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TAX EVASION VS. TAX AVOIDANCE

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Abstract *The aim of this article is to raise awareness between the fine line of tax evasion and tax avoidance at SMEs level in Romania. Herein are presented four practical examples that could be regarded as fiscal measurements (fiscal optimization) or could be reconsidered by the fiscal authority as an illegal measurement taken by the company's management. Because we are under the jurisdiction of Romanian fiscal law (tax code) 227/2015 the examples that are illustrated within the article may not be suitable for other Countries, especially outside of EU (European Union).*

Key words:
Tax evasion, Management, Fiscal measurements Fiscal law
JEL Codes:
H29
H26
H30

1. INTRODUCTION

As a main component in every economy, tax has always posed a concern among individuals that are organized under a collective form (or as we call it today, "society"). Different studies have illustrated that country development and taxation work hand in hand. The ability of governments to raise taxes in order to finance public goods is essential to achieving economic development and growth. Many developing countries find it very difficult to raise the revenue required to provide basic public services such as infrastructure or schools. (Clemens F. and George R., 2013).

A main source of the assumed shift in some of the burden toward labor is the consideration of international capital flows. Standard incidence analysis indicates that immobile factors such as labor bear some of the capital income taxes imposed within a country as the result of capital flight, with this burden approaching full shifting to labor as a country's size diminishes (for example, Kotlikoff and Summers 1987), (cited by Auerbach, 2018).

A tax represents a compulsory payment (direct or indirect) made by an economic agent or by a person in the benefit of the government with the purpose to be reinvested towards the benefit of the society as public goods (infrastructure, education purposes, investments opportunities, other facilities for individuals, etc.). Taxes are not voluntary. When income exceeds an allowable minimum, income taxes are assessed on that excess income by the federal government, and possibly, by certain state and/or local governments. Many states (and other smaller governmental units) require the sellers of certain consumer goods or services to collect sales taxes on these purchases. Failure to collect and remit these taxes to the appropriate governmental unit, subjects the responsible persons to civil, or even criminal, penalties. (Shirley D., Karen A. Fortin, 2019)

Developing countries are well known to have difficulty raising tax revenues. Whereas the tax-to-GDP ratios of industrialized countries are usually above 30 percent, developing countries often observe tax-to-GDP ratios of 15 percent or lower. This limits the capacity of the state to fulfill its tasks, especially to provide public goods and services that reduce poverty and foster economic development. One major challenge of raising taxes in developing countries is that many businesses—particularly small domestic businesses—are not registered with the tax authorities and operate in the shadow economy. (Hebous, Shafik, and Nadine R., 2013)

As a growing literature (e.g., Giavazzi and Tabellini 2005; Persson and Tabellini 2007; Papaioannou and Siourounis 2008) emphasizes, democracy and economic growth have a two-way relationship. On one side, democracy may contribute to the economic growth of a given country; on the other side, the process of economic development may increase the chance of a democratic transition. (Carmen Comaniciu and Liliana Bunescu, 2013)

Tax sovereignty allows each country the freedom to establish a tax system which they established on its territory, to define taxes that make up the system, specify the subjects of taxation, to determine the tax base, imposing size quotas, setting time limits for payment, to grant tax exemptions to establish tax penalties, to establish remedies and procedure tax dispute resolution, etc. (Condor, 1999)

As an article is presenting[1] under the Romanian legislation, the individual has the obligation to pay the following taxes and duties: Profit tax; income tax (also applicable to income obtained from Romania by non-residents); VAT and Local taxes and duties.

There is an obligation to pay profit tax by non-residents (individuals who carries out activities in Romania in an association without legal personality); residents associated with Romanian enterprises for income made both in Romania and abroad.

Income tax is applied in the case of non-resident individuals operating in Romania in an association without legal personality or in the case of resident individuals associated with Romanian legal persons who earn income both in Romania and abroad, from associations without legal personality.

