TAX EVASION BETWEEN FRAUD AND OPTIMIZATION

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Abstract

Tax optimization, often called legal tax evasion is the use of methods and techniques that are within the law, in order to reduce or even cancel the tax liability. To achieve such an approach, the taxpayer or his advisers must know in depth the tax law - and by extension, the financial and administrative law - and, moreover, must be functional tax jurisdictions which allow the use of appropriate assemblies.

The recent leasks, as WikiLeaks, LuxLeaks, SwissLeaks, Panama Papers etc. on financial flows to tax havens highlight the far-reaching unprecedented evasion and tax fraud, both in the amounts involved - trillions of dollars - and sophisticated assemblies used primarily by multinational companies to the detriment of the public finances of Member territory headquarters and branches which are located and, therefore, detrimental economic and social life of those countries.

Tax evasion is based on legal mechanisms which, combined together in the montages of increasingly complex, allowing operators, mostly multinational legal entities to circumvent national tax law and not pay the taxes due.

The border between tax optimization, tax evasion and fraud is very thin, optimization using various legal methods to reduce the tax owed, whereas tax evasion using illegal means, which covered crime.

Tax evasion reveals either optimize or fraud. There is a significant international dimension of tax evasion because it is favored by multinational corporations operating conditions.

Keywords: *tax evasion, fraud, optimization, leaks, multinationals.*

1. Introduction.

Definitions of fiscal optimization, evasion and fraud

The concepts of optimization and tax fraud can be defined without interfering with each other. Thus, tax optimization are accomplished by using legal means - deductions, tax reductions, exemptions, derogatory regimes, tax niches like tax credit etc. - whose legitimacy and effectiveness can be challenged by one of the stakeholders, ie public authorities, but which nevertheless remain within the law.

Tax fraud can be identified by the two cumulative elements:

- doubtful operations identifying the tax base and determining the amount of tax liability within national involved jurisdictions;
- bad faith of the taxpayer who violated the law in order to reduce the amounts to be paid as tax.

The term "tax evasion" is vague and leaves room for interpretation, especially since generally distinguish between legal avoidance and illegal evasion, the latter being, in fact, tax evasion.

According to OECD, the international organization that develops and disseminates economic studies most often consulted, tax evasion can be defined by three features:

- taxpayer does not comply with the legislator's intention, or taking advantage of loopholes in the text of the law, whether the provisions contained therein for purposes other than those provided;
- actions taken by the taxpayer have real justification or there are justification other than the display;
- taxpayer tries not to show the procedures they used, which sometimes is even provided in the sales contract, as it is suggested by a tax adviser.

2. Optimization and tax evasion mechanisms

2.1. General characteristics of tax optimization schemes

Net revenue optimization methods that use the companies, mainly multinationals, fall into several categories:

- procedure of assignment to a category of businesses, "check the box", through which companies can choose to classify a category of companies which have the right to repatriate profits;
- transfer pricing mechanisms applied in goods trade, services, financing product between entities of the same group, used as the main form of tax optimization, but is, in most cases, a form of legal evasion;
- companies nicknamed «hybrid», functioning only as a "mailbox" for multinationals, who transfer their profits in tax havens, mostly thanks to tax conventions concluded between countries. Thus, the company resident in Ireland, with the Board in Bermuda is subject to Bermuda tax laws;
- choosing a "state tunnel", ie a state that allows the benefit of a resident company is not taxed at source and,

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thus, can be transferred in a tax haven. For example, in the European Union, a company resident in France owned by American multinational Über[1] using a tunnel Dutch firm to bill services, which would require it to pay tax in the Netherlands. Dutch company pays right to use, very high, patents Über subsidiary in Bermuda, where, however, those payments are not taxable. In this scheme, the Dutch company is only an intermediary, a "firm tunnel" to escape multinational Über the incumbent tax liability by receiving royalties from the patent.

