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Taxes and social instability: How large corporations and wealthy taxpayers hide taxable money?

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ABSTRACT

Non-compliance with tax obligations, particularly by wealthy taxpayers and large corporations, continues to represent a source of social injustice that fuels social instability, especially in developing countries. Understanding the strategies of tax evasion and avoidance is of critical importance. This article highlights five main strategies used by large corporations and wealthy taxpayers to avoid taxes, including tax havens, the underground economy, aggressive tax optimization, alternative financial markets, and crypto currencies. We also propose several actions to tackle global tax non-compliance, including prevention, peer reporting, active monitoring of compliance indicators and inter- national cooperation. These actions can be combined to achieve optimal results in reducing tax evasion and avoidance.

KEYWORDS

Tax evasion; tax avoidance; tax compliance

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1. Introduction

Tax evasion and tax avoidance cause serious disruption to the society and tax administrations functioning by reducing tax revenues, creating unintended distortions or non-neutralities in the tax system (Chiarini et al., 2022; Mengistu et al., 2022; Dang and Nguyen, 2022; Ozili, 2020; Godar, 2018; Zucman, 2014; Enahoro and Olabisi, 2012). Theoretical models have been developed to show that in presence of tax evasion, taxation affect markets in ways not intended by the legislators (Chiarini et al., 2022; Mengistu et al., 2022). These fraudulent practices also introduce inequities in the tax system especially between honest citizens and tax evaders (Goh et al., 2016; Rego and Wilson, 2012; Tanzi and Pellechio, 1995). Eventually, tax evasion could reduce taxpayers' confidence in the tax system, with long run spillover effects (Popescu and Šebestová, 2022; Dyreng et al., 2008). Therefore, the fight against tax evasion is a priority objective for most tax administrations.

Since taxable income is highly concentrated among large cooperatives and high- income taxpayers, and they have more sophisticated mechanisms to circumvent the tax system, the impact of non-compliance by these taxpayers is higher for tax administrations worldwide (Godar, 2018; Zucman, 2014). Every year millions of dollars are lost by tax authorities due to the non-compliance of various taxpayers. Evidence in the literature show that large corporations and wealthy individuals, because of the value of their taxes, have a greater share in this tax evasion see (Zucman, 2014; Gravelle, 2019b; Godar, 2018)).

For instance, Guyton et al. (2020) combine random audit data with offshore bank accounts data to estimate the size and distribution of income tax evasion in the United States. The results suggest that evasion through off- shore financial institutions is highly concentrated at the very top of the income distribution. Zucman (2014) also shows that financial transaction through offshore corporations reduce the tax revenues by around 20% in United States. Using ad- ministrative data, Gravelle (2019b) found that large corporations and wealthy individuals hold trillions of dollars of assets in tax havens. Understanding the broad mechanism of non-compliance of these high-income taxpayers is central to detecting tax evasion and implementing effective tax policies (Guyton et al., 2021; Gravelle, 2019a). Another study conducted by Fuest et al. (2022) in Germany revealed that 82% of large German corporations have subsidiaries in tax havens. In terms of profitability, Fuest et al. (2022) show that these subsidiaries are more profitable for corporations than those located in non-tax haven countries. This study estimates at UR 5.4 billion the annual loss of tax base for the Dutch tax authorities.

An important prerequisite for fighting tax evasion among wealthy taxpayers is to understand the main strategies used and to implement effective methods to annihilate them. Therefore, the objective of this paper is two-fold. First, we focus on how corporations and wealthy taxpayers manage to hide so much money from the tax authorities. Secondly, we discuss actions that might allow to reduce tax evasion. From the literature, we highlight five main strategies used by corporation and wealthy individuals to avoid tax. These strategies include tax heavens, underground economy, aggressive tax optimization, parallel financial markets, and cryptocurrencies. Regarding mitigation actions, the effectiveness of international cooperation, prevention strategies, peers reporting, and active monitoring of compliance indicators are discussed.

