

## Fighting with Tax Fraud-Best Practices and Steps for the Future

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### **Abstract**

*The purpose of this paper is to identify the best methods that can be implemented by a state, or a group of states for protection against tax fraud; the paper also suggests improved mechanisms at the European and international level in the fight against tax fraud. The research method is a survey in which independent professionals and civil servants with positions of responsibility in relevant institutions in the field of combating tax fraud have expressed their views on tax fraud and how to take action to reduce or prevent it. The study objectives are finding the most appropriate measures and detection techniques that could be more useful to the state for the necessary protection against tax fraud, finding the most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud. The study reveals that the most important measure that a government can implement for fighting tax fraud is the cooperation between public organizations. Also, civil servants working in the fiscal/judicial field should be highly qualified and comply with clearly stated ethical standards. Ground and maritime surveillance for the detection of smuggling illegal excisable goods for the detection of illicit trafficking of sensitive goods by sea are extremely important. They are as important as detailed procedures for dealing with cases of suspected fraud and for guaranteeing the quick transmission of information to the competent authorities; another kind of desirable procedure is those that guarantee the protection of the whistle-blowers. Implementing management's responsibility for financial reporting, likewise to The Sarbanes-Oxley Act in the United States, is crucial for minimizing the level of tax fraud at the international level. Hopefully, working together within OECD/G20 Inclusive Framework on BEPS, 139 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance at the international level, improve the coherence of international tax rules and ensure a more transparent tax environment. More than 130 states reached an agreement in July 2021 on reform of multinational taxation to impose a minimum global profit tax of "at least 15%" on them. Likewise, the European Union also has strong institutions and strategies against tax fraud.*

### **Keywords**

*Tax fraud; tax avoidance; BEPS; shadow economy; minimum global profit tax.*

## **Introduction**

The purpose of this paper is to identify the optimal methods useful to the state, for protection against tax fraud and propose better mechanisms at the European and international level in the fight against tax evasion and fraud. The fight against tax fraud has become a very interesting topic for the public around the world in the last decade, following journalistic investigations such as LuxLeaks, Panama Papers, Football Leaks, Bahamas Leaks, or Paradise Papers, which made revelations about tax havens and tax avoidance and even tax fraud.

First of all, one has to understand the conceptual differences between tax evasion and tax fraud. Tax evasion happens when a taxpayer does not declare income to a tax authority that has a right to know about it and the crime of claiming expenses for offset against a taxable income when knowing that those expenses should not be claimed for that purpose. Tax fraud consists of the taxpayer's conduct in flagrant violation of the law to evade the payment of taxes, fees, contributions, and any other amounts due to the state budget.

Some authors consider legal tax avoidance or planning through the use, manipulation, or interpretation of legal concepts (legal terms) resulting in reduced tax liability (Pasternak, & Rico, 2008, p. 2). There are such legal tax avoidance areas or countries, known as tax shelters or tax-havens. A tax shelter is one type of tax avoidance, and tax havens are jurisdictions that facilitate reduced taxes (Dyrenge, Hanlon, & Maydew, 2008).

A tax haven is „a country or place which has a low rate of tax so that people choose to live there or register companies there to avoid paying higher tax in their own countries” (Cambridge English Dictionary, 2018). The most famous "tax havens" are Andorra, the British Virgin Islands, Seychelles, the Cayman Islands, Luxembourg, Cyprus, and Malta. In all these states, the legislation allows the establishment of so-called "offshore" companies. They take advantage of differences in tax law between two or more countries and are used to launder illegally obtained money or, at least, for tax evasion. Following international pressure, some of these states have been forced to change their legislation.

Schneider and Williams (2013) use the term „shadow economy” to describe market activity consisting in the production of non-banned products, hidden from public control, to avoid the payment of taxes, social benefits, or other regulations. Measuring the shadow economy is an extremely difficult approach because it involves estimating the economic activity that is deliberately veiled by the managers and accountants of fraudulent companies in official transactions. State statistics do not take into account or underestimate the size of the shadow economy. The average size of the shadow economy of the 158 countries over 1991 to 2015 is 31.9 percent, according to a study of the International Monetary Fund. The largest ones are Zimbabwe with 60.6 percent, and Bolivia with 62.3 percent of GDP. The lowest ones are Austria with 8.9 percent and Switzerland with 7.2 percent (Medina & Schneider, 2018).

