



## Corporate tax evasion: The case for specialists<sup>☆</sup>

Vilen Lipatov\*

Frankfurt University, Grüneburgplatz 1, 60323, Germany

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### ABSTRACT

We analyze the role of accounting specialists who help corporations evade/avoid taxes in a game of incomplete information played by a tax authority, corporate taxpayers, and an accounting specialist. In addition to a full equilibrium characterization, we establish that (i) marginal changes in enforcement are not effective when evasion/avoidance is pervasive; (ii) fines on firms as opposed to specialists are more effective in such situations; (iii) reducing auditing costs and increasing “creative accounting” costs are effective in curbing evasion when tax compliance is relatively high.

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## 1. Introduction

The phenomenon of tax noncompliance is pervasive throughout the world<sup>1</sup> and may have unpleasant consequences for the economy. Economic literature usually agrees on four main issues: (i) noncompliance may increase the deadweight loss from distortionary taxation (Feldstein, 1999); (ii) it may impede the ability of government to collect tax revenue and serve its debt obligations (as in recent Greek experience<sup>2</sup>); (iii) it calls for wasteful enforcement activities (Slemrod and Yitzhaki, 2002); (iv) it may hinder promotion of equity, as the effective tax rate depends on the unobservable characteristic of “tax honesty” and evasion opportunities (Andreoni et al., 1998). Thus, it is important to understand what factors determine equilibrium tax compliance, and this is precisely the research question most of the literature in this field aims at answering.

However, the vast majority of contributions to the tax compliance literature abstract from the specific knowledge necessary for evasion and avoidance<sup>3</sup>. To show that this is a regrettable omission, in the following, after introducing necessary definitions, we discuss anecdotal evidence suggesting that tax specialists play an important role in determining tax compliance.

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\* Tel.: +49 69 798 34777; fax: +49 69 798 35015.

E-mail address: [lipatov@em.uni-frankfurt.de](mailto:lipatov@em.uni-frankfurt.de)

<sup>1</sup> See, for example, the survey by Schneider and Enste (2000).

<sup>2</sup> Online at <http://www.economist.com/node/16792848>.

<sup>3</sup> For a detailed survey of income tax evasion literature, see Andreoni et al. (1998).

Usually, a line between lawful underreporting of tax obligations, also known as *tax avoidance*, and illegal understatement, referred to as *tax evasion*, is drawn. In reality, though, it is virtually impossible to distinguish between the two. In this situation it makes sense to break down underreporting into simple and sophisticated rather than into evasion and avoidance. We define *simple tax evasion* as understatement that does not require special expertise (accounting or financial). Correspondingly, understatement of tax liability that requires such special knowledge will be called *sophisticated tax evasion*.

There are no exact figures about any kind of tax evasion at our disposal. For simple evasion, the shadow-sector estimations presented, e.g., in [Schneider et al. \(2010\)](#) are a good proxy. Sophisticated evasion eludes such attempts, as it is reported and looks legal up to the moment the whole complicated arrangement is uncovered. Thus, what we can observe here are really big cases, the results of firm audits and of changes in the proportion of corporate tax revenues in total tax revenues. The latter, as noted by [Slemrod \(2004\)](#) for the US, have fallen from 6.4 percent of GDP in 1951 to less than 1.5 percent of GDP in recent years. Indirect evidence for growing sophisticated evasion is provided by the fact that “America’s largest and most profitable companies paid less in corporate income taxes in last three years, even as they increased profits,” as [Browning \(2004\)](#) states.

Corporate tax evasion, as opposed to individual, can hardly be simple. For one thing, corporations undergo regular (every three to five years in most countries) audits by the tax authorities. Thus, in order to hide simple evasion, a firm has either to perform a transaction illegally, facing the problems of contract enforcement and depriving itself of the benefits of law, or to officially close down before the corresponding check, rendering it impossible to gain reputation, which is crucial for successful functioning in many markets.