The rest of the paper is structured as follows: Section 2 discuss tax evasion schemes mainly used by large corporations and wealthy taxpayers. Section 3 analyses possible avenues to reduce international tax evasion. Section 4 concludes.

2. Tax evasion and tax avoidance schemes

The concepts of (illegal) tax evasion and (legal) tax avoidance, although referring to distinct behaviors, share the same underlying intent, namely to avoid taxes (Alstadsæter et al., 2022). Tax evasion consists in not reporting all income or profits to tax authorities (Merks, 2006; Dell'Anno, 2009; Petersen et al., 2010). This non-compliant behavior includes schemes such as hiding a portion of income to avoid taxes, not remitting taxes collected to the government or using any illegal means to reduce taxes. Conversely, tax avoidance is a legal action that consists of taking advantage of the provisions and shortfalls of the legislation in order to legally reduce the income or profits declared and thus the resulting tax (Alstadsæter et al., 2022; Merks, 2006). While planning to reduce taxes through deductions or credits may be legal, abuse of the legislation occurs when activities are conducted in a manner that avoids obligations and taxes against the spirit of the legislation. Table (1) shows an overview of strategies of tax evasion and tax avoidance used by large corporations and wealthy taxpayers.

2.1. Tax havens

The Panama Papers in 2016 and the pandora papers in 2021 revealed tax heavens as the biggest tax evasion strategies used by large corporations and wealthy individuals (Fernando and Antoine, 2022; Li and Ma, 2022). The OECD defines tax heaven as a territory that offers attractive taxation (very low or non-existent tax rates), absolute bank secrecy which is unfailingly opposed to any tax administration of a third country-, and offers great ease in creating a company or opening an account, all against a background of extreme opacity (Fuest et al., 2022; Behuria, 2022; Garcia-Bernardo et al., 2022; Kemme et al., 2017; Eden and Kudrle, 2005). The legal system of these countries and territories provides significant opportunities for multinationals and wealthy individuals to avoid their tax obligations in their country of origin. Depending on the criteria used, the list of coun- tries classified as tax havens may vary (Menkhoff and Miethe, 2019; Dharmapala and Hines Jr, 2009; Palan et al., 2013). However, some countries are found in most of the lists. These are the British Virgin Islands, Anguilla, Panama, Seychelles, Vanuatu, Dominica, Fiji, Guam, US Virgin Islands, Palau, American Samoa, Samoa, Trinidad and Tobago. These tax havens offer large corporations and individuals the opportunity to evade taxes simply by not declaring business, income and assets managed in that country. According to Shaxson (2019), more than half of the world's financial transactions pass through tax havens. Zucman (2014) estimates that about 8% of the world's financial wealth is held in tax havens. This is a strong indication of the magnitude of these tax havens in the global financial environment and therefore of the magnitude of tax evasion associated with them. The strategy is to allocate an important part of its activities through institutions installed in tax havens or by setting up one or more offshore shell companies. In this way, all income from the activities of the corporation will be exempt from taxation in the legitimate territory of origin of the company. Tax havens are, by principle, territories that are reluctant to cooperate with international organizations. In addition, bank secrecy guarantees the confidentiality of the banking information of companies and individuals, and legal secrecy guarantees the anonymity of the owners of large companies. In the case of wealthy individuals, the most common stratagem is the use of offshore and false name living in a tax haven and the creation of a trust. A trust is a legal entity based on a contract of trust between the wealthy individual and a nominee in charge of the finances under the management of the fictitious trust. Thus, the wealthy taxpayers avoid taxation in their home jurisdiction by placing his funds in the trust. With regards to the determinants of tax heavens use, Makni et al. (2019) use a sample of 235 Canadian firms active between 2014-2015 and show that multinationalism, assets intangibility, thin capitalization, withholding taxes, equity-based management remuneration, and tax fees paid to auditing firms increase firms' likelihood to hide taxable money through tax havens.