Value Added Tax is an indirect tax owed to the Government, owed by the individual carrying out an economic activity, materialized in most of economic operations. The standard rate is 19% and

[1] Eli Doron, 2008, "Taxele si impozitele datorate de persoana fizica in Romania" available at http://www.ro.dt-law.co.il/articles.asp?ArticleID=975, accessed 22/03/2019.

applies to the tax base for taxable transactions that are not tax-exempt or not subject to reduced rates. There are also reduced tax rates applied for housing delivery as part of social policy under the conditions of fiscal law (Romanian tax code 227/2015).

Local taxes and duties are represented by specific taxes and fees that are collected by local authorities and can be different from one area to another. Here, are included: building tax, land tax, fees for issuing certificates, hotel tax, etc.

Entrepreneurship is a complex, multidimensional phenomenon analyzed by different fields of study. Entrepreneurship is an engine of economic development. Governments around the world are searching for or implementing policies to stimulate entrepreneurship as a means to create new employment opportunities, reduce poverty and foster innovation and economic growth. Taxation is one of the main tools at governments' disposal entrepreneurship in order to maximize its benefits. (Dondena, 2017)

As Bruce Hiller put it in an interview, "Redistributing wealth from the super-rich or even 'middle class' to poorer citizens … in and of itself will do little to improve general social conditions… Education and family are key ingredients in lasting income generation…" Don Powell's suggestions reflected Hiller's concerns: "'Inequality' is a concept of relativity … Focusing on the absolute will help to engender answers to how the absolute can be changed. A few suggestions: appropriate … education; socio-economic policies that foster the family unit; incentives … for capital formation and application, health improvements, elimination of resource waste (principally government but also business)" (Michael Gerson, 2014)

2. TAX AVOIDANCE VS TAX EVASION

Tax avoidance is the legitimate minimizing of taxes, using methods included in the tax code. Businesses avoid taxes by taking all legitimate deductions and by sheltering income from taxes by setting up employee retirement plans and other means, all legal and under the Internal Revenue Code or state tax codes. (Jean Murray, 2019)

A loophole is a technicality that allows a person or business to avoid the scope of a law or restriction without directly violating the law. Used often in discussions of taxes and their avoidance, loopholes provide ways for individuals and companies to remove income or assets from taxable situations into ones with lower taxes or none at all. Loopholes are most prevalent in complex business deals involving tax issues, political issues and legal statutes. They can be found within contract details, building codes and tax codes, among others. (Will Kenton, 2018)

Tax evasion, on the other hand, is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. In this situation, the phrase "ignorance of the law is no excuse" comes to mind. (Jean Murray, 2019)

So, the main difference between tax avoidance and tax evasion is that the latter (tax evasion) could led you to jail, while tax avoidance represents just a legal measure that an enterprise could use in order to diminish the amount paid to the government.

3. FISCAL OPTIMIZATION THROUGH FINANCIAL CONTROL

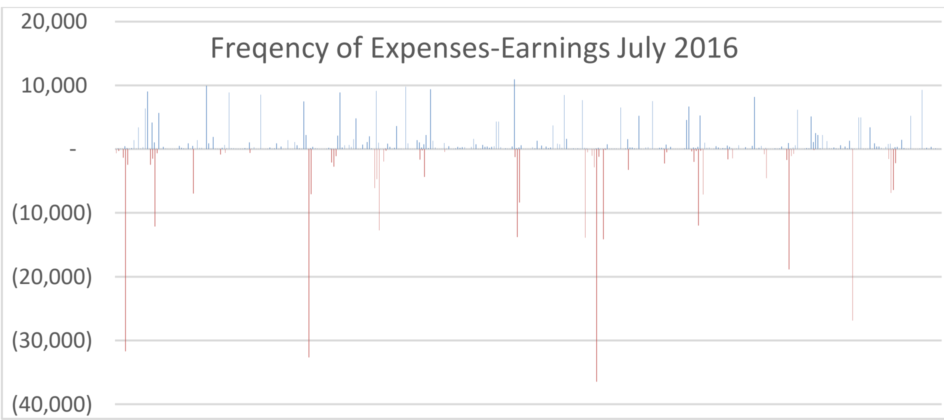
Financial control is the means by which an organization's resources are monitored, directed and measured. Financial control is the practice of managing and controlling an organization's resources to achieve its objectives and protect the interests of shareholders. (B Resource Guide, 2009). Financial control is, through its results, one of the most important sources of information necessary for the efficient management of the general management action, whose main purpose is to determine the optimal decisions to be used as levers of the economic activity manager achieve the objectives of the proposed programs. (Moroşan Gh., 2017).

