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A psychological perspective on tax avoidance: Deferential avoidance vs. defiant avoidance

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Abstract

Is a taxpayer's act of tax avoidance deemed compliant or non-compliant? Academic researchers, investigating tax compliance behaviour, address the term tax avoidance differently for a variety of purposes. In order to gain insight into compliance behaviour, it is important to get a clear understanding of the meaning of tax compliance. In addition, how to classify and perceive the various behavioural responses to taxation is of crucial importance not only for academic researchers and policy makers, but for ordinary taxpayers whose tax behaviour is embedded in social structure and influenced by social representations. In this paper, I discuss relevant issues regarding the conventional conceptualisations of tax avoidance, and present a distinguished concept of tax avoidance which represents two different statuses with insights from psychological approaches to tax behaviour in general and motivational posture in particular. I argue that the term tax avoidance itself should be regarded as neutral. Defiant avoidance refers to potentially unacceptable avoidance, which has the capacity to be challenged by the tax inspector and disallowed by the tax courts. On the contrary, deferential avoidance is in compliance not only with the provision of the law, but also with the spirit and purpose of law and fiscal policy. The bottom line is that the concept of tax non-compliance should necessarily include defiant avoidance, but exclude deferential avoidance as being legally, morally and socially approved.

Keywords: tax compliance, tax avoidance, motivational posture, deferential avoidance, defiant avoidance

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1. INTRODUCTION

In modern societies, taxes are the most important source of financing the public goods, and taxation is usually the most powerful economic tool to encourage socially desired activities and/or reduce inequality of income distribution. However, tax avoidance as well as tax evasion is known to be a universal and pervasive phenomenon in all societies. Tax non-compliance entails not only a reduction in public services owing to the loss of tax revenues, but distortion of income distribution as taxpayers have different opportunities for paying less tax.

Facing different opportunities for evasion and/or avoidance, taxpayers may end up with disrespect for the authority and feelings of unfairness, which, in turn, dampen their willingness to pay taxes. Thus, it is of great interest for the government to implement a fiscal policy that strengthens tax compliance. In order to design an optimal tax policy, it is important to understand the decision process of taxpayers and the underlying motivations that influence their behaviour. In this regard, the way to classify and treat the various behavioural responses to taxation is of crucial importance not only for academic researchers and policy makers, but for ordinary taxpayers whose tax behaviour is embedded in social structure and influenced by social representations (Kirchler, 2007).

For several decades, researchers of various disciplines have paid much attention to the problem of tax compliance. Scientific studies of tax compliance predominantly investigate individual income taxes because they rest primarily on taxpayers' honesty and integrity; individuals can decide whether and to what extent to comply with the law. In order to gain insight into compliance behaviour, it is important to get a clear understanding of the meaning of tax compliance. Although it has long been studied within economics, accounting, law, sociology and psychology, researchers still have difficulty in finding well-defined concepts of tax evasion and tax avoidance which are directly associated to the meaning of tax compliance. To avoid embarrassment, researchers have been quick to classify 'avoidance' as legal tax planning and 'evasion' as illegal tax planning as if one can determine the legality of a tax structure easily (Weisbach, 2004).

The main purpose of this study is to offer a refined conceptualisation of tax avoidance as an important taxpayer behaviour in compliance decision making. To this end, I review relevant literature from various disciplines, gain insight from them, and provide a differential treatment of tax avoidance. In the following sections, I discuss relevant issues regarding the conventional conceptualisation of tax avoidance, and present a distinguished concept of tax avoidance which represents two different statuses with the insight from psychological approach to tax behaviour. I argue that the term tax avoidance itself should be regarded as neutral term. I coin the terms 'defiant avoidance' and 'deferential avoidance' to represent the two different forms of tax avoidance. Defiant avoidance refers to the potentially unacceptable avoidance, which has the capacity to be challenged by tax inspectors and disallowed by tax courts. On the contrary, deferential avoidance is in compliance not only with the provision of the law, but also with the spirit and purpose of law and fiscal policy. The bottom line is that the concept of tax non-compliance should necessarily include defiant avoidance, but exclude deferential tax avoidance as being legally, morally and socially approved.