Tax fraud and tax evasion lead to budget losses and breaches of the principle of fair taxation. They can also cause distortions of capital movements and conditions of competition. The anti-fraud information system has two main areas that it frequently deals with: mutual assistance in the customs field and the management of irregularities in several spending sectors. According to some authors, accounting violations are widespread: in an average year, 43% of companies misrepresent their financial reports, even when we ignore simple clerical errors (Dyck, Morse, & Zingales 2013).

Internationally, several journalistic investigations have shocked the world in the last decade by the extent of the tax fraud they have denounced. Among these surveys, we mention Panama Papers and Luxleaks. Panama Papers is considered the biggest leak so far, which made public the secrets of a law firm, namely the Mossack Fonseca company, registered in Panama that was in charge of creating mailbox-type phantom companies. 11.5 million documents attesting to irregularities were found in this case. The data leaks contain confidential records of 213,634 offshore companies, along with the names of twelve current and former heads of state, nearly 200 politicians from around the world, and several personalities from various fields of activity, whereas Mossack Fonseca set up and managed these offshore companies between 1970 and 2015 (Obermaier, Obermayer, Wormer, & Jaschensky, 2016). In 2014, the International Consortium of Investigative Journalists conducted a survey analyzing tax decisions and harmful practices in Luxembourg (LuxLeaks). They found that 340 multinationals had made agreements with Luxembourg, which could reduce their taxes to a minimum (Wayne & Carr, 2014).

Hopefully, a lesser frequency of trade fraud is recorded when governments enhance information collection and processing through digitalization, as Kitsios, Verdier, and Jalles revealed in 2021 (Kitsios, Jalles, & Verdier, 2021). For instance, in the European Union, the anti-fraud information system assists customs assistance through the rapid and secure transmission of information, VOCU (Virtual Operations Unit), secure e-mails (AFIS-MAIL), CIS, and FIDE databases. and the A-TIS (transit anti-fraud information system) analysis tool. Similarly, Eurofisc was set up for faster and more efficient communication between the Member States, to combat VAT fraud. For an even faster evolution of the data, the Commission uses new Transaction Network Analysis (TNA) software. To maximize the potential of TNA to identify fraudulent networks across the EU, Regulation (EU) no. 904/2010 as amended clarifies the provision of common data processing and analysis services within Eurofisc. Involvement in such processing and analysis services remains voluntary, but Member States must give Eurofisc officials' access to data from their VAT Information Exchange System (VIES) related to transactions in the EU via TNA, so that potential frauds can be identified, including those involving traders established in the non-participating Member States.

On 20th June 2016, the Council adopted the EU Directive 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, known as the ATAD Directive (Council Directive EU 2016/1164). The rules stated by this directive are intended, among other things, to prevent the artificial transfer of profits by taking out interest-bearing loans; an effect of this fact is that the companies that are part of a group are financed more expensively both from the affiliated parties, respectively from other companies in the group, as well as from the financial institutions.

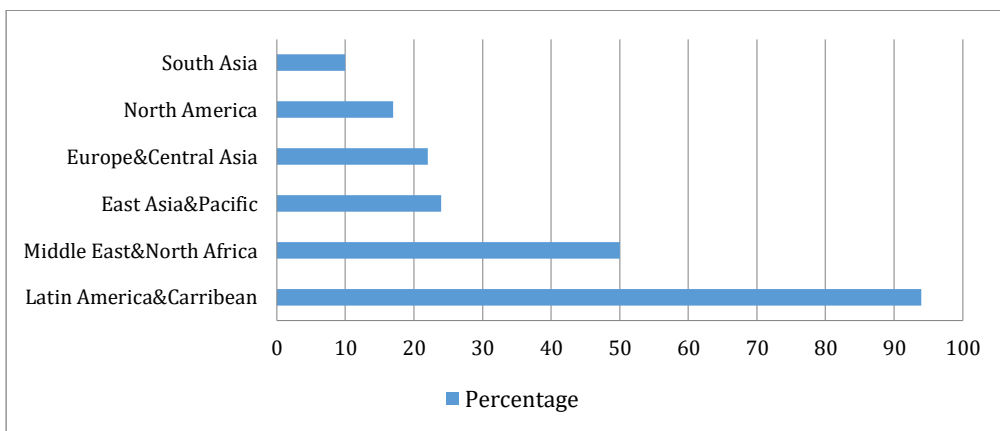
The challenges are global and require close international cooperation. The EU is working with its partners in the International Financial Action Task Force (FATF) to develop and implement international standards. FATF is an intergovernmental organization founded in 1989 on the initiative of the G7 states. to create an effective police force capable of combating money laundering and terrorist financing. The

organization's headquarters are located in Paris, in the OECD Headquarters building. With more than 200 countries and jurisdictions committed to implementing them. The organization has developed the FATF Recommendations, or FATF Standards, which guarantee a coordinated international response to prevent organized crime, corruption, and terrorism. They help authorities go after the money of criminals dealing with illegal drugs, human trafficking, and other crimes. The FATF also works to stop funding for weapons of mass destruction (FATF, 2021).

