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Ethics of Tax Interpretation

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Abstract
This article joins a somewhat nascent, but growing, body of scholarship addressing the ethical obligation to pay tax. The analysis is grounded to the ethical duty to obey law generally and highlights two competing orientations to statutory interpretation. The norms of self-interested advocacy suggest that tax planners should assert that interpretation that will generate the most wealth for the client. The norms of professional advising, by contrast, direct the tax planner to interpret tax law with reference to plain meaning, interpretive maxims, court precedents, and legislative purpose. When the two orientations differ, the ethical duty to obey law requires the tax planner to recommend, and for the taxpayer to follow, the latter view. Case studies drawn from a Louisiana sales tax avoidance scheme and from Google's profit-shifting activities illustrate the ethical issues incumbent in tax interpretation.

Keywords Tax avoidance · Tax advising · Legal interpretation

Introduction

Too often, a literal interpretation of a tax regulation is used to circumvent the policy goals and normative compromises that inform the regulation itself. This article compares and contrasts a literal, plain-meaning interpretation of regulatory language with an interpretation that employs the full panoply of interpretative steps, including deference to legislative policy compromises, respect for judicial precedents, and most importantly, an application of traditionally embraced maxims of statutory construction. The article contends that the ethics of tax interpretation require due deference to the latter approach.

The article begins by considering and accepting the proposition that there is an ethical obligation to obey reasonably just laws promulgated in reasonably just societies, including most local, state, and federal tax laws. The article then explores the implications of this ethical duty. It defends the idea that in tax planning and in professional tax advising, the duty of legal obedience requires a fair-minded application of the full array of interpretive tools. The ethical dimensions of tax interpretation are illustrated with an example drawn from a dispute over a state sales tax law, and then extended to the global arena where profit-shifting to international tax havens has generated widespread attention.

Tax scholars draw a distinction between tax compliance, tax evasion, and tax avoidance (Prebble and Prebble 2010). To comply means to abide by both the letter and the spirit of the law. Evasion violates both letter and spirit, and avoidance follows a literal interpretation of the law while purposefully circumventing its spirit. Whereas tax evasion is criminal, tax avoidance is not, and judicial remedies for the latter are limited to civil penalties, nullification of the tax position, and payment of back taxes with interest (Kahan 1997).

The scholarly literature identifies a so-called "tax gap," defined as the difference between taxes owed and taxes collected. Estimates place the U.S. tax gap at about $450 billion per year, or one-fifth of all taxes due (U.S. Government Accountability Office 2017). About two-thirds of this gap derives from tax evasion, one-sixth from taxpayer insolvency, and one-sixth ($75 billion annually) from tax avoidance, that if challenged, would be invalidated in court (Ostas and Hilling 2016, pp. 748–749). To the extent that abusive tax shelters and other avoidance schemes are perceived as manipulations of one's legal obligations, general cynicism rises and voluntary compliance erodes (Kovach 2008, p. 275).

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Not surprisingly, one finds a sizeable literature on tax avoidance. Much of this literature focuses on how a court should treat a literal interpretation of a tax regulation when that interpretation violates the legislative purposes manifest in the law itself. These jurisprudential studies typically emphasize anti-avoidance rules such as the economic-substance doctrine and the sham-transaction test which empower courts to disallow literal interpretations that violate legislative intent (e.g., Symposium 2001; Likhovski 2004). Other parts of the avoidance literature discuss legislative attempts to close tax loopholes and the responses one gets from taxpayers who are intent on circumventing those reforms (e.g., Kovach 2008; DiLeo 2002). Many of these articles describe a sort of dance between regulators and regulated as one follows the lead of the other, and the legislation gets more and more convoluted and complex (e.g., Partlow 2013).

Scholarly literature has recently appeared addressing the relationship between tax avoidance and corporate social responsibility (e.g., Bird and Davis-Nozemack 2018; Avi-Yonah 2014). Here, the focus is not on the courts, nor the legislature, but on taxpayers themselves. There is also a literature on the ethical obligation to pay tax generally (e.g., Alm and Torgler 2011; Prebble and Prebble 2010). Reuven Avi-Yonah discusses the ethical pressure placed on a tax advisor who is asked to offer a "more-likely-than-not" letter on a tax avoidance scheme proposed by a large client. If the advisor refuses, the client is likely to go elsewhere. In such situations, Avi-Yonah recommends that the advisor should "just say no" (Avi-Yonah 2017, p. 10).

This article contributes to the literature on the ethical duty to pay tax and to a more nascent literature on the ethical obligation to comply with regulatory law generally. Its novelty lies in the structure of the argument advanced and in the combination of ideas not typically linked. The article (1) grounds the analysis to the issue of political obligation, (2) distinguishes between the professional norms of advocacy and advising, (3) links professional advisory norms to the full panoply of statutory interpretation principles, and (4) then applies this framework to issues of tax avoidance.

Given the thorny nature of the issue of political obligation, it is not possible to prove in this article that one has an ethical obligation to obey law simply because it is law. Indeed, political philosophers have been debating this question for centuries, and no consensus has emerged. The article's contribution lies in illustrating what an embrace of an ethical duty to obey law would imply in the world of tax. Like Avi-Yonah, this article argues that the ethics of tax interpretation requires economic self-restraint in tax planning. The article contends that this duty applies to both taxpayers and to professional tax advisors. The article also calls for economic self-restraint when disingenuous literal interpretations of tax laws seem to pay.

