

# The effects of tax avoidance



## **Summary**

Tax avoidance has been a major menace in many governments worldwide. Therefore, this article will focus on tax avoidance by multinationals and the tax loopholes that motivate this unfair practice among nations. Companies such as Starbucks, HSBC, Google, Barclays bank and Amazon have been accused on more than one occasion of corporate tax avoidance. How do they go about this and get away with it? Do governments favor big corporations at the expense of domestic small and mid-level companies? At the end of this article, it will be clear and evident that indeed tax avoidance is morally wrong unless monitored under stringent government rules and regulations. In essence, this article focuses on the extent to which tax avoidance limits government expenditure (thus government spending) and the extent to which this problem affects the economy and society as a whole.

## **The Moral violation of Tax Avoidance in a nutshell**

In these hard economic times of recessions and escalating unemployment in Europe and America, governments are implementing budget cuts in an effort to cope with national debts and the aftereffects of this global economic pandemic as a whole. Inflation reports have become the business norm of major mainstream media houses like CNN and BBC.

It has become almost impossible to hear of a rise in employment levels or deflation in prices. What this means in essence is that as governments implement budget cuts, they also result to internal borrowing measures such as increasing taxes on goods and services in their respective local markets. At the end of the day, the ordinary hard-working citizen is left to grapple with

how to balance an increasingly insufficient paycheck with ever-increasing prices of goods and services.

It is because of this reason that tax avoidance shifts the tax burden from the evasive and tricky corporation to the honest middle and low income earning citizen. This is clearly a sign of tax bias practiced in broad daylight. The sad bit about this is that many governments don't have stringent measures to punish such big 'untouchables'. Is it that someone within is pulling the strings to ensure that justice isn't upheld? Are these mysterious government entities 'sufficiently compensated' by tax avoiding multi-national corporations for a 'job well done'?

Because the interesting bit about tax avoidance is that it doesn't amount to tax evasion. For instance, in 2011, the Google firm in the UK had amassed a whopping 395 million pound turnover. But as it turns out, the United Kingdom treasury only received 6 million pounds; an astoundingly tiny fraction of the profits. Similarly, Amazon had sales of 3.35 billion in the same year but contributed a mere 1.8 million pounds to the British Treasury .

As absurd as these two randomly picked incidences sound, what these companies did was legal. Essentially, no laws were broken despite the moral absurdity of such obvious, draconian and potentially 'tax evasive' actions. Why aren't there any laws to address such malice? Does it mean that someone is not doing his job and is being paid by these multinationals to keep quiet?

Because at the end of the day, money is power thus more money translates to more power; to control, to manipulate, and eventually, to destroy economies and thus the society as a whole. The problem with tax avoiding firms is that their global market presence translates to humongous profits. This of course means too much money and thus too much power. And unfortunately, their power exceeds that of many government officials who are more than willing to do their devious bidding for that ‘extra pound’.

Just taxation practice is based on the tenets of fairness and equality across the board not just within the circle of multinationals, but also within economies as a whole. The entire population has got to be convinced that the burden of tax is evenly spread across varying income levels and corporate profits.

Tax avoidance by ‘the elite’ however brings about unnecessary tension due to economy class favoritism that’s making someone bear more unjust burden than he ought to. When the citizenry sees such tax injustices, then it’s bound to demand for the law to curb such dubiously lawful menaces.

### **Facts supporting the moral absurdity of tax avoidance and how some countries are curbing the menace**

Tax avoidance potentially amounts to financial impunity. Incorporated tax laws with gaping holes and obvious loose ends are the biggest aids of tax avoiding multinationals (Samuel, 2005). In essence, firms are subject to business taxes whereas individual income earners are subject to personal taxes. For firms to practice tax avoidance in business taxes, they usually relocate their branches to offshore tax havens thus registering as alien business entities offshore. This makes firms avoid generating income

onshore more and more with every alien business subsidiary that they register offshore.

Thus, American based Google and Amazon avoid paying taxes in the UK by being classified and registered as non-resident business entities. This entitles them to avoid being taxed not only as resident businesses, but also as resident alien businesses. This is despite the fact that they enjoy all government rights and services similar to resident businesses in the host offshore havens. This in turn makes them pay less taxes to the American tax collector, also known as the IRS.

FTSE 100 firms and Banks based in the UK are also key culprits in this menace, with 38% of their subsidiaries located in tax havens. High street banks such as The HSBC, Barclays bank, Lloyds and IBS have a combined total of 1, 649 companies (Action Aid). A unanimous FTSE company is claimed to have transferred pricing payments so as to enable a whopping 100 million pound shift from subsidiaries based in developing country into tax havens where a ridiculously lower tax rate is incurred. A lack of stringent regulations on transfer pricing leaves loopholes for tax avoidance as taxable profits move to tax havens without breaking any law. Luxemburg, Liechtenstein principality, Delaware State, Nauru and Cayman islands are in fact the leading offshore tax havens that are menacingly unregulated and house profits that extend to dealings in drugs and arms trade.

