Perspectives on Tax Optimization: Opportunities and Challenges

Flavius Valentin Jakubowicz
The Bucharest University of Economic Studies, Romania
flavius@jasill.ro
Ionela Munteanu
„Ovidius" University of Constanta, Faculty of Economic Sciences, Romania
consultant.munteanu@gmail.com

Abstract

The importance of taxation has always had a dual side. While the state is interested in increasing its budget revenues by influencing taxability, taxpayers are interested in reducing their tax obligations. In this regard, the concept of tax optimization has different meanings depending on the interests of the parties concerned. This paper presents a literature review on tax optimization issues and highlights opportunities or challenges associated with tax mechanism. Tax compliance methods, tax avoidance or fraud are subjects of particular attention. Topics such as the impact of taxation on business organization forms, complexity of regulations, tax havens, cryptocurrency and transfer prices are competing to clarify the meaning of tax optimization and to receive theoretical approaches and practical examples of interest to both scholars and professionals involved in tax practice.

Key words: tax optimization, tax planning, tax avoidance, tax fraud
J.E.L. classification: H26, H30, H87

1. Introduction

Tax administration has long provoked intense research debate. The economy has ups and downs, periods of calm or significant challenges. In recent years, the economic balance has faced strong challenges due to the COVID-19 pandemic and the war in Ukraine (Aivaz et al., 2022). There are a number of questions that concern the general public: How can taxation be optimized? How can we legally pay less taxes?

Tax perception has always represented a dual role (Hong et al., 2010, p.82). While the state wants to increase budget revenues by influencing taxability, taxpayers want to reduce tax payments. In this context, the definition of tax optimization has different meanings, depending on the person who is interested in formulating answers.

Decision-making processes and the variety of options generated by the complexity of the tax system can be simplified by an approach based on an explanation of interest concepts (Pukeliene et al., 2016, p.30). In this view, tax optimization can be seen in three directions: tax planning, tax avoidance or tax fraud.

The present paper proposes a review of tax research. Mechanisms and attitudes towards taxation are analyzed in two ways by comparing the perspectives of the State and the complied attitudes of the taxpayers. The study uses descriptive and explanatory methods to observe the dynamic relationship between scientific literature and regulatory reference, and proposes a number of practical examples. A number of tax arrangements are examined, with analysis focusing on the position between right or wrong, legal or illegal, according to research on the subject.

2. Theoretical background

Tax planning can mean voluntary compliance with tax payments. Studies show a number of situations in which tax optimization can be done in compliance with the law. A good knowledge of tax rules can enable the dimensioning of the tax base in a way that can benefit both the taxpayer and the state that collects the taxes. Optimization of general costs is an example of the planned allocation of economic resources in the sense of future estimates of taxes due.

Tax planning has existed since ancient times, when citizens tried not to pay taxes to the king and the administrative system. In modern times, financial planning has been shown to be an objective need in the business environment (Mills et al., 1998, p.1), mainly due to changes or regional differences in the application of financial legislation. From the legislator's point of view, budgetary planning was a requirement of the budget forecasting framework for calculating budget revenues that the state expects to receive from taxes.

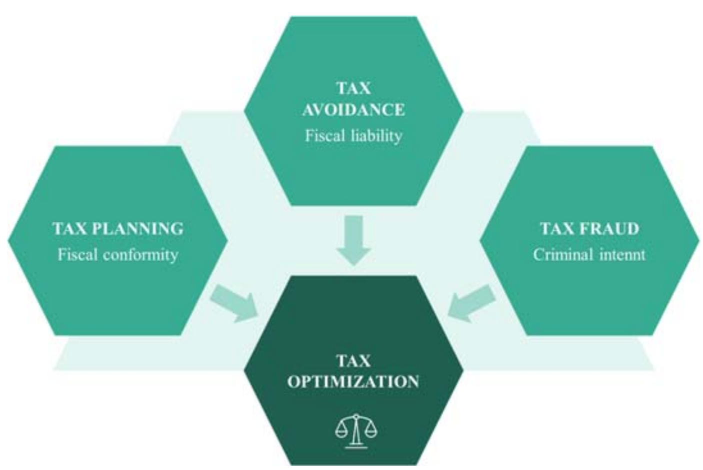
Fiscal planning is based on international treaties and conventions to avoid double taxation between partner States on the basis of reciprocity. The ease of access to the various tools specifically related to financial planning gives the economic operator the opportunity and legal reduction of his tax burden by reducing the tax base, with the possibility of avoiding serious mistakes regarding the development of optimization methods, without the intentional commission of any crime.

