

Legal and Illegal Tax Evasion

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Abstract: *In the economic and social plan, tax evasion is a reality seen in various forms, such as the keeping of not realistic accounting books; willful destruction of documents that might lead to the discovery of real product deliveries, adopted prices, fees received or paid, establishing false customs declarations for the goods import or export, preparing false tax declarations, while knowingly not mentioning but a portion of the incomes. The largest tax evasion - 60% - is generated from VAT, while social contributions generate approximately 24% of the total fiscal evasion, mainly through the phenomenon of “illegal work” (employees in the underground economy). For this purpose it is necessary a deep reform of the taxes administration, mainly in the direction of increasing the degree of tax collection. The phenomenon as a whole is very difficult to control and to quantify and to this contribute also the tax laws’ peculiarities, tax policies, corruption and the standard of living.*

Key words: tax evasion, fiscal fraud, mechanisms of the tax evasion

JEL classification: H2, H26, H3

1. Literature Review

The definition of relevant terms used in the characterization of the phenomenon of tax evasion seems at first glance to be relatively straightforward. Unlawful tax evasion (tax fraud) is defined as the illegal use of various means with the aim of reducing tax liabilities—for example, false tax returns for taxable income. By contrast, the lawful tax evasion—for instance tax-planning or attenuation - is legal, the only question that arises is whether such action is correct or not from the technical point of view. This might require though a court decision. However, the distinction between tax evasion and fraud is basically clear. Although it is not a new phenomenon, or unknown, lawful tax evasion has become a subject barely discussed intensively in the past few decades. In the contemporary era, the used terminology has become increasingly more complex, especially due to the fact that the tax authorities are trying to blur the distinction between the two concepts and introduce in the sphere of tax fraud acts and facts that according to the theory are normally included in the category of lawful evasion.

In this context, it should be stressed that the lawful tax evasion involves taking parts of the taxable matter, without having the character of an offence or crime. *"Tax evasion is built on lawful paradoxes, which do not allow an unequivocal confirmation or denial of certain legislative controversial issues and, therefore, submitted to interpretation."*⁵⁴ As a rule, the lawful tax evasion is defined as legal procedures that allow you to designate the dropping of taxation without contrary to tax laws.

⁵⁴ Pătroi D. (2006), Tax evasion between the permissive side, offense type and criminal character, Economic Publishing House, Bucharest, pg. 86.

Basically, any public report that analyzes the lawful tax evasion must begin with the statement that the activities that led to its manifestation are legal, although it affects the amount of payment obligations by the State budget. Without a doubt, it is well understood that there is a major difference between tax evasion, which involves hiding or concealing revenues, whether fraudulent or not, and that is essentially illegal, and the lawful evasion respectively, which is legal.

To be able to be dealt with and put into practice a lawful evasion requires a very good knowledge, understanding and application of existing tax laws. This is a particularly important topic relevant to explaining fiscal gaps. The term of tax evasion is not synonymous with tax fraud. Lawful tax evasion involves the attempt to reduce the amount of owed taxes by employing absolutely legal fiscal means. It occurs when individuals take advantage of weaknesses or ambiguities identified in the tax legislation. Although the means used are legal and not fraudulent, the effects are considered inappropriate or abusive. Thanks to subjectivism in the interpretation and application of tax legislation, delimitation of the border between lawful tax evasion and evasion in certain specific cases can be difficult to draw.

In terms of fiscal fraud, this implies a violation of tax laws, a conscious and deliberate crime against the rules regarding the payment of the taxes.

Unlawful tax evasion or tax fraud is analyzed by symmetry with the previous formula. It means a conscious and direct violation of tax laws, being a direct and deliberate infringement to the rules laid down for the determination and payment of a tax. This is the case of taxable matter dissimulation through the lack of tax declaration, through fictitious transactions or creation of fictitious businesses.

According to experts in the field, the tax fraud represents "*all practices aimed at circumventing all or part of the tax due to the State.*"⁵⁵ The definition seems confusing and incomplete because it excludes items of intentionality and the mechanisms through which they are circumvented the State's tax revenue. Also, it is not taken into account the element of crime occurring in the direction of avoiding the payment of taxes or to obtain undue benefits from tax sources.

