Tax Evasion in the European Union

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Abstract

Tax evasion is a significant issue within the European Union (EU), impacting both individual member states and the EU. It involves individuals or businesses deliberately underreporting income, hiding assets, or engaging in other fraudulent activities to reduce their tax liability. This study aims to identify most common methods of tax evasion used by European companies. Consequently, we detail the various measures the EU has taken to address tax evasion and enhance cooperation among member states to combat this problem.

Key words: transfer prices, intra-community loans, tax provisions, investments
J.E.L. classification: H26

1. Introduction

Tax evasion is the practice of reducing the amount of tax owed by companies and individuals by exploiting loopholes in tax legislation. It is a legal practice, but one that is often seen as unethical and unfair, particularly by governments that rely on tax revenues to fund public services and infrastructure.

In the European Union, tax avoidance has become a major problem in recent years, with reports suggesting that billions of euros of tax revenue are lost each year due to the actions of companies and individuals trying to avoid paying their fair share of tax. This has led to increased scrutiny of tax laws and the introduction of crackdowns on those who engage in such practices.

One of the key factors contributing to tax evasion in EU Member States is the existence of tax havens. These are countries or territories that offer low or no tax rates and other incentives, such as secrecy, to attract companies and individuals to reduce their tax liabilities. Examples of tax havens in the EU include Luxembourg, Ireland, and the Netherlands, all of which are accused of offering tax breaks to multinational corporations.

This topic is of great interest because legal tax avoidance is a common set of practices among multinational companies to reduce the tax rate partially or fully. This means less tax collected to the state budget and has effects on the state infrastructure, health system, education system, economic growth, welfare of the nation and so on.

2. Theoretical background

Legal tax avoidance, or tax planning, is the practice of organizing financial affairs in a way that legally minimizes the amount of tax owed to the government. Although it is a common practice, it is often a controversial topic because of the perception that it allows wealthy individuals and corporations to avoid paying their fair share of taxes.

Essentially, legal tax avoidance involves taking advantage of the various tax deductions, credits, and exemptions available under the law. For example, individuals may choose to invest in tax-deferred retirement accounts, such as 401(k) plans or Individual Retirement Accounts (IRAs), which allow them to reduce their taxable income and defer paying taxes on their investment earnings until

they withdraw money in retirement.

Researchers studying tax evasion typically explore various aspects of this complex and multifaceted phenomenon. Their work involves examining the underlying causes, economic implications, and legal frameworks related to tax evasion. Key areas of focus are the following:

- Economic Models and Analysis: Researchers developed economic models to understand the incentives and behaviors that drive tax evasion. This involved examining how individuals and businesses make decisions about tax compliance and the economic consequences of tax evasion on governments and societies (Ghazo et al, 2021, p.228; Biondo et al, 2022, pp.801-803).
- Empirical Studies: Conducting empirical studies involved analyzing real-world data to identify patterns, trends, and factors influencing tax evasion. Researchers used statistical methods to quantify the extent of tax evasion, identify high-risk sectors, and assess the effectiveness of enforcement measures (Slemrod, 2007, p.28; Galbiati et al, p.6).
- Behavioral Economics: Understanding the psychological factors that influence tax compliance is a key aspect of research. Several studies explored how cognitive biases, social norms, and other behavioral factors impact individuals' decisions to evade taxes or comply with tax regulations (Alm et al, 2021, p.181; Chetty, 2008, p.3).
- Legal and Regulatory Frameworks: Researchers examined the effectiveness of existing legal and regulatory frameworks in deterring and prosecuting tax evasion. The role of international cooperation, tax treaties, and anti-money laundering regulations was highlighted (Shaviro, 2020, p.11; McCafery, 2021, p.28).
- Tax Policy Analysis: Investigating the impact of tax policies on evasion is crucial. Researchers assessed how changes in tax rates, tax credits, and deductions influence individuals' and businesses' decisions to comply with tax laws or engage in evasion (Bird, 2016, p.161).
- Cross-Border Tax Evasion: Given the global nature of financial transactions, researchers often focused on cross-border aspects of tax evasion. This included analyses of the use of tax havens, transfer pricing schemes, and international efforts to combat cross-border evasion (Dyreng et al, 2019, p. 185, Guyton et al, 2023, p.12).
- Technological Advances: As technology evolved, researchers explored how innovations such as cryptocurrencies, blockchain, and digital platforms may affect tax evasion. Understanding the role of technology is crucial for reducing tax evasion (Thuneibat et al, 2022, p.1367).
- Compliance Strategies: Research also focuses on identifying effective strategies for promoting tax compliance. This refers to studying the impact of public awareness campaigns, tax education programs, and the design of tax collection systems (Han, 2020, pp.150-165).
- Corporate Tax Evasion: Researchers investigate tax evasion by corporations, examining practices such as profit shifting, the use of tax havens, and the effectiveness of measures aimed at increasing corporate tax transparency (Contractor, 2016, p.6).
- Social and Ethical Dimensions: Examining the social and ethical dimensions of tax evasion involves considering public attitudes toward tax compliance, perceptions of fairness, and the role of social norms in shaping behavior (Contractor, 2016, p.10).

