

# TAX EXPLOITATION

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## TAX EXPLOITATION<sup>1</sup>

### 1. *The problem of tax exploitation*

The fact that some taxpayers are arbitrarily obtaining or trying to obtain tax advantages for themselves constitutes one of the most important contemporary problems for courts, legislators and legal policy.

The term tax exploitation will be used to describe such economic arrangements as are, exclusively or mainly, based on tax considerations and which aim at a tax advantage not anticipated by the lawmakers, tax advantage here meaning that the arrangement in question produces a lower taxation than the relevant normal arrangement would have done.

Tax exploitation must be negatively distinguished from economic arrangements made in order to obtain tax advantages expressly offered by the legislation, for instance deductible deposits on establishment accounts, deductible payments to pension funds, save-as-you-earn accounts etc. Likewise, the idea of tax exploitation must be distinguished from evident cases of tax fraud, i.e. concealment of obviously taxable incomes ("black" economy etc.).

Positively delimited, tax exploitation can be defined as economic arrangements in the "grey zone" of tax law where any attempt to make a legal decision will have its complications. At first sight, the tax advantage aimed at seems lawful. In the first phase, an application of the law will often lead to the result either that taxation is not authorized by the law, or that, on the contrary, the expense or loss, etc. in question is, in fact, deductible. On closer examination, however, the application causes some doubt when it becomes clear that the result of the preliminary interpretation is at variance with the object of and reasons for the tax prescriptions involved. It adds to the doubt, of course, that the tax exploitation is often attempted by means of ingenious and artful arrangements which are not usual or normal in the situation at hand. Thus, the tax exploitation is rather artificial and proforma-like, which gives the impression that the economic transactions are just *ad hoc* arrangements.

<sup>1</sup> This article is based on of the author's doctoral thesis: *Skatteudnyttelse*, København 1989.

Applying the law creates a dilemma when tax exploitations are considered from a tax law point of view:

- 1) Must the tax advantage aimed at be accepted according to the immediate characterization of the arrangements made and from a literal interpretation of the tax prescriptions involved—either because no legal title to taxation can be found, or because the taxpayer is entitled to the exploitation by a prescription favourable to him?—If so, the tax exploitation may be called “tax planning”. This concept, then, covers tax exploitations which are lawful and in accordance with the underlying tax laws. Or
- 2) must the arrangements made and the tax advantage thereby aimed at be set aside in accordance with the setting aside of the immediate characterization of the said arrangements and/or in accordance with a broad or a restricted interpretation of the relevant tax legislation?—If so, the tax exploitation may be called tax evasion (improper tax avoidance). This concept, then, covers tax exploitations which are illegal and not in accordance with the underlying tax laws. The legal consequence of tax evasion (improper tax avoidance) is reassessment of the tax return and payment of the tax avoided. Or
- 3) must the tax exploitation not only be set aside as improper tax avoidance but also be punished as criminal tax evasion, because the tax advantage has been attempted by means of incorrect or misleading information to the authorities?—The term criminal tax evasion is used about such cases, including tax fraud, where the criminal laws have been violated, and the legal consequences hereof are a back duty as well as a criminal liability in the form of imprisonment and/or fine.

An attempt will be made to describe the treatment of tax exploitation according to Danish law. The object is to find out and analyse the legal standards which decide the legal consequences of various kinds of tax exploitation. The main questions are whether the authorities, although reluctantly, will have to accept the given tax exploitation as a manifestation of lawful tax planning, whether it may be set aside as improper tax avoidance according to the tax laws, therefore releasing an increase in taxable income, or whether it must be considered not only as illegal but also as punishable tax fraud, since the tax advantage aimed at is attempted by means of incorrect or misleading information.

Clearly, the way a given tax exploitation is legally qualified will often have considerable economic consequences for the taxpayer. At best, he may obtain a large economic profit through the tax advantage released.

At worst, he may receive a demand for increased tax payment as well as suffering imprisonment of some length and/or a fine.

Danish law contains no general prescriptions regarding such qualification. Neither does it contain any general standards concerning evasion or abuse of either public law in general or tax legislation in particular. Thus, the tax laws yield no general instructions as to the delimitation between tax planning and tax avoidance.

Of course, the legislation contains specific provision regarding criminal liability for tax fraud and other kinds of criminal tax evasion. The main prescriptions are found in section 13 of the Danish Tax Management Act (*Skattekontrolloven*) and concern the person who, with intention to evade taxation, submits incorrect or misleading information to the authorities in his income tax return and elsewhere. The maximum penalty is 2 years' imprisonment, extended to 4 years for tax fraud of especially serious nature, cf. the Danish Criminal Code (*Borgerlig Straffelov*), sec. 289. While the application of Danish criminal law is of course subject to a strict duty to prove that the criminal act in question is covered by the law, cf. the Criminal Code, sec. 1, the delimitation between tax avoidance and criminal tax evasion is still causing some doubt. This is because the sec. 13 criminal tax evasion provisions are normative and define the area of criminal liability only in broad and generalizing terms. For instance, not only definitely false information is punishable, but also information that is merely misleading. This, of course, must cause some doubt, seeing that the Danish tax legislation contains no clear and distinct requirements on the contents of income tax returns and other information to be submitted to the authorities.

Despite such legislative and legal uncertainties the appliers of the law, i.e. the courts, have developed legal standards for the qualification of tax exploitations.

In what follows a "doctrine of reality" will be used, the chief requirement of which is that, in cases of tax exploitation, taxation must be governed by the real economic content of the given transactions, rather than by their formal clothing. The doctrine of reality allows the setting aside and correcting of empty and artificial transactions made for tax saving purposes, so that tax can be charged according to the real content of the transactions rather than the outer form. The general standard of reality as the basis of taxation is not an arbitrary norm which allows taxation at discretion. Its use requires a positive check that usual and normal business conditions have been set aside for tax-saving purposes, so that the form of the transactions contrasts with their real

content. The doctrine of reality, then, is concerned with the assessment of the contents of a given tax exploitation from a tax law point of view.

In criminal law the doctrine of reality is supplemented by the "fiction approach"; the income tax return must state the whole truth and the content. If it does not, but gives only the (misleading) form, and if in this way the taxpayer attempts to obtain tax advantages through tax evasion, criminal liability may be incurred. What in the first place decides the imposing of liability to punishment is the fact that the taxpayer by fraud or gross negligence is attempting to give the authorities a misleading picture of the content of the transactions made, so that no correct assessment will be possible. The fiction approach, then, concerns the taxpayers's description of his transactions.