While in host offshore havens, these multinationals are usually private and secretive in regards to their finances thus raising eyebrows in regards to the integrity of their financial reports. The ignorance, inability and inexperience

of developing countries such as China, India and Brazil to deal with the tax avoidance menace further aggravates the situation (Phyllis, 2003). This also brings in the problem of the inability to measure precisely how much worth of tax avoidance has been practiced in these countries. Multinationals are actually taking advantage of this by rapidly expanding their offshore investments to the detriment of offshore haven governments which don't benefit from such investments as they ought to. For instance, the budget deficit for the Chinese government amounted to 3% of its GDP.

Also in Mexico, it's estimated that a whopping 40% of its entire citizenry might be untaxed (Gori, 2001). This goes to show how the citizenry in itself can be its own worst enemy when it comes to combating tax avoidance within resident businesses (Das-Gupta 1995). India has also been a victim too considering the fact that tax revenue percentage of GDP dropped sharply from 9.8% in 1991 to 8.95% in 1999.

Exploding liberalization in these developing countries has sparked massive inflow of foreign investments. In fact, when direct foreign investment recipients are considered by merit, Brazil, China and Mexico have been at the zenith of this list for the past ten years. European, American and Japanese multinationals have been the biggest contributors to this direct foreign investment inflow thus playing key role in the growth of these developing economies.

Interestingly enough, the local businesses have not enjoyed the chunk of foreign trade since related multinational firms in these tax havens control a majority of foreign trade (Chan, 1998). They do this by exercising

sophisticated profit shifting mechanisms via manipulation of prices to dodge stringent measures enforced upon foreign exchange hence significantly cutting down on uncertain socioeconomic outcomes. In essence, intermediaries and basic raw materials are over invoiced while at the same time exports are underpriced thus enabling record tax avoidances.

The Chinese open-door economic reform has made it maintain its enviable position as the greatest absorber of foreign direct investment (FDI) among developing nations to date. For instance, according to the 2002 United Nations Economic report, China got 28% of all FDI flowing into developing nations in 2001. The year 2002 was particularly good for FDI enterprises in China as 409, 000 foreign investment enterprises were approved with a net worth of 425 million USD. Consequently, foreign direct investments in China have been key to its economic growth. The evidence is quite clear when it's considered that 52% of China's imports and 50% of its exports can be attributed to foreign investment enterprises (FIEs) within the country.

Yet strangely enough, a resounding majority of these foreign investment enterprises is reporting record losses despite expanding at an astronomical rate. This automatically entitles them to avoid taxes. Tax avoidance escalated sharply in 2000 with a record \$1. 22 billion worth of noncompliance being reported ( Ming, 2001). This sparked a sharp rise in tax related audits in 2001.

Brazil on the other hand exercises some fairness in taxation by taxing local and alien enterprises similarly. In fact, tax rules and laws applied to limited liability companies and corporations alike are similar irrespective of whether

the firm is resident or non-resident. This is because foreign enterprises prefer taking the forms of corporations and limited liability companies.

But interesting to note is the fact that limited liability companies aren't obliged to disclose their financial reports to the public. However, corporations possess the comparative advantage of raising capital through IPOs (Initial Public Offers) of the share capital. Brazil has however come under sharp criticism as having a sophisticated taxing mechanism that hinders its business competitiveness globally. Despite this obstacle, the country has proven to be less naïve when it comes to dealing with tax avoidance incidences by adopting the principle of *'If you can't beat them, then join them.'*

This is because it has taken advantage of tax avoidance tendencies by FEIs by offering tax incentives for establishment in distinct underdeveloped regions. For instance, a 50% tax cut on income is offered by the Brazilian government to industrial and agricultural enterprises that establish themselves in the marginalized and less developed North East and Amazon regions. In addition, a firm that sparks development in industrial technology has the right to an incentive on technical services and a 50% tax credit discount on royalties.

Expatriates who have achieved the status of Brazilian residents are also obligated to pay a progressive income tax on their worldwide paycheck up to a maximum of 27.5%. This is because taxation upon individuals is implemented on cash basis. A factor to consider is that expatriates are considered residents if they've domiciled in Brazil for more than a year.



Brazil also tackles tax avoidance by taxing a 25% withholding tax on nonresidents living in tax havens compared to a 15% withholding tax on those who don't. This is because nonresidents are entitled to royalties, dividends and interest. When it comes to transfer pricing, proper laws that are compatible with OECD have been enacted to ensure the proper determination of import and export prices.

## **Conclusion**

The rationale behind payment of taxes is that we owe a duty to three entities; namely to the state, the community, and last but not least, to God. Therefore in as much as tax avoidance is morally unjustified and inexplicable, it is distinctively clear that governments worldwide should take the initiative to curb this menace. Better still, governments can take advantage of the situation and enact sound laws that create morally acceptable tax avoidance, such as tax incentives and tax breaks offered by the Brazilian government to develop marginalized areas and to spark innovative development. That way, an equitable tax basis is maintained and society is generally happy to share the burden of tax on the basis of a non-secretive, convincingly just and morally acceptable manner.

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