Ethical Duty to Pay Tax

Philosophical discussions of the ethics of legal obedience trace to Plato's recounting of Socrates's trial and death (1956 [400 BCE]). Condemned to die, Socrates has an opportunity to escape but chooses instead to drink the fatal hemlock. In response to Crito's questioning, Socrates offers four ethical reasons to obey law. First, Socrates contends that his long residence in Athens shows that he has *consented* to obey Athenian law. Second, he reasons that he owes a debt of *gratitude* to a society from which he has benefitted. Third, he maintains that it would be *unfair* to mistreat his fellow Athenians because Socrates himself has enjoyed the legal obedience of others. Finally, anticipating *rule utilitarianism*, Socrates reasons that if everyone where to disobey the law, then society would surely fail.

Modern philosophers continue to debate whether there is an ethical obligation to obey law, and if so, then on what grounds. Proponents of each of Socrates's four ideas have appeared over the centuries. Socrates's notion of consent found expression in the contract theory of political obligation developed in Hobbes's *Leviathan* (1991 [1651]) and Locke's *Second Treatise of Government* 1980 [1690]. Echoing Socrates's appeal to gratitude, H. L. A. Hart linked the duty to obey law to a reciprocity norm where the benefits received from society generate a duty to share in society's costs (Hart 1955, p. 185). John Rawls found a deontological first-order duty to support reasonably just social institutions, including the administration of law (Rawls 1971. pp. 355–356). A modern rule-utilitarian could contend that the widespread refusal to obey law could erode society's ability to function (e.g., Collins 2014).

Of course, not everyone is convinced that there is an ethical duty to obey law. A political anarchist, for example, would contend that the state cannot be ethically justified; hence, there is no duty to obey (Stanford Encyclopedia of Philosophy 2017). A philosophical anarchist, by contrast, may take the position that even if the state is legitimate, this does not imply an ethical duty to obey its laws (Sartorius 1981). In addition, even if there is a *prima facie* duty to obey *some* laws, that duty it is not absolute. Even among philosophers who find a robust ethical duty to obey, there is room for permissible civil disobedience (Rawls 1999 [1969]). Sophocles examined civil disobedience in the play *Antigone*, where his protagonist justifiably defies Creon's decree she deems unjust (1986 [442 BCE]). Similarly, Harriet Tubman defied slavery laws; Mahatma Gandhi incited a boycott of the British salt tax; and Martin Luther King, Jr. led sit-ins. In each case, history portrays the actor as the hero, not the villain. If the state is unjust, then there is no political obligation to obey its laws, and

individuals must use ethical judgement when deciding which laws to obey even within reasonably just societies.

The question at hand is whether there is an ethical duty to comply with a tax regulation promulgated in a reasonably just society, and if so, then what is the proper way to interpret any ambiguity, vagueness, conflicts, or gaps incumbent in that regulation? The answer may depend on the moral pedigree of the tax law in issue. Laws that address sensible matters in sensible ways would seem to deserve more respect than ones that seem unjust or inane. In addition, laws enacted in accord with due process may carry more moral weight than ones enacted behind closed doors and in response to special interests. The remainder of Part I proceeds in three sections: the first examines the moral pedigree of tax law generally; the second addresses the steps of statutory interpretation; the third considers anti-avoidance rules.

Moral Pedigree of Tax Law

Some laws deserve more respect than others. Consider, for example, the ethical duty to obey workplace safety regulations. If the employer knows that precautions not required by the regulations would significantly protect workers at a reasonable cost, then these additional precautions should be, and hopefully are, taken on ethical grounds, even if the regulations do not require them. Laws that directly implicate human health, safety, and dignity address *malum in se*, that is, they address matters that are wrongful even if the law does not prohibit them (Pepper 1995, pp. 1576–1580). Knowingly subjecting a worker to a preventable health and safety risk is wrongful even if the law permits it. With matters that are *malum in se*, if the legal rule proves inadequate to meet one's ethical obligation, then one should inform the government of the inadequate nature of the regulation while living to the higher standard (Raz 1984, pp. 160–161).

Other laws, by contrast, constitute *malum prohibitum*, that is, the wrongfulness of the act can only be determined with reference to the law itself (Pepper 1995, pp. 1576–1580). Tax law provides the classic example (Kahan 1997). There is nothing inherently right or wrong with either deducting an expense or amortizing it over time. Whether the expense should be deducted or amortized can only be determined with reference to the law itself. With matters that are *malum prohibitum*, there is no ethical reason to hold oneself to a higher standard than the one specified by law (Molero and Pujol 2012). Hence, the ethical duty to pay tax, if it exists, derives solely from the general *prima facie* ethical obligation to obey reasonably just laws enacted by reasonably just societies.

The tax literature identifies three justifications for taxation: (1) to finance public expenditures, (2) to redirect social and economic behavior, and (3) to redistribute wealth (Avi-Yonah 2006). The first justification is particularly important to state governments as they cannot maintain deficit spending in the same manner as the federal government (Murphy 2015, pp. 52–57). Excise taxes redirect behavior. For example, a tax on a particular product will redirect consumer demand; a tax on a production technology will shift supply. Regarding redistribution, some taxes, like the federal income tax, are generally progressive, others, like state sales taxes, are regressive. For each type of tax, the legislature offers a policy justification. These justifications typically involve pragmatic compromises and the balancing of competing social norms.

Reflecting on one's ethical obligations regarding this hierarchy of laws, one finds that when the law in question directly addresses issues of human health, safety, or dignity (*malum in se*), then the law points to an important topic, but it does not set the ethical measure. One must go beyond the law when the law is inadequate to meet its moral aim. Similarly, when the law is unjust, as with Creon's decree or the British tax on Indian salt, then once again, the law carries no moral weight. One must be guided by conscience. What then of tax? As a matter of *malum prohibitum*, it seems that one would first ask whether the government was legitimate and whether the particular tax was enacted pursuant to due process. One would then ask whether the specific tax was reasonably effective in reaching legitimate policy goals. If each of these questions is answered in the affirmative, then one is left with the question as to whether there is an ethical duty to obey a reasonably just law promulgated in a reasonably just society, simply because it is law. Yet, as discussed above, one finds no consensus on that issue in the philosophical literature (Edmundson 1999).