### 1.1. *Tax exploitation as an international problem*

The problem of tax exploitation is well known by all modern States whose tax systems are based on income taxation. The taxation aspects, but not the criminal aspects, have been the topic of several international congresses and seminars. This concerns especially the question of how to describe and distinguish between tax planning and improper tax avoidance.<sup>2</sup>

In the history of tax law Germany and the United Kingdom hold outstanding positions. Income taxation as a systematic method of taxation was developed concurrently in both countries at the end of the last century. Despite the great past and present similarity between their income taxation systems there are considerable differences, especially in the trends regarding the necessity of taxation being legally authorized. Immediately after the introduction of income taxation in Germany, the requirement for legal independence and functionality of taxation developed, meaning that taxation should not be hampered by formalistic conditions of total legality but, instead, should be governed by rationali-

<sup>2</sup> Thus the International Fiscal Association, London 1965, *IFA-Report VOL 50a*: "The interpretation of tax laws with special reference to form and substance, 1965", International Fiscal Association, Venice 1983: *IFA-Report VOL 68a*: "Tax avoidance—Tax evasion", 1983, International Bar Association, London 1982: *Tax avoidance—Tax evasion*, Nordiska skattevetenskapliga Forskningsrådet, Sverige 1976: *NSFS-Report no. 3*: "Kringgående av skattelag". *Det 30. nordiske juristmøtet*, Oslo 1984: Report VOL II, p. 241 ff, Council of Europe: *International Tax Avoidance*, Publications of the International Bureau of Fiscal Documentation, no. 31, Amsterdam 1981, OECD-Report: *Tax avoidance—Tax evasion*, Paris 1979 and *International Tax Avoidance and Evasion—A study by the Rotterdam Institute for Fiscal Studies*, VOLs A and B 1981.

ty. In the United Kingdom, conversely, the traditional requirement for a clear and indisputable legal title to execution of power, including taxation, prevailed. If a given economic transaction was not totally comprised by a taxation prescription, taxation had to be given up.

The reasons for calling attention to these two countries are, first, that a great many countries when elaborating their own taxation systems have been influenced by the German or English traditions. Secondly, at an early stage, the legal systems of the two countries diverged as to their attitudes to the legal aspects of tax exploitation. This divergence at the same time, represents two main forms of such attitudes.

In Germany general standards against abuse, intended to prevent taxpayers from usurping tax advantages through abuse of the civil freedom of contract, were introduced into the legislation at an early stage. The "wirtschaftliche Betrachtungsweise" (business point of view) standard according to which, in case of tax exploitation, taxation should be governed by the "wirtschaftliche" (businesslike) content rather than by the external form of the arrangement, has been present in German tax law for decades and is still implicitly to be found there.<sup>3</sup>

In England, until the beginning of the 1980's, tax exploitation was a question of legislation, since no economic transaction could be subject to taxation without a clear and distinct legal title. If an ingenious and elaborate arrangement contained a series of part transactions, each of these had to be judged "step-by-step". The most frequent consequence of such judgment was that the tax exploitation must be upheld. The English legislature, therefore, had to react against undesirable tax exploitation through legislation which has entailed vast and greatly detailed anti-avoidance rules.<sup>4</sup>

At the beginning of the eighties, moreover, the Lords changed their attitudes, so that henceforth tax exploitation might be set aside from a general judgment of the realities. Thus the House of Lords, applying the "new approach" made an overall assessment by which strictly literal interpretation and judgment of a complex transaction "step-by-step" were abandoned.<sup>5</sup> Instead, the Lords applied a realistic interpretation of the legislation and a general judgment of the transaction as a whole.

<sup>3</sup> Cf. Klaus Tipke, *Steuerrecht—ein systematischer Grundriss*, 9. Aufl. Köln, 1983, pp. 100 ff. and Hübschmann-Heppe-Spitaler, *Kommentar AO ad AO 1977 § 4 Anm.*, pp. 188 ff, both with detailed references.

<sup>4</sup> J. Avery Jones in *British Tax Review* 1983 pp. 9 ff and pp. 113 ff.

<sup>5</sup> Cf. *Tax Law in the Melting Pot, A study by the Revenue Law Committee of the Law Society of the Ramsay Doctrine after Furniss v. Dawson*, with proposals, London 1986.

Internationally, a certain uniformity may be observed between the legal status of the individual countries. On the other hand, the standards applying to tax exploitation are different. In some countries, general prescriptions have been incorporated in the tax legislation broadly stating the kinds of abuse which should not be accepted. This is true, for instance, of Germany, Sweden and Finland. In other countries, for instance the United Kingdom and Norway, new unwritten standards regarding the distinction between tax planning and tax evasion have been created through the practice of the courts.

Denmark belongs to the latter group of countries, although, compared to a number of others, it has an exceptional status, since during the last few decades Danish legislature and court practice have increasingly been prosecuting tax exploitation as punishable tax fraud and other kinds of criminal tax evasion. The Danish authorities, therefore, must decide not only whether, from a taxation point of view, a given tax exploitation should be upheld as lawful tax planning or must be set aside as unlawful tax evasion, but also whether, from a criminal point of view, a tax exploitation is to qualify as punishable. Under Danish law, as mentioned, penal liability is incurred not only by concealing obviously taxable income and deducting false expenses but also more broadly.<sup>6</sup>

Criminal liability, then, is incurred not only for giving positively incorrect information but also for trying through intentional or grossly negligent perversions, suppressions, concealments and similar manipulations to hamper official assessment of the given transactions. This development of criminal liability has been strongly criticized by tax experts. It has been argued that the description of the limits of criminal liability has not been sufficiently clear and distinct.<sup>7</sup>

### 1.2. *Reasons for tax exploitation, its conditions and manifestations*

The main reason why taxpayers try to avoid or minimize a given taxation is subjective, and must be seen in connection with the usual definition of taxation as citizens' compulsory cash payments to society not returned as public payments. The main reason why tax exploitation is to some

<sup>6</sup> On the need for increased criminal prosecution for tax exploitation in German law, cf. Gerhard Dannecker, *Steuerhinterziehung*, and in English law *Report from the Committee of Enforcement Powers of the Revenue Department*, London 1983, HMSO ("The Keith Report") VOL 2.

<sup>7</sup> Cf. Finn Thomsen in *UfR* 1982B p. 232, Aa. Spang Hanssen in *Revision og Regnskabsvæsen*, 1988 nr. 5 p. 16 ff, and I.A. Strobel in *Revision og Regnskabsvæsen*, 1982 p. 459 ff.

extent successful is objective, and must be sought in the structure of the income tax system.

Subjectively, the tax payment is felt as a heavy burden not directly compensated for by corresponding benefits. It must be considered, therefore, a common human reaction to try to throw off or at least relieve this burden. The intensity of the effort to do so is directly proportional to the rate of taxation. Very high marginal rates contribute to increase tax exploitation, since the tax advantage aimed at will be so much larger.