2. CONVENTIONAL DEFINITION OF COMPLIANCE, EVASION, AND AVOIDANCE IN TAXATION

Roth et al. (1989) claim that tax compliance is accomplished provided the taxpayer files all required tax returns at the proper time, and that the returns accurately report tax liabilities in accordance with the internal revenue code, regulations and court decisions applicable at the time the return is filed. In short, tax compliance consists of the timely filing of any required return, the accurate reporting of income and tax liability, and the timely payment of all tax obligations (Plumley, 1996). In its simplest form, tax compliance is a term which describes the taxpayers' willingness to pay their taxes (Kirchler, 2007).

Non-compliance represents any failure to meet tax obligations whether it is intentional or inadvertent. Although non-compliance consists of three parts: non-filing of tax returns, underreporting of tax, and underpayment of tax, most of studies have focused on the underreporting problem as a deliberate non-disclosure. Taxpayers can fail to comply either because they made a mistake when filling their tax return, or because they wished to reduce their tax liabilities. Unintentional non-compliance could also result from such factors as complexity and ambiguity in tax legislation or tax procedure (Jackson and Milliron, 1986). Even though both cases may end up with non-compliance, intentional non-compliance is of interest to researchers because the underlying motivation to reduce taxes may lead to various behavioural responses. In most studies, intentional non-compliance has been discussed under the concepts of tax evasion and tax avoidance.

Tax evasion (or tax cheating) refers to intentionally paying less tax than the law requires, as a deliberate act of non-compliance (Elffers et al., 1987). Individuals can evade income tax by underreporting income and/or by over-claiming deductions. Tax avoidance, on the other hand, is almost always deemed an intentional and legal response to taxation in which taxpayers undertake tax planning activities so as to reduce tax liability. Stiglitz (1985) distinguishes tax avoidance strategies within income tax such as postponement of taxes, tax arbitrage across individuals facing different tax brackets, and tax arbitrage across income streams that face different tax treatment. Hasseldine (2005) underlines that tax minimisation by which taxpayers comply but structure transactions so as to pay less tax can be distinguished from non-compliance. In terms of this point of view, tax evasion is illegal, while tax avoidance is legal and would therefore be considered as tax compliance.

The distinction between legal tax avoidance and illegal tax evasion may be clear in theory, but in practice, there are many grey areas that are subject to interpretation of rules. A body of rules, however dense it might be, offers loopholes for those individuals seeking to act according to the letter of the law, but not according to its spirit (Alm et al., 2012). Tax avoidance usually includes the reduction in tax burden by means of practices that take full advantage of legal ambiguity, sometimes exploiting loopholes in the tax laws. Sandmo (2005) argues that in engaging in tax avoidance, the taxpayer has no reason to worry about possible detection, although he points out tax law ambiguity which might have the avoidance transaction unacceptable to the tax collectors. That is to say, tax avoidance captures both certain tax positions, as well as uncertain tax positions that may or may not be challenged and determined illegal. As Hanlon and Heitzman (2010) point out, a problem with tax shelters is that

it is almost always ambiguous whether the transaction is permissible or not. In many cases of tax avoidance, one cannot easily determine the legality of a tax structure. The definition of tax avoidance provided by OECD² reflects the tricky business:

[Tax] avoidance is a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.

3. ECONOMIC APPROACH TO TAX AVOIDANCE

From an economist's point of view, avoidance is considered as the reduction in tax burden by means of practices that take full advantage of the tax code such as income splitting, postponement of taxes and tax arbitrage (Alm, 1999). Economic rationality, that puts a great emphasis on efficiency, encourages tax avoidance without additional risk because it increases the taxpayers' utility for those who try to maximise their own profit. In fact, tax minimisation schemes that entail no more risk are often perceived as a clever strategy. In consequence, micro-economic analysis of tax law enforcement usually addresses the non-compliance problem with tax evasion decisions as a straightforward application of the economics of crime (Becker, 1968). The basic assumption of traditional deference models is that the taxpayers potentially wishes to hide their actions from the tax collector, whereby the tax evasion decision is analogous to portfolio allocation; they can either choose a safe portfolio (truthfully declaring their gross income and paying the full tax liability), or a risky portfolio (evading taxes by underreporting their gross income) (Sandmo, 2005).