Tax avoidance refers to situations in which taxpayers find ways to reduce taxes (Kovermann et al., 2021, p.20). Avoiding taxation can be creative and within the legal framework. Deep knowledge of tax mechanisms and levers for identifying financial benefits are situations that lead to identifying aggressive tax planning opportunities (Feller et al., 2017, p.494), or to reassessment of taxation applicable to certain operations, so they can be used to find tax debt. Mechanisms to solve tax avoidance problems are often artificial, inaccurate or not within the legal framework. Tax avoidance situations most often result in the application of contraventional sanctions by the financial authorities. There are also some exceptions, such as situations where evidence of fraud is identified, which trigger the launch of criminal investigation mechanisms.

Tax fraud is a combination of illegal acts and acts by which taxpayers evade paying taxes. In cases of physical fraud, information supplied to the authorities is intentionally distorted and does not represent a true picture of an entity's financial position. The penalties imposed on the detection of tax fraud have a serious repercussion (Aivaz et al., 2022, p.337) and are classified as criminal sanctions. The detection of tax fraud leads to the calculation of damages and the responsibility of the people who committed them.

Unlike tax planning and tax avoidance, tax fraud is carried out with the explicit intention of illegal acts (de La Feria, 2020, p.240). In these circumstances, management assumes a very high risk of non-compliance (Chiriac et al., 2022), assuming violations of the rules of residence.

Figure no. 1. The graphical representation of tax optimization categories



Source: Own research

However, practice has shown that there are few cases in which financial regulations are incomplete or interpretational (de La Feria, 2020, p.240) and that the inclusion in one of the three categories of financial optimization is left to the authority of the interpretation authorities with fiscal control responsibilities. Figure 1 shows in graphical terms the meaning of the concept of tax optimization. According to previous studies relating to practical situations, fiscal planning is a form of financial compliance, tax avoidance is a form of violation of the regulation punishable by infringement, while financial fraud is subject to the strictures of criminal regulations, which sanction the intention of fraud and the responsibility of the perpetrator.

Tax arrangements are another way of defining financial optimization. Understanding tax arrangements is directly related and influenced by the interest of the State in granting tax exemptions or facilities. The motives for fiscal arrangements are to stimulate production, maintain or create new jobs, reduce the grey economy and, in general, stimulate social and economic development.

This article examines various forms of taxation, and analyses whether they can fall into one of three categories of tax planning, tax avoidance, or tax evasion.

3. Research methodology

The methodology used in this paper allows for an explanation and comparative analysis of the main tools and mechanisms for fiscal optimization. The descriptive and dynamic study of specialized literature on the specific mechanisms for financial optimization contributes to the creation of a representative framework (Koverman et al., 2021, p.20) in which the results of scientific research are analyzed in relation to the evolution of a specific regulatory framework and current practice.

4. Findings

The complexity of the concept of fiscal optimization lies in the double nature of its evaluation. The principles of taxability relate to the neutrality of taxation, fair dimension of the tax burden compared to the achieved tax base, predictability of taxes, efficiency and certainty of taxation. These principles are clearly clear, but practice shows that reflection in real situations often faces several challenges.

4.1. Transfer pricing

The management of economic entities uses various methods and activities to reduce taxes and costs. The assessment of the accuracy or artificiality of financial decisions made in operations between affiliated parties or exercising various forms of mutual control is carried out through the transfer price mechanism (Yao, 2013, p.1). Specific transfer price regulations mainly aim to establish whether or not preferential prices are applied between members of a group of entities.

The financial authorities wish to determine and limit the profits achieved at a reasonable level, in accordance with the "arm's length" principle. Any transaction must respect the principles of the competitive market, in which both buyers and sellers act independently without any interference by the other parties.

In the case of transactions between group members, members can exercise various forms of control among themselves, establishing disproportionate tax bases in relation to the results of the financial year or even avoiding taxation. On the basis of network value, intra-group transactions are determined based on networks that would normally be connected for a similar transaction when participating economic entities act independently of the network.

