

TAX EMBEZZLEMENT AND UNDERGROUND ECONOMY: A LEGAL APPROACH IN ANALYZING TAX AVOIDANCE AND TAX EVASION

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Abstract

The factors such as tax avoidance and tax evasion has always been a crucial cause behind growth of underground Economy. The research is proposed with the objective of analysing the concepts of tax evasion and tax avoidance and find the legal mechanism for framing the laws to curb such growth of underground economy. To achieve this objective the research is partitioned into two parts. The first part deals with the explanation and analysis of Tax avoidance and Tax evasion and tries to distinguish between the two. After analysing both the major factors of tax embezzlement that being responsible for underground economy, the research in the second part tries to find the solution for these factors with the help of the concept of cost-benefit analysis and applying the similar analogy in present scenario. The Cost-benefit mechanism analyses any situation or action by cutting the costs derived out of that action and then retrieving benefit out of that and thus giving the result whether such action is beneficial during that time or not. The research tried to apply similar analogy in the factors of tax evasion and tax avoidance but instead of cost has used the term harm. The harm and benefit perspective analyses the situation of individual and his probability of paying the taxes by putting him in different situations which either leads him to punishment in law or the benefit. If the laws are framed in regards to such mechanism might result in impeding the growth of underground economy. Thus, the research by analysing the concepts of tax evasion and tax avoidance provides a legal mechanism for framing laws for tax administration.

Keywords: Tax avoidance, tax evasion, underground economy, etc.

Introduction

Economics can be described in various different ways. It is the study of decision-making power of a particular individual regarding the topics related to finance and wealth. In other words, as stated by Adam Smith “*economics is the inquiry in the nature and causes of the wealth of nations.*”¹ However, this definition of Adam Smith faced various criticisms as it was found to be the wealth centric one. And thus Alfred Marshall, a British economist was of the view that “*Economics is the study of a man in the ordinary business of life and argued it to be the subject of both Study of wealth as well as mankind and called it to be the social*

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¹ An Inquiry into the Nature and Causes of the Wealth of Nations, available at: <https://www.econlib.org/library/Smith/smWN.html> (lastly visited on July 24, 2020).

science".² Later the Modern definition of the economics came which stated that "*Economics is the study of how people and society choose, with or without the use of money, to employ scarce productive resources which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various persons and groups of society.*"

Thus, in general the economics can be defined as the study of human behaviour or his thinking regarding the choosing power of a specific commodity which he finds beneficial for himself. However, the black money is the most disturbing factor found in this subject of economics that can hamper almost any economy in the world. As said "*20 percent of the wealth in India belongs to the 80 percent of population and 80 percent is with the 20 percent of population.*" Though India being the world's fifth largest economy but the problem of black money lies in its roots. Also, as black money is hidden in nature, it cannot be calculated in any original economy and hence possess a great threat to any economy of world. Various acts such as tax avoidance, tax evasion, and all type of money that come from illegal acts, all these factors are responsible for the Black money. However, the research conducted is going to focus on these factors and how they are responsible for the underground economy of that particular country. Moreover, the research also describes the reason behind such acts.

Tax evasion and tax avoidance though seem to be the same terms but are totally different. Tax evasion is the use of illegal methods of concealing income or information from the IRS or other tax authority whereas Tax avoidance is the use of legal methods of reducing taxable income or tax owed. On the other hand, the underground economy is the wider ambit of all these factors which include all the black economy existing in the society. Thus, the research is an overall study of these factors and how they affect the economy of a particular state with the purpose of reflecting the reasons behind the emerging black or underground economy and the root causes behind its existence till now.

Rationale of the Study

The black money is the most disturbing factor of any economy which is responsible for falling of any economy as the wealth which is acquired by illegal or any illicit methods result in segregation of the black money in that particular economy and such wealth cannot be disclosed due to which it remains invisible in nature. Thus, the research is conducted with the

² What is Economics, *available at*: <https://corporatefinanceinstitute.com/resources/> (lastly visited on July 24,2020).

purpose of studying the causes behind the emergence of this black money and also reflects the reasons behind its continuance till now.