2.2. The underground economy

The other tax evasion strategy is the underground economy, which includes all legal and non-legal activities whose revenues escape the tax authorities (Koloane and Bodhlyera, 2022; Huynh, 2022; Williams and Schneider, 2016; Kemal, 2010; Blackburn et al., 2012). The activities concerned are illegal when they are prohibited by law (drug sales, prostitution, etc.) or when legal activities are carried out under illegal conditions. The latter category includes strategies such as undeclared employment, non- declaration of employees, under-invoicing, smuggling, corruption and fraudulent ac- counting (Abu Alfoul et al., 2022; Torgler and Schneider, 2009). These underground economy activities represent significant losses for the tax authorities. The sectors of the economy that are conducive to tax evasion through the underground economy are essentially those where cash transactions are common, such as construction, illegal sales, smuggling and drug trafficking. High taxes, recession, high unemployment, and negative public attitudes toward government and taxes are both causes and consequences of the spread of the underground economy and associated tax evasion and avoidance (Blackburn et al., 2012; Kemal, 2010; Torgler and Schneider, 2009).

2.3. Aggressive tax optimization

Tax optimization, a strategy of tax avoidance, consists of exploiting subtleties of a tax system or inconsistencies between several tax systems with the intent to neglect the spirit of the legislation (Lenz, 2020; Brodzka et al., 2017; Carrero and Seara, 2016). The optimization techniques used by large corporations and wealthy individuals are di- verse and varied (Di Fazio, 2021; Aburajab et al., 2019; Cachia, 2017). Among others, the optimization by undercapitalization, which consists in overestimating the financial charges in order to reduce the profit and therefore the tax deductible, is the most known strategy. The other strategy is tax expatriation, which consists of multinational companies artificially relocating their profits in countries where the tax system is more favor- able to them, rather than in the countries where they create value (Chen and Lehmer, 2021; Ftouhi and Ghardallou, 2020). Chen and Lehmer (2021) even find evidence of US multinationals which consistently shift domestic earnings to near- zero. Their results suggest that multinationals corporations that face tax incentives to shift earnings and taxpayers with larger revenue shifting ability are more likely to report near-zero domestic earnings. These aggressive tax optimization practices, often at the limit of legality, are very strongly concentrated in tax havens and create considerable losses in tax revenues for tax administrations. Depending on the country, Ftouhi and Ghardallou (2020) and Kutera (2017) show that abusive tax claims and royalties are also tax optimization mechanisms used by large corporations to receive refunds to which they are not legally entitled.

2.4. Parallel financial markets and cryptocurrencies

The shadow banking system has grown in recent years to become an important pillar of the money laundering and tax evasion in many developed countries (Ötsch and Schmidt, 2016; Zagaris, 2007). This system includes all institutions offering credit and other financial intermediation services outside the scope of banking regulation (Paiardini, 2015; D'Arista and Schlesinger, 1993). These institutions therefore perform bank-like activities without being subject to banking regulations, in particular the sharing of information with tax authorities where legal provisions allow. Thus, these financial intermediaries often serve as a tax umbrella for large corporations and wealthy individuals. It plays a primordial role in the operation of shell companies and also in the laundering of money from the underground economy (Salami, 2021). Thus, this parallel system allows to hide the revenues and profits of certain companies and wealthy individuals through business models that are often illegal. As an illustration, Prospector Edge in Canada offered a tax shelter to investors in the form of a franchise that commercializes software (cloud-based stock-keeping). Under this business model, the investor buys the franchise on credit, but deducts almost the entire cost of the purchase from taxable income. OECD data indicates that the shadow banking sector accounted for about 51 trillion euros in 2011 (about $70 trillion), or between 25 and 30 percent of total global financial sector assets or 50 percent of bank investments. Estimates suggest that this sector accounted for about 40% of Canada's nominal GDP at the end of 2012 and 95% of U.S. GDP at the end of 2011. This makes the parallel financial markets one of the most important players in the global financial crisis that countries must control.