When tax avoidance is addressed in a context of non-compliance, it usually refers to strategies to exploit legal ambiguities which lead the taxpayer to an uncertain tax position about legality. For example, the primary aggregate non-compliance measure, 'tax gaps' — generally defined as the difference between actual tax collected and the potential tax collection under full compliance with the tax code — includes (legal) avoidance and/or (illegal) evasion (Gemmell and Hasseldine, 2014). This form of tax avoidance as non-compliance is sometimes called 'aggressive tax planning (ATP)'. Although a precise and widely accepted definition of ATP is probably not available (Alm, 2014), it is often seen as a tax avoidance transaction that complies with the letter but not the spirit of the law and the intention of fiscal policy (OECD, 2011).

Seldon (1979) points out that there is virtually no distinction between aggressive tax avoidance and evasion because their causes and their consequences are basically the same. Likewise Kirchler et al. (2003) underline that they have similar desire to reduce the tax burden, and similar effects to reduction of revenue yields. Plus, both activities are contrary to the intention of the government and have the effect of bringing about an unintended and undesired redistribution of income (van de Braak, 1983). Similarly, Alm (2014) argues that economic justification of an ATP scheme is generally limited, and even non-existent.

However, the problem of 'aggressiveness' consists in its subjective interpretation of uncertainty in terms of a tax position. Hanlon and Heitzman (2010, p.137) underline

² <http://www.oecd.org/ctp/glossaryoftaxterms.htm>

that the degree of aggressiveness depends on individual perceptions and attitudes toward risk; different people often have different opinions about the aggressiveness of a transaction as the beauty is in the eye of the beholder. Thus, aggressiveness seems not to be a satisfactory conceptualisation of the non-compliant aspect of tax avoidance.

4. MORAL ASPECT OF TAX AVOIDANCE

Tax evasion and tax avoidance have previously been treated as though they were mutually exclusive. Cross and Shaw (1981) point out that this dichotomy is to be explained by the desire to keep separate criminal from non-criminal activity. However, Sandmo (2005) suggests that the borderline between what seems morally right and wrong does not always coincide with the border between what is legal and illegal. He illustrates the compliance dilemma: the poor house painter who does a bit of extra work via the black economy violates the law, while the wealthy investor who engages a tax lawyer to look for tax havens does not (Sandmo, 2005, p. 646).

While tax evasion is more closely related to horizontal equity and depends on the taxpayer's degree of risk aversion or honesty, tax avoidance causes the problem of vertical inequity because the rich people have more opportunities of avoidance. Song and Yarbrough (1978) report that taxpayers are known to complain that the government provides unequal opportunities to different income groups in terms of reducing the tax burden. Here we can see that it seems to ordinary taxpayers that tax avoidance is predominantly the prerogative of rich. Put differently, tax avoidance means a transfer of collective costs from sophisticated to unsophisticated taxpayers, and tax evasion a transfer from dishonest to honest tax-payers (van de Braak, 1983).

This situation raises a moral concern, and the avoidance is often referred to as 'abusive' or 'morally repugnant'. Brock and Russell (2015) argue that the subset of tax avoidance practices that are problematic from a normative perspective is captured by 'abusive tax avoidance'. In reality, however, it can be very difficult to determine whether a complex strategy is in fact abusive. Tax compliance is more than the technical meeting of the letter of the law for the purpose of game playing with that law. It is a willingness to act 'within the spirit as well as the letter of tax law and administration, without the application of enforcement activity' (James and Alley, 1999).

