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Analyzing Global Tax Evasion: Mechanism Design Approach and Core Strategies of Tax Avoidance

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Abstract

In recent years, tax avoidance has gained widespread attention from the public, the media, and governments, especially in poorer nations where its negative effects are more pronounced. Governments are giving the battle against tax avoidance practices priority to address this problem. Transfer pricing, which involves moving profits from high-tax jurisdictions to low-tax jurisdictions, and the use of tax havens, which are nations or territories that offer low tax rates and other tax incentives to draw in foreign investment, are two examples of tax avoidance strategies. The use of tax law loopholes, claiming excessive deductions or exemptions, and proactive tax planning are additional strategies. Using a mechanism design approach that considers people's probabilistic views about the extent of public good provision and the structure of the tax system, this study will analyze tax evasion in a global setting. Additionally, this article will go into the idea of tax evasion as well as the core ideas of tax avoidance strategies, such as transfer pricing and the usage of tax havens.

Keywords: Tax avoidance, mechanism design, taxation, tax havens, transfer pricing

INTRODUCTION

Taxation, in its most basic form, is the mechanism through which governments collect revenue from individuals and businesses to provide public goods and services that benefit society as a whole. Taxes are levied on a wide range of items, including income, earnings, goods and services, and real estate [1]. Normative public economics is focused on determining how the tax system might be organized to maximize social benefit while minimizing inefficiencies [2]. The research on optimal taxation, on the other hand, often assumes that the government's financial requirements are given exogenously, and that the supply of public goods is not expressly considered. As a result, this technique may fail to represent individuals' various preferences for public goods [3]. Papers that do consider public goods provision in the context of taxation typically assume that individuals' preferences for public goods are common knowledge. This assumption may not always hold in practice, as individuals may have varying preferences for different types of public goods, and these preferences may not be fully revealed to the government. As a result, designing an optimal tax system that takes into account individuals' preferences for public goods can be challenging [4].

Tax avoidance, which refers to the legal manipulation of the tax system to reduce the amount of taxes owed, can complicate the design of an optimal tax system. In recent years, tax avoidance has been a major concern for governments worldwide, especially in developing countries that are disproportionately affected by the adverse effects of tax avoidance. The next section will delve into the concept of tax avoidance and its implications for the tax system.

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THE LEGAL STATUS OF INTERNATIONAL TAX AVOIDANCE

It can be challenging to distinguish between legal but undesirable international tax avoidance and illegal tax evasion. A possible approach to differentiate between the two is by examining the taxpayer's intent. If the taxpayer's actions are a result of legal loopholes or shortcomings in the tax system, then even though it goes against the spirit of the law, it would still be considered tax avoidance and thus legal. However, deliberate actions aimed at reducing or eliminating tax liability through concealment or misrepresentation constitutes illegal tax evasion.

Governments are aware of this practice and have attempted to resist it through a variety of means, including strengthening tax rules, establishing fines for aggressive tax planning, and enforcing international tax treaties to avoid tax base erosion and profit shifting [5]. However, there is a tight line between legitimate tax planning and abusive tax avoidance, and it can be difficult to determine which side of the line, a particular action falls on. Many people believe that proactive tax planning is used by some firms and rich individuals to unfairly lower their tax liability, which can have a negative impact on government revenue and public services [6]. As a result, there is ongoing debate concerning the morality of international tax evasion and whether it is ethical behavior.

The legal framework for the mechanism of income tax plays a crucial role in ensuring compliance with tax laws and regulations, and is facilitating the collection of revenue to fund public services and programs. It typically includes laws and regulations that define taxable income, establish tax rates, and outline procedures for filing tax returns and paying taxes [7]. It may also include provisions related to tax audits, penalties for noncompliance, and the collection of unpaid taxes. By providing a clear set of rules and regulations, the legal framework helps to promote transparency, accountability, and fairness in the administration of income tax.

METHODS OF INTERNATIONAL TAX AVOIDANCE

It is clear that failing to declare or underreporting income, financial assets, and income from foreign assets to domestic tax authorities is considered tax evasion. Similarly, manipulating pricing or engaging in transactions with the intent to reduce tax liabilities is also considered tax evasion [8]. While these activities are often carried out by individuals or small groups, international tax avoidance is primarily associated with wealthy individuals and large multinational corporations, although the distinction between the two is not always clear, according to many scholars [9].