The European Commission adopted on September 3, 2020, its 31st annual report on the protection of the European Union's financial interests. In 2019, 939 fraudulent irregularities were reported, much less than in previous years. 2019 was a year of progress for many reasons, such as the transposition by the EU Member States of the Directive on the fight against fraud to the Union's financial interests by means of criminal law (the 'PIF Directive'), the adoption of the Directive on the protection of persons who report breaches of Union law (the 'Whistleblowing Directive'), the adoption of the new Commission Anti-Fraud Strategy, the nomination of Ms. Laura Codruța Kövesi as European Chief Prosecutor (The European Commission, European Anti-Fraud Office, 2020).

One of the most effective institutions for protecting the interests of the European Union, fighting against fraud, corruption, and any other illegal activity is the European Anti-Fraud Office (OLAF). Between 2010 and 2020, OLAF concluded over 2200 investigations and recommended the recovery of over €7.5 billion to the EU budget, also issued over 3000 recommendations for judicial, financial, disciplinary, and administrative action to be taken by the competent authorities of the Member States and the EU. As a result of OLAF's investigative work, the amounts unduly spent have been gradually returned to the EU budget, and criminals facing criminal prosecution before the courts form better anti-fraud protection measures, which have been implemented in all Europe. (The European Commission, European Anti-Fraud Office, OLAF in figures, 2020).

In a study published in 2019, Janský and Palanský (2019) demonstrate that a higher share of investment from tax havens is associated with a lower reported rate of return on inward foreign direct investment and observe which country groups' tax revenues are most affected and present varied effects across income groups and regions as shown in Figure 1. The results suggest the 79 countries included in the sample lose a total of \$125 billion due to profit shifting (Janský & Palanský, 2019).



**Figure 1. Average tax revenue losses per geographical region (as a percentage of Gross Domestic Product)**  
(Janský & Palanský, 2019)

## Research methodology

The research method is the analysis of the literature, focusing on current issues related to tax evasion and fraud, followed by a survey in which Certified Public Accountants, tax consultants, civil servants with positions of responsibility in relevant institutions in the field of combating tax fraud, employees of Big Four companies, lawyers, auditors, managers, university professors in economics and others have expressed their views on tax fraud and how to take action to reduce or prevent it. As such, the quantitative-qualitative method is used, by applying the questionnaire as a specific tool in the data collection process.

The study objectives are:

- Objective no. 1. Finding the most appropriate measures that could provide the state with the necessary protection against tax fraud;
- Objective no. 2. Finding the most appropriate detection techniques that could be more useful to the state for the necessary protection against tax fraud;
- Objective no. 3. Finding the most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud.

The research includes questions with multiple choice answers, but also open-ended questions, which inquired for personal opinion on those questions. Regarding the research sample, the respondents of the questionnaire work in the fields specified above, in countries of the European Union. The data collection and interpretation were performed automatically and securely, the online questionnaire being applied between June 1-10, 2021, and 217 responses were collected.

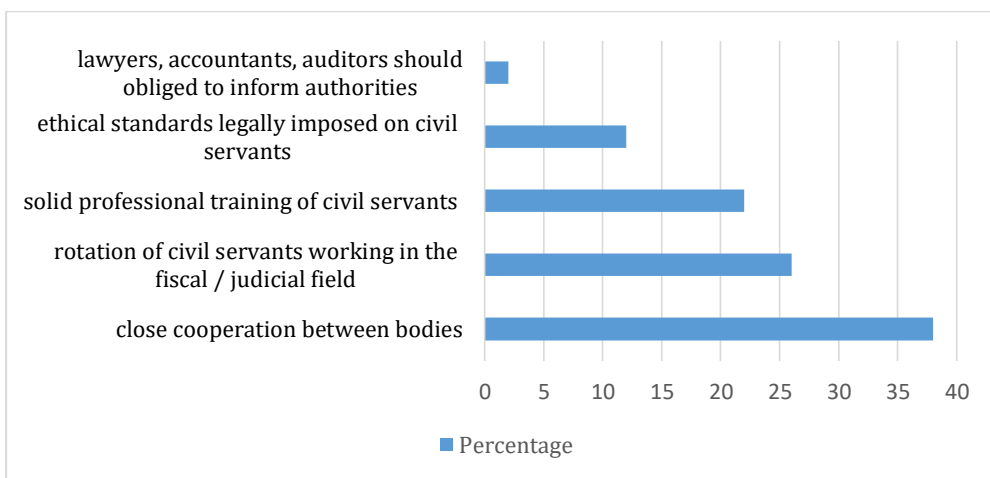
## Research questions. Result and discussions