5. LEGAL ASPECT OF TAX AVOIDANCE

In law, evasion is characterised by deception and concealment: avoidance by honest disclosure (McBarnet, 1991). Tax evasion involves failing to disclose income to the tax authorities. In this case, the question is whether the omission was as a result of criminal intent or honest error. The legal consequence of the two types of evasion is of huge difference: the formal, which is considered financial fraud, may culminate in criminal penalty such as physical imprisonment, while the latter usually entails a fine. In reality, however, taxpayers who are accused of underreporting are rarely subject to the severe punishment because it is very difficult to prove criminal intent. Thus, most people do not feel that violations constitute so serious a crime; Song and Yarbrough

(1978) reported that the typical taxpayer considers tax evasion only slightly more serious than stealing a bicycle.

McBarnet (2003) views game playing as a particular kind of attitude towards the law, in which one regards the law as something to be utilised to meet one's purposes rather than as something to be respected as defining the limits of acceptable activity. Similarly, Salter (2010) addresses the game playing with of society's rules which involves the use of technically legal means to subvert the intent of society'. He argues that a rule-following game (or compliance game) involves the actual exploitation of these gaming opportunities. This involves following the letter of the law but not necessarily its intent or spirit, as well as violating grey areas of the law in ways that are not easily understood or recognised as violations. In this regard, tax avoidance can be characterised as a rule-following game in tax compliance decisions. McBarnet (2003) also argues that one of the functions of creative compliance is 'fraud insurance': a tax planning device may fail in court without being branded a tax fraud. He refers to the creative compliance (tax avoidance) 'whiter than white collar crime' in that it differs from tax evasion in form rather than substance, purpose or effect (McBarnet, 1991).

Nevertheless, legality does not offer a practical guideline between compliance and non-compliance. The legality of tax avoidance has a contingent nature insofar as a tax minimisation scheme exploiting loopholes might be either successful or not. No one can certainly expect that an avoidance scheme shall be proved legal or illegal *ex-ante*; it merely has the potential to be illegal or legal since the determinations typically are made *ex-post* through the challenge of the tax inspector and court decision. Furthermore, for most of the cases which are not subject to the legal action, the legality is undeterminable. Similarly, the terms 'aggressiveness' or 'abusiveness' in terms of legality are subject to hindsight bias, which is only determined by an *ex-post* enforcement process. The contingent nature of tax avoidance is the key attribute that makes the legal distinction line blurry.

6. MARKET FOR TAX AVOIDANCE: THE ROLE OF TAX PRACTITIONERS

Acknowledging the limit of a purely rule-based approach, some countries have adopted a general anti-avoidance rule (GAAR) which requires the transaction to be arranged for any *bona fide* purpose other than to avoid tax. Likewise the tax benefit obtained must be consistent with the object, spirit or purpose of the provisions relied upon. Brock and Russell (2015) argue that a tax avoidance arrangement is abusive when it reduces explicit taxes in a manner not intended by lawmakers. But how can we know the intent of lawmakers or the spirit of the laws? It is also subject to various interpretations, and even professionals, who have a legitimate and efficient function as intermediaries between taxpayers and the tax authority (Hasseldine et al., 2011), may well disagree about the spirit or purpose of a particular provision. Even the tax scheme sold by tax professionals may be interpreted *ex-post* as a vehicle for tax avoidance in regard to exploiting the spirit of the tax law (Murphy, 2004). The practitioner's stance, therefore, cannot be regarded as correct or incorrect until it is proven so by the judiciary.

Tax practitioners may assist their clients in devising strategies to exploit legal ambiguities (Erard, 1993). Salter (2010) reports that many business people and their

lawyers and accountants view testing the outer limits of the law as a natural and acceptable feature. As entrepreneurial businesses, accountancy firms have developed organisational structures and strategies to sell tax avoidance schemes to corporations and wealthy individuals, which they refer to as tax solutions or tax strategies (Sikka and Hampton, 2005). As Braithwaite (2003a) points out, the industry of tax avoidance primarily rests on the talents of financial advisors. Furthermore, the tax preparer has a direct interest in whether a position is determined *ex-post* in an IRS audit to be overly aggressive. An overly aggressive position may result in a loss of client goodwill or a preparer penalty in such a jurisdiction as the US (Kaplan et al., 1988). Brock and Russell (2015) further illustrate the role of professionals in designing, promoting and implementing abusive tax avoidance strategies as the prerogative of wealthy individuals and large corporations.