We are going to analyze a company's expense and earnings in two different periods. The company activates in the field of physical products (i.e. commercializing bricolage materials). The main issue is that because of the specific of the company, the bricolage sector is conditioned by weather and seasons. Therefore, the company is dealing with seasonality of sales.

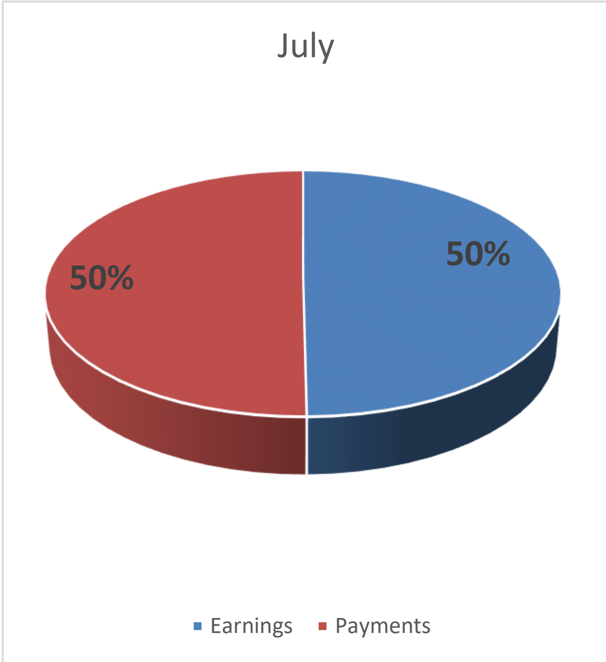
We are going to analyze two different periods. From resource management perspective, the company is facing some difficulties because it needs to find an optimum quantity of assets. The number of employees is also an issue due to the profit compared between the periods of time.

The first period (July) is representative for the profitable period. In this month, the company has a productive period, with higher profits and a bigger number of clients compared to February. This is the period when the profit is "harvested" and provisions are made for the rough period. In this scenario, the assets of the company are engaged at full capacity.

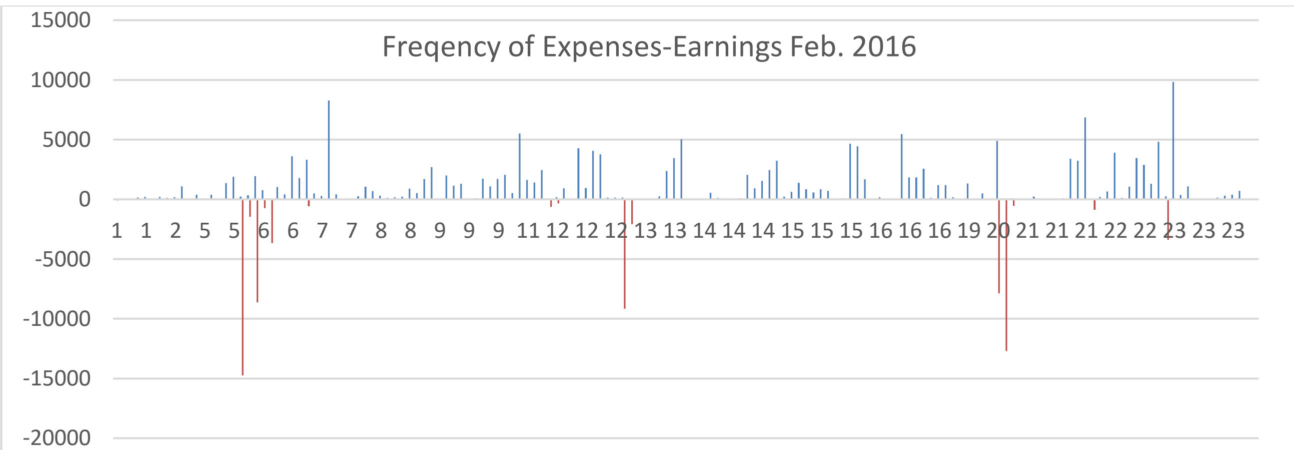
In the graph below we are analyzing the frequency and the volume of earnings compared to the frequency and volume of payments. For the month of July, the company had a total volume of 334,042 m.u. of earnings (sales) with 10 clients per day as average. On the other side, the company have made a total of 336,616 m.u. expenses with an average of 3 payments per day.