The Factors Responsible for the Existence of Black Money

The black economy is that part of a country's economic activities which does not fall in the rules and regulations of a country relating to commerce. However, the legality of such activities depends on the goods and services that are involved within them. Just as any other economy is made of various related markets which being considered as the whole, the underground economy is made of black markets. People operate in black economies in order to trade contraband, avoid taxes and regulations, or skirt price controls or rationing. This black market arises when an economic activity regarding certain goods and services is restricted by the government wherein such economic activity is stated as illegal or is being taxed so much that it becomes cost prohibitive. A black market also has the ability to make illegal goods and services available as well as can make expensive goods available at very low prices.³

Thus, there are various factors affecting any economy including tax avoidance, tax evasion, tax embezzlement etc. However, the research is going to focus on two main factors that is the tax avoidance and tax evasion.

Tax Avoidance

Tax avoidance is modification of an individual's financial situation by the way of legal methods which in turn reduces their amount of tax unlike that from tax evasion wherein the illegal methods are used for same. This situation is generally accomplished by claiming the permissible deductions and credits.⁴ Avoiding taxes is a simulated chain of transactions wherein a tax payer gets tax benefit and such kind of behaviour is unlikely in natural business conditions.⁵ The rules regarding the same can be split into two parts, the general anti avoidance rules (GAAR) and the specific anti avoidance rules (SAAR). However, GAAR are used when facing tax avoidance methods that are not regulated by SAAR wherein the tax

3 Ablon, Lillian, Martin C. Libicki, and Andrea A. Golay, *Markets for Cybercrime Tools and Stolen Data: Hackers Bazaar*, RAND Corporation, pp. 3-20 (2014), <http://www.jstor.org/stable/10.7249/j.ctt6wq7z6.9> Copy (lastly visited on July 25, 2020).

4 https://www.investopedia.com/terms/t/tax_avoidance.asp (lastly visited on July 25, 2020).

5 Andrius Paulaukas, *Definition of tax avoidance, its features and relationship with tax evasion*, 1 Public policy and Administration Research Journal (2006).

administrator has discretion to decide whether action of a tax payer corresponds to the aims of laws established.

If the nature of the common tax avoidance is examined then there are two doctrines that take into effect, the business purpose rule and the substance over form principle. Tax avoidance is defined using both of these principles in Tax administration law of the Republic of Lithuania. The Article 69 of the same states “*when any transaction of a tax payer or any group of transactions are made to reach a tax benefit directly or indirectly delay a term to pay a tax, to reduce a tax or completely escape from taxation, or to increase the sum of a tax, which the tax payer has a right to refund (deduct), or to shorten a term for this refunding (deduction), tax administrator has a right to calculate payable tax using substance over form principle.*”⁶ Thus, in this case the tax administrator acts independently from tax payer and regenerates the misrepresented or unrevealed facts.

Such taxes could be avoided by the tax payer in various different ways like he may hide the facts that are an object to the taxation, he can produce a duplicate or false transaction without reflecting its real purpose, he can even fabricate the contract or may represent any such fabricated transactions in his accounts. Thus, there’s a need that such legitimate transaction should be accepted as tax avoidance.⁷ In regards to the legal context, the tax avoidance being stated into Internal Revenue Code and has a length of about 75,000 pages. The lawmakers tried to use the code to manipulate behaviour of taxpayer with the help of offering credits, deductions in tax, exemptions regarding various aspects like education, healthcare, investments etc. Death benefit being given by the LIC is excluded from taxes for family protection. Capital gains and home mortgages being deduced to lower rate so as to encourage the investments and homeownership.