In addition to the traditional parallel financial market, cryptocurrencies have become a new avenue for tax evasion (Alm, 2021; Marmora, 2021; Hendrickson and Luther, 2021). By posing a significant detection problem, cryptocurrencies are used for illegal activity by corporation and wealthy individuals including tax evasion. Inability to observe cryptocurrency transactions is a major source of tax evasion as administration only rely on self-reported earnings and transactions.

Table 1. Overview of Tax evasion and Tax avoidance strategies schemes.

	Strategies	Literature
Tax evasion and Tax avoidance schemes	Tax heavens	Fernando and Antoine (2022), Li and Ma (2022), Fuest et al. (2022) Behuria (2022), Garcia-Bernardo et al. (2022), Kemme et al.(2017), Eden and Kudrle (2005), Menkhoff and Miethe (2019), Dharmapala and Hines Jr (2009), Palan et al. (2013), Shaxson (2019), Zucman (2014).
	Underground economy	Koloane and Bodhlyera (2022), Huynh (2022), Williams and Schneider (2016), Kemal (2010), Blackburn et al.(2012), Abu Alfoul et al.(2022), Torgler and Schneider (2009).
	Aggressive tax optimization	Lenz (2020), Brodzka et al. (2017), Carrero and Seara (2016), Di Fazio (2021), Aburajab et al.(2019), Cachia (2017), Chen and Lehmer (2021), Ftouhi and Giardiello (2020), Kutera (2017), Ftouhi and Ghardallou (2020).
	Parallel financial markets and cryptocurrencies	Ötsch and Schmidt, (2016), Zagaris (2007), Paiardini (2015) D'Arista and Schlesinger (1993), Salami (2021), Alm (2021), Marmora (2021), Hendrickson and Luther (2021).
	Tax heavens	Fernando and Antoine (2022), Li and Ma (2022), Fuest et al. (2022) Behuria (2022), Garcia-Bernardo et al. (2022), Kemme et al.(2017), Eden and Kudrle (2005), Menkhoff and Miethe (2019), Dharmapala and Hines Jr (2009), Palan et al. (2013), Shaxson (2019), Zucman (2014).

3. Fighting tax evasion and tax avoidance

3.1. Prevention strategies

Several strategies can be implemented to prevent tax evasion. Among others, the simplification of processes is one of the important points (OECD, 2019; Fernando and Antoine, 2022). Nudges are greatly suggested by behavioral economists to improve the relationship with taxpayers and the tax administration by strengthening taxpayer confidence, accompanying taxpayers in their tax declarations (Vainre et al., 2020; Alm et al., 2019; Fonseca and Grimshaw, 2017). The complexity of the tax systems of some countries may encourage taxpayers to resort to tax evasion schemes. Public communication strategies have also shown important results in the fight against tax evasion. Indeed, tax administrations are increasingly using non-coercive methods, as voluntary correction, and behavioral nudges to encourage corporations and individuals to correct their amounts, with the promise of no penalty (Botzem, 2019). Social approaches to improving the public administration's image and the government's rigorous management of public finances are generally positive signals that the government is acting. In addition, As suggested by the OECD (2019), the establishment of a framework to support businesses and individuals by the tax administration can con- tribute to increasing trust between the tax administration and taxpayers, all of which has an impact on tax compliance.

3.2. Active monitoring of compliance indicators

In order to combat tax evasion, it is important to measure the relevant indicators of tax evasion, the risks of tax evasion, and the profiles of tax evaders at risk, and to engage in mechanisms to monitor compliance and behavioral indicators (Savic´ et al., 2022). In a pivotal report on managing and improving tax compliance, the OECD (2004) encourages the use of public opinion-based surveys and research to measure compliance indicators such as taxpayers' attitudes, awareness, perception, risk preferences, tax morale, social norms and intention to comply. Analyzing the trends of theses behavioral indicators can support strategic evasion risk assessment. Using administrative data to assess risk of tax evasion is also encouraged (OECD, 2004). A rigorous follow-up of the population at risk will allow to measure the im- pact of the actions and to redirect the actions implemented. Bergman (2003) suggests that monitoring these indicators might improve tax administrations both enforcement measures but also the ability of fast adjustments to evasion patterns.