Extensive studies on tax compliance and evasion have been published (Heineman et al, 2013, pp.230-231; Abraham et al, 2017, pp.180-181; Alstadsæter et al, 2019, pp.2080-2082) focusing on the economic and behavioral aspects of taxation, exploring factors that influence individuals' decisions to evade taxes. Concerning variables related to public policy, it was highlighted that audits and fines exhibit distinct interactions when it comes to both extensive and intensive margins. These factors positively influence the extensive margin, and their interaction demonstrates a positive correlation: as the probability of an audit increases, the influence of the fine rate on the decision to comply becomes more significant, and conversely. (Alm et al, 2021, p.185). Similarly, corporations can use legal tax shelters or offshore accounts to reduce their tax liabilities. These strategies can include incorporating in countries with lower tax rates or setting up subsidiaries in tax-friendly jurisdictions.

However, advocates of tax avoidance argue that it is a necessary tool to promote economic growth and innovation. (Barker, 2009, p.4). By reducing tax liabilities, individuals and corporations can invest more money in their businesses or in new ventures, which in turn can create jobs and stimulate economic activity. They also argue that many of the tax deductions and exemptions available under

the law are designed to incentivize certain behaviors, such as charitable giving or investing in renewable energy. Ultimately, the legality of tax avoidance depends on compliance with the relevant tax laws and regulations. While there is no single guaranteed strategy to reduce tax liabilities, individuals and corporations can work with tax professionals to develop a tax plan that maximizes their savings while staying within the law.

3. Research methodology

This study conducts bibliographic research. Specialized literature in the field of tax evasion has been studied, and the main methods identified as ways to avoid tax payments have been extracted. In general, such studies aim to analyze and synthesize information from specialized literature to better understand the phenomenon of tax evasion and the methods used to avoid it. We explored various sources such as books, scientific articles, government reports, and other relevant documents. Case studies, tax legislation, and reports from international financial institutions were also analyzed. Generally, methods to avoid paying taxes and duties are diverse and include:

- Transfer pricing. In such situations, companies can manipulate prices in transfers between their entities to reduce profits and, consequently, taxes.
- Tax base erosion. Companies prefer to use legal or less transparent methods to reduce the income considered in tax calculation.
- Tax havens. Multinational companies transfer assets to jurisdictions with lower taxes or more favorable legislation regarding taxation.
- Issuing false or fictitious invoices. Companies or individuals often issue invoices for services or goods that were not actually provided, creating false expenses to reduce profit tax.
- Using registered companies for tax purposes. In many cases, legal entities are used to hide or manipulate money flows.

Bibliographic research in this field provides a broader perspective on tax evasion, highlighting various aspects and methods used in practice. It is important to approach this subject by analyzing multiple sources to obtain a comprehensive understanding of the phenomenon.

4. Findings

4.1. Methods of tax evasion within European Union

There are several methods of tax evasion within the European Union. These include transfer pricing, intra-company loans, deferral of taxation through provisions and investments.

Transfer pricing is a practice in which companies set prices for goods or services that are sold between different parts of the same company. This practice has become increasingly common in recent years, particularly among multinational corporations, as a way of minimizing their tax liabilities. One of the key factors contributing to transfer pricing in the European Union is the existence of tax havens.