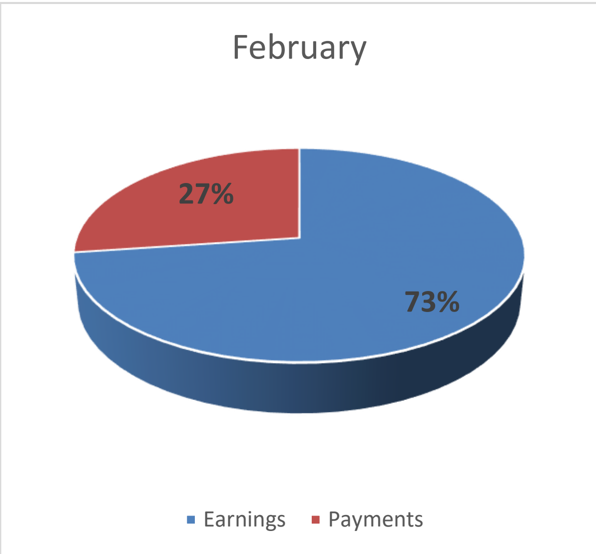
If we analyze the graph below, we can identify that the company had spent all of its resources for creating stocks. This is due to the “hunger effect”. Have you ever been to a supermarket when you are hungry, and at the exit realized that you bought too much food? Making a comparison, because the amount of sales is high and the efficiency of utilizing the assets is close to 100%, the management has a “hunger” and/or expectancy that the growth will continue forever. Using this deficient judgement, they will over-supply and create inefficient reserves (stocks). From tax perspective, this behavior will reduce the profits to zero and therefore, there will not be any taxes payed for the period.



On the other hand, if we consider the second period (February) there will be a considerable difference. In the graph below we are analyzing the frequency and the volume of earnings compared to the frequency and volume of payments. For the month of February, the company had a total volume of 180,750 m.u. of earnings (sales) with 5 clients per day as average. On the other side, the company have made a total of 67,440 m.u. expenses with an average of 1 payment per day.



If we evaluate the graph below, we can identify a considerable difference between the earnings and payments for the month of February. Because the company acquired large amounts of stock in the previous period, the amount of earnings is 3 times larger than the amount of payments. Due to the substantial oversupply that was acquired in the positive period, the company has enough merchandise to place on the market. From tax perspective, because the profits will be larger, the firm will be forced to pay all its taxes in the unfavorable season.



To conclude, although we are facing a market that deals with seasonality, the taxes are postponed from the positive season towards the penniless period because of needy management decisions. This could be classified as tax avoidance, but in reality, the tax is just postponed toward the winter months (when the activity of the company is not very intense).

Fiscal optimization
Model 1

Tax optimization represents an overall investigation of a financial position or plan from a tax perspective in order to fulfill the company's goals with tax-efficiency planning. It may have many different aspects, including, as we presented above the timing of both income and purchases (and other expenditures), allowable deductions or a different approach towards the "issue". However, it may be suitable only in specific conditions and the method can be applied only under jurisdictions (tax conde) that has a holistic approach towards the differences between income tax and profit tax. To be more specific, the Romanian fiscal code makes a clear boundary between small enterprises and larger ones. This may be the case of any fiscal code that has some "experience" and can be considered mature.

