Difference between tax avoidance and tax evasion

Contractors are free to use tax avoidance strategies to reduce their tax liabilities, and depending on their appetite for risk this could range from investing in a **pension** to joining an aggressive offshore tax avoidance scheme.

Tax evasion, however, is a criminal offence and although typically subject to civil rather than criminal investigations by HMRC, can lead to a criminal conviction and even imprisonment.

Despite the line between the two appearing to blur at times, as long as a contractor is acting within the law in force at the time, then avoiding tax should not result in any prosecution.

However, some contrived tax avoidance schemes may not be as robust as they appear, and HMRC may be able to find a way to declare a scheme invalid, shut it down and claim back taxes, interest and possibly penalties from the participants.

Contractors should take great care to be aware of the risks before joining any avoidance scheme.

What is tax evasion?

According to HMRC: "Tax evasion happens when people deliberately don't pay the tax they should. Tax evasion is a crime." The key word here is deliberate, which includes the taxpayer knowingly concealing information or lying to the taxman to reduce their tax liability.

In a contracting context, this could involve deliberately falsifying self assessment tax returns for income tax and **corporation tax**, or not declaring income that should be taxed, perhaps paying it into a different bank account or accepting undeclared cash as payment.

> **Tax evasion happens when people deliberately don't pay the tax they should**
>
> HMRC

It could mean deliberately evading taxes indirectly by, for example, claiming a non-allowable business expense deliberately to reduce the contractor limited company's corporation tax liability. Or moving assets offshore and not declaring them to the taxman.

Tax evasion does not just apply to the more obvious taxes such as income tax. It can also apply to National Insurance Contributions (NICs), corporation tax, capital gains tax, inheritance tax and payments due under Pay As You Earn (PAYE).

Customs and excise fraud casts the net even wider, and applies to complex areas such as import tariffs, hydrocarbon duties, environmental taxes and duty on tobacco and alcohol. Fortunately, the vast majority of mainstream contractors are unlikely to encounter these types of taxes.

Processes and penalties for tax evasion

Where HMRC suspects tax fraud may have occurred, its **Code of Practice 9** describes how an investigation will run, and highlights that cooperating might help speed up the investigation, although this will go on regardless "with or without your voluntary co–operation".

Depending on its seriousness, the investigation could become a civil or criminal case. Because of the sums likely to be involved, a contractor suspected of tax evasion is likely to undergo a civil investigation, although it could still lead to criminal charges.

The penalties for tax evasion vary. At the very least, a contractor found falsely claiming expenses to reduce corporation tax will have to pay back taxes, interest and a penalty. More serious cases can lead to a criminal conviction, heavy fines and imprisonment.

The tax avoidance continuum – tax planning versus tax avoidance

Whilst tax avoidance is legal, there is a continuum of tax strategies; where a contractor wants to be on that continuum depends on their appetite for risk.

At one end of the continuum are ISAs, personal and company pensions, charitable giving and various other tax reliefs. These activities tend to attract the softer description of being called 'tax planning', although they are still technically tax avoidance.

As a contractor moves along the continuum there are tax planning measures such as using a limited company to pay **low salary and high dividends**, **income splitting** and employing a spouse or civil partner.

Riskier ends of the tax avoidance spectrum

At the more extreme and riskier ends of the tax avoidance spectrum are tax avoidance schemes. These vary hugely in type, return and risk. Some contractors have used schemes for many years that are regarded as 'watertight'.

Others have been caught in schemes that HMRC has found various means to invalidate and shut down, usually by showing they were not in fact legal according to the tax laws in place at the time that the contractor joined the scheme. In this case, usually the scheme promoter did not think through the scheme fully, so left it open to challenges.

When a scheme is shut down, the scheme participants are usually told by HMRC that they have to pay back the tax they saved by participating in the scheme, in addition to having to pay interest on the tax they owe and possibly penalties. It can be an expensive experience for contractors caught in this way.

But it should not be forgotten that tax avoidance is perfectly legal, and used to a certain extent by most taxpayers. Deliberate tax evasion, on the other hand, is illegal and a criminal offence.

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