It seems that one can do no better than to return to Socrates and ask whether the four arguments he advanced are sufficiently persuasive to support a *prima facie* ethical obligation to comply with tax law. The answer for this writer is yes. Perhaps none of Socrates's arguments: (1) consent, (2) reciprocity, (3) fairness, or (4) utility, standing alone, is sufficient. None are free from philosophical attack. Yet, for this writer, each of these arguments offers an intuitive appeal. Hart's reciprocity notion that if one benefits from society then one should share in its costs makes sense. Rawls's assertion of a fundamental duty to support reasonably just social institutions, including the administration of law rings true. And if one is benefiting from the tax compliance of one's fellow citizens, then it appears unfair to cheat. Finally, it would seem that society needs taxpayer compliance to be able to meet its policy objectives.

In sum, the four Socratic arguments, taken in some combination, seem to this author sufficient to generate a *prima facie* ethical obligation to comply with most tax laws. Although this assertion has not been proven, if indeed it can be proven, the remainder of this article *assumes* that there is an ethical duty to obey reasonably just laws promulgated

in reasonably just societies. The article's contribution lies in clarifying the specific ethical duties of tax interpretation that a general ethical duty to obey law implies. The discussion now examines what it means to "comply" with tax law.

Principles of Statutory Interpretation

Tax law, like all areas of law, has to be interpreted. Disputes over tax interpretation typically involve a tension between the letter and the spirit of the law (Symposium 2001). The letter, of course, refers to a literal interpretation of the statute or regulation. But words can have more than one meaning, and ambiguity makes law difficult to interpret (Dickerson 1975, pp. 42–49). Words can be vague, requiring the drawing of lines between taxable and non-taxable activities without clear guidance (Dickerson 1975, pp. 49–51). Tax laws also can have gaps, conflicts, and inconsistencies. This is particularly true when more than one taxing authority claims jurisdiction, as one often finds in interstate transactions and in the global arena (Murphy 2014). Rules written by different sovereigns may be ill-fitting indeed.

Whenever the plain meaning of a tax law seems inadequate to resolve interpretative issues, then recourse to the spirit of the law becomes appropriate. Yet, the spirit of tax law is similarly complex. The spirit refers both to the legislative policy goals that inform tax law and to the balance of competing social norms expressed in the tax code. The policy goals typically reflect a compromise between competing aims, and the social norms are multiple (Katz 1996, pp. 13–14). For example, the tax code strikes a policy compromise between the need for government revenues to fund public services and a societal deference to the prerogatives of private property and entrepreneurship. The code also balances a social norm which sees tax as a public benefit with one that sees tax as a private burden (Hilling and Ostas 2017). In short, alternative interpretations of the tax code can often be credibly advanced.

Tax courts tend to follow the traditional techniques of statutory interpretation (Black 1911). Statutory interpretation begins with due deference to the plain meaning of the language expressed in the legal rule (Scalia 1997). If that language is clear on its face, then that ends the inquiry, and the fact pattern is simply examined under the literal language of the rule and a judgement is rendered. In most tax cases, plain meaning analysis suffices, and no further inquiry into meaning is appropriate. In some settings, however, the language of the law seems ambiguous, vague, gap-riddled, or conflicted (Dickerson 1975). In those situations, interpretation requires inquiry into maxims of construction, legislative purpose, and relevant judicial precedents (Kim 2008).

Turning to a time-honored treatise, one finds the plain meaning doctrine (*ita lex scripta est*) firmly entrenched as the "Cardinal Rule" of statutory interpretation (Black 1911, p. 46). Yet, that same treatise specifies that literal interpretations must give way in the face of absurd results (Black 1911, p. 51). Black writes:

> When the interpretation of a statute according to the exact and literal import of its words would lead to absurd or mischievous consequences, or would thwart or contravene the manifest purpose of the legislature in its enactment, it should be construed according to its spirit and reason, disregarding or modifying, so far as may be necessary, the strict letter of the law (Black 1911, p. 66).

Similarly, reference to legislative purpose is needed where the language of the statute is "ambiguous, or admits of more than one meaning" (Black 1911, p. 76). There is also an interpretive maxim against ineffectiveness, calling upon an interpretation of law that effectuates legislative purpose rather than frustrates it (Black 1911, p. 84).

Linguistic imperfections are not limited to ambiguities where a word can be read one way or the other, but include vagueness as well (Dickerson 1975, pp. 49–51). Statutory references to "reasonableness" or "fairness" require an interpretative boundary line not provided for in the statute. Sometimes the vagueness is unintentional, for example, legislators may not realize that a statute that references a "heap of sand" may not specify the point at which a growing collection of sand particles becomes a heap. At other times, the vagueness is intended. For example, recent codification of the economic substance doctrine into the tax code suggests that literal interpretations of the law will not be honored if the transaction lacks an economic purpose other than to reduce taxes (I.R.C. § 7701(o)(5)(A)). The economic substance legislation purposely uses vague language so as to limit perversions of the law through hyper-literal interpretations (Miller 1956).

The traditional techniques of statutory interpretation also recognize value in deferring to prior interpretations rendered by the courts. Black notes, "Judicial decisions previously made upon the interpretation of particular terms and phrases used in a statute … are generally of controlling force in establishing a correct construction" (Black 1911, p. 298). Of course, courts themselves are honor-bound to interpret statutes in accord with traditional techniques. Yet, once the precedent is established, it provides another source of stability with reference to black letter law.