Effect of Tax Avoidance on the Tax Code

This act tax avoidance being legal in nature is used by various people thus resulting in intense use of it in Tax code and making the tax code being one of the world’s most complex tax codes. To avoid the payment of higher taxes the taxpayers spend a lot of time analysing the situations through which they could avoid higher taxes. As the code gaining the dynamic nature it becomes difficult for the families to make decisions regarding school, retirement, investments etc. However, the main victims of this ever-evolving tax code are businesses as it

6 Law on Tax Administration of The Republic of Lithuania, 2004, art. 69.

7 *Supra* note 5.

affects their hiring decisions and growth strategies to a greater extent. This problem can be easily examined from the fact that from year 2006, around 4,500 federal tax rule changes have occurred to the tax code and most of them are the product of tax avoidance.

Thus, tax avoidance is the main reason behind such complicated tax code. Moreover, the proposals that have been introduced for a long time are to simplify the tax code either by reducing the tax rates or by removing the provisions regarding the tax avoidance. However, if the tax rate is lowered it would automatically eliminate the need for tax avoidance.

Tax Evasion

Tax evasion is no different activity from the tax avoidance but the difference here is that tax evasion is an illegal way of avoiding or paying true tax liability. If an individual caught during evading taxes are usually subject to criminal charges or substantial penalties. Wilful failing of payment of taxes is an offence under the Internal Revenue Service tax code. Tax evasion consists of both the illegal non-payment as well as underpayment of taxes. In case if a taxpayer fails to submit the appropriate tax forms, IRS can determine it based on the information provided by third parties, such as W-2 information from a person's employer or 1099s. An individual is not considered guilty unless the failure to pay taxes is found intentional in nature. Thus, tax evasion occurs only when an individual with the intention and illegally avoids the tax liability, which is criminal charge subject to fines and penalties and even imprisonment at times. But in order to levy the criminal charges on a particular individual it is essential that the tax avoidance occurred intentionally. In some cases, an individual is not only liable for the unpaid taxes but can also be found guilty for official charges and may serve a jail time. According to the IRS such penalties include jail time of no more than five years, a fine of no more than \$250,000 for individuals or \$500,000 for corporations, or both along with the costs of prosecution.

The Effect of Tax Evasions on the Economy

A variety of factors are to be taken into consideration while determining the if the act being intentional in nature. Generally, a taxpayer's financial situation is determined for the confirmation of non-payment was fraud or some concealment of reportable income. The non-payment of the taxes can be judged to be fraudulent in nature where taxpayer makes efforts to conceal facts by associating them with person other than themselves which may include reporting income under a false name and Social Security number (SSN), constituting identity

theft. In several cases the tax evasion stated in the IRS website the tax liability is understated from the usual numbers. Various businessmen undervalue their sums of their receipts to agency which seems to be purposeful evasion of tax.⁸

Difference Between Tax Avoidance and Tax Evasion

Tax evasion and tax avoidance though seem to be similar concepts but have a slight line of difference between them. In general tax avoidance can be defined as legal ways by using tax regimes so as to pay lowest rate of tax. However, the tax evasion is same as that of tax avoidance but illegal methods are adopted to achieve the objective. Both these activities are equally dangerous to the economy and are majorly considered to be done by the white collared people or the people having a very high income. In other words, tax avoidance can be stated as the legitimate way of minimizing the taxes and maximizing the after-tax income with the help of methods in the tax code which ultimately results in the tax code becoming more and more complex. Tax evasion on the other hands is illegal way of avoiding the payment of taxes which usually involves hiding or misrepresenting income. The main component here is the intention as without intention an individual cannot be deemed for commission of tax evasion. During the commission of tax avoidance, the loopholes of a particular law are recognized and then an effort to pass out of higher payment of taxes is done by taking advantage over such loopholes. Thus, it's very difficult to find the solution for the tax avoidance as everything is done by legal methods. On the other to stop the tax evasion, the penalty or fine is to be increased so that if the harm caused to an individual is greater than the cost incurred by him for payment of tax the chances of him paying the tax would increase.⁹