2.2. Aggressive tax planning - a form of tax evasion

In many cases, mainly in multinational companies, tax optimization is achieved through aggressive tax planning, using abusive leaks from preferential tax law and conventions. Some examples of such techniques of tax evasion are set out below [MFP 2014]

- transfer pricing abuse. Intellectual property rights of a parent company are transferred to a subsidiary resident in a country where proceeds from these are little or no taxation. Another subsidiary, using those patents pays an overstated amount of the first branche, the whole multinational company tax on income from intellectual property rights are very low or zero;;
- the use of agreements between subsidiaries, such an understanding of price for goods or services exchanged. Thus, the acquiring company recognizes the amount to be paid as a debt, interest is deductible from the taxable base and seller company consider same amount as a financial asset that brings dividends, which are generally taxed less or not at all;
- locate a branch in a country with a permissive tax regime for certain categories of products / activities with the aim of using that subsidiary in a process of international tax optimization;
- location of the sale of assets in a country with low tax rates. Assets are bought and then sold by a subsidiary resident in a low tax country, where there are no taxes levied on capital gains from the sale of assets.

Transnational companies are able to obtain from the tax authorities in different countries capabilities that allow them to significantly reduce tax obligations they have towards those jurisdictions. These countries accept taxing some branch located on the territory of multinationals less than in accordance with the general provisions of taxation in order to attract big companies to invest directly in those countries, and therefore bring significant amounts as capital injection in their economies.

A conclusive example is Ireland[2], which granted multinational companies - such as the American IT: Google, Apple, Microsoft, etc. – the right to create resident companies in Ireland and who have, in their turn, branches in other jurisdictions (so-called mechanism "double Irish") between them can be made transfers of revenues provided from activities. Thus, profits made by an Irish resident company belonging to a multinational can be routed to its subsidiaries in a tax haven where the tax rate is about 0%. Note that Ireland does not have legal provisions related to transfer pricing, which allows international tax evasion like the one above.

For example, tax evasion scheme applied by Google in Ireland was: Google Ireland Limited company pays royalties to Google Ireland Holdings, which is the holder of patent law Google. On the other hand, Google Ireland Holdings has located its Board in Bermuda - a tax haven heavily used by multinational companies - and transferred their benefits there, where they are not taxed.

2.3. General aspects on transfer pricing

In general, in the the integrated companies composed of several entities there are indispensable exchange of goods, services and financial products. The prices of those goods and services that are traded are called transfer pricing or internal assignment. These prices occupies a place of primary importance in the financial management of companies belonging to the group, and for the entire multinational financial performance, the main causes being:

- transfer pricing is a performance management tool for companies because through them can achieve financial evaluation of the various entities in the group;
- transfer pricing allow transfer of benefits between the entities, which, when those entities are located in different national tax jurisdictions, highlights their managers skills to optimize taxation for whole society, without a close relationship with economic and / or comercial performance of their specific activity.

In the relationship between the two entities, either subsidiaries of a group or independent firms under trade relations, the transfer prices used between them determine the profit that each one obtained by sale of products or services they produce and/or sell. It follows logically that the manipulation of transfer pricing allows groups, especially multinational companies to consider increasing the margin and decide accordingly, the geographical location of its component entities in jurisdictions where the tax environment is most favorable.

Also in the international economic environment, which requires competitive relationship increasingly freer, transfer prices are of paramount importance, because using them as a tool to optimize financial management, managers society multinational can determine economic and financial performance of each entity component. In addition, analyzing the fiscal environment in which they are resident, multinational company management can achieve optimal tax planning, so that fiscal pressing from tax of the whole group to be minimal.

[1] Über American society offers its customers an application that can call taxis using a tablet or an iPhone.
[2] http://www.financialsecrecyindex.com/PDF/Ireland.pdfhttp://www.financialsecrecyindex.com/PDF/Ireland.pdf.

The correct determination of transfer prices are also a major concern for direct and portfolio investments, because the image of a business they present can reflect economic and financial reality or induce an completely false impression, stimulating or or vice versa discouraging investment.

For example, a company can buy components from its subsidiary located in another country, with a transfer price below the market price. These subsidiaries will account for less income, so a profit tax base smaller, consequently the amount of tax payment as corporate tax will be lower, which negatively affects tax public revenues in that country. Public authority in the country where is located the purchasing company - which can be even parent company - is not interested in correcting prices, because if that company issues its consumption products within its jurisdiction, the tax payable will be bigger.

The phenomenon of reducing the tax base can be, however, repeated in the case of the mother company. Multinational company creates a business intermediary enterprise between manufacturer and distributor, which locates in a state with a very small tax - so-called tax haven - or having concluded special tax arrangements. In these jurisdictions, multinationals can afford to recognize sales prices very high and very low purchase prices, resulting in a high nominal profit margin, but which will be little or no taxed.