The concept of tax fraud unites "all illegal practices which allow not paying, in whole or in part, the tax required. These practices are likely to be sanctioned through administrative or even criminal punishments."⁵⁶

Criminal law is different from country to country, so offending behavior considered as such according to the laws of a country cannot be considered as being criminal in nature according to the criminal laws of another country. Furthermore, the definitions of tax fraud and evasion may overlap, so it is up to the administrative demarcation of acts/instruments, namely the decision to continue or not a case of tax evasion in a specific instance.

2. Legal Tax Evasion

Effective tax evasion may occur as a result of some legislative deficiencies or other discrepancies in the way in which legislation is drafted, that cannot be corrected through purposive interpretation. This is not necessarily a failure of policy, but it can also raise difficulties in applying the interpretation, particularly where the tax policy underlying the proposed legislation is not clear, as happens in the case of technical issues of tax law.

⁵⁵ Popa Ș., Cucu A. (2000), *Underground economy and money laundry*, Expert Publishing House, Bucharest, pg. 12.

⁵⁶ Craiu N. (2004), *Underground economy between "Yes" and "No"*, Economic Publishing House, Bucharest, pg. 28.

The phenomenon occurs particularly during periods of adopting new tax laws or changing old ones, but also when the State intensively uses tax levers to stimulate certain areas of activity. Evasion of tax obligations shall be performed through the interpretation of tax legislation in favor of the taxpayer. However, the effect of this behavior is represented by the reduction in budgetary revenues.

Many countries make a clear distinction between the *unacceptable and acceptable tax evasion*. Unacceptable tax evasion is done by means of authentic and legal transactions, but which involve false commercial structures. It's about indirect infringement or misuse of tax laws or bilateral treaties. Unlike these, acceptable methods of tax evasion or tax planning, determine the reduction of tax liabilities through transactions or other activities that are regulated by law.

Lawful tax evasion is favored by the tax laws complexity. Excessive complexity makes room for disputes concerning the legislature's intent and creates the necessary prerequisites to identify those arrangements within the letter, but not in the spirit of the law. In this context it is not surprising that the issue of tax evasion attracts considerable attention in areas such as the taxation of companies at the international level, in which case national tax systems must interact with external tax systems, which is why complexity is probably inevitable.

Another area in which there is a lawful tax evasion is the taxation of financial companies where financial innovation (for instance the use of derivatives) allowed the conduct of transactions in ways that lead to a more favorable tax treatment, but with essentially the same economic substance as simple transactions that would have been taxed less favorably.

3. Unlawful Tax Evasion

Unlawful tax evasion (tax fraud or fraudulent) implies direct and deliberate circumvention of tax laws, being criminally sanctioned. It gets substance through illegal hiding of all or part of the taxable matter by taxpayers in order to reduce or eliminate their tax liabilities. This has a negative impact on the financing of public expenditure. Evasion means *"a deviation (usually criminal) from the tax agenda (stated by specific rules), with the deliberate willingness to evade taxation and related (most often) to the transmission of inaccurate or incomplete information, which are designed to give the author of the offence undue tax advantages."*⁵⁷

Fraudulent tax evasion forms are⁵⁸: traditional, legal, accounting, and by circumvention.

Tax fraud can occur at two times: at the settlement of the tax and at the moment of payment. The first phase aims to reduce taxable matter by minimizing the income and over sizing the financial expenditures. The second phase takes into account indirect taxes, in particular the Value Added Tax (VAT) and customs duties. For example, through a false import declaration relating to the characteristics of the imported products, they may transfer from a higher tax to another, a reduced one.

Among the ways of manifestation of tax fraud there are the following:

- lack of/partial statement and lack of the incomes registration for the deliberate purpose of their non-taxation;

⁵⁷ Pătroi D. (2006), Tax evasion between the permissive side, offense type and criminal character, Economic Publishing House, Bucharest, pg. 97.

⁵⁸ Hoanță N. (1997), Tax evasion, Economic Publishing House, Bucharest, pg. 191.