International tax avoidance refers to a range of methods that can be used to minimize tax liabilities in various jurisdictions, including transfer pricing, tax havens, treaty shopping, hybrid entities, and IP transfers, among others, but it is crucial to recognize that some of these methods may be considered illegal tax evasion, while others may be legal forms of tax planning [10]. The determination of whether a particular method of tax avoidance is legal or illegal may depend on the specific facts and circumstances involved. Some of the points are listed here:

- *Transfer pricing:* This involves manipulating the prices of goods and services within a multinational corporation to shift profits to lower-tax jurisdictions. For example, a subsidiary of a multinational corporation may sell goods or services to another subsidiary in a higher-tax jurisdiction at an inflated price to reduce profits and taxes in the higher-tax jurisdiction.
- *Tax havens:* Companies can use tax havens, which are countries or territories with low tax rates, to hold profits and assets offshore. This allows them to avoid taxes in higher-tax jurisdictions.
- *Treaty shopping:* This refers to the practice of structuring business activities to take advantage of favorable tax treaties between countries. For example, a company may establish a subsidiary in a country with a tax treaty that provides favorable rates on certain types of income.
- *Hybrid entities:* These are entities that are classified differently for tax purposes in different countries. For example, a corporation may be classified as a partnership for tax purposes in one country and as a corporation in another. This can allow for tax savings by taking advantage of different tax treatment in different jurisdictions.

- *Intellectual property (IP) transfers:* Companies may transfer IP rights, such as patents or copyrights, to subsidiaries in low-tax jurisdictions to reduce tax liabilities in higher-tax jurisdictions.

TRANSFER PRICING IN INTERNATIONAL TAX AVOIDANCE

Transfer pricing is a legitimate business practice used to allocate costs effectively in multinational corporations, but it can become abusive when used solely to avoid taxes, leading to tax evasion. Governments worldwide have implemented transfer pricing regulations that demand companies use arm's length pricing, i.e., the prices set for goods and services should be equivalent to those that would be negotiated between unrelated parties. Moreover, companies must maintain documentation to support their transfer pricing decisions and comply with transfer pricing audits conducted by governments. On the one hand, the increase in multinational corporations has provided benefits such as increased efficiency and economies of scale, but on the other hand, it has also given rise to the issue of transfer pricing. Cianca suggests that multinational enterprises establish subsidiaries in different parts of the world to take advantage of national tax rate differences and increase profitability [2]. Transfer pricing involves relocating profits and expenses within a group of enterprises. The United Nations defines transfer pricing as the practice of setting prices for transactions involving the transfer of property or services between associated enterprises forming part of a multinational group. This study will discuss the implications of transfer pricing, as well as the main causes of transfer pricing malpractice identified in previous research.

TRANSFER PRICING RULES

Transfer pricing policies have been enacted by governments to discourage multinational firms from participating in abusive transfer pricing practices. When setting prices for transactions between related organisations within the same multinational group, corporations must employ arm's-length pricing. There are also international transfer pricing guidelines, such as those produced by the OECD, to provide a framework for countries to develop their own transfer pricing policies and encourage consistency in their use. The ultimate objective of transfer pricing rules is to ensure that multinational corporations pay appropriate taxes in the countries they operate in while preventing the manipulation of transfer pricing practices to artificially reduce their tax liabilities. Although there is extensive documentation on profit shifting and the underlying reasons for transfer pricing malpractices, the effectiveness of legislation aimed at curbing these practices is not well-researched and has limited literature available.

THE EFFECTIVENESS OF TRANSFER PRICING RULES TO LIMIT TRANSFER PRICING

The impact of transfer pricing rules on reducing transfer pricing practices is influenced by several factors, including the strength and enforcement of the rules, multinational corporations' willingness to comply, and the complexity of the international tax system. Although transfer pricing rules have been implemented by many countries and international organizations, their effectiveness in curbing abusive transfer pricing practices is still debated. Some studies indicate that transfer pricing rules have been successful in reducing profit shifting by multinational corporations, while others argue that the rules are not robust enough, and more needs to be done to combat abusive transfer pricing practices. In addition, multinational corporations may employ various strategies to bypass transfer pricing rules, such as using tax havens or engaging in treaty shopping. Ultimately, the effectiveness of transfer pricing rules in limiting transfer pricing practices may hinge on governments' willingness to work together and coordinate on international tax policy and enforcement. It is important to consider the potential drawbacks of implementing transfer pricing rules, such as high administrative burden, compliance costs, and tax disputes. While these rules are necessary to prevent transfer pricing abuses, governments must be cautious in selecting transfer pricing mechanisms that are feasible for both the government or revenue authority and the multinational enterprise. If the costs of implementing these rules exceed the benefits obtained, it may not be worth the effort to enforce them.

CONCLUSION

Transfer pricing is a complex and multifaceted issue that has both benefits and drawbacks. Governments have implemented transfer pricing rules to limit abusive practices and ensure that multinational corporations pay their fair share of taxes, but the effectiveness of these rules remains a subject of debate. While the potential costs of establishing transfer pricing frameworks should also be considered, addressing transfer pricing issues ultimately requires collaboration and coordination between governments and international organizations. By promoting transparency, fairness, and consistency in international tax policy and enforcement, we can work towards a more equitable and sustainable global tax system.

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