In order to facilitate the growth and fast development of an SME, the fiscal code allows small income tax instead of profit tax. More specific, if total revenue of a company is smaller than 1.000.000 Euro over a financial year period, the company can pay a preferential income tax (in this case 1%), mentioning the fact that there may be also other conditions to be met. If the company exceeds total income of 1.000.000 Euro, it will be forced to pay profit tax (16%).

In the case presented bellow we are formulating the supposition that a company exceeds the 1.000.000 Euro threshold not by much. In this scenario, the company will be forced to pay 16% profit tax. However, the business owner can overcome this issue by establishing a second company and move a part of the revenue. This way the owner will manage to keep the revenues under the 1.000.000 Euro threshold for each company and pay income tax instead of profit tax.

In the first scenario, the company has a turnover of 1.800.000 Euro and a supposed profit of 10%. The total profit will be 180.000 Euro. In this case the company will pay profit tax of 16%, that is 28.800 Euro.

In the second scenario, the "company" is breaking down its revenues into two different companies in order to keep its revenues under 1.000.000 Euro for each one of them. In this case, supposing that the companies are meeting all other conditions[2], it will pay only 1% of total revenue, that is 18.000.

(000)EURO	Profit tax(16%)	Income tax(1%)
Turnover	1.800	1.800
Profit	180	180
TAX	28.8	18

To conclude, using this specific measure, the entrepreneur can minimize the taxes payed and "embezzle" the government using a legal loophole. This method can have certain limitations if we try to imagine the following scenarios. First, the profit should be significant when expressed as a percent of turnover. Second, let's say the profit of the company is lower than 6.25% (break-even) from the turnover, the taxes payed will be similar if not greater in the second scenario.

Model 2
Employee vs Entrepreneur

This model is widespread all over Europe because is favorable for the individuals from financial perspective. It addresses the issues of taxes from the perspective of an employee vs an entrepreneur.

Bellow we have an employee that has a gross income of 10.225 m.u.. In the given scheme, the employee will receive only 5.850 m.u. of the 10.225 m.u.. In other words, under the Romanian jurisdiction (fiscal law), the government will "confiscate" 41.5% of gross income as taxes. 25% representing the Social insurance, 10% representing the health insurance and 10% representing the income tax. There are some other deductions and taxes that I've missed for simplification purposes. All in all, the employee pays 41.5% of its revenues to the government.

[2] See fiscal code (tax law) 227/2015

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Employee taxes		**Net salary**	
Total Gross Income	**10 000**	**NET income realized**	**5 850**
Social(pension) insurance 25,0%	2 500	Meal tickets value	0
Health insurance 10,0%	1 000	**NET salary**	**5 850**
Personal deductions	0		
Income tax 10%	650		
TOTAL employee taxes	**4 150**		

In the different scenario, the individual has the option to establish an SME and bill to its employee monthly. Supposing that the revenue is the same as in previous scenario, the individual (entrepreneur) will need to pay 3% income tax, and 5% dividends. The total amount will be significantly smaller (8% vs 42.5%). Although the company has the same cost (10.000 m.u.), the income received by the employee is different.

In the first sequence, only 5.850 m.u. from the 10.000 m.u. will go through the government filter, while the remaining will be paid as taxes. On the other hand, if the individual will bill on its company a monthly invoice of 10.000 m.u., he will be able to take advantage of more than 9.000 m.u.. This is another example of a possible “loophole” that the government can’t fully control.

Tax evasion or tax avoidance?

As European VAT Desk Says: “Member states shall exempt from VAT the supply of goods dispatched or transported to a destination outside their respective territory but within the Community, by or on behalf of the vendor or the person acquiring the goods, for another taxable person, or for a non-taxable legal entity acting as such in Member State other than that in which dispatch or transport of the goods began”[3].