General Anti-avoidance Rules

The U.S. Supreme Court has developed a set of general anti-avoidance rules (GAARs) that disallow hyper-literal, self-serving interpretations of tax regulations. These include the "substance-over-form," "sham transaction," "step transaction," "economic substance," and "business purpose" rules

(Libin 2010). The doctrine of substance-over-form traces to *U.S. v Phelps*, where the U.S. Supreme Court directed lower courts to ignore the form of a tax transaction if that form has no substantive content (257 U.S. 156 (1921)). The sham transaction rule arose in *Higgins v. Smith* where the Supreme Court held that when a tax event is unreal or a sham, then that lower courts should "disregard the effect of the fiction as best serves the purposes of the tax statute" (308 U.S. 473, 477 (1940)).

A third GAAR, the business purpose rule, traces to the Supreme Court case of *Gregory v. Helvering* (293 U.S. 465 (1935)). Gregory sought to acquire a set of shares from her investment company without declaring a dividend. She first directed her company to sell the shares to a newly formed company, which then transferred the shares to her, and then the newly formed company dissolved. The three steps, taken collectively, satisfied the literal requirements for a tax-free reorganization, so no dividend was declared. Gregory later sold the shares claiming a favorable capital-gains rate. The U.S. Supreme Court held that Congress had intended that reorganizations done for a business purpose should not be a taxable event, but the taxpayer in *Gregory* had no purpose other than to reduce her taxes (*Gregory*, p. 470). The favorable treatment was disallowed.

Although typically cited for the business purpose rule, *Gregory* also provided the foundation for the economic substance rule (Bankman 2000). According to this rule, for a tax event to receive favorable treatment, it must be taken for a business purpose and have an *economic effect* other than to reduce taxes. Illustrating the interrelated nature of the five GAARs, the *Gregory* case could have been decided under the doctrine of substance-over-form, as a sham transaction, as a step-transaction, under the business purpose rule, or pursuant to the economic substance rule. Taken collectively, these five GAARs illustrate that living to a literal interpretation of a tax regulation does not necessarily equate to obeying the law. A proper interpretation of a tax law needs to incorporate the principle underlying the five interrelated GAARs. That principle states that if one assumes an ethical obligation to obey tax law, then there is a duty live both to the letter and to the spirit of tax regulations.

Professional Tax Planning

Taxpayers often seek an opinion from a lawyer, certified public account, or other tax planner before taking a tax position (Prebble and Prebble, p. 696). Tax law can be complex, and alternative interpretations are possible. The Internal Revenue Code requires a tax planner to have a requisite level of certainty with regard to an interpretation of law before recommending a position. Typically, the planner must believe that the tax interpretation, if challenged, would be more likely than not sustained on the merits (Pauly 2008). If this requisite is not met, and the position leads to an understatement, then the taxpayer must pay back taxes, interest, and a twenty-percent civil penalty. If the taxpayer follows the tax advice in good faith, then no criminal charges ensue.

Although not all tax planners are lawyers, many are. As professionals, lawyers are subject to a code of ethics articulated in the American Bar Association's *Model Rules of Professional Conduct* (ABA 2010). The Preamble distinguishes between the roles lawyers play as *advisors* and as *advocates*. It states:

> As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal *rights and obligations* and explains their practical implications. As advocate, a lawyer *zealously asserts the client's position* under the rules of the adversary system (ABA, Preamble, 2010, emphasis added).

Reflecting on the above, it would seem that a lawyer serving in the role of an advocate may be required to interpret tax law in a way that best serves the client's pecuniary interests. This may include a zealous defense of aggressive tax posturing. The advisory role, by contrast, would require a relatively less aggressive interpretation, where the lawyer informs clients of both their rights and their obligations, including the ethical obligation to live to the spirit of the tax regulations. The following sections contrast the two roles.

Tax Planner as Advocate

Suppose that Congress taxes activities X, Y, and Z. A taxpayer rearranges things, achieving the effects of X, while characterizing the activity as W. The taxing authority challenges the characterization as fraudulent and indicts the taxpayer for tax evasion. The taxing authority implores the court to look through form to substance and to denounce the filing as a sham. The taxpayer hires a lawyer. As an advocate, the lawyer must zealously defend the tax position taken. The lawyer emphasizes that W was not listed as taxable; hence, the client has lived to the letter of the law. But the defense does not stop there. The lawyer also asserts that the client has lived to the spirit of the tax law. Legislative purpose almost always involves compromises and is almost always open to debate. Given the ambiguities in legislative intent, coupled with the limits of language, it becomes possible to offer a self-serving interpretation of most legal texts.

ABA Model Rule 3.1 provides guidance on the ethics of advocacy. It states, "A lawyer shall not bring or defend a proceeding, or assert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal" (ABA 2010). Rule 3.1 explains that "the

law is not always clear and never is static [and] account must be taken of the law's ambiguities and potential for change" (ABA 2010). It also notes that legal interpretations "are not frivolous even though the lawyer believes that the client's position ultimately will not prevail" (ABA 2010). It short, the Rule suggests an aggressive approach to legal argument once litigation has begun.

A fair reading of Model Rule 3.1 suggests an aggressive approach to legal argument. The key, of course, is that one ideally finds a zealous advocate on both sides of the bar. Zealousness on one side balances zealousness on the other, and the synthesis, provided by the impartial judge, renders a reasonably fair, and potentially best, result. If the system is working effectively, the advocate should assert the tax interpretation, even if strained, that advances the interests of the client. The question is whether a similar ethic informs the role of lawyer as an advisor.

Tax Planner as Advisor

Lawyers are not always advocates; sometimes they serve in advisory capacities. For example, it is common for a tax lawyer, or other professional tax planner, to recommend the initial tax position filed. Absent the pressure of an adversarial setting, tax advisors have a relatively greater opportunity to reflect upon the broader obligations of the client, including the ethical obligation to abide by a professionally honest interpretation of the tax law. ABA Model Rules articulate the expanded role. Under the caption, "Advisor," Rule 2.1 states: "In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors that may be relevant to the client's situation" (ABA 2010). The Comment to Rule 2.1 explains: "It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied" (ABA 2010).