7. MOTIVATIONAL POSTURES OF TAX AVOIDANCE: DEFERENTIAL AVOIDANCE AND DEFIANT AVOIDANCE

In some cases, avoidance is encouraged by legislation granting favourable tax treatment to specific activities and no additional risk exposure to be challenged as illegal. For example, investing in municipal bonds or paying into superannuation schemes to minimise tax is explicitly encouraged, whereas off-shore tax havens are explicitly discouraged and put the taxpayer in an uncertain tax position. Thus, a tax planning activity or a tax strategy as an act of tax avoidance could be anywhere along the continuum of tax compliance depending upon *ex ante* intentions as well as *ex-post* enforcement. Seldon (1979) coined the term ‘avoision’ to capture the problem associated with differentiating legal and illegal tax schemes. Braithwaite (2003b) argues that it is possible to divide the strategies of tax avoidance in terms of the degree to which they push the limits of legality. James and Alley (2004) argue that the meaning of compliance can be seen as a continuum of definitions: the meaning of tax compliance can be defined from narrower economic rationality to wider behavioural cooperation. Van De Braak (1983) argues that tax resistance, conceived of as an amalgam of negative reactions towards public revenues, does not only include (legal and illegal) efforts to minimise tax payments but also attitudes towards taxation. McBarnet (2003) calls this creative compliance, whereby taxpayers adhere to the strict letter of the law but find loopholes and caveats to minimise their tax without regard for the spirit of the law. All these attempts to understand the clear meaning of tax compliance shed light on the conceptualisation of tax compliance behaviour reflecting the taxpayers’ attitudes towards the legitimacy of avoiding taxes.

People exhibit great diversity in their motivations and in their tax compliance behaviour. Braithwaite (2003b, p. 18) refers to ‘the interconnected sets of beliefs and attitudes that are consciously held and openly shared with others’ as motivational postures. She suggests five motivational postures: commitment, capitulation, resistance, disengagement and game-playing. In particular, game playing involves ‘playing games’ with the tax office and taking advantage of particular laws and loopholes. She reports that the postures most strongly related to the aggressive minimization of tax were game playing and resistance. In short, while commitment and capitulation reflect ‘deference’, the others represent ‘defiance’ towards tax authorities. Kirchler and Wahl (2012) also provide empirical evidence of the positive association between tax avoidance exploiting legal loopholes and defiant motivational

postures such as resistance and game playing. Now, with the two broad motivational postures — deference and defiance — we are capable of dividing the mixed concept of avoidance into two different contents of avoidance: deferential avoidance and defiant avoidance. Evasion is the option for those who hate to pay taxes and have located themselves outside the reach of the law (McBarnet, 2003). While deferential avoiders stand firm within the boundaries of the law, defiant avoiders who engage in potentially abusive tax schemes (Brock and Russell, 2015) try to push the boundaries of the law's intent by self-serving in terms of law interpretation without obviously crossing those boundaries.

8. CONCLUSION

Owing to the poor knowledge and misunderstanding of tax evasion and tax avoidance, some people have the misconception that when they reduce the tax bill, they are breaching the tax laws and may get entangled in legal action. People can rationalise their underreporting (cheating) by the fact that tax evasion is widespread and any kind of tax avoidance is potentially illegal. The concept of tax avoidance is thus confusing not only to ordinary taxpayers but to scholars and policy makers. The complex meaning of tax avoidance is due partly to academics inasmuch as they use it differently for a variety of purposes. Traditionally, efforts within tax law to minimise tax payments are usually described as tax avoidance, whereas efforts outside the law are described as tax evasion. I believe that this confusion is mainly caused by the misleading conceptualisation of tax avoidance as well as tax compliance.