3.3. Peer reporting and random audits

Peer reporting has been shown to be a important means to detect tax evasion. In United states, Gravelle (2009) found that personal income tax losses due to tax evasion are facilitated by a lack of reporting. Gravelle (2009) suggests that tax authorities should encourage peer reporting through social norms-based advertising campaigns, rewards, behavioral economics nudges or other incentive mechanisms. However, other studies also suggest cultural differences might affect the efficiency of such approach. For instance, Romaniuc et al. (2022), in a field experiment, found that participants in Moldova view the act of cooperating with central authorities as less socially acceptable than taxpayers in France. There result also suggest that participants in Moldova will tend to engage less frequently in peer reporting than participants in France. Overall, the mixed results suggest that peer reporting is an interesting avenue, but it needs to be explored within the social context of each tax administration. Furthermore, it has been clearly established in the literature that random auditing can capture tax offenders when proper selection criteria are used (Snow and Warren Jr, 2005; Guyton et al., 2021; Advani et al., 2021). Snow and Warren Jr (2005) show that an increase in taxpayers' uncertainty about whether the audit will detect tax evasion could increase compliance among prudent taxpayers if they believe they will be taxed at least the amount of the evaded taxes.

3.4. International cooperation

International banking cooperation is undoubtedly one of the most effective methods of combating tax evasion by multinationals (Jiang et al., 2022; Yang et al., 2022; Prettl and von Hagen, 2022). Johannesen and Zucman (2014) advocated for the end of bank secrecy will be a major step in reducing corporate and wealthy tax- payers ability to avoid tax. The exchange of strategic data between tax administrations and with the banking system of tax havens will be an effective tool to fight global tax evasion. As suggested by Emmenegger (2017) a revision of international tax laws, with the participation of tax heavens countries is needed.

Table (2) present an overview of multiples strategies to fight tax evasion and tax avoidances for tax administrations.

Table 2. Overview of strategies to address Fighting tax evasion.

	Strategies	Literature
Fighting Tax evasion and Tax avoidance	Prevention	OECD, (2019), Fernando and Antoine, (2022), Vainre et al., (2020); Alm et al., (2019); Fonseca and Grimshaw, (2017), Botzem (2019).
	Active monitoring of compliance indicators	Savic´ et al. (2022), OECD (2004) Bergman (2003).
	Peer reporting	Gravelle (2009), Romaniuc et al. (2022).
	International cooperation	Jiang et al. (2022), Yang et al. (2022), Pretti and von Hagen (2022), Johannesen and Zucman (2014).

4. Conclusion

This paper aimed to shed light on the various strategies implemented by large corporations and the wealthy to hide their revenues and profits from the tax administration. The results highlight multiple mechanisms of tax evasion and tax avoidance used by large corporations and wealthy taxpayers including tax havens, the underground economy, aggressive tax planning, parallel financial markets, and cryptocurrencies. This paper also contributes to the current debate on tax compliance (Jiang et al., 2022; Vainre et al., 2020; Alm et al., 2019; Fonseca and Grimshaw, 2017; OECD, 2004) by suggesting potential strategies to reduce tax evasion and tax avoidance. These strategies include preventive actions, active monitoring of compliance indicators, peer reporting and international cooperation. While this paper is an interesting first step, further analysis will be needed to focus on each of the potential mitigation strategies and methods that can enhance the effectiveness of tax administration.

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Conflict of interest

All the authors claim that the manuscript is completely original. The authors also declare no conflict of interest.

Author contributions

Conceptualization: MMO; Investigation: MMO and MLL; Review: MMO and MLL; Writing – original draft: MMO and MLL; Writing – review & editing: MMO and MLL.

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