Advisory settings call for a balanced interpretation of legal obligations. Any good lawyer can articulate a spectrum of interpretations with regard to most, if not all, legal texts. If hired by the defendant, the lawyer offers the defendant's interpretation; if hired by the plaintiff, then the plaintiff's. But as an advisor, the tax planner needs to construct and recommend the single "best" interpretation. This interpretation results from a professionally honest application of legal reasoning techniques free from any political or self-serving bias. Recognizing the value of legal predictability, the best interpretation gives due deference to the plain meaning of the statute, but balances that meaning with reference to legislative intent, general public policies, prior interpretations, and maxims of construction. In essence, the advisor is not asking who *will* win if an action is taken or not taken, but rather who *should* win?

The notion of a single best interpretation of tax law highlights issues associated with tax avoidance. Adopting the role of advocate, the tax planner will be oriented to assert a position that best meets the client's needs. In practice, this may devolve into a self-centered calculation of the likelihood that a position will be challenged, the likelihood that the position will be upheld, and the likely consequences if the position is disallowed. It will also involve a calculation of the tax saved if the aggressive tax position is taken and goes unchallenged. If a literal interpretation of tax law can be advanced, then the negative consequences may be limited to a civil fine. Tax regulations require the advisor to certify to the client that the position, if challenged, is more likely than not to be upheld in court. Yet, this prediction of judicial action is a matter of opinion, and if planners perceive their role as an advocate, then they are likely to be somewhat aggressive in taking their stances. This is particularly true if the client is in the market to find lucrative tax advice.

Advocacy norms seem to be at play in the *Gregory* case discussed above. The taxpayer, almost assuredly, received professional tax advice before undertaking her step transaction in an attempt to reduce her taxes. The transactions had no purpose other than to reduce her taxes, and the taxpayer showed no restraint in exploiting a literal interpretation of the reorganization rules in way that violated the spirit of the Internal Revenue Code. The initial filing was taken at a time when the "substance-over-form" rule had been an established tax principle for over a decade. The filing was also during the heart of the Great Depression, a time when the government needed revenues to support social objectives. Of course, the position taken ultimately failed. But, *ex ante*, the tax planner apparently thought the transaction might not be challenged, if it were challenged, then the positon might prevail, and if it did not prevail, then the consequences would not include jail time. Based on these calculations, employing the step transaction seemed worth the risk.

Advisory norms, by contrast, require the tax planner to adopt a different orientation. The advisor looks beyond literal readings of the tax law, employing the full panoply of interpretative tools, including, but not limited to, the plain meaning rule. Legislative intent, maxims of interpretation, and judicial precedents all play central roles. If a literal interpretation seems to be cost effective, but the balanced interpretation seems best, then the advisor will suggest restraint where the advocate may take the more aggressive posture. The advisor also takes due note of the various GAARs. Sham transactions with no business purpose other than to avoid taxes are not taken even if they appear to be cost effective. This economic self-restraint derives from and reflects the ethical obligation to obey law. The ethical issues

associated with aggressive tax planning and tax avoidance are illustrated in the following case.

Louisiana Sales Tax

Most states in the United States charge a sales tax on purchases of personal property consummated in their state. In Louisiana, the sales tax, third highest in the nation, varies somewhat by parish, but averages about 10%. Louisiana residents who bring out-of-state purchases home are levied a "use tax" of 10% on those items, less a credit for sales taxes already paid in the other state. In the following case, a $350,000 recreation vehicle (RV) was purchased and used in Louisiana, yet no sales or use tax was paid. The taxing authority brought suit for back taxes, alleging fraud (Edwards et al. 2018).

Stating the Case

In *Thomas v. Bridges* (144 So. 3d 1001 (La. 2014)), Lane Thomas, a Louisiana resident, was charged with tax fraud by the Louisiana Department of Revenue. Thomas had formed a Limited Liability Company (LLC) in the state of Montana. He directed the LLC to purchase a $350,000 RV from a dealership in Hammond, Louisiana. Thomas immediately took possession of the RV in Louisiana, and then directed the LLC to register the vehicle in Montana. Establishing the LLC and registering the vehicle were both accomplished by mail, as neither Thomas, nor the RV, has ever been to Montana (Jess 2015).

Louisiana statutes levy a *sales tax* on "the sales price of each item or article of tangible personal property when sold at retail in this state" (La. Rev. Stat. § 47:302(A)(1) (West 2016)). Louisiana also levies a *use tax* on "the cost of each item or article of tangible personal property when the same is not sold but is used, consumed, distributed, or stored for consumption in the state; provided there shall be no duplication of the [above sales] tax" (La. Rev. Stat. § 47:302(a)(2) (West 2016)). With regard to most personal property, the Louisiana sales tax is collected by the merchant at the time and place of the sale. With regard to vehicles (including RVs), the sales tax is "due at the time of registration" (La. Rev. Stat. § 47:303(B)(1)(a) (West 2016)).

The Louisiana taxing authority instigated the fraud action against Thomas in his individual capacity. The Montana LLC was not a party to the suit. Thomas argued that a use tax applied only to items *not sold* in Louisiana; hence, it was inapplicable in this case. He also contended that the sales tax had not come due because the RV was never registered in Louisiana. Finally, he argued that if any Louisiana sales tax or use tax were due, it would fall upon the Montana LLC as purchaser and owner of the RV, but not upon him personally. The taxing authority prevailed on the tax evasion claim before the Louisiana Board of Tax Appeals, but Thomas won in the Louisiana District Court, Louisiana Court of Appeals, and Louisiana Supreme Court (144 So. 3d 1001 (La. 2014)).