- hiding the real size of revenue by drawing up fictitious documents or falsification of documents;
- the establishment of phantom companies through which illicit commercial operations are carried out, identification of the directors, members or shareholders being virtually impossible;
- smuggling.

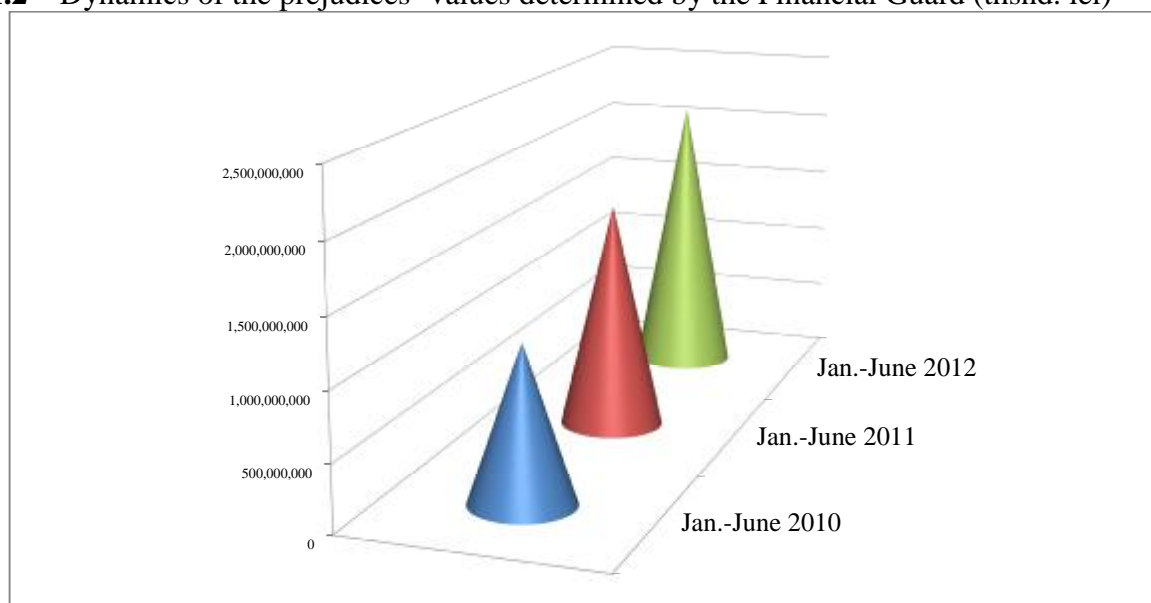
As a result, fiscal fraud is of bad faith and represents an intentional, direct and certain breach of tax laws.

The multiple transformations (qualitative, quantitative, structural, legal, etc.) that have occurred in the Romanian economic environment have led both to reinforce old "trends" in the field of tax evasion and tax fraud, but also to the emergence of new methods and directions in this regard.

The main ways of tax fraud regard:

- "evasion of payment of VAT on intra-Community transactions or, by case, the amplification of this illegal activity by processes known as "Carousel fraud";
- evasion of excise duty through the illicit sale of fuels obtained from mixtures of petroleum fractions, re-distribution of energy products, etc.;
- evasion of excise duty through illicit trade of cigarettes from smuggling or illegally manufactured;
- evasion of excise duty, by trading made clandestinely liquors, framed with bad faith in the category of intermediate or from smuggling;
- evasion of payment of VAT through the import of consumer goods and stating very low values, followed by illicit trade, at the level of the real market price"⁵⁹.

Fig. 1.2 – Dynamics of the prejudices' values determined by the Financial Guard (thsnd. lei)



Source: Ministry of Public Finances, National Agency for Fiscal Administration, Financial Guard, Report on the results of the Financial Guard's activity in the 1st semester, 2012, www.gardafinanciara.ro