Objectively, a “modern” income tax system offers great possibilities of exploitation. Income taxation in today’s society is highly differentiated, and taxation is imposed on the basis of the taxpayers’ arrangements according to private law. The great number of possible economic transactions in a given connection corresponds with a number of different fiscal consequences.<sup>8</sup>

Income taxation and the policy behind it date back to the last century. Its concepts and systematics reflect a social structure and economy widely different from those of today. The explosive development, however, which should actually have brought about an entirely new taxation system has so far caused only a current up-dating and reformation of the existing system. In Danish tax law the principal statute is still Nr. 149 of April 10th, 1922 on taxation of income and property. Development since 1922 is reflected by the isolation of a number of elements which have been made the subject of special legislation.

At the same time, a number of areas hitherto untaxed have been subjected to taxation. The result has been that taxation rates have increased exorbitantly during this century. Concurrently, in order to adapt tax legislation to society as it has developed, it has been rendered more detailed and complicated. Technically, the system suffers from a number of serious shortcomings. It is impenetrable and unnecessarily laborious even to specialists. Despite strong political demands for a final adjustment of the income tax system, the will or power have not yet been sufficient to dethrone income tax as the staple method of taxation in the industrialized world. Consequently the system has become greatly differentiated. As a result of varying political considerations, precipitate legislation, the serving of non-fiscal purposes etc., economic transac-

<sup>8</sup> A number of international examinations of the extent of “black economy” have been made for instance in Scandinavia by BRÅ-Rapport 1980:3, *Ekonomisk kriminalitet*, Stockholm, Arne Jon Asachsen and Steinar Strøm, *Skattefritt—svart sektor i vekst*, Oslo 1981, and Gunnar Viby Mogensen, *Sort Arbejde i Danmark*, København 1986.

tions of some similarity may now meet with widely different fiscal reactions.

Such structural differences are what tax exploiters try to utilize. The freedom of contract in private law enables taxpayers to arrange their economic transactions in such a way that the fiscal consequences will be as profitable as possible. In a number of exploitation cases the freedom of contract has been used to the limit. This gives a touch of artificiality and fiction to the transactions made, even though they cannot be characterized as being made proforma or otherwise non-binding. The basic question, therefore, is whether such transactions which, as to form, claim advantageous tax consequences but which, as to real content, indicate the contrary, must be acknowledged by the assessment.

### *1.3. Some main forms of tax exploitation*

Briefly, the most important structural differences in Danish tax legislation are the following:

- 1) Same income and same form of income produce different taxation for different taxpayers.
- 2) Same taxpayer is subject to different taxation on different forms of income.
- 3) Same taxpayer and same form of income produce different taxation according to different national and municipal tax systems and in different years of assessment.

These structural differences produce well-known and important problems, generally summarized as the problems of the right income receiver (1), the right designation of the form of income (2), and the right designation of the geographical and temporal location of the income (3).

The structural differences also produce different forms of tax exploitation which might be called 1) income transfer, 2) income transformation and 3) income shifting.

#### 1) Income transfer

If the tax exploitation includes the utilization of different taxpayers' different tax rates it is called income transfer. This may be done, for instance, by transferring income from one taxpayer to another so that the income is represented as earned by a taxpayer with a lower tax rate, e.g. a child, a company, etc. A large number of Danish judgments and

decisions illustrate this phenomenon, especially regarding gifts, loans, trade cooperation between family members, etc. and also regarding transactions between companies and their shareholders. The basic question in such cases is no. 1 above—the right income receiver.

### 2) Income transforming

If the form of income is transformed so that it is represented in another form, this is turned income transformation. Here, the taxpayer aims at presenting the income in a form subject to a lower tax rate than the real form would produce. This is done by transforming personal income (wages, payments, trade income etc.: tax rate up to 68 %) into capital income (interest, dividends, return etc.: tax rate up to 56 %), ordinary income (68 %) into capital gain (50 % with special deductions) or totally tax free profits. It is characteristic of these forms of exploitation that the manifestation of the income is altered in the taxpayer's favour. The basic question here is no. 3 above—the right designation of the income.

### 3) Income shifting

Shifting the geographical or temporal location of the income may be called income shifting. If the shifting is effected by transferring the income to another country with a lower tax rate (tax haven) it is called "migration of income abroad". If it is effected through transfer of income or expenses from one year of assessment to another year with lower tax rates it is called change of income periods. The general question in such exploitation cases is that of no. 2 above—the right geographical and/or temporal location of the income.

From these three main groups of tax exploitation the existing, rather numerous, decisions and judgments may be systematized.

#### 1.4. "The principle of running water"

Tax exploitation may be said to follow the principle of running water: tax exploitation may perhaps be dammed but never stopped, at any rate not within the income tax systems used today, which must serve various tax policy purposes. The only effective protection against tax exploitation will be to remove the structural differences so that tax is imposed according to a steady percentage on all taxpayers and all forms of income. Such a tax system will hardly be accepted by a modern social liberal society.

Since its introduction at the beginning of this century the system of

income taxation has clearly developed according to the running water principle. Innumerable modifications in the legislation and by court decisions have stopped tax exploitation schemes, but with the only result that new forms of exploitation have been invented and the procedure has had to start all over again. The question, one might say, has been not whether, but how, tax exploitation should be combated; whether it should be done by specific or general control and whether the combat should be a matter of legislation or be governed by the legal authorities as part of the common administration of justice.

In some countries, e.g. the United Kingdom and Sweden, the courts have accepted a number of tax avoidances because of lack of the necessary legal title to taxation, even though the transactions in question ought to be taxed from a legal policy point of view. An English theorist has described the legal state in the United Kingdom in the following expressive words: "In any jurisdiction less sophisticated than ours, such schemes would simply be laughed out of court."<sup>9</sup> This has forced the legislature to carry through a number of amendments, new legislation, etc. Such specific anti-avoidance laws, however, have soon been undermined according to the running water principle. Since no legal policy is able to put up with a powerless legislation, sooner or later a set of prescriptions against avoidance, abuse and the like is going to evolve. Nevertheless, even general and broad anti-avoidance legislation have been unable to stop the water from running.

As part of their common administration of justice, the courts in a number of countries, for instance Denmark, have developed general norms for distinguishing tax planning from tax evasion. Consequently the parliaments have not felt called upon to interfere. In other countries the courts have not found themselves authorized to create such new law, and the legislator, therefore, has been forced to carry through a number of pieces of general legislation. This is the case, for instance, in Sweden where a great many cases of evidently taxable exploitation have been accepted by the courts.<sup>10</sup>

In Sweden the "Lag mot skatteflykt" (Act against tax evasion), controlling abuse of the tax laws, was introduced in 1981. Naturally, such legislation has been severely criticised since, strictly speaking, it annuls all the other material tax statutes. It must be admitted that the criticism is well-founded, too, because such legislation gives rise to more uncer-

<sup>9</sup> P.J. Millet in 1982 *The Law Quarterly Review*, pp. 213 ff.