**Objective no. 1.** Finding the most appropriate measures that could provide the state with the necessary protection against tax fraud.

The first interrogation of the questionnaire was: “Which of the following measures could provide the state with the necessary protection against tax fraud?”

The answers and the respective percentages were the following:

- a) close cooperation between bodies, both at national and international level (38 %);
- b) whenever possible, the rotation of civil servants working in the fiscal/judicial field (26%);
- c) solid professional training of civil servants working in the fiscal/legal field regarding the fight against fraud (22%);
- d) ethical standards legally imposed on civil servants working in the tax / judicial field to mitigate the risks of conflict of interest (12%);
- e) lawyers, accountants, auditors should be legally obliged to inform the relevant state institutions about the tax frauds of which they become aware in their professional activity (2%).



**Figure 2. Most appropriate measures that could provide the state with the necessary protection against tax fraud**

Indeed, as most respondents (38 %) have indicated, fiscal harmonization measures must include the establishment of a common system of cooperation between states, in particular, regards the exchange of information by which the competent authorities will support each other and cooperate with the European Commission and other international bodies. For example, to collect the value-added tax due, Member States cooperate to help ensure that VAT is set correctly.

By introducing the standard on the automatic exchange of information and, at the same time, by abolishing banking secrecy for tax purposes throughout the European Union, it has been imposed on the Member States to automatically exchange a wide range of financial information with each other, in line with the new OECD / G20 global standard for the automatic exchange of information. Council Regulation (EC) No 904/2010 on administrative cooperation and combating fraud in the field of value-added tax was adopted for supporting the fight against the scourge of tax fraud. The pieces of information are communicated, as far as possible, by electronic means. Furthermore,

by EU Regulation no. 904/2010, Article 33, an entity called "Eurofisc", was established, as a network for rapid exchanges, processing, and analysis of specific information on cross-border fraud between the Member States and the coordination of any subsequent action (Council Regulation No 904/2010).

26% of respondents have indicated that, whenever possible, the rotation of civil servants working in the fiscal/judicial field is desirable, as a method to fight tax fraud. For instance, in Romania, by Order of the Romanian Minister of Public Finance no. 946/2005, it was stated that each public entity must identify the functions considered to be sensitive and establish an adequate rotation policy for employees holding such positions. The plan for ensuring the rotation of employees holding sensitive positions must be drawn up so that an employee does not usually work for more than 5 years in such a position. The inventory of sensitive functions usually includes those functions that have a significant risk in relation to the achievement of objectives (Ministerul Finanțelor Publice, Ordin nr. 946/2005).

Solid professional training of civil servants working in the fiscal/legal field regarding the fight against fraud was indicated by 22% of respondents as a way to prevent tax fraud. Therefore, complex, permanent professional training is crucial. The emphasis must be on high-quality training, in the fields of accounting, taxation, information technology, forensic techniques; professional training may also consist in sharing information and experiences with specialists from other countries, for the dissemination of various case studies.

Ethical standards legally imposed on civil servants working in the tax / judicial field to mitigate the risks of conflict of interest were considered as important by 12% of respondents. The management and employees of the public entity working in the tax / judicial field must know and uphold the ethical values and values of the entity, respect and apply the regulations on ethics, integrity, avoidance of conflicts of interest, prevention, and reporting of fraud, acts of corruption and reporting irregularities.

Only 2% of respondents considered that the lawyers, accountants, auditors should be legally obliged to inform the relevant state institutions about the tax frauds of which they become aware in their professional activity. Imposing such obligations can be considered that it is interference in the consultant-client relationship and does not take into account the principle of professional secrecy.