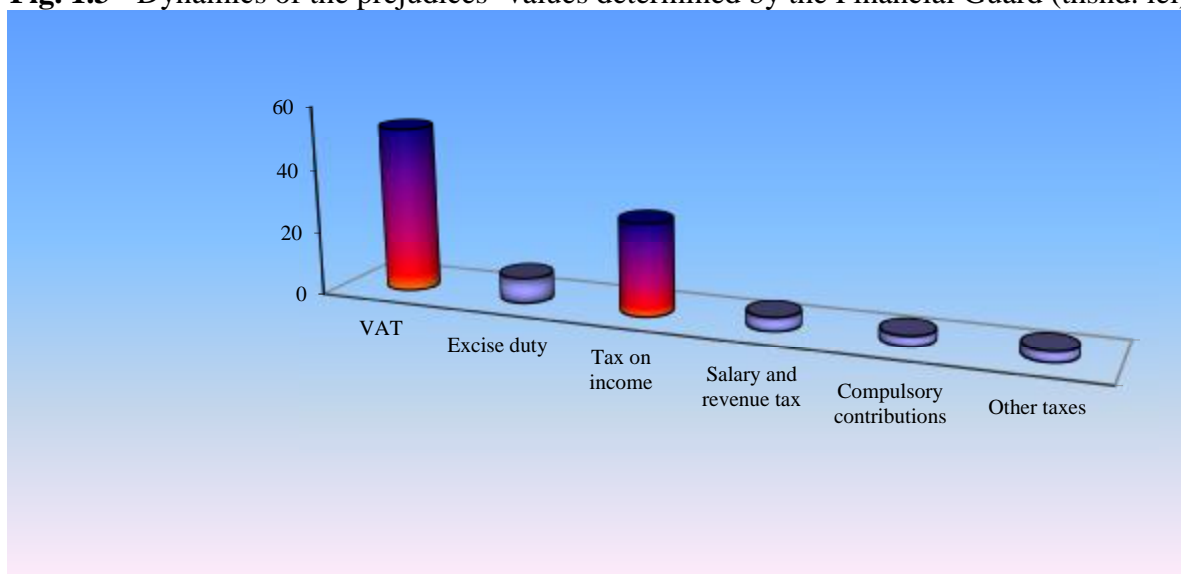
⁵⁹ Ministry of Public Finances, National Agency for Fiscal Administration – Report on the control activities carried out by the Financial Guard

Considering the multitude of acts of tax evasion nature, from practical cases⁶⁰ analysis presented to the general public, cases investigated by the bodies with powers of inspection, we have identified the main areas, mechanisms and techniques used by persons or groups of persons for committing this crime:

1. in the field of intra-Community acquisitions;
2. in the field of production and sale of oil, fuels and other oil components (mineral oils);
3. in the field of production and sale of alcohol and alcoholic beverages;
4. in connection with the production and sale of cigarettes and tobacco products;
5. in the field of recovery of recyclable industrial waste (in particular ferrous and non-ferrous);
6. in the field of operation, management, processing and sale of timber;
7. trade in grain, milling and bakery products;
8. in the field of gambling and casinos;
9. in the import of goods.

It was found that the fraudulent tax evasion (tax fraud) is a dynamic phenomenon that adapts in a very flexible and fast way to the economic situation, according to which changes its orientation from an income tax to another.

Fig. 1.3 - Dynamics of the prejudices' values determined by the Financial Guard (thsnd. lei)



Source: Ministry of Public Finances, National Agency for Fiscal Administration, Financial Guard, Report on the results of the Financial Guard's activity

Figure 1.3 shows a high fraud in VAT, income tax and excise duties.

Less rigged are the local taxes and fees, which are easier to follow. In their case tax administrations do not have special problems and as a result, are less affected by tax controls.

The most commonly used means⁶¹ of partial or total circumvention of taxes are set out below.

⁶⁰ The different presented tax evasion mechanisms have been taken from the Financial Guard's Reports.

⁶¹ Ene C.M. (2010), Underground economy – Theory, models, applications, Transversal Publishing House, Târgoviște, pg. 358.

In the case of *VAT*, the main mechanism through which the evasion of payment is represented either by the fictitious increase of deductible VAT, either by false reducing the collected VAT. A significant proportion regards also the refunds of VAT. Some of the techniques of fraud of this tax are considering:

- no sales invoices;
- not-including in the basis of VAT calculation of all bills or all transactions falling within the scope of VAT;
- willful and wrong application of the deductions of VAT or repeated deductions in the same document;
- misuse of VAT forms;
- reduction of VAT by stornos without legal documents;
- unwarranted application for VAT refund;
- intra-Community acquisitions/delivers without complying with the legal provisions concerning the reverse taxation, etc.