Tax avoidance can be defined in a broadest way to include tax evasion (Mo, 2003). In this way, tax evasion can be perceived as avoiding taxes with obviously illegal means. Considering the technical meaning of avoidance as a deliberate act to pay less tax, it can also include tax saving with obviously unobjectionable consumption or investment decisions. Scholars have considered tax evasion and tax avoidance from many perspectives, such as the legal, ethical and economic. They may as well be considered from a psychological perspective because it will provide a better understanding of taxpayer compliance behaviour in terms of academic research, legislation and administration.

Individuals take a variety of actions to reduce their tax liabilities. Weisbach (2004, p. 2) argues that we cannot assume pre-existing definitions of tax avoidance and evasion: working less, elaborate financial structuring and plain old cheating are all merely responses to taxation. In a similar vein, I would say those are all merely behavioural responses to taxation motivated by tax avoidance, thereby they can all fall into the category of avoidance. The difference depends on their attitude towards taxes, risk preference, tax knowledge and opportunity. Now, back to the question? Is tax avoidance a compliant or non-compliant behaviour? In my opinion, neither is correct answer.

The term 'tax avoidance' can be used in a broadest way, including within the definition any activity, arrangement or transaction that reduces the total amount of explicit taxes. In that regard, tax evasion is also best conceptualised as avoidance with an intention to violate tax law. A taxpayer who aspires to avoid taxes can have various tax strategies depending on their attitude towards taxes, knowledge and willingness to hire tax professionals etc. These strategies vary from complying with

the letter to gaming with the law, and also to cheating the government. The thesis is that avoidance in itself should not imply any negative connotation.

As noted above, some researchers have tried to differentiate two different aspects of tax avoidance such as aggressive tax planning or abusive tax planning. However, the aggressiveness and abusiveness rest primarily on subjective interpretations of attitudes towards risk and morality, respectively. Essentially, they fail to capture the different behavioural intentions of a taxpayer in terms of compliance with the provision and spirit of the law. Defiant avoidance refers to the potentially unacceptable avoidance, which has the capacity to be challenged by the tax inspector and disallowed by the tax court. On the contrary, deferential avoidance is in compliance not only with the provision of the law, but also with the spirit and purpose of the law and fiscal policy. In this respect, tax evasion can be conceptualised as illegal avoidance, whereby the term avoidance itself should be treated as being neutral. Therefore, the concept of tax non-compliance should include defiant avoidance and illegal avoidance (tax evasion), but exclude deferential avoidance.

Although traditional economic models of tax evasion tend to frame the evasion decision as rational taxpayers' gambling with tax authorities (Baldry, 1986), it seems more like a 'cheating' rather than a fair gambling. The real gambling situation is prominent in case of defiant tax avoidance because both the taxpayer and the tax authority are confronted with uncertainty about the *ex-post* legality of transaction which ultimately depends on a court decision. The meaning of tax compliance must include both compliance with the letter of the law and a respectful attitude towards the spirit of the law and fiscal policy (James, 2012). The proposed conceptualisation based on two different motivational postures will help to understand the meaning of tax avoidance and tax compliance not only for academic researchers and policy makers, but for ordinary taxpayers as well.

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Appendix: a conceptual differentiation of tax avoidance

<i>Three categories of tax avoidance</i>	Deferential tax avoidance	Defiant tax avoidance	Illegal tax avoidance (Tax evasion)
Comply with the form of tax laws	Yes	Yes	No
Comply with the spirit and purpose of tax laws	Yes	No	No
Similar concepts	Tax saving; tax minimization; tax planning	Abusive tax avoidance; aggressive tax planning; creative compliance	Tax fraud; tax cheating
Legality	Legal	Contingent on audit and court decision	Illegal
Motivation to reduce tax liability	Yes	Yes	Yes
Knowledge	Common knowledge	Private knowledge especially from tax professionals	Deception
Strategies	Real substitution of labour, consumption and investment usually recommended by the tax laws	Tax sheltering, restructuring	Concealment of income, over-claiming of deduction
Motivational postures	Commitment, capitulation	Game playing, resistance	Resistance
Compliance	Tax compliance	Tax non-compliance	Tax non-compliance