The use of transfer pricing can allow companies to shift profits to low-tax countries and reduce their tax liabilities in high-tax countries. This is particularly common among multinational corporations, which often have operations in several countries. By setting prices for goods or services that are sold between different parts of the same company, companies can manipulate these prices to shift profits to low-tax countries and reduce their tax liabilities in high-tax countries.

Transfer pricing is therefore the practice of setting prices for goods or services that are sold between different subsidiaries of the same company. The practice is used by multinational corporations to transfer profits from high-tax countries to low-tax countries to minimize their total tax liability to the government. For example, a multinational corporation has a subsidiary in France and another subsidiary in Ireland. The French subsidiary produces a product that is sold to the Irish subsidiary, which then sells the product to customers in Ireland. The multinational corporation can manipulate the price of the product sold between the two subsidiaries to transfer profits from France, where the tax rate is high, to Ireland, where the tax rate is low.

To illustrate how this works in practice, suppose the French subsidiary produces a product for €100 and sells it to the Irish subsidiary for €120. The Irish subsidiary then sells the product to customers in Ireland for €150, making a profit of €30. If the multinational corporation had priced the product sold between the two subsidiaries at €100, the French subsidiary would have made a profit of €0, while the Irish subsidiary would have made a profit of €50. By setting the price of the product sold between the two subsidiaries at €120, the French subsidiary earns a profit of €20, while the Irish subsidiary earns a further €30. This means that the multinational corporation can transfer profits of €20 from France to Ireland, where the tax rate is lower, thus reducing the overall tax liability.

The transfer pricing method is among the most common in the literature. It assumes the existence of at least two related entities, one of which must be in a low-tax country and the other in a high-tax country. According to the literature, the reasons why a company chooses to remain in such a high-rate state would be: accelerated economic growth, population, wage levels, or other reasons.

Intra-company loans are a common way for multinational corporations to move funds between subsidiaries in different countries. This practice involves one subsidiary lending money to another subsidiary within the same company. Intra-company loans are often used to finance business operations or to finance certain investments, but also to avoid taxation in a legal way.

In the European Union, the use of intra-company loans is subject to certain rules and regulations. These rules aim to prevent companies from using intra-company loans as a way of artificially shifting profits to low-tax jurisdictions or to avoid paying tax, but there are nevertheless ways to practice this.

One of the key regulations organizing intra-company lending in the European Union is the EU Interest and Royalties Directive. This directive was introduced in 2003 and aims to prevent companies from using intra-company loans to transfer profits to low-tax countries. Under the directive, companies can transfer interest and royalty payments between subsidiaries located in different EU countries without having to pay withholding taxes. However, these payments must be made on an arm's length basis, which means they should be set at a level that would be charged between unrelated parties in a similar transaction.

The EU Interest and Royalties Directive applies to all companies that are incorporated in an EU Member State and have subsidiaries located in other EU Member States. The Directive also applies to companies that are incorporated outside the EU but have a permanent establishment in an EU Member State.

In addition to the EU Interest and Royalties Directive, there are other rules and regulations that legally organize intra-company loans in the European Union. For example, the Anti-Tax Avoidance Directive (ATAD), which was introduced in 2016, includes provisions designed to prevent companies from using intra-company loans to artificially reduce their tax liabilities. ATAD sets limits on the amount of interest that can be deducted from taxable income and requires companies to demonstrate that loans are used for genuine business purposes.

The use of intra-company loans in the European Union is also subject to transfer pricing rules. These rules require companies to price intra-company loans on an arm's length basis, which means that prices should be like those charged by unrelated parties in a similar transaction. Companies must be able to provide evidence that their intra-company loans are normally priced, and failure to do so can result in penalties and fines.

In the European Union there are provisions allowing companies to defer taxation of certain income and expenses. This practice, known as deferral, can help companies manage their cash flow and reduce their short-term tax liabilities. However, it can also lead to the accumulation of large amounts of untaxed income, which can create tax planning opportunities and may be seen as unfair by some taxpayers and policymakers.