Thomas readily admitted that he created the Montana LLC, called Angel Rocks, as a means to avoid paying tax in Louisiana. His success in court relied on several things. Perhaps most importantly, the Louisiana taxing authority never brought charges against Angel Rocks LLC, despite the fact that Angel Rocks bought the vehicle, registered the vehicle, and had an asset—the vehicle itself—that could be subject to a tax lien. If either a Louisiana sales or use tax were owed, it was probably owed by Angel Rocks LLC, not by Thomas in his personal capacity (Edwards et al. 2018). Competent pleading by the Louisiana taxing authority would have charged both Thomas and the LLC. In addition, the taxing authority did not raise the economic substance doctrine or other GAAR.

Thomas also relied on a self-serving, literal reading of the statutory language. The statute states that the sales tax is "due at the time of registration." Thomas read this to mean that the tax was due at the time of registration *in Louisiana*. This is a plausible interpretation. After all, the statute is addressing Louisiana law, and other parts of the statutory scheme charge the Louisiana Department of Transportation with the duty to collect sales tax on vehicles. But an alternative reading was possible as well. The statutory language could mean that the sales tax is due at the time of *first* registration of the vehicle *in any state*. The statute itself is silent. It says neither registration in Louisiana, nor does it say first registration in any state. Thomas's interpretation prevailed in court.

Ethical Analysis

Thomas, like all members of a reasonably just society, has a duty to obey reasonably just laws. Yet, his interpretation of the law led to a result that was inconsistent with the manifest purpose of the legislation. It enabled both the sale and the use of a new vehicle in the state of Louisiana without paying either a sales or use tax. Surely, this was contrary to legislative intent. This is not to say that the court erred in its decision. Given the pleading, the Court's holding seems reasonable. The frustration of legislative policy goals derives from the tax dodge itself. Literal interpretations of tax statutes inform tax obligations, but do not always define them (Black 1911, p. 66). The plain meaning rule provides the Cardinal Rule of tax interpretation; yet, pursuant to widely accepted principles of statutory interpretation, properly applied, the rule must give way to more purposeful interpretations so as to avoid results inconsistent with legislative intent (McMahon 2000).

Louisiana collects sales and use taxes as a means of financing public services. Uniform collection of these taxes assures impartially and promotes a perception of fairness. If Thomas had interpreted his legal obligations with reference to the spirit of the law and then complied with both letter and spirit, then he would not have initiated this scheme. One suspects that Thomas may have found a way to rationalize his self-serving behavior, convincing himself that he was obeying the law while simultaneously taking advantage of in-artful pleading by the taxing authority and a gap in the statutory scheme. He may have felt pride in beating the government. Yet, notwithstanding the fact that Thomas prevailed in court, his actions seem to reflect a general disrespect for the duty to obey reasonably just laws.

Thomas seems to have approached the law with sole reference to what he could get away with. One expects that he did a cost-benefit analysis. Thomas could assert a legal defense based on a literal reading of the statute; hence, even if he had been found guilty of tax fraud, his penalty would likely have been civil, not criminal (Kahan 1997). This factor may go a long way in explaining why tax avoidance seems so prevalent. One must wonder, however, whether Thomas would feel a sense of embarrassment if he had used the expensive RV, complete with Montana tags, while enjoying a tailgate party at a Louisiana Tech versus Louisiana State football game. After all, if Thomas shirks his duty to pay Louisiana tax, his Louisiana neighbors would have to provide for the shortfall, either by accepting less state services or by paying more tax themselves.

The ethical approach would have been to interpret the Louisiana tax code, not with reference to a hyper-literal and disingenuous interpretation, but with due respect for the policy goals and social norms that underscore the law. A central maxim of statutory interpretation requires an embrace of law in its entirety (Black 1911; Dickerson 1975). One is not free to pick and choose among which laws to interpret, but rather, proper interpretation requires reading each provision with reference to the legislative context more broadly viewed. This would include respect for anti-tax avoidance doctrines such as substance-over-form, economics substance, and the sham transaction rule (Bankman 2000). These anti-avoidance laws, whether enacted in legislation or created by the courts, directly state that living to the letter of the law with the intent to violate the spirt of the law is ethically wrong, and legally ineffective.

Thomas selected from a menu of laws as to which to use, which to exploit, and which to ignore. He used Montana LLC law and the Full Faith and Credit Clause of the U.S. Constitution to establish Angel Rocks LLC as an independent entity that had to be respected by the Louisiana courts (Edwards et al. 2018). He exploited an imprecision in the Louisiana tax code that stated that the sales tax on vehicles sold in Louisiana was due at registration. Thomas ignored anti-avoidance rules. He also got lucky. The Louisiana Supreme Court refused to consider the sham transaction allegations raised by the taxing authority on appeal because the count had not been raised at trial. If the taxing authority had included the Montana LLC as a defendant and raised anti-avoidance rules from the start, the case may have come out differently.

One's tax obligations should not be defined by a cost-benefit analysis where the taxpayer calculates *ex ante* that a particular tax position is worth the risk. Such a conception fails to distinguish between willful, but potentially unpunished, tax evasion and full tax compliance. In also invites widespread tax avoidance. To maintain a logically meaningful distinction between legal obedience and legal disobedience, one needs a barometer beyond economic consequence. A professionally honest interpretation of legal texts, by contrast, provides a workable barometer. Had Thomas respected his ethical duty to obey anti-avoidance rules, he would have registered his RV in Louisiana and paid his $35,000 in tax as intended by the Louisiana legislature. Legal obedience means abiding by both the letter and the spirit of the law, not simply doing what one can get away with.