Corporate scandals<sup>4</sup> become possible with sophisticated evasion, which is hard to detect, as it requires counterchecking of many legal entities, some of which may be in a different tax jurisdiction (another city, state, country) or even liquidated by the time of audit. A broad collection of material about such scandals<sup>5</sup> has been prepared by Roy Davies and includes Enron as probably the most famous case. An excellent collection about US corporations involved in scandals is due to Citizen Works.<sup>6</sup>

The principal feature of corporate scandals is that fictitious contracts are made to overstate the performance of a company. This is done to boost the benefits of chief executives and stock prices, and tax fraud comes as a by-product of such efforts. Despite being a secondary goal, the tax evasion in these cases is very substantial, and it is increasing, as anecdotal evidence suggests ([Johnston, 2003a,b](#)).

Apart from the scandals, sophisticated evasion is represented by conventional tax shelters. The following examples of shelters common in the US may seem benign, but taken on a large scale are very detrimental to social welfare<sup>7</sup>: (i) deferring taxes to later years; (ii) obtaining leverage through various financing arrangements; (iii) deducting prepaid interest; (iv) not including prepaid income.

How can the auditors help in performing sophisticated evasion?<sup>8</sup> First, they have to certify the tax reports for public corporations. This also means that the auditors are an essential part of sophisticated evasion schemes. Secondly, they may actually assist smaller corporations, providing tax consulting that may include evasion. That is why in our paper the key role is played by the accounting specialist, modeled as a local monopolist (alternatively, it can be a number of tacitly colluding specialists) providing sophisticated evasion service for a set of real-sector firms.

Another application of our setup is even more direct: in former Soviet Union (fSU) countries the evasion service is usually provided by an accounting firm associated with a commercial bank. This way every client of a bank has an option to arrange its accounts to minimize its tax obligations. The accounting firm is a local monopolist, as there are substantial costs of changing a bank, and hence of changing the evasion specialist. There is a lot of anecdotal evidence for money laundering through the Russian banks. Sophisticated evasion goes hand in hand with laundering; in most cases it is difficult or impossible to separate the two phenomena.<sup>9</sup>

The study by [Levin and Movshovich \(2001\)](#) shows that sophisticated evasion accounted for about 90% of all corporate tax evasion in fSU countries. Moreover, the famous scandal with Yukos has opened up a bit the mechanism of such evasion to the general public. Briefly, the oil giant managed to reduce its corporate tax liability virtually to zero by shifting its operations on paper to a small republic within Russia and making special arrangements with the regional government. It is common knowledge that other Russian corporations were not very different from Yukos in their tax arrangements, but avoided prosecution.

Despite the evidence summarized above, the modest body of the literature that does take into account tax specialists either (i) assumes away their participation in evasion or (ii) looks at tax specialists inside a firm. Within branch (i), [Reinganum and Wilde \(1991\)](#) focus on the potential of the specialists to lower the costs of filing reports. Using a game of perfect information, they come to the conclusion that the tax authority audits reports prepared by tax specialists more intensively. [Franzoni \(1999\)](#) looks at the auditors as “gatekeepers” who can moderate the relation between tax authority and taxpayers. He finds

<sup>4</sup> A recent example is the German scandal related to Liechtenstein as a tax haven; details are available in *The Economist* (February 21, 2008), online at [http://www.economist.com/world/europe/displaystory.cfm%3Fstory\\_id=10733044](http://www.economist.com/world/europe/displaystory.cfm%3Fstory_id=10733044).

<sup>5</sup> Available at <http://www.exeter.ac.uk/RDavies/arian/scandals/classic.html%23credit>.

<sup>6</sup> Can be found on <http://www.citizenworks.org/enron/corp-scandal.php>.

<sup>7</sup> The list and a discussion of tax shelters versus IRS measures to curb them can be found at [http://www.usa-federal-state-company-tax.com/tax\\_shelter\\_techniques.asp](http://www.usa-federal-state-company-tax.com/tax_shelter_techniques.asp).

<sup>8</sup> For a list of cases involving the four big auditors in 2007–09 see [http://www.usa-federal-state-company-tax.com/tax\\_shelters.2007-2009.asp](http://www.usa-federal-state-company-tax.com/tax_shelters.2007-2009.asp)

<sup>9</sup> An example of a bank connected to an evasion specialist can be found in [Zheglou \(2006\)](#).

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