One of the most common ways for EU companies to defer taxation is through the use of tax provisions. Tax provisions are liabilities that companies withdraw from their accounts to cover potential future tax liabilities. These provisions can be used to defer taxation of income, such as profits that are expected to be subject to tax in a future period. They can also be used to defer the taxation of expenses, such as losses that may be carried forward to offset future profits.

The use of tax provisions is governed by accounting standards such as International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). Under these standards, companies are required to make provisions for potential tax liabilities in accordance with relevant tax laws and regulations. The use of tax provisions may also be subject to scrutiny by tax

authorities, who may challenge the amounts set aside by companies and require them to pay additional tax.

Investments made by companies to avoid taxes in the European Union can take many forms, from legitimate tax planning to aggressive tax avoidance schemes that may be considered illegal. The use of such schemes has become a growing concern for EU policymakers as they can lead to significant revenue losses for national tax authorities and distort competition in the single market.

Another form of investment made by companies to avoid taxes in the EU is the use of tax incentives and subsidies offered by Member States. These incentives are often designed to attract foreign investment or to encourage certain types of economic activity, such as research and development or green energy. While these incentives may be legitimate and serve a useful purpose in promoting economic growth, they can also create tax planning opportunities for companies seeking to reduce their tax liabilities.

In recent years, the EU has introduced several measures aimed at tackling aggressive tax avoidance schemes by companies operating in the region. For example, the EU Tax Avoidance Directive (ATAD) includes provisions aimed at preventing companies from artificially shifting profits to low-tax jurisdictions using intra-group financing arrangements, such as the use of hybrid borrowing arrangements or transfer pricing manipulation. ATAD also includes rules designed to prevent companies from using mismatches between different tax regimes to avoid paying tax altogether.

In addition to ATAD, the EU has introduced several other measures to increase transparency and combat tax evasion. These include the introduction of mandatory country-by-country reporting for multinational companies and the adoption of a common EU list of non-cooperative jurisdictions for tax purposes.

4.2 Methods of combating legal tax evasion within European Union

The European Union (EU) has implemented various methods to combat tax evasion, including:

- Common Consolidated Corporate Tax Base (CCCTB): the EU has proposed that the CCCTB should establish a single set of rules for calculating a company's taxable profits in the EU, regardless of its location. This proposal aims to reduce the complexity of tax rules and close loopholes that allow companies to shift their profits to low-tax countries.
- Anti-Tax Avoidance Directive (ATAD): ATAD is a set of EU-wide rules designed to prevent companies from using aggressive tax planning practices to avoid paying taxes. The Directive introduces measures to combat tax practices such as hybrid mismatches, interest deductions and exit taxation.
- Country-by-country reporting (CbCR): The CbCR requires multinational companies to report financial data on a country-by-country basis, including information on profits, taxes paid and employees. This reporting allows tax authorities to identify potential tax avoidance practices and take appropriate action.
- Automatic Exchange of Information (AEoI): AEoI is a system of information exchange between EU Member States that allows tax authorities to obtain information on taxpayers' financial accounts held in other countries. This system is designed to prevent tax evasion by allowing tax authorities to detect offshore accounts and undisclosed assets.

Moreover, the EU has set up a Code of Conduct Group on business taxation, which aims to promote fair and transparent tax practices among EU Member States. The Code encourages countries to eliminate harmful tax practices and implement measures that prevent aggressive tax planning.

5. Conclusions

Legal tax avoidance is a common practice in the European Union, and it is often a controversial topic because of the perception that it allows wealthy individuals and corporations to avoid paying their fair share of taxes. Although legal tax evasion exists, it is important to note that it is different from tax avoidance, which is illegal. The European Union has adopted a series of measures aimed at combating tax evasion, but it is difficult to evaluate if these measures are effective, as long as laws offer companies possibilities to avoid taxes.

Companies’ use of investment to avoid tax in the European Union is a complex issue that can take many forms. While some forms of tax planning may be legitimate, aggressive tax avoidance schemes that exploit loopholes in the tax system or artificially shift profits to low-tax jurisdictions can have a negative impact on national tax revenues and competition in the single market.

Although measures adopted by the EU demonstrate its commitment to combating tax evasion, challenges remain, including differences in national tax systems and legal frameworks. Enforcement and cooperation among member states are crucial for the effective prevention and prosecution of tax evasion in the EU.

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