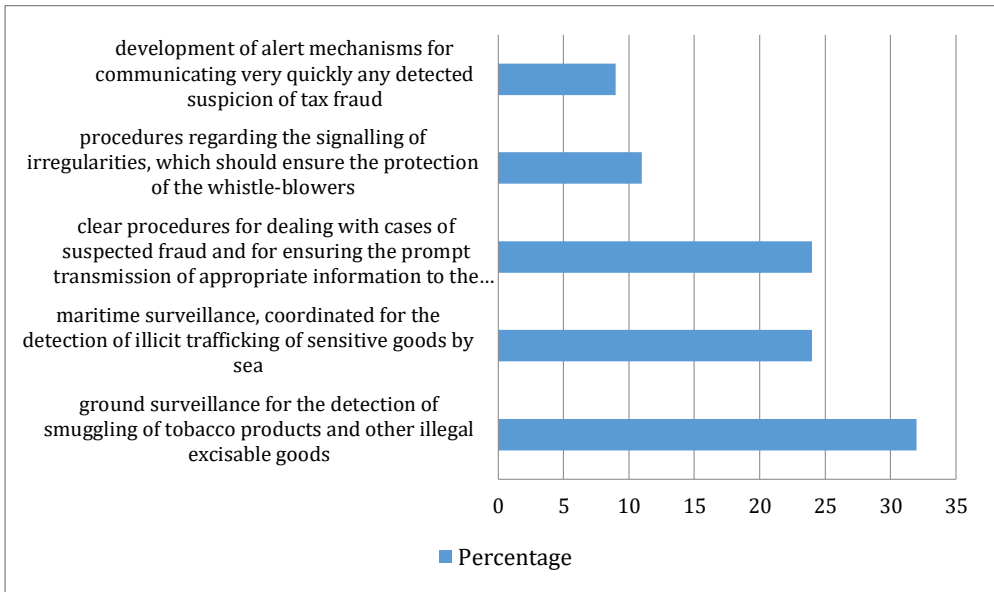
**Objective no. 2.** Finding the most appropriate detection techniques that could be more useful to the state for the necessary protection against tax fraud.

The second question asked in the survey was: "Which of the following detection techniques could be more useful to the state for the necessary protection against tax fraud?"

The answers and the respective percentages were the following:

a) ground surveillance for the detection of smuggling of tobacco products and other illegal excisable goods (32 %);

- b) maritime surveillance, coordinated for the detection of illicit trafficking of sensitive goods by sea (24 %);
- c) clear procedures for dealing with cases of suspected fraud and for ensuring the prompt transmission of appropriate information to the competent authorities-24 %
- d) procedures regarding the signaling of irregularities, which should ensure the protection of the whistle-blowers (11 %);
- e) development of alert mechanisms for communicating very quickly any detected suspicion of tax fraud (9 %).



**Figure 3. Detection techniques could be more useful to the state for the necessary protection against tax fraud**

Ground surveillance for the detection of smuggling of tobacco products and other illegal excisable goods was indicated by 32 % of respondents as one of the most important ways to avoid tax fraud. The illicit tobacco trade makes cigarettes available at prices inferior to those set to discourage smoking. Illicit products do not comply with product regulations, such as labeling. The illicit tobacco trade also causes significant losses to public revenue: if all cigarettes sold on the black market were sold legally, the budget of the EU and its Member States would receive above EUR 10 billion annually (European Commission Brussels, 2017).

Maritime surveillance, coordinated for the detection of illicit trafficking of sensitive goods by sea and clear procedures for dealing with cases of suspected fraud and for ensuring the prompt transmission of appropriate information to the competent authorities are equally (24 %) indicated by respondents as useful tools for fighting the plague of tax fraud.

Procedures regarding the signaling of irregularities, which should ensure the protection of the whistle-blowers, are considered important by 11 % of respondents.



The implementation of such procedures represents an extremely difficult managerial approach, in the context of applying the values of the culture of trust and ensuring an environment of morality within any public institution, given the risk of perceiving the procedure as similar to the denunciation. It is the task of the employee or any other whistle-blower that, in case of identifying some evidence regarding the existence of some possible frauds, corruption to bring the respective evidence to the knowledge of the competent bodies of the state. Under no circumstances should an employee who discovers such evidence and acts to bring it to light be sanctioned or rewarded. Such action must be seen as the exercise of professional duty. Those who report, according to the procedures, irregularities, of which, directly or indirectly, they are aware, will be protected against any discrimination.