The *Thomas* case illustrates the limits of legislatively and judicially imposed GAARs. For these rules to be fully effective, the taxpayer must voluntarily embrace an ethic of professionally honest tax interpretation. This self-restraint is a corollary to a meaningful acceptance of a duty to obey law. In short, if one accepts the duty to obey law, then the duty to engage in professionally honest tax planning, including due respect for anti-avoidance rules, follows naturally. Professionally honest tax planning, of course, will significantly reduce both the $450 billion annual tax gap and the $75 billion in annual tax avoidance.

Aftermath of the Case

Montana has no sales tax, no vehicle excise tax, and offers modest vehicle registration fees. In addition, Montana does not disclose lists of registered owners. This has caused some commentators to identify Montana as a tax haven (Jess 2015). In addition, it seems that other states follow the Louisiana pattern of collecting sales tax at the time of vehicle registration. Not surprisingly, a cottage industry of tax planners is promoting this tax dodge, and Montana tags are appearing on vehicles in various states, including Massachusetts, Colorado, Minnesota, Arizona, and California.

Political reactions to this sales tax scheme have varied from state to state. Both a concurring judge in *Thomas* and the dissenting judge called upon the Louisiana legislature to close the loophole. The Louisiana legislature has yet to act (Edwards et al. 2018). Several other states, however, have successfully collected back taxes and gotten fraud convictions for overly aggressive manipulations of this sales-tax

avoidance scheme. Colorado, for example, has secured more than a dozen criminal convictions and recovered more than $2,000,000 in back taxes (Mitchell 2008). Minnesota and Massachusetts have each recovered more than $1,000,000. Both California and Arizona have established hotlines where neighbors report neighbors who drive vehicles with Montana plates (Jess 2015).

There is also an irony to the *Thomas* opinion. It seems to have been decided the way it was due to idiosyncrasies in its procedural history, including confusion over parties, issues, and relevant facts. Tax planners and taxpayers may have both misread the holding and seized upon the dicta of the court in its rhetorical defense of the rule of law, even if that defense was ill-conceived (Christensen 2016; Dietsch 2011). The decision provides an unfortunate precedent that may encourage other taxpayers to conclude that the law allows for tax avoidance schemes. The law, properly interpreted, does not.

Reflections on Tax Avoidance

At first blush, the above sales-tax scheme seems of relatively little scope, involving rather modest sums. The case is discussed at length primarily because the facts are easy to follow, making it easier to highlight the ethical issues involved. Essentially similar tax avoidance schemes appear rampant in a global context, annually amounting to hundreds of billions of dollars in lost revenues to governments around the world (Murphy 2014). Of particular concern is tax base erosion caused by global profit-shifting. Many of these profit-shifting schemes can be quite complex, but the ethical issues mirror those found in the simpler RV tax dodge just discussed. The following sections discuss global profit-shifting and offer ethical reflections.

Global Profit-Shifting

Tax avoidance occurs domestically, as in the RV case, but it is particularly prevalent in global arenas. In an oft-cited article, Professor Edward D. Kleinbard explains a global tax avoidance scheme involving "profit-shifting" (Kleinbard 2011). A multinational enterprise (MNE) domiciled in a relatively high corporate income tax venue, such as the United States, forms a subsidiary corporation in a tax haven such as Bermuda. The MNE transfers intellectual property to the subsidiary in exchange for one-hundred percent of the Bermuda firm's equity. The Bermuda subsidiary then licenses the intellectual property back to the MNE in exchange for royalty fees. The fees are deducted as an expense by the MNE, reducing its U.S. tax bill, and reported as income in Bermuda. Because Bermuda does not have a corporate income tax, the overall tax for the parent-subsidiary group is lessened and profits accumulate in Bermuda. It is estimated that over $2.6 trillion have been accumulated by off-shore, wholly owned subsidiaries of U.S. MNEs in such places as the Cayman Islands, Bermuda, and other tax friendly venues (ITEP 2017). This untaxed income typically can be reinvested around the globe, as U.S. corporate income tax only comes due when the funds, typically in the form of dividends paid to the parent, are repatriated to the United States. Hence, the MNE is able to invest pre-tax money.

Kleinbard notes that this profit-shifting scheme can become quite complicated (Kleinbard 2011). To illustrate, he explains the double Irish with a Dutch sandwich scheme adopted by Google. Google set up a subsidiary in Ireland, transferring intellectual property in exchange for stock. Pursuant to Irish law, the Irish subsidiary was then combined with a subsidiary in Bermuda establishing a dual residency with regard to tax. The U.S. government perceived the company as Irish because that is where it was incorporated, and the Irish government perceived the domicile as Bermuda because that is where its "mind and management" was centered (Kleinbard 2011, p. 709). The Irish/Bermuda subsidiary then licensed the intellectual property to a Dutch corporation pursuant to a contractual arrangement that required the Dutch corporation to relicense the property to a second Google-owned subsidiary in Ireland. That second Irish entity then marketed the intellectual property throughout Europe, the Middle East, and Africa. The marketing entity payed royalties to the Dutch company who then paid royalties to the Irish/Bermuda firm, and the income was reported in tax-free Bermuda (Kleinbard 2011, p. 712). Kleinbard explains that these complications were used because the transfers between the Irish companies and the Dutch company were not recognized as taxable events under U.S. tax law, and the transfer between two members of the European Union is not subject to a withholding tax (Kleinbard 2011). This aggressive tax planning was quite effective, and Google paid virtually no corporate income tax in the United States, or elsewhere.

A public outcry arose when the double Irish with a Dutch sandwich arrangement was reported in the press. Tax compliance suffers when taxpayers lose faith in the system (Kovach 2008, p. 275). Once there is a perception that successful companies like Google are playing fast with their legal obligations, it becomes easier for the common taxpayer, like Thomas, to rationalize tax avoidance (Picciotto 2007). Unfortunately, the data shows that corporate profit-shifting through manipulations of intra-group loans, corporate inversions, transfer prices, and Dutch sandwiches may have reached epidemic levels (ITEP 2017; Gravelle 2015).