In such a situation, it is injured including parent company tax jurisdiction, public finances being threatened by the reduction of income sources. Thus, by examining the structure of tax revenues in most states with economy based on competitive relationships It can be noted that the share of tax corporate is important - reaching over 12% of total governments revenues[3] - which makes risks observed reduction in the tax base of this tax to be perceived as real and very damaging to public sector financing in those countries.

In this context, the regulation of transfer pricing has become a necessity for all countries, especially since the process of economic and financial globalization accelerated, many countries, particularly the developing countries, are not prepared to bear the shocks the liberalization of foreign trade.

Although no recent[4], the concerns of limiting multinational companies to practice transfer prices between their component entities as they wish prompted worldwide tax authorities to adopt regulations on transfer pricing and implicitly to calculate the tax base for profit tax.

Regulation of transfer pricing between subsidiaries of multinationals must meet several basic requirements, some of which being considered essential for countries where these companies are located:

- transfer pricing must ensure the international effectiveness, manifested by facilitating foreign direct investment by multinational companies in third countries, mainly through the adoption of agreements to avoid international double taxation between the States concerned;
- transfer pricing should promote equity between countries where subsidiaries participating in the exchange of goods, services, financial products are located, so the tax base in each country to show real added value and in this way it could avoid tax evasion.

The need to regulate transfer pricing is even more acute, as the developments in recent years, very fast, have increased significantly the volume of trade and financial exchanges, in the context of expanding globalization. In addition, the polarization of the population in terms of disposable income, and thus of the quality of life, in many countries of the world, under the pressure from increasing demands on public authorities, because they produce and / or distribute more numerous and better quality social services. This, however, requires a considerable increase in the budgetary allocations for the social sector and therefore require public revenues, primarily tax increased.

The settlement and acceptance process of these regulations on transfer pricing comes out not only developed countries, that were making up after only two decades more than 80% of the international trade, but also in many other developing countries their share in trade between all contries came to exceed at the moment 40%[5].

In this context, the work of the World Forum in order to regulate transfer pricing have resulted since 2013 in a program known as "Base Erosion and Profit Shifting" (BEPS), program supported by the states participating in debates and to be finalized and implemented in the coming years[6].

OECD countries, which have joined and other non-OECD, agreed on the basic principles on these prices, primarily in the exchange of information between tax administrations, as documentation outlining the structure and specificity productive, trade and financial activities of the resident firms and methods for determining transfer pricing of component entities groups when these groups are multinational.

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[3] http://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do.

[4] Since 1917, US law "War Revenue Act" provide US tax authorities the right to carry out adjustment corporate tax base.

[5] A good example are the states of the group BRICS (Brazil, Russia, India, China and South African Republic) whose importance in the global market is growing, both due to the increase of the GDP per capita and increasingly extensive penetration of international markets.

[6] Considering that tax base erosion and transfer benefits to jurisdictions applying lower taxation is a major risk facing the public finances of any country, the OECD and the G20 adopted in 2013 a plan containing 15 actions to restrict the possibilities of evasion tax.

Project BEPS aims to ensure public budgets volume of tax revenues in line with the economic development and the value newly created by a package of measures to combat the business, particularly holdings and multinationals, tax optimization through the use of any leaks the law or agreements with foreign tax administrations.

Source: *www.oecd.org/fr/fiscalite/beps.htm*

BEPS is built taking into account the principles for transfer pricing, those principles have been defined in OECD Guidelines since 1995. The most important of these principles is respect by any multinational company, the full competition determining transfer prices in transactions between its subsidiaries, or the use of prices that are comparable to those charged between independent enterprises with the same activity under similar conditions. In many cases, however, products, services or intangible assets exchanged have no equivalent on the market and therefore, transfer pricing can not be determined by comparison. To overcome this difficulty, OECD has proposed several methods that can be established and / or controlled transfer prices in compliance with the arm's length principle.