<sup>10</sup> Cf. on the whole Sture Bergström, *Skatterett og civilrätt*, 1978, with a summary in German.

tainty than it removes. Moreover, tax exploiters may hereafter not only abuse the tax legislation but also the abuse legislation.<sup>11</sup>

## 2. TAX EVASION

The above sketch of the form, background and conditions of tax exploitation does not contribute to an understanding of what legal prescriptions are essential in connection with the extremely important distinction between tax planning and tax evasion.

Danish tax legislation contains but few prescriptions with the direct purpose of preventing tax exploitation. Existing court decisions, therefore, are of special importance when trying to state what legal standards are applied to control tax exploitation.

Naturally, the application of the law which is the task of the courts does not differ in tax exploitation cases from in the solution of other legal disputes. The task must be to apply the current law to the specific case and from this to draw a legal conclusion. It will be natural to start from the tax prescriptions which are relevant to the specific case of exploitation. Here the courts will realize that an interpretation, even extended, of the prescriptions involved in relation to the arrangement presented by the taxpayer will produce no final results. Thus, one cannot obtain a better understanding of the tax exploitation problem by characterizing it as a question of traditional interpretation of the law, which should not surprise anybody since the very idea of tax exploitation is to arrange one's transactions with a view to bypassing the tax laws. Through this the tax exploitation gains its ostensible legitimacy and unimpeachability. As it is, the problem of tax exploitation simply appears when a preliminary traditional interpretation applied to the basis of taxation submitted by the taxpayer produces a certain consequence profitable to him. Next, this immediate result of the interpretation is contradicted by a number of considerations, unspoken motives, etc. which cannot indisputably be characterized as part of the specific legislation involved. The question then becomes whether the regard for tax policy set aside by exploiters will be able to find other expressions which might be effective as valid standards for classifying tax evasions. Such standards must, of course, respect the taxpayer's claim to legality

<sup>11</sup> In fact, the law has been reformulated several times, cf. *SOU* 1989:81, Ny generalklausul mot skatteflykt (New general standard against tax evasion).

and his legal rights. It is a condition, too, that the standards are empirically based and form part of current law.

An attempt will be made, relating tax evasion to existing court decisions, to analyse the general problems in this area. Different angles of legal approach will be considered and a legal conclusion will be drawn.

## 2.1. *Some angles of legal approach to tax exploitation*

### 2.1.1. *Proforma transactions and abuse of law*

In Scandinavian theory, tax exploitation problems have traditionally, been treated under the names of proforma transactions and abuse of law.<sup>12</sup>

Proforma transactions are generally understood as transactions claiming to produce certain legal consequences which, however, those involved in the arrangements have renounced beforehand. The proforma transaction, thus, implies an outward and an inward transaction at variance with each other. It is easy to imagine proforma transactions entering into a tax exploitation project. Deductions can be made by means of proforma transactions, for instance interest on proforma loans, depreciation of proforma purchases, etc. Such fictions, of course, should not be accepted at the assessment but must be replaced by facts. However, legal decisions made on the basis of proforma terminology are hard to find. Only a few decisions concerning proforma emigration to foreign countries may be mentioned.<sup>13</sup>

Kindred to proforma transactions are such transactions as are given an incorrect or misleading designation in the income tax return or documents supplementary to it. Such transactions are also said to be "wrongly labelled". An incorrect designation is, of course, most important if it means that the transaction must be judged differently. The examples are numerous, for instance interest designated non-taxable capital gain, generally taxable income (68 % rate) designated special income (50 % with special deductions) etc. All the complicated theory of disguised dividend and distribution deals with incorrectly designated transactions. Proforma transactions and incorrectly designated transac-

<sup>12</sup> Cf. on the whole Dag Helmers, *Kringgående av skattelag*. Stockholm 1956, Jens Feilberg Jørgensen, *Omgåelse af rets-regler*, København 1966, og Nordiska Skattevetenskapliga Forskningsrådets Skriftserie nr. 3, *Kringgående av skattelag*, Stockholm 1975.

<sup>13</sup> For instance 1981 UfR 752 Ø (Østre Landsret = Eastern High Court), 1983 UfR 664 Ø and 1976 UfR 925 H (Højesteret = The Supreme Court).

tions have the common feature that they offer no realistic bases of assessment. The transactions filed are fictitious and often satisfy the criminal law requirements for classification as criminal tax evasion. The concept of proforma transaction is still generally accepted, although it is rather difficult to define because of all the theoretical and practical problems it contains.

The concept of abuse of law is less unambiguous and, therefore, even more difficult to define. The term is used of the taxpayer's evasion of the tax law. This is done by representing a transaction as not comprised by a certain prescription, although its economic outcome is the very object which the prescription is meant to tax. In such cases a discrepancy between the wording of the prescription and its content or meaning, as it would appear from a realistic interpretation, is exploited. Similarly a prescription regarding deduction may be exploited by means of arrangements which make the conditions of deduction seem fulfilled, although the total result of the arrangements does not lie within the area aimed at by the prescription. If the problem of evasion is to be taken seriously it must, of course, be acknowledged that prohibitions and prescriptions have a field of application beyond their wording. The interpretation of the prescriptions, of course, should not depend on the parties' intention to evade the prescriptions or their dissatisfaction with them. The difference between proforma transactions and abuse of law is that the former imply a discrepancy between the formal transaction pretended and the real one actually made, whereas the latter implies no such discrepancy between form and content. The transaction pretended here is also actually made, even though it is often chosen instead of another with different fiscal consequences, which would be the normal and ordinary transaction under the circumstances.

According to Scandinavian theory, it has been generally accepted that proforma and incorrectly designated transactions should not be accepted at the assessment, whereas it has been disputed how to judge abuse of law. There is broad agreement that classification with abuse of law should not in itself be a sufficient reason to set aside a tax advantage. It has also been agreed, however, that the legal judgment of a case of abuse of law must depend on how the prescription involved is interpreted. The discussion, then, has focused on the question of whether a specific method of interpretation should be applied. If so, the method must imply a specifically broad understanding of taxation prescriptions and a specifically limited understanding of prescriptions concerning deductions. However, no higher court decision has been found to document the use of a specific method of interpreting cases of abuse of

law, and as to the lower courts, such use belongs to the past. The predominant Scandinavian theory, therefore, has denied the existence of a legal standard applicable to evasion.<sup>14</sup>

It is a serious shortcoming of the theory of proforma transactions and abuse of law that it does not offer sufficient guidance as to the question of proof. In theory it may be possible to define the concepts and hence to deduce legal standards to be applied to tax exploitations, but such results cannot be transferred to real life. Both concepts involve important points of dispute and it must be admitted, moreover, that they can hardly be kept apart in practice, since transactions aiming at the same result will naturally be very much alike. Only the disguises chosen are different. A proforma transaction is not meant to produce an effect according to its content, so the disguise will be determined by the facts. If the object is to evade the tax laws the transaction must have the very effect it indicates, so the disguise will be determined by the wording of the law. The two concepts are bound to become blurred.

