the question here from different viewpoints, achieving maybe dissimilar results, but certainly improving the understanding of the topic.

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