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Tax avoidance and tax evasion schemes – crossing the thin line in the MNCs. The case of Central and South America

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ABSTRACT

This paper describes the schemes that the multinational companies from Central and South America employ in an attempt to reduce their tax obligations even at a cost of surpassing the legal limits. I include only the corporations listed in the Forbes 500 from 2015. All of them are headquartered in Brazil. I find evidence that, first, Brazil is characterized by a complex and, at the same time, open to lax interpretation and application tax system. Then, I also find out that four out the five revised multinational enterprises have seen themselves involved in investigations due to alleged irregularities in their tax-related practices.

INTRODUCTION

One of the multiple effects of the globalization process could certainly be related to the spirally-growing complexity of the schemes that the multinational companies (MNCs) employ when it comes to pay less taxes. The difficulty that the international tax systems experience in keeping pace with these individual maneuverings, does not add much help in preventing crossing the fine line between the legal and the abusive practices. But exactly what strategies do the MNCs adopt in their pursue for saving on the tax bills?

First, we need to be aware of the difference between tax avoidance and tax evasion. Tax avoidance has to do with finding mechanisms to decrease the taxes due while still sticking to the law requirements and disclosing to the authorities all the relevant information. Meanwhile, tax evasion implies illegal actions set in practice (S. Akhtar, F. Akhtar, John and Wong, 2017). In other words, the intentional nature of the actions aimed at actually avoiding the compliance with the legal tax obligations is what determines the boundary between the two concepts.

The primary research subject of this investigation is the multinational company, which owns certain specific characteristics that covert it from an orthodox, profit-seeking institution into

cross-border operating enterprise. Bartlett and Ghoshal (1989, pp. 23-46 cited by Madhok and Liu, 2006) define it as a network of subsidiaries where each one has its own roles and responsibilities, yet they are linked through an integrated central structure, normally referred to as a headquarter. Furthermore, the multinational corporation commonly encompasses at least several lines of operation with specific management traits shaped or influenced by the area of the world where it is actually doing business (Roche, 1996). On the other hand, Burger, Jindra, Marek and Rojec

(2018) interpret the MNC as an integration of strategies, rather than physical establishments which creates global value chains and opens the way to new business opportunities, thus to new sources of innovation. What stands behind the writing of the present paper are the tax evasion, turmoil-natured cases that arise with certain frequency even in the presence of increased governmental scrutiny and more intense interference from the international regulatory institutions such as the Organization for Economic Co-operation and Development. In a further investigation, the focus will be placed on the North American MNCs and, subsequently, on Europe-based ones. That will allow, in a mode of a culmination, to establish a comparison in an attempt to identify certain patterns in the tax evasive practices that the MNCs employ worldwide.

LITERATURE REVIEW

Even though the theme is more relevant than ever, there is no abundant research performed that is related directly to it on one hand and is recent on the other one. Akhtar et al. (2017) evaluate the impact of the tax evasion on the performance of the MNCs and whether the governance of this type of enterprises relates to the probability of incurring in the above-mentioned illegal maneuvering. However, the research does not actually detail the range of schemes that permit the MNCs understate their tax liabilities.

On the other hand, Donohoe (2014) contemplates the financial derivatives as a major tool of tax incompliance, keeping in mind that this is rather a source classified under the category of tax avoidance strategies and not a tax evasion instrument. Chernykh and Mityakov (2017) investigate on the role of the Russian banks as intermediaries in the usage of the offshore schemes as a common tool of tax evasion. Though relevant, the study does not focus precisely on the MNCs but rather considers the banks from Russia as facilitators and the offshore-based banks as participants themselves in evasion-related activities.

Blaufus, Hundsdoerfer, Jacob and Sünwoldt (2016) revise through experimental approach the impact of legality on the human behavior. They link the moral costs with the decision of tax minimization under the scenarios of its legal or illegal treatment. The authors suggest that we might expect a governmental policy declaring certain tax schemes as illegal to be effective as a tool of reducing the tax incompliance only when the country is high-tax morale. However, this might not have the anticipated outcome in a low-tax morale economy.

In the same line of thought, Kirchler, Maciejovsky and Schneider (2002) state that, apart from the merely economic variables (incl. tax rates, audit frequency, etc.), there are psychological factors, like for example, perceived fairness, cooperation on social norms, etc., that play an important role and thus need to be considered when analyzing the tax decision behavior. Through a multiple-step empirical research, they find out that the higher the income, the lower the tax compliance. Nevertheless, the finding is out of the scope of the present work due to the fact that the participation group within the research has been integrated by small business owners.

Now, if we look at the tax compliance from the perspective of the costs that its monitoring represents for the governments and international institutions, these are very significant and much greater in the case of the indirect taxes as the VAT or the retail sales tax (Fabbri, 2015). As a result of the verification complexity, the author claims, the taxpayers will have an incentive to underreport the taxes due.

Interesting findings on the tax evasion theme are the ones evidenced by Kenyon (2008) in his study on the Brazilian companies. The author suggests that those companies which see themselves involved in evasive practices tend to be less willing to contract an external audit and, besides, demonstrate less frequency in approaching the stock markets as a source of financing. Moreover, Kenyon (2008) mentions the trade, services and construction sectors as the ones with highest proclivity to evade their tax compliance obligation. This, according to the author, is due to their characteristic of being more labor-intensive and of counting with lower portion of fixed assets versus intangible ones (as a percentage of total assets) which, as a consequence, implies more complicated traceability and lower visibility.