**Objective no. 3.** Finding the most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud.

The survey has also contained open-ended questions. I was interested in identifying the most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud. Thus, at this third question respondents indicated: segregation of responsibilities as one of the best methods for creating internal control; others proposed the periodic and unexpected inventory of management, data security as useful methods for a well-established internal control, strengthening of the internal audit function within companies, the elaboration of clear legislation, with a high emphasis on recovering damages, for example, extended confiscation, seizure of assets, large fines for tax evasion, tax verification of companies after a thorough risk analysis sampling. Many respondents consider that countries should also implement management's responsibility for financial reporting, similarly to The Sarbanes-Oxley Act. The act requires that top managers personally certify the correctness of financial reports. If a top manager expressively or wilfully makes a dishonest certification in the US, he or she can face between 10 to 20 years in prison.

Most frequent answers of respondents regarding most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud	
a)	segregation of responsibilities as one of the best methods for creating internal control
b)	periodic and unexpected inventory of management
c)	data security
d)	strengthening of the internal audit function within companies
e)	the elaboration of clear legislation, with a high emphasis on recovering damages (extended confiscation, seizure of assets, large fines for tax evasion, tax verification of companies after a thorough risk analysis sampling)
f)	implementing management's responsibility for financial reporting, likewise to The Sarbanes-Oxley Act in the United States

**Figure 4.** *Most effective methods that should be imposed by law to create an internal control system in the companies to reduce the phenomenon of tax fraud*

One last question I asked the respondents after the survey was: “Do you consider that independent professionals (accountants, tax advisers, lawyers, etc.) should obligatorily declare to the state the transactions they become aware of in relation to clients regarding their activities with offshore entities or other actions that have the potential for tax fraud?” Most respondents answered in the negative and argued that it meant an intrusion into the consultant-client relationship and a serious breach of the principle of professional secrecy.

### Conclusions and recommendations

The study reveals that the most important measures that a state can implement for fighting tax fraud are the cooperation between institutions, both at the national and international levels. It is desirable to broaden the area of administrative cooperation, including by simplifying the procedures used in requesting or providing mutual support. The civil servants working in the fiscal/judicial field should comply with ethical standards and have to participate in high-quality training sessions.

Ground and maritime surveillance for the detection of smuggling illegal excisable goods for the detection of illicit trafficking of sensitive goods by sea are extremely important. They are as vital as thorough procedures for dealing with cases of suspected fraud and for guaranteeing the quick transmission of information to the competent authorities; another type of needed procedure is those that guarantee the protection of the whistle-blowers. Implementing management's responsibility for financial reporting, likewise to The Sarbanes-Oxley Act in the United States, is crucial for minimizing the level of tax fraud at the international level.

Over time, the EU has developed a solid regulatory framework. However, the rules must be constantly adapted to deal with the risks posed by:

- technological innovation - such as virtual currencies;
- increasing the integration of financial flows in the internal market;
- the global dimension of terrorist organizations;
- the ingenuity of criminals to exploit gaps or problems in the system.

Since 2018, the EU has had stricter anti-money laundering rules in place. These rules make it difficult to hide illegal funds through layers of fictitious companies and strengthen controls on high-risk third countries. The rules also strengthen the role of financial supervisors and improve access to and exchange of information. The EU's Security Union Strategy for 2020-2025, enhances the EU's framework for anti-money laundering and countering terrorist financing. The Commission has proposed in July 2021 an EU-wide limit of €10,000 on large cash payments (The European Commission, 2021)

Working together within OECD/G20 Inclusive Framework on BEPS, 139 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. The BEPS plan includes recommendations for legislative changes both nationally and internationally, to counter situations of erosion of the tax base. A very important feature that is part of the BEPS Plan is the emphasis on the

transfer of information as clearly as possible and the reporting between taxpayers and tax officials, but also between the authorities of other states. More than 130 states reached an agreement in July 2021 on reform of multinational taxation to impose a minimum global profit tax of "at least 15%" on them. International collaboration to end tax avoidance. Organization for Economic Co-operation and Development, International collaboration to end tax avoidance (Organization for Economic Co-operation and Development, International collaboration to end tax avoidance, 2021).

### **Limits of research**

The limits of the research are related to the small number of respondents and the fact that they work in Romania and other countries of the European Union, being neglected other countries that are certainly affected by the phenomenon of tax fraud. However, we intend to apply a similar questionnaire in the future to a larger number of respondents, located on other continents, so that the research becomes more relevant.

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