Underground Economy

The underground economy refers to the transactions that are illegal because of the goods and services that are provided are unlawful in nature or they fail to co-ordinate with the governmental requirements on the same. This underground economy also referred as the black market, informal economy or shadow economy comprises of various illegal activities like child trafficking, illegal prostitution, sale of drugs etc. The untaxed sale of goods, tax avoidance, tax evasion, are some of the primary sources of the underground economy. It is very difficult to gauge the accurate size of underground economies because of their

⁸ *Ibid.*

⁹ <https://www.economicshelp.org/blog/glossary/tax-avoidance/> (lastly visited on July 26, 2020).

anonymous character by which they aren't subject to governmental oversights due to which they can't generate tax returns and thus didn't appear in official reports. As a result, the money spent which is not accounted in the official recorded transactions can represent the breadth of black-market activity.

Tax payment being the duty of every individual having good income and an inseparable part of every economy plays a great role in production of black economy resulting in expansion of underground economy. The activities such as tax evasion and tax avoidance skilfully play their role in expansion of the black money in the country. The non-payment or underpayment of the taxes results in the allocation of money in taxpayers account who may or may not use it wisely and thus hampering an economy of the country to a wider extent. However, on the other hand if that individual invests that money and earns a profit through it then it contributes the economy of the state. But the main problem which needs to be focussed on is that how can this wealth reach the government so as to get converted to white money which can further be used for the development of nation.

Control over Underground Economy

Though this underground economy is growing with time, there are certain ways through which it could be stopped which are as follows:

Reduction in tax rates: If the personal income tax rates are reduced then it would encourage the individuals to report income more accurately and completely.

Legalization of certain underground economic activities: If certain underground economic activities which have less intensity of crime and can affect an economy to a greater extent such as gambling and prostitution, then the government can legitimately tax on these activities thus resulting in increase in revenue. Now one may think that why not legalise all such underground economic activities but this isn't possible because though it would be beneficial for the economy but would ultimately result in the increase in crime rate.

Establishment of higher paying legal jobs: The main reason behind an individual committing any crime which harms the economy of the state is the wealth which he acquires from it. However if certain high paid legal jobs are established which could almost provide the same income to such individuals as the wealth they acquire by committing such crimes then they would be more encouraged in applying for such jobs as the risk part which would be on them for the crime would be reduced and thus would prefer doing those jobs over

committing any economic crime. Thus, governments can stimulate the creation of higher-paying legal jobs, which would automatically shrink the underground economy.

Solution to Tax Embezzlement: A critical Analysis

The underground economy is anonymous in nature due to which it makes easy for any individual to hide it by the ways of tax avoidance and tax evasion. However, the nature of tax paying of a particular individual can be analysed from the harm and benefit perspective wherein the behaviour of a Rational being regarding the payment of tax is studied by putting him in various conditions. The factors such as the punishment or the harm caused to that individual in case, he doesn't pay the tax (h), the amount of tax to be paid (A), the probability of being caught after tax avoidance (P) etc. The factors h, that is the harm caused after commission of tax avoidance and A, that is the amount of tax to be paid are related to each other.

If the harm caused to the individual (h) is greater than that of the amount of tax to be paid (A), then any individual of rational mind would pay the tax on time so as to avoid the harm caused to him. On the other hand, if the harm caused (h) is equal to that of the amount (A) then in that case the individual may or may not pay the tax depending on the probability of him being caught in the process. Thus, the probability (P) plays a very important role in studying the rational human behaviour regarding the tax payment. Higher would be the probability of any individual being caught higher would be the chance of that person paying the tax.

Let this chance be 'X'

Thus, in that case, X would be directly proportional to P.

Also, if analysed it can be concluded that, the X is dependent on three factors:

- The harm caused to the tax-payer in case of non-payment of tax.
- The Amount to be paid by the tax-payer.
- The probability of the tax-payer being caught after the non-payment of tax.

Thus,

$X = f(h, P, A)$.