4.2. The Territorial Legal System

The use of a particular place for the establishment of a company or business significantly changes the tax burden (Yao, 2013, p.1). There are sometimes significant differences in tax conditions depending on the region, state, area or jurisdiction. Such an example are the disadvantaged areas declared at the level of different regions, where the difficulty of living or working conditions urges the State to grant different types of financial facilities. In addition, taxes and duties may vary from region to region in the same state depending on local development, trade flows or industrialization. The determinants of the fiscal system are many, and studies show over time the determination of the government to establish the tax system according to the economic context.

4.3. The legal organization form of the entities

The use of a form of legal organization can have the same influence as the mode of taxation (Yost, 2022) both in terms of the taxation of the realized revenues and in terms of the taxes to be owed to employees. Several European countries offer different levels of taxation depending on the size of the company, the number of employees, or the legal form of the business.

For example, in Romania, the most commonly used legal entities are authorized physical persons (P.F.A.), individual partnerships (I.I.), limited liability companies (S.R.L.) and limited liability companies-beginners (S.R.L.-D.). The tax system varies depending on the legal form of the entity, from S.R.L. to S.R.L.-D. Similarly, the use of a legal form such as P.F.A. or S.R.L. can be an alternative to different income tax rates. Depending on the business activity or complexity, the option for the legal organization form may be extremely beneficial or, the opposite, the generator for significant tax burdens.

According to certain financial indicators, companies with a narrow activity can be tax payers on the income of micro-enterprises, while other entities with a broader activity are tax payers of profit. Depending on the number of employees of small companies paying, the tax rate may vary, depending on whether there are employees or whether the company employs labor.

In recent years, Romania's legislation has changed constantly, which has increased the pressure on investor activity and the ability of enterprises to predict their financial obligations.

4.4. Accounting and fiscal policies

In general, accounting policies can affect tax assessments for transactions. Tax planning can be considered a competent, practical or aggressive tool for business financial optimization (Feller et al., 2017, p.494). The choice of some tax policies to the detriment of others, adapted to the specificity of the activity, can make the difference between a lower or higher tax level. In actual cases, a variety of accounting records can be used, based on revisions of national accounting standards or "IFRS" and observing the financial rigors established at the national level. The use of several methods of evidence for goods and materials stocks (FIFO, LIFO, CMP) in financial stability has a significant impact on the financial results of a reference period for economic players.

4.5. The postponement of tax payment

To maximize the potential of cash-based optimization systems (Mills et al., 1998, p.1), it is necessary to plan tax payments according to well-established plans and distribute them by month, quarter, and year, which are usually paid on the last day of maturity. There is an important research directive on the effects of creative accounting and financial reporting on the reality of reported operations and taxability (Blazek, 2021, p.2007).

The conditions for tax payment vary depending on certain conditions relating to the delivery of goods, the provision of services or the payment of advances. Good business planning can lead to the establishment of a framework for financial opportunities at the business level.

4.6. Fiscal heavens and off-shore tax arrangements

The phenomenon of financial evasion has reached a magnitude not only at national level, but also at international level, especially in very developed countries with very high tax levels. Investment mechanisms are closely related to the efficiency of the organization and control mechanisms of tax authorities, the challenges of globalization (Hong et al., 2010, p.82) and the risk of non-compliance that enterprises may experience in different territories, respectively.

Each Government has its own tax system, which is higher or lower in taxation. This situation can offer companies useful tools, such as relaxed corporate taxes, or challenging, such as aggressive controls and uncertainty in tax forecasts due to frequent changes in tax regulations.

However, in some areas of "tax havens", the grant of tax facilities or relaxed taxation is not necessarily influenced by the size of the company, but by the simple location of its tax residence. The existence of such areas can benefit some investors who are qualified to manage fiscal mechanisms in order to optimize their business interests. Offshore vehicles are the most common mechanisms in business development within the framework of tax paradises. In the usual language, the term "offshore" means "outside the coast". A practical example is when a company acts outside the geographical area in which it is established, without employing local resources. In a simple language, this term includes all economic activities carried out by entities outside the national borders of the State in which they reside.