Ethical Analysis

The tax system relies, in large measure, on voluntary compliance which can only be sustained if the system is perceived to be reasonably fair by taxpayers. Although the term

fairness is notoriously imprecise, a key component to fairness resides in governmental respect for the *rule of law*. Dedication to the rule of law limits the arbitrary whim and caprice of government officials, and enables taxpayers to plan their affairs, knowing in advance the tax consequences of their choices. The rule of law provides taxpayers with a shield against unfair treatment by the taxing authorities (Nozick 1974, p. 169). This is an essential component of tax fairness (Hilling and Ostas 2017).

Ironically, the avoidance problem derives, in part, from the rule of law itself. Tax avoidance arises when taxpayers use a literal interpretation of a tax regulation to circumvent the legitimate policy goals sought by the legislature, and then tax courts, out of respect for the rule of law, feel unable to address that circumvention (Picciotto 2007). That is, courts often accept literal interpretations, holding that an avoidance plan is legal, and implicitly blaming the legislature for the imprecision in the law (Symposium 2001). In so doing, the courts may be equating the rule of law with literalism. Properly conceived, the rule of law does not require literalism. Arguably, the rule of law is best honored when courts offer a more pragmatic jurisprudential stance, one that pays due deference to legislative intent (Ostas and Hilling 2016).

The use, or misuse, of literal arguments by taxpayers can generate a sense of unfairness among the taxpaying public and undermine the tax system generally. Ultimately, tax avoidance frustrates legislative attempts to raise revenues, redirect behavior, and redistribute wealth. In the late twentieth-century, tax avoidance centered on exotic financial arrangements designed to create tax shelters in ways never contemplated by the taxing authorities. Today, tax avoidance seems to be most pronounced through exploitation of international tax-havens.

Respect for one's ethical duty to obey law does not equate to literalism. As discussed in Part I, the traditional-interpretative technique pays due deference to literal arguments, but it is not straight-jacketed by literalism (Llewellyn 1950). When a literal interpretation thwarts legitimate policy goals, the ethical duty to obey law requires tempering the literal interpretation with reference to interpretative maxims, relevant judicial precedents, and legislative purpose (Levi 1949). Thomas sought to buy and use an RV in Louisiana without paying either a Louisiana sales or use tax. A single office address in Bermuda may be home to hundreds, if not thousands, of corporations, none of whom actually conduct business at that address. The 80,000 firms domiciled in the Grand Caymans, with a population of 50,000 and one movie theater, have more wealth than all the banks in Manhattan, New York (Shaxson 2011, p. 18). These facts seem both odd and specifically designed to frustrate legitimate policy goals.

Using literal interpretations of the tax code to circumvent legislative intent is not in accord with the taxpayer's ethical duty to obey law. These literal arguments reflect self-interest. The accountant, financial adviser, or tax lawyer calculates the likely consequences of taking a particular tax position. A self-serving, cost-benefit analysis provides the only guide. Finding a literal interpretation typically removes the scheme from the criminal dockets, dramatically increasing the economic value of the avoidance plan. Often the potential for detection and/or prosecution may be low. In addition, the courts may be reluctant to use anti-avoidance legislation to address the matter. In short, economic calculations may suggest that tax avoidance pays. The epidemic level of profit-shifting among MNEs suggests that profit-shifting may be both ethically tainted and highly profitable (Zucman 2014).

Problems associated with tax avoidance can be reduced by legislation, by the courts, and by private self-restraint. Legislatively, the Organization for Economic Cooperation and Development and the European Union, working in harmony, are addressing the problem of tax-base erosion caused by global profit-shifting, focusing on the need for transparency and cooperation between nations (Dourado 2015). Courts can supplement these efforts by being more aggressive with the anti-avoidance doctrines addressing sham transactions (Ostas and Hilling 2016). This article has focused on the third prong, the need for individual self-restraint derived from the duty to obey law, properly interpreted.

It may be important to re-emphasize that the ethical self-restraint articulated in this article does not require the taxpayer to pay more tax than the law, properly interpreted, requires. The ethical obligation to obey law requires the taxpayer to comply with both the letter and the spirit of the tax code. Tax loopholes and underenforced laws pose economic temptations, and ethical self-restraint becomes manifest through the taxpayer's willingness to refrain from exploiting these opportunities. Self-restraint means complying with a professionally honest interpretation of the tax code, rather than seeking to exploit the imperfections in the law or the legal system for private gain.

Conclusion

This article contributes to the scholarly literature regarding the ethical duty to pay tax. The analysis begins by considering and accepting an ethical duty to obey law generally. The article then examines what such a duty would imply with regard to tax interpretation. The discussion distinguishes between the norms of professional advocacy and the norms of professional advising on tax matters. It also provides a detailed discussion of the principles of statutory interpretation, including a balanced appeal to plain meaning, maxims of construction, judicial precedents, and legislative purpose. An argument is advanced that the ethics of tax advising requires a professionally honest interpretation

of tax regulations consistent with the full set of interpretive tools. Although this duty of honest interpretation can be imposed by judicial precedent or by legislative fiat, to be to fully effective, it requires a voluntary, ethical embrace by taxpayers and by tax advisors. Case studies drawn from a Louisiana sales tax avoidance scheme and from Google's profit-shifting activities illustrate the ethical issues incumbent in tax interpretation.

Compliance with Ethical Standards

Conflict of interest The author declares that he/she has no conflict of interest.

Human and Animal Rights The author declares that this article does not contain any studies with human participants or animals performed by any of the authors.

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