### 2.1.2. *Transactions between associated persons—community of interest*

Tax exploitations are mostly effected through economic transactions between parties with common interests (associated persons). Such community is especially expedient when making mutual agreements to favour tax advantages instead of pursuing normal business. Within a community of interest, economic profit is of secondary importance compared to minimizing the aggregate taxation. The community of interest, therefore, is suitable for transfer of income from one member to another with a lower marginal tax rate, if possible in such a way that the former also obtains a right to deduction. Other arrangements open to communities of interest are transformation of income through perverted transfers, prices determined by taxation, etc. Particularly important are “coupled transfers” by which a multitude of assets of different tax relevance are sold together at market prices and the total selling amount is distributed at discretion over the various assets. This enables the parties to allocate a disproportionate part of the selling price to assets which are not taxed when sold.

Communities of interest may be either general or specific. What decides the community is that the normally opposite economic interests

<sup>14</sup> Magnus Aarbakke, however, has claimed the existence of such a standard in Norwegian court practice, in *Lov og Rett*, 1970 pp. 1 ff, and in *Kringgående av skattelag*, NSFS nr. 3 pp. 137 ff.

of the parties have been annulled because of family relations, acquaintance or company connections, or for specific taxation considerations. The discretionary distribution of income and expenses means that the parties collective economic status and possibility of consumption will increase because of the reduced taxation. The mutual shift of economic status, for instance in consequence of sales at cut prices, will be adjusted otherwise. This can be done on a later occasion or by letting the transferred income replace another contribution, for instance maintenance, gift, etc.

When analysing, from a tax law point of view, the importance of community of interest it is necessary to realize that parties with common interests are able to make agreements and legal arrangements with each other and with third parties just like everybody else, unless there is an explicit legal prohibition against it. Such prohibitions are rare, however. In general, parties with common interests have the same right as other legal persons to let taxation considerations influence the existence, content and form of specific transactions. If there are no specific tax prescriptions, such transactions cannot be set aside solely on grounds of the parties' community of interest. When it is of interest to enlist community of interest among the systematic concepts applied in connection with tax exploitation, this is because such community is very useful for manipulating the basis of assessment to produce tax advantages not foreseen by the legislator. The question is then whether and to what extent the legal authorities are entitled to set aside and correct such arbitrary methods, thereby neutralizing them.

Selskabsskatteloven (The Company Taxation Act), sec. 12—the “Arm’s-length principle”

Section 12 of the Danish Company Taxation Act contains an important prescription concerning international communities of interest within company relations (international groups of companies). According to this prescription the authorities are entitled to set aside unusual conditions in economic arrangements between a foreign controlling company and a Danish subsidiary company if such conditions reduce the income of the Danish company. What determines the conditions as being unusual is whether, on account of the dominating influence of the foreign company, the Danish company is subject to other economic terms than those generally prevailing between independent parties.

Corresponding prescriptions may be found in foreign tax systems and are often said to constitute the “arm’s length principle” in international

trade, etc. According to this principle the authorities are entitled to set aside terms which are not governed by business considerations and which produce of shift of income within the framework of the group. Instead, the tax is imposed according to such terms as would be acceptable under corresponding circumstances and which independent parties would have agreed upon, so-called “arm’s-length terms”.

Two conditions must be fulfilled for sec. 12 of the Company Taxation Act to apply. First, the assessment authorities must prove that the subsidiary is subject to a foreign dominance exceeding usual trade relations. Secondly, the authorities must prove that the company is subject to terms not corresponding to the arm’s length terms in a similar situation, and that these terms are of importance to the assessment of the taxable income. When these two conditions have been fulfilled a correction can be made by which the “unusual” terms etc. are replaced by “usual” terms stated according to the arm’s-length test.

Sec. 12 of the Company Taxation Act has been of little effect in practice.<sup>15</sup> Undoubtedly, this is mostly because it has been difficult for the authorities to prove the existence of unusual terms and afterwards to state the corresponding normal terms. Nevertheless, the prescription is of great importance in theory as an expression of a generally valid principle of market-determined terms.

The principle of arm’s-length terms in sec. 12 of the Company Taxation Act is of general importance to every international and national community of interest. It has been long accepted in Danish tax law theory that the taxation authorities are entitled to correct the basis of assessment if this has been manipulated to obtain tax advantages. The more specific guidelines to this are indicated by abundant court practice in the area. It is generally held that correction can be made under the following conditions:

- 1) that the tax authorities prove the existence of a community of interest,
- 2) that the tax authorities prove or at least render it probable that the content or form of the transaction are unusual compared to a normal transaction determined by market conditions, and

<sup>15</sup> In a couple of sensational court decisions regarding the settling price of multinational oil concerns to the Danish companies, the authorities’ contention that the prices demanded from the Danish companies were too high was not upheld, cf. 1988 UfR 527 H and 1987 Tidsskrift for Skatteret p. 60 Ø.

- 3) that the unusual terms must be supposed to have been produced by the community of interest.

Moreover, it is held that the correction must be legally entitled. This should not be misunderstood to mean that a specific legal title is necessary for the authorities to correct the basis of assessment. The correct statement of the real basis of assessment by the authorities is nothing but a setting-aside of such unusual and not-business-governed terms as have been produced by the community of interest and, as such, requires no specific legal title. On the contrary, the demand for a legal title must be taken to mean that taxation according to the normal and business-governed, although hypothetical, terms forming the new basis of assessment after the correction must accord with the law. A number of court decisions illustrate the right of the authorities to disregard or reinterpret the transactions of communities of interest.

The most important precedent to date is the “Havnemølle-dom” (The cornmill case) of the Supreme Court, 1960 UfR 535 H. The shareholders of a company had segregated a well-defined and lucrative part of the undertakings of a company into a personal partnership made by the shareholders in the company. This caused a reduction of the total income of the company, since part of the company income up till then was hereafter earned by a partnership owned by the shareholders. The segregation was effected in such a way that the partnership did not bear any economic risk or run any independent business activity; nor had it any justification except the avoidance of double taxation of corporate dividends. Hereafter, part of the—secure—income of the company was transferred to the partnership. The Supreme Court set aside the fiction as a basis of taxation. The decision was founded on the assumption that the normal and usual income of the company could not, to avoid double taxation of corporate income, be transferred to a partnership. According to Danish tax law, partnerships are not subject to independent taxation; for which reason the tax is charged on the individual members. Conversely, the income of stock companies is taxed doubly, first through company taxation and then through taxation of dividends with the shareholders.