There are different views on the assessment of the existence of these tax havens, and the studies developed in this direction sometimes propose a comparative approach to tax havens and tax sanctuaries specific to States with excessive taxation (Hansen and Anke, 2001, p. 1103). On the one hand, they are considered to have a role to play in avoiding certain taxes, which is why attempts have been made to standardize fiscal regulations or to streamline information communication between financial authorities organised at the national level. According to the OECD, the mechanisms that have the greatest influence on the financial system and that have the greatest impact on trade and investment are those that erode the national tax base and weaken the authority and structure of the national financial system. According to estimates, only developing countries lose US$ 50 billion annually due to financial evasion using a financial instrument as their main instrument.

On the other hand, tax havens are catalysts for many businesses, such as multinationals. There are opinions that support their function of stimulating competitiveness. At the same time, some consider the governance structures of these countries to be developed compared to the governance structures of non-tax haven countries (Dharmapala, 2008, p.661).

In general, offshore agreements arise when companies register in a State or geographical area, engage in major economic activities in different countries or geographical areas, but benefit from special facilities in the country where their headquarters are registered. States recognized as legal residences are available to those interested, through an offshore mechanism, in generous fiscal status for companies carrying out economic activities on their territory. These relaxed regulations result in a tax reduction or even non-existent tax burden. Offshore companies are financial instruments used in financial arrangements, to avoid excessive taxation, to increase the profitability of enterprises for the benefit of shareholders, to ensure freedom of movement of financial resources, and to ensure the anonymous distribution of benefits.

4.7. Cryptocurrencies – reflections on tax avoidance

Cryptocurrency is a particular modern payment method that uses cryptography, a decentralized and insufficiently regulated mechanism through which non-taxable and non-declared financial transactions can be made.

The use of cryptocurrencies is often assimilated to tax facilities specific to tax havens (Marian, 2013, p.38), from the point of view of lack of regulation or lack of taxation. The most common currencies in the digital economy are Bitcoin, Etherum, Ripple, Litecoin si Monero. In 2009, the use of Bitcoin appeared and rapidly increased (Chason, 2019 p.279). Its popularity has increased and its flexibility in use has given rise to concerns among the European and global authorities engaged in the fight against economic crime.

Recent research draws attention to the fact that digital currency transactions are similar to cash transactions, payments are anonymous and very difficult to follow. Many countries' banking systems do not recognize cryptocurrencies as currencies or legal means of payment, but as alternative means of payment, and warn for the risks associated with the use of these digital currencies (Marian, 2013, p.38). At the same time, more and more states are aware of the tax avoiding mechanisms for cryptocurrency transactions and are implementing new regulation for tax optimization and fraud prevention.

The impact of virtual currency transactions is not only limited to significant imbalances in the country's income balance and negative impact on the economy, but it can also cause serious infrastructure damage (Kethineni&Cao, 2020, p.325). The widespread acceptance of cryptocurrency payments can facilitate tax evasion and considerably increase the impact of money laundering and terrorist financing.

5. Conclusions

The frequent changes in business taxation often bear the impression of political reasons. Other factors for regulation change appears to be the institutional difficulties or professional skills that challenge public authorities with attributions in management or control of taxpayers active in the market. Tax changes are considered appropriate in periods of economic elasticity, where business profitability is high and tax changes have no major impact on the continuity of business activities. In recent years, the general economy has faced unprecedented challenges, such as major transport or social imbalances, immigration flows or resource crises caused by the effects of the pandemic and the war in Ukraine. Under these circumstances, the need for economic research has increased the development of scientific studies and the identification of opportunities or solutions to the severe problems facing the world economy.

Since the phenomenon of tax evasion and fraud has a negative impact on the creation of economic imbalances at the global level, urgent and effective action and measures are needed. The research on this subject has identified opportunities or challenges for states to reduce the phenomenon of tax fraud. Good financial management is one of the main means of tackling financial nonconformity and tax evasion. Principles of good fiscal governance represent common benchmarks accepted and implemented at several state levels, with the main aim of limiting the risks of the spread of the negative effects of fiscal non-compliance.

Considering the creativity of the mechanisms that give the concept of fiscal optimization a side of non-compliance or violation of legal provisions, it is necessary to intensify research in this direction. Awareness of the phenomenon of fraud or fiscal inefficiency in general is indispensable. The taxation mechanism determines the budgetary balance at the level of each country. Tax principles apply to the actors involved in tax transactions and, at the same time, to safety and certainty in the prediction of future activities. The present study presents a review of the multitude of meanings that financial optimization acquires, as well as the perspectives through which it is evaluated. Understanding the concept of fiscal optimization and promoting fairness in its acquisition are, in the authors' opinion, values for stabilizing tax mechanisms in a general sense.