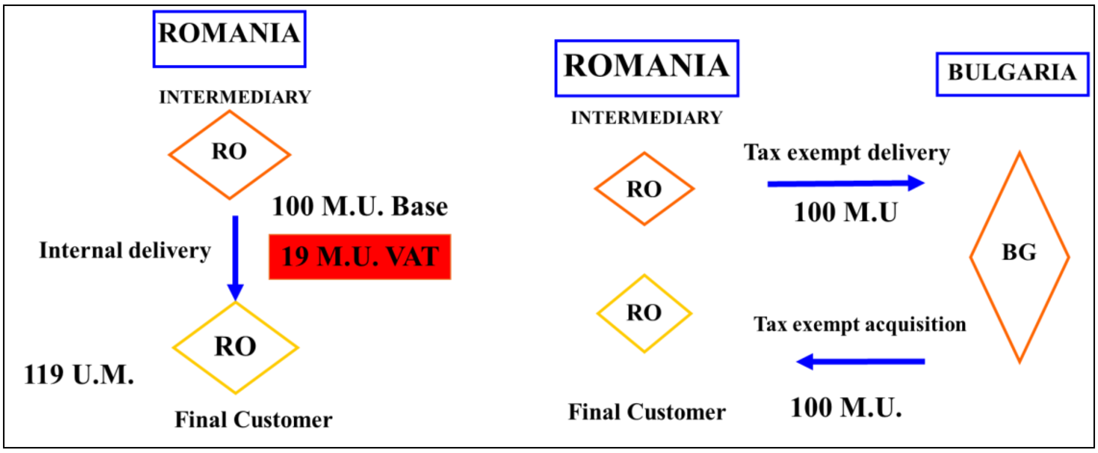
The following scheme includes a larger number of companies (at least two) and the final consumer of the product could be an individual that does have a legal personality, but doesn’t plan to resell the products/services (under specific conditions).

Because the EU regulates the VAT when external acquisitions are made (imports and exports between EU countries) it can be created a loophole that avoids paying the VAT.

[3] Article 138 (1) from the VAT Directive, Available at https://vatdesk.eu/eu-vat-news/86-vat-news-12-2015, accessed 23.03.2019

When a final customer (it uses the product in personal purposes and does not plan to resell) buys a product, he is the "main beam" that pays the total VAT to the government. By using an external company, the final customer (supposing that has a company and aims to use the product in its own purpose) will not pay the VAT. This will offer an competitive advantage for the seller that uses this procedure.

In the example given below we are supposing that a company sell its products to a final customer. The base price of the product is 100 m.u.. In the first case the final customer will be forced to pay the base price of the product (100 m.u.) plus the VAT (19% in Romania), totaling at 119 m.u..



In the second scheme, the intermediary will use an external company to conduct the transaction. First, the Romanian company sells towards the Bulgarian company without VAT. Second the Bulgarian company sells back to the Final customer that is located in Romania without VAT again. In the end, the final customer will only pay 100 m.u. for the product. Hence the company managed to subtract from the VAT payment. This scheme is widely used around the EU and the government is aware of the issue.

4. TO CONCLUDE

As presented above, there are a number of methods "loopholes" that can be used in order to pay less taxes toward the government. However, many of them may be subject to criminal offence and might led you to jail. I do not encourage anyone in using an aggressive tax optimization strategy due of the obvious risks encountered. Herein I have presented four practical examples that could be regarded as fiscal measurements (fiscal optimization) or could be reconsidered by the fiscal authority as an illegal measurement taken by the company's management. Because we are under the jurisdiction of Romanian fiscal law (tax code) 227/2015 the examples that are illustrated within the article may not be suitable for other Countries, especially outside of EU (European Union). May it be a subtle financial control of the company, a division of revenues with the purpose of meeting specific thresholds, a choice between entrepreneurship or employee, or just a VAT scheme, there are only two certain things in this world: Death and Taxes.

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