Besides these material conditions of reality and market terms in economic transactions within communities of interest, a more exact documentation of the fulfilment of such conditions is also required. Even though, in general, tax law contains no conditions regarding the form of the documentation required, such requirements are to a certain extent sharpened towards communities of interest. Oral agreements,

therefore, will not be accepted as justification of deductions of interest on family loans—uneven distribution of profits in family partnerships, etc. unless supported by objective circumstances.

### 2.1.3. *Private law and tax law*

Understanding the relation between general private law and tax law is important to understanding the problem of tax exploitation. Tax law presupposes that taxable economic advantages are given a private-law qualification. The taxation cannot be fixed until the economic transaction and the advantage produced by it are qualified according to private law as wages, interest, gift, sales profit, maintenance, damages etc. In fact, a necessary prerequisite of tax law is the total complex of concepts belonging to private law.

Considering that our economic system presupposes freedom of contract as well as personal freedom, and that the basis of taxation is greatly differentiated and subject to a number of structural variations, it is evident that freedom of contract may be abused to manipulate taxation by framing contracts in such a way as to allow the parties, so to speak, to steer round the burdensome tax prescriptions. Hence, the question is whether, and if so to what extent, tax law will be able to free itself of this private-law control, so that taxation may be governed not by formal private law concepts but by the real economic circumstances which must, in the last analysis, be the basis of taxation.

It is evident that such a deviation from the very ground of tax law requires quite extraordinary reasons. An absolute condition is the existence of an evident discrepancy between the formal qualification of the given transaction and the actual economic circumstances. In German tax law the theory of “die wirtschaftliche Betrachtungsweise“ has been widely accepted. According to this theory taxation may take place independently of the formal private law qualification being imposed; instead, in accordance with the actual economic circumstances. This implies that the legal policy considerations incorporated in the legislation are given a chance to penetrate in practice too. Most Danish tax law theorists, however, have rejected such a theory as being inapplicable in Denmark. This, no doubt, is because Danish private law does not consist of stiff and pre-defined standards, but of flexible and functional concepts suitable for controlling tax law. Thus, the concepts of sale, gift, employment, etc. do not express pre-defined phenomena but may assume several different shapes. This rarely causes confrontations between the private law control and the tax law effect but, after all, it must

be admitted that such harmony will hardly exceed a certain limit. Beyond this limit, it may be maintained with perfect justice that there is a sphere where tax law disengages itself from private law control.

An important precedent illustrating this fact is to be found in 1982 UfR 738 Ø (Østre Landsret (Eastern High Court)). In this case a travel agency group had acquired a number of aircraft for the air services of one of its companies. One aircraft however, was transferred to an ad hoc partnership formed by the founder and one of the managers of the travel agency. The partnership then leased the plane to the airline company with an option, the group warranting the obligations of the partnership and bearing all other risks too. The Eastern High Court refused the members of the partnership the right to deduct depreciation, working deficit etc. Because of the close community of interest between the parties the refusal was based on the assumption that the leasing contract was made with the sole purpose of establishing a formal joint ownership for the manager, with no economic contribution or risk and with no right to dispose of the aircraft. The only purpose of the partnership and the leasing arrangement was to lower taxes. Under these circumstances it was stated that the agreements could not be claimed in the assessment of the taxable incomes and property of the members of the partnership.

The judgment must be seen as an expression of a specific concept of ownership and business. On the face of it, the partners were the formal owners of the aircraft and were exploiting it commercially by hiring it out. The normal fiscal consequences hereof, i.e. the right to deduct for depreciation and deficit, however, were not acknowledged. The judgment, then, is based on the assumption that formal ownership and commercial working do not produce the fiscal consequences mentioned above unless they involve normal characteristics such as an actual freedom of disposal, an actual chance of profit or a risk of loss of profit, etc.

Corresponding judgments may be referred to, for instance 1986 UfR 289 H (Højesteret (Supreme Court)) on the setting aside of a tax arbitration by which the taxpayer had acquired for money borrowed some current riskless securities releasing tax free exchange profits. By this transaction the interest on the loan exceeded the interest on the securities and, seemingly, the profit on the exchange must be stated as a loss by the taxpayer. When taking account of the tax consequences (deductible interest on loan, tax free exchange profit) the transaction as a whole turned out profitable. However, the taxpayer was not allowed to deduct the interest on the loan, since the Court was not able to adduce in the tax case the transactions which were valid according to

private law. The Supreme Court stressed the fact that the securities acquired were given as security for the loan in such a way that the lender was authorized to relend them. The taxpayer, then, had owned the securities only for a "short moment" and so the economic transactions claimed did not exist in reality.

The judgement in 1984 UfR 121 H may also be referred to. Here the Supreme Court refused deduction of interest on loans which were paid largely in cash. The Court based its judgment on the assumption that the loan contracts were not fiscally valid.

The above judgments may be taken as an indication of the existence of a legal standard to the effect that lawful and valid transactions will not be acknowledged by the courts if they are not "flesh and blood", but only empty frames determined by fiscal considerations.

## 2.2. *The doctrine of reality in tax law*

As mentioned above, the legal decision as to whether a given tax exploitation is to be judged as (lawful) tax planning or (unlawful) tax evasion is a common problem to appliers of the law. The subsumption under tax law raises two main problems: 1) description of the facts, and 2) application of the legal prescriptions to the facts described. As explained above, the problem of tax exploitation is first a matter of how to describe the facts. This is because tax exploitation is simply characterized by the taxpayer's manipulation and arranging of the very transactions which the taxation system has in mind. The taxpayer is adapting and organizing his economic transaction in such a way as to pursue purely fiscal purposes instead of adequate economic purposes in the real world. In other words, the existence or at least the terms of the economic transactions are solely for fulfilling the conditions of a given tax advantage. It is a misunderstanding, then, to take the problem of tax exploitation as a question of interpreting the legal prescriptions involved. The task is to deduce the true contents of the arrangement. Any interpretation is likely to be insufficient when made without first examining the facts to be judged by the prescriptions interpreted, and the endeavours will typically result in the taxpayer obtaining the tax advantage aimed at.

Instead, when judging a given tax exploitation the task is, in the first place, to concentrate on the analysis and estimation of the facts, i.e. the claimed economic transactions. A preceding analysis may show that no economic transaction, though lawful and binding according to private

law, should produce fiscal consequences at its face value. From the angles of approach described above it is possible to classify such cases under a legal standard by which the transactions made may be fiscally set aside and corrected. Such authority to correct is solely of fiscal importance and does not influence the private law rights and duties.