In the case of *corporation tax*, fraudulent actions relate to the following:

- reduce the tax base through various means (including on costs of some oversized charges without evidence or without legal basis, such as fines, penalties, expenses, depreciation, daily allowances, protocol expenses, etc.);
- deduction of personal expenses of the owners, shareholders or employees;
- failure in the accounting records of all incomes;
- erroneous computations and discrepancies between the records and the factual stock or between shipping prices and the prices in real mode;
- failure in accounting of exchange rate favorable differences or prices or of the differences established by inspection acts;
- failure in accounting of obligations concerning the due income taxes and failure to comply with payment terms of corporation tax, etc.

As regards *excise duties*, tax fraud is carried out through:

- non-inclusion in the tax base, in whole or in part, of the taxable amounts;
- improper calculation or miscalculation of excise duty on alcohol and alcoholic beverages in the context of changes in alcoholic strength;
- non-inclusion in the sale price of the products of the excise tax imposed on them;
- failure in accounting of obligation for payment of excise duty;
- evasion of excise duty, passing excise imposed goods to some category with no excise duty obligation, etc.

Income and wages taxes are rigged by the following methods:

- non-inclusion in the tax base of all revenues;
- miscalculation, non-retaining and mispayment of the wages tax in the case of temporarily employed persons, part-time or of those with a collaboration contract;
- non-taxation of income paid to employees by means of income of wage-type nature like incentives, bonuses, benefits in cash or kind, etc.;
- non-compliance with legislation on tax basis calculation, aggregation and personal deductions;
- the non-registration of payment of tax obligations on wages;
- non-compliance with the terms of payment of wage taxes.

Such procedures are elements of the tax evasion crime, and their particular content put them within the following categories:

- “the crime of refusal to present the official accounting documents required to establish the budgetary obligations;
- the crime of evading payment of tax liabilities by issuing incomplete or improper official accounting records or through acceptance of such documents;
- the crime of evading the payment of tax liability by means of not recording some activities or by exerting unauthorized activities;
- the crime of evading payment of tax liabilities by non-declaration of some incomes, or by hiding taxable source or object, or as a result of fictitious transactions;
- the crime of failing to reveal in legal accounting documents the revenue or to register fictitious expenses, in order to avoid the payment of tax liabilities;
- the crime of organizing or leading double accounting records or alteration or destruction of legal accounting documents or data storage means, for the purpose of reducing tax liabilities;
- the crime of evading payment of the taxes through ceasing of the shares held in a limited liability company;
- the crime of fictitious reporting on the premises of a company, its subunits or working points, in order to circumvent the tax control”⁶².

Obviously, all these offences laid down by laws constitute forms of manifestation of tax fraud. Following the legal procedure differs depending on the offence, but the regulatory means always produce a result, materialised in pecuniary penalties (administrative fines) or imprisonment (depending on the offense, the limits range from one year to 12 years)⁶³.

Concluding, processes used by taxpayers to evade tax liabilities which they are responsible are diverse, but in constant adaptation to changes in tax laws and accounting. No one and nothing can provide practical, concrete situations diversity, nor offenders’ ingenuity.

Due to the fact that by evading the payment of taxes certain individuals or interest groups earn huge profits at the expense of honest traders, who feel the inequitable distribution of the tax burden, it is important to identify the causes generating tax evasion so that mitigation/combate efforts of this phenomenon can be oriented in the correct and realistic direction. “Maximizing the public budgetary resources cannot be achieved except through the entire taxable materials detection and correct assessment of it, through the proper application of tax methods and techniques for determining taxes and fees and by discouraging the phenomenon of tax evasion”⁶⁴.

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⁶² Balaban C. (2003), *Tax evasion. Controversial aspects in theory and legal practice*, Rosetti Publishing House, Bucharest, pg. 29

⁶³ Voicu C., Boroi A., Molnar I., Gorunescu M., Corlățean S. (2008), *Business criminal law*, 4th edition, C.H.Beck Publishing House, Bucharest.

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