The role of the external auditing for the abolishment or, at least reduction, of the tax avoidance and evasion schemes employed by the MNCs, is by far contradictory. Albeit it is to be expected that the higher the frequency of the audit performed by a third party, the lower the probability of engaging in illegal, evasive practices, there is evidence that this is not always the case. Jones, Temouri and Cobham (2018) demonstrate through the use of count models that there is a strong positive correlation between the contracting of a Big 4 accountancy firm (being the Big 4 composed by Ernst & Young, Deloitte, PwC and KPMG) and the extent to which the MNCs build and maintain subsidiaries in tax heavens. Furthermore, the authors point out the danger of conflicts of interest given that precisely these four far-reaching accountancy firms provide expertise services to and negotiate tax rulings with many tax authorities. In the meantime, they do not only limit themselves to auditing the companies but also generate important revenue from tax consultancy to those same enterprises. And, it results at the end that the more tax services a company obtains from its auditor, the lower turns out to be its effective tax rate (Hogan and Noga, 2015, pp. 285-305 cited by Jones, Temouri and Cobham, 2018).

Finally, Otusanya (2011) summarizes eight trends, which he defines as “fiscal and moral termites” (p. 319) and which, in its majority, have been speeded up by the impact of the globalization phenomenon. These are, as pointed out by the author, the growing importance of the e-commerce; the more frequent use of electronic money (instead of real money); the use of intra company trade, incl. transfer pricing, employment of off-shore centers and tax havens; use of complex financial tools such as derivatives and hedge funds; the difficulty to tax the financial capital; growing international activities and forum shopping. What Otusanya (2011) essentially stresses out is the role of those factors as facilitators of the evasive and avoidance strategies that the MNCs adopt around the world.

Latin America´s MNC – role in the tax avoidance and evasion practices

In accordance with the latest list of Fortune 500 (2015) which includes the largest companies in a global ranking, Latin America is represented with only six enterprises, all of them from Brazil. Three - from the banking and financial services sector (namely, Itau Unibanco, Bradesco and Cielo), one - from the beverages industry (Ambev), another one - from the mining sector (Vale) and, finally – Petrobras whose core operations are focused on the oil and gas industries.

The economy of Brazil is the biggest one in Latin America as measured by nominal GDP (World Bank, 2017). Revising the most recent ranking of Doing Business elaborated by the World Bank (2018), evidences that the country occupies the startling 125th place out of 190 economies on the series of indicators incl. access to credit, paying taxes, resolving insolvency, legal reforms, etc. If we look specifically at the paying taxes´ indicator we could note that Brazil ranks among the worst ten economies as a consequence of its 184th place. The methodology employed by the World Bank team in elaborating this measure integrates component indicators such as total tax and contribution rate (expressed as a % of pre-tax profits), time (nr. of hours per year) it takes to prepare, file returns and pay taxes, number of tax payments per year, among others. It results that, in the case of Brazil, an average company destines 68.4% of its pre-tax profits to paying corporate income tax, labor taxes, property and property transfer taxes, to mention several (World Bank, 2017). This percentage represents undoubtedly a significant burden to the private initiative and might lead us to think that the MNEs headquartered in the Latin America´s economic giant have actually an incentive to instrument a diversity of tax-savings or, in a worst scenario, tax avoidance tactics. Moreover, for the purpose of preciseness, it is worth mentioning that, in accordance with the most recent information published by Deloitte (Deloitte.com, 2018), the corporate tax rate itself in Brazil is 34%. If we scroll down the whole list included in the study and integrated by 166 economies, we could easily realize that only few more countries (incl. Malta, Zambia and Dem. Rep. of Congo) have a slightly superior tax rate. The 34% rate is composed by a statutory corporate income tax rate of 15%, a surtax of 10% that is collected on income exceeding BRL 240,000 per year and, finally, a 9% social contribution tax, which increases to 20% in the case of the financial institutions (Deloitte.com, 2018).

The latest profound reforms in the Brazilian tax system date back to more than 20 years ago (Gobetti & Orair, 2017) with the amendments in the legislation concerning the dividend income and the interest deduction. As a result, even compared to some of the other BRICS economies (being those namely Brazil, Russia, India, China and South Africa) that tend to have relatively high corporate income tax rates as visible from the summary report of Deloitte for the period 2013-2017 (Deloitte.com, 2017), Brazil still maintains its top position as far as this indicator is concerned.

On the other hand, a peculiarity of the Brazilian corporate legal system that certainly has implications for the companies´ tax-related behavior and strategies is first, the obligation of the publicly traded companies to pay at least 25% of their net income as dividends, unless they register current or accumulated losses (Colombo and Caldeira, 2017). Paying out dividends implies no tax advantage in Brazil. However, the companies have the possibility to pay interest on equity (IOE) instead. This scheme consists in distributing cash to shareholders and enjoying tax deductibility

(base: corporate income tax and social contribution tax) for its treatment as an expense. The amount of the deduction could not exceed the greater between 50% of the net income or 50% of accumulated profits (Colombo and Caldeira, 2017) and the eligibility is not universal.

Still, under the scenario of having these two alternatives, it is to expect that the majority of the eligible companies would opt for paying interest rather than dividends. Nevertheless, Colombo and Caldeira (2017) do find out that, many of the Brazilian companies keep on preferring the payment of dividends instead of IOE. The authors suggest that the costs for the