The decisive factor in the tax authorities' title to correct taxpayers' transactions is the right to make taxation follow the actual content and the real economy of those transactions. This means that empty and fiscally determined transactions and terms whose sole purpose is to be "coulisses" of quite other actual economic circumstances may be set aside. The standards used for the description of tax-exploiting transactions can be designated the doctrine of reality. According to this doctrine, taxation in cases of tax exploitation must follow the real economy and the actual content of the transactions which form the basis of taxation, rather than the formal clothing of the transactions. The chief sphere of the doctrine of reality, thus, must be such cases.

The more detailed contents of the doctrine of reality will have to be established, of course, in relation to the specific forms of tax exploitation. It lies beyond the scope of this account, however, to describe such details. The range of the doctrine is demonstrated by a number of judgments in various cases, where the decisions were made not so much from an interpretation of the true content of the legal prescription as from an isolation of the real content of the transactions made. Once it has been established that the basis of assessment offered by the taxpayer must be corrected and replaced by the real transaction, the traditional interpretation of the relevant legislation will normally be obvious.

The doctrine of reality is created by judges and, therefore, it has proved possible, in general, to control tax exploitation without legislative interference. On this account the development of Danish law and legal policy has been harmonious. The legislative power has been under no pressure to carry through a number of fiscally useless legal prescriptions not meant as of guidance for tax collectors but solely as "stop laws". Nor has the legislator been obliged to enact any laws against abuse in general, and the entire foundation of material legislation, therefore, has shifted.

The doctrine of reality is no arbitrary standard allowing the means to be justified by the end. Its purpose is not to repair the shortcomings and imperfections of the tax laws. Its task is not to authorize taxation where no authority is otherwise to be found. This is so even if a transaction has been found which according to current legal policy ought to be taxed but cannot be because of the lack of a legal title to taxation. The

doctrine does not clash with the condition of legality either, since it is concerned solely with the preceding qualification of the transactions to be taxed. The doctrine of reality has the express purpose of authorizing a fiscal correction of obviously fictitious transactions containing a discrepancy between the outward formal clothing and the inward reality. The right of correction enables the tax authorities to set aside or fiscally reformulate the transactions made and to charge the tax on the basis of the actual content of the transactions claimed. The application of the doctrine, then, must depend on a necessary testing including the tax authorities' documentation of a discrepancy between form and content. Not any transaction with a formal stamp can be set aside. The validity of such steps, for instance, as contracting a marriage, founding a company or emigrating to a foreign country cannot be contested with reference to their lack of real content. In that kind of transaction, in fact, the form itself is what constitutes the content.

### 3. CRIMINAL TAX EVASION—TAX FRAUD

#### 3.1. *The substance of criminal tax evasion*

The distinction between unlawful (according to tax law) tax evasion and tax fraud which is not only unlawful but also punishable must, of course, be made on the basis of the prescriptions of criminal tax law.

The prescription concerning punishable tax fraud is found in Skattekontrolloven (Taxes Management Act), section 13, and runs:

“Sec. 13. Anyone who with the intention of evasion of taxes to be paid to the State submits incorrect or misleading information for the purpose of deciding whether a person is liable to pay tax or for the assessment or calculation of taxes, is punishable for tax fraud by fine, lenient imprisonment or imprisonment up to two years.

Subsec. 2. If the act is committed through gross negligence the punishment is fine or under aggravating circumstances, lenient imprisonment.”

The prescription is supplemented by sec. 289 of the Criminal Code on tax fraud of especially gross nature for which the maximum penalty is four years' imprisonment. According to court practice, tax fraud of an especially gross nature is committed if the tax evaded exceeds 500,000 Danish kroner.

Traditionally, a liability for tax fraud exists when intentional or grossly negligent omissions of obviously taxable income or deductions of false expenses have been proved. If so, the tax return is positively incorrect or, rather, false. However, the description of the objective

conditions of tax fraud in Danish law is remarkable, seeing that penal liability is incurred not only by positively incorrect information but also by merely misleading information. The term misleading means that the information, although not false or positively incorrect, is unsatisfactory and insufficient for a correct assessment of taxation.

The criminal law condition of misleading information being submitted was topical for the first time in case, 1983 UfR 705 H. The well known leader of a political party offering determined opposition to the tax system in operation was prosecuted for gross tax fraud. The accused, who also worked as a lawyer, had established some "economy arrangements" securing the participants large deductions of interest. The arrangements were open to the clients of the accused who took part on his own account too. The idea was to raise a loan from one or more stock companies founded with the sole purpose of lending money to the participants in the economy arrangements. The loans were then used to buy one or more of the companies which took part in the arrangement as money-lenders. Interest and repayment on the loans were provided through new loans from the companies involved, and thus the natural persons participating filed deductible interest while the lending companies filed the same interests as taxable income. The new loans were repaid, and interest was paid on them, by means of additional loans, and so on. The payments on all these loans circulating in the system were mostly settled by set-offs, book-keeping transfers etc.

While, as to income tax, the participants filed considerable deductions of interest from their high-rate taxable personal income, the same interest was taxed as low-rate income with the companies. Moreover, the companies might totally avoid this tax according to prescriptions then in force allowing considerable basic deductions from company income. When, as a rare exception, the income exceeded this bottom maximum it was eliminated by buying and selling shares between companies, ending up with a loss.

As to property, the natural persons stated rapidly increasing debt incurrence while the companies stated a corresponding increase in property. The lawyer was, with considerable public attention, prosecuted for gross tax fraud and complicity in tax fraud with others.

The prosecution was remarkable in that tax exploitations of the same kind had hitherto been treated as civil tax cases without any claim for penal liability. In 1983 the case was finally decided by the Supreme Court. The decision was based upon the assumption that the deductible interest claimed was merely book-keeping transactions which could not be claimed relevant to taxation. The information in the tax return

concerning such deductions therefore, was held incorrect. The incorrect information was judged to have been submitted intentionally, because the true facts of the economy arrangement were not completely explained to the authorities, only seemingly isolated transactions appearing as actual economic loan contracts being stated. Moreover, it was taken into consideration that the accused was an expert on tax law. Consequently, he was sentenced to three years' imprisonment and a fine of about 940 000 Danish kroner.

Legally, the judgment is remarkable in that the tax return was not incorrect in the ordinary sense of the word. The deductible interest, etc. claimed in fact, completely corresponded to the book-keeping transfers and entries produced. At most, the information might be judged misleading, since the statements of the individual returns were insufficient for correct assessment by the authorities. Considered in isolation, each return seemed to state individual loan transactions, and it could not immediately be concluded that the actual arrangement consisted of a number of loans, which were circulating within a closed system and which were not meant ever to be repaid.