Methods for determining transfer prices proposed by the OECD Guidelines [Pellefigue J., 2016] can be divided into two categories:

- methods that calculate trading prices between subsidiaries of the same multinational company, starting estimate the share of each subsidiary involved incumbent in total profit. Share of profit or benefits can be achieved in several ways:
    - directly share net margin (TNMM Transactionnal Net Margin Method), which determines the net margin / profit per branch compared with net margin made by independent similar enterprises. This method is most often applied in calculating transfer prices because the necessary information is available from accounting reports;
    - directly share in overall profits (PSM Profit Split Method) between different branches involved, depending on the proportion participating in the product /service. The method is less used because of the complexity and the absence of specific procedures;
- flat allocation profit according to a distribution formulas (Formulary Aportionment). The most commonly used formula is known as "formula Massachusetts", which determines index distribution of profits made across multinational companies by a subsidiary "i", as a weighted average tangible AC, turnover CA and as the wages fund FS

$$i = \alpha * \frac{ACi}{\sum_{J=1}^{n} AC_j} + \beta * \frac{CA_i}{\sum_{j=1}^{n} CA_j} + \gamma * \frac{FS_i}{\sum_{j=1}^{n} FS_j}$$

Where:

i = branch concerned

n = total number of branch / subsidiary of the multinational society

$\alpha + \beta + \gamma = 1$

Although at the level of the OECD is considered that the method is cumbersome, the European Union is being developed proposing a Directive ACCIS[7] proposing sharing profits between subsidiaries of multinational society, according to a formula similar to the formula Massachusetts;

- methods aimed comparability of prices and / or margins achieved by independent firms to market. Among these methods are found:
- methods using the market prices of (CUP Comparable Uncontroled Price) compared with transfer pricing proposed, which are a method rarely used because it is difficult to identify products / services completely similar;
- increased purchase price method (CPM Cost Plus Method), using mainly an accepted price of the supplier to delivery or production, plus a profit margin;
- resale price method (RPM Resale Price Method), which takes into account the price that the company producing the goods / services invoiced by a selling company belonging to the same multinational, who resells the product to an independent company. The final price minus profit margin approximated the average level that it applies independent company.

The last two methods are little used because informations on profit margins practiced by the firms are difficult to measure correctly and businesses are not legally obliged to disclose such information.

3. Conclusions

Tax optimization is a goal of every company, because thereby increase financial profitability. Often, the mechanisms by which it can carry out a fiscal optimization seek to exploit leaks of national law and, in this case, talking about legal tax evasion.

Among other methods are also tax arrangements which privileged multinationals derive from host countries to their foreign subsidiaries. These practices, however, are regarded by the public authorities and / or the population of those countries as immoral because, on the one hand reduce government revenues which primarily finances social policies and, on the other hand, seriously affect competition.

Press disclosures in recent years - including the largest response was WikiLeaks, LuxLeaks, SwissLeaks and Panama Papers - they showed the huge size of the tax worldwide evasion. It is mainly evasion which goes beyond legislation, but exploiting its weaknesses, both nationally and in the international conventions.

The consequences of tax evasion are high in all countries, but the worst records in emerging economies that have a greater need for public funds to develop and, in addition, benefit little from theit own resources due to the actions of the multinational companies in their territory, usually in agreement with public authorities in host countries.

The international tax regulations need

[7] European Commission proposal for a Directive on common consolidated tax tax (ACCIS) submitted for debate and adoption by the Council of the European Union in 2016.

Tax rules on corporate tax is a constant concern and very timely for both multinational and national tax authorities where the component entities are resident. Note that if in terms of tax rates, according to international treaties[8], each national jurisdiction is fiscal sovereign, sizing trim corporate tax can be influenced by the decisions of multinational companies through transfer pricing, in compliance with the relevant legal framework

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[8] The tax system acts to collect public revenues from taxes and, in addition, guide economic growth and contribute significantly to achieving macroeconomic balance. Accordingly, in any national tax system, resident status is crucial because any resident entity is the main contributor. However, if they work in several countries or tax jurisdictions, it is difficult to identify tax residency and thus the tax burden on the entity.

To avoid double taxation of the international organizations - first OECD, and the UN - have proposed models of bilateral tax conventions to which the concerned States establish methods for calculating the tax liability for taxpayers resident in one state but which earn revenues in other State. Tax conventions play a key role in regard to taxation in the current major expansion context of globalization. Thanks to these agreements may encourage foreign investment and, consequently, can stimulate national and global economic growth. On the other hand, thanks to bilateral tax conventions the tax administrations of the concerned States can act against tax evasion and tax fraud even international.

Source : : Manuel de l'ONU relatif à certains aspects de l'administration des conventions concernant la double imposition établi à l'intention des pays en développement Édité par Alexander Trepelkov, Harry Tonino et Dominika Halka, Nations Unies New York, 2015, https://www.taxcompact.net/documents/UN-Handbook_DTT_FR.pdf.