Tax Evasion

Tax evasion can be described as the non-payment of tax through the illegal methods, where the probability factor comes into effect. In that case if the factor 'P' can be co-related with the taxation laws of that state which forms a chain between the factor 'X' and 'P' so as to understand the analogy between the same. Thus, stricter are the taxation laws of a particular country higher would be the probability of a particular individual being caught. Also, on the other hand the strictness of these laws may have the effect on the factor 'X' directly wherein the chance of a particular rational being to pay the tax may vary according to the variance in the laws. The factor 'h' could be co-related with the laws regarding the penalty of a particular tax code. Even this factor has the direct effect over 'X' as the variance in the penalty of non-payment varies the fact of chance that a particular rational being would pay the tax. Thus, there's a need to optimize the factor 'h'.

Now to avoid the non-payment of tax it is essential that the amount 'A' must not be equal to that of harm caused 'h' that is the harm to the individual must always be greater than the amount of tax to be paid by him. So, to avoid this condition another factor 'R' can be brought which determines the penalty in case of non-payment of tax.

- If $h > A$, then any person of rational mind would pay the tax so as to avoid the harm, thus no need for optimization.
- If $h = A$, then an individual may or may not pay the tax based on the probability factor, thus there's a need for optimization.

(Note: the condition $h < A$ cannot be taken into consideration as the smallest value 'h' could attain is 'A'.)

Thus, to optimize the value of A the factor 'R' must be added to it whose value must always be greater than zero.

Thus, $h+R > h$, as $R > 0$.

However, the nature of the factor 'R' here is such that higher the value of 'R' higher are the chances of an individual to pay tax.

Thus, it can be stated that 'R' is directly proportional to 'X'.

Hence, $h+R > A$

However, in case of tax avoidance the cost benefit analysis can't be proposed.

Tax Avoidance

Unlike tax evasion, tax avoidance is the legal way of reducing the tax amount by claiming to the most deductions as approved by law. As this being the legal process, it doesn't constitute a punishment on commission of it. But on the other hand, increase in its commission leads to the tax code becoming more complex as in some or the other way some individual finds the gap or a loophole in that particular law and tries to take advantage of it for his deductions. Also, it can be observed that commission of tax avoidance is mostly seen in the private corporations wherein they can show their fake documentations and data on income to deduce their tax amount. All this results in the huge loss to the economy as this money forms a black money and comes under the tag of underground economy.

In one of the cases held at New Zealand *IRC v. Duke of Westminster*¹⁰ it was stated that;

“every man is entitled if he can order his affairs so that the tax attracting under the appropriate Acts is less than it would otherwise be if he succeeds in ordering them so as to secure this result, then, however unappreciative the commissioners of Inland Revenue or his fellow taxpayers may be his ingenuity, he cannot be compelled to pay the increased tax.”

Hence, though this act of tax avoidance, which seems legal in nature but is at times misused for deduction of tax amount or from protection of higher taxation. As a result of which it becomes difficult to find out the remedy for the same.

If the tax rate over certain goods or service is reduced to such extent that an individual doesn't find it efficient to adopt the tax avoidance for its reduction that is if the tax rate are reduced to its bottom most point then in that case it won't be efficient for an individual to invest his money as well as time for finding a legal way through it with the help of tax avoidance. Though this strategy seems to be perfect one but bringing it in practical use is very difficult.

¹⁰ *IRC v. Duke of Westminster*, (1936) AC 1.

Conclusion

In this era of ever-growing development, the economy plays a very great role in shaping the development of any country. But factors such as black money are responsible for the downgrading of any economy and the main source for this black money is the underground economy which is the whole market of black money also called as the black economy. Though its practically not possible to completely eradicate this black economy but can be kept under control so as to cause less harm to the economy. Tax avoidance and Tax evasion though seem to be similar in nature but have slight gap of difference between them which is legality. The act of tax avoidance is legal way and thus an individual cannot be punished in case of commission of the same but in latter case as it being illegal in nature an individual is liable under its commission.