### 3.2. *"The fiction approach"*

The Supreme Court judgment just described has given the "fiction approach" its name. This not-very-well-defined concept comprises cases where the traditional condition of incorrectness is not fulfilled, but where the information submitted in the return contains, nevertheless, a qualified attempt to mislead. Legally, the theory causes some hesitation, because any subsequent rejection by the tax authorities of a given economic transaction may imply the imposing of a criminal liability, since such rejection stamps the return as misleading as regards the content of the transaction. After this, the criminal liability is determined solely by the subjective conditions, that is from the answer to the question whether the misleading information has been submitted deliberately or at least through gross negligence. This must cause doubt and hesitation, since, in criminal law, the subjective factor is very difficult to state, especially in cases of tax exploitation where the subjective responsibility has to be assessed on the basis of rather complicated laws and where the very fact that the taxpayer is aiming at a tax advantage does not in itself fulfil the conditions of responsibility.

Accordingly, the courts have applied "the theory of fiction" very moderately and have raised a criminal prosecution only in cases of larger evasion with pronounced culpability.

Especially tax evasion in the form of emigration to tax havens has been prosecuted as a criminal offence. In a number of cases emigration with subsequent discontinuance of paying taxes to Denmark has been rejected, because the taxpayer had kept an address in Denmark. Despite considerable doubt, actual and legal, regarding the domiciliary status, the cases have been treated as criminal cases resulting in severe terms of imprisonment.<sup>16</sup> The factor provoking punishment in these cases has been the intentionally incorrect information submitted about moving to another country.

Other transactions judged as tax fraud are intermediate invoicing, in dominating companies domiciled in tax havens of profits on import/export trade with foreign commercial partners. The decisive factor in such judgments has been that the subsidiary companies in the tax havens making the intermediate invoices were mere "mailbox companies" without employees and with no other function than that of absorbing part of the actual profits of the Danish firm. The failure to inform about the true facts of the intermediate invoicing has been judged misleading, even though intermediate invoicing does not differ formally from other kinds of middleman's business, and even though the tax return in these cases does not differ from the returns of other legitimate transactions. As, in many cases, the misleading information has been judged to have been submitted intentionally, a liability to punishment for tax fraud has been imposed in addition.<sup>17</sup>

In other cases the theory of fiction has been made the basis for imposing criminal liability in connection with transactions between company and shareholder enabling the shareholder to receive disguised dividends etc.

Of special importance is that the theory of fiction is also applied in cases where the intention of the accused is not a direct one. Responsibility is imposed also for inferior degrees of intention, i.e. if the accused is able to prove that he did not know that the transactions in question implied tax fraud, but had merely realized that this was most probable. From this may be concluded that the courts are leaving to the taxpayers themselves the responsibility for taking part in dubious and inadvisable transactions made in order to obtain tax advantages.

No clear and unambiguous delimitation of criminal responsibility can be drawn using the theory of fiction. The only possible conclusion is that

<sup>16</sup> Cf. for instance 1987 UfR 888 H and a number of unpublished judgments.

<sup>17</sup> 1982 UfR 703 Ø, 1983 UfR 845 Ø and 1984 UfR 784 H.

the question of liability to punishment will arise if the tax return contains qualified insufficiencies, perversions of the actual relations, transformations, veilings and similar manipulations. It is a common feature of the judgments involved that the taxpayer has been trying unduly to veil the reality of the transaction.

#### 4. REALITY AND FICTION IN LEGAL TAX POLICY

Tax exploitation is a question of enormous importance to legal policy, the legislature and, of course, legal authorities.

On one hand, there is the individual taxpayer's indisputable right to legality and due process. The citizens in a community governed by law have a claim to protection against not only unauthorized but also unpredictable taxation. This claim is still more urgent as regards the imposing of liability to punishment. Likewise, citizens have a claim that valid and lawful transactions be acknowledged and made the basis of taxation if they express real circumstances and are actually made. This claim must be fulfilled irrespective of any unforeseen tax advantage being the result.

On the other hand, tax exploitation causes great damage. If widespread, it undermines tax legislation as well as legal-policy endeavours to distribute burdens and advantages among the population. If tax exploitation is not countered by the legal system, general confidence in the tax laws will be lost. Private taxpayers and business life will be forced into "paper transactions" and other fictitious steps to obtain an even taxation. As to competition, tax avoidance and tax evasion are highly detrimental to the law-abiding business, which incurs additional expenses for tax payments which are perhaps avoided by others.

In Denmark these considerations are to some extent balanced by the introduction of the doctrine of reality created by the courts. In criminal cases the doctrine is supplemented by the standards concerning liability to punishment for fictitious information. Besides, tax exploitation is countered by a close and thorough control by the tax authorities. The control work is facilitated by the use of modern auditing methods, for instance EDP, crosschecking, cooperation with other authorities, etc. Moreover, the legislator is increasingly realizing that the most effective protection against tax exploitation is to remove or at least reduce the structural differences within the tax system. This will diminish the advantages of alternative transactions. Important legal policy considerations, however, speak against a single-string system placing taxpayers, forms of income and tax rates on the same footing.

From a legal policy point of view it must be concluded that Danish law comprises suitable and adequate standards for the judgment of questions of taxation. It has proved possible to balance opposing considerations in a reasonable way without too detailed and hence meaningless legislation. This does not mean, of course, that any decision made on the basis of the doctrine of reality is correct and blameless, merely that the rejection of empty transactions determined by tax purposes constitutes, on the whole, an acceptable state of law and secures the necessary legality of taxation.

The doctrine of reality makes heavy calls on the authorities and courts. It must be ensured that the doctrine is not made an excuse for charging taxes at discretion, and that only evident cases of inconsistency between formality and reality can cause the setting aside of a transaction. Not every unusual and peculiar transaction answers the conditions. The task of the legal system must be to apply the doctrine of reality to such situations where the lack of reality is so flagrant that another doctrine, that of equality, would actually be violated if the return were acknowledged.

The use of the theory of fiction when imposing criminal liability is more disputable. Misleading the tax authorities is increasingly looked upon as a crime, and a crime which should be punished severely. Only by that means can it be ensured that taxation is imposed on a real basis. The theory of fiction, however, implies a number of uncertainties. It is especially difficult, or even impossible, to state clearly and plainly the scope of the criminal liability. This may only be done in the form of a kind of survey of items. It is remarkable that about the same number of tax evasions have been treated as criminal cases as the number treated merely as administrative tax cases. There is no other possible explanation than that the different enforcement of law must be accidental. This, of course, means an inadmissible discrimination with far-reaching consequences. Internationally, therefore, the Danish theory of fiction is unique. It burdens the prosecution and the courts with a heavy responsibility to avoid imposing criminal liability for any insufficient or incorrect information but only to do so in qualified cases of misleading with the aim of obtaining an illegal tax advantage.