6. References

- Aivaz, K.A., Munteanu, I., Stan, M.I., Chiriac, A., 2022. A Multivariate Analysis on the Links Between Transport Noncompliance and Financial Uncertainty in Times of COVID-19 Pandemics and War, *Sustainability*, Vol. 14, Issue 16, https://doi.org/10.3390/su141610040.
- Aivaz, K. A., Munteanu, I., Chiriac, A., 2022. An exploratory analysis of the dynamics of the activity of the Fiscal Anti-fraud Directorate General in the 2014-2020 period at the level of Romania, *Technium Social Sciences Journal*, Vol. 30, pp. 337-347, https://doi.org/10.47577/tssj.v30i1.
- Blazek, R., 2021. Creative accounting as a global tool for tax optimization. *SHS Web of Conferences* (Vol. 92, p. 02007). EDP Sciences. https://doi.org/10.1051/shsconf/20219202007.
- Chason, E. D., 2019. Cryptocurrency Hard Forks and Revenue Ruling 2019-24. *Va. Tax Rev*., 39, 279.
- Chiriac, A., Munteanu, I., Aivaz, K. A., 2022. The Financial Implications of Non-Compliance in the Transportation Business. *8th BASIQ International Conference on New Trends in Sustainable Business and Consumption*. pp. 298-305, Conference Proceedings, 25-27 May 2022, https://doi.org/10.24818/BASIQ/2022/08/039.
- de La Feria, R., 2020. Tax fraud and selective law enforcement. *Journal of law and Society*, 47(2), pp. 240-270. https://doi.org/10.1111/jols.12221.
- Dharmapala, D., 2008. What problems and opportunities are created by tax havens?. *Oxford Review of Economic Policy*, 24(4), pp. 661-679. https://doi.org/10.1093/oxrep/grn031.
- Feller, A., & Schanz, D., 2017. The three hurdles of tax planning: How business context, aims of tax planning, and tax manager power affect tax expense. *Contemporary Accounting Research*, 34(1), pp. 494-524. https://doi.org/10.1111/1911-3846.12278.
- Hansen, N., A., Anke S. K., 2001. The Political Geography of Tax H(e)avens and Tax Hells. *American Economic Review,* 91 (4), pp. 1103-1115. https://doi.org/10.1257/aer.91.4.1103

- Hong, Q., & Smart, M., 2010. In praise of tax havens: International tax planning and foreign direct investment. *European Economic Review*, 54(1), pp. 82-95. https://doi.org/10.1016/j.euroecorev.2009.06.006.
- Kethineni, S., & Cao, Y., 2020. The Rise in Popularity of Cryptocurrency and Associated Criminal Activity. *International Criminal Justice Review*, 30(3), pp. 325–344. https://doi.org/10.1177/1057567719827051.
- Kovermann, J., & Velte, P., 2021. CSR and tax avoidance: A review of empirical research. *Corporate Ownership and Control,* 18(2), pp. 20-39. https://doi.org/10.22495/cocv18i2art2.
- Marian, O., 2013. Are cryptocurrencies super tax havens. *Mich. L. Rev. First Impressions,* 112, 38.
- Mills, L., Erickson, M. M., & Maydew, E. L., 1998. Investments in tax planning. *The Journal of the American Taxation Association*, 20(1), pp. 1-20.
- Pukeliene, V., & Kažemekaityte, A., 2016. Tax behaviour: assessment of tax compliance in European Union countries. *Ekonomika,* 95(2), pp. 30-56. https://doi.org/10.15388/Ekon.2016.2.10123.
- Yao, J. T., 2013. The arm's length principle, transfer pricing, and location choices. *Journal of Economics and Business*, 65, pp. 1-13. https://doi.org/10.1016/j.jeconbus.2012.09.004.
- Yost, B. P., 2022. Do tax-based proprietary costs discourage public listing?.*Journal of Accounting and Economics*, 101553. https://doi.org/10.1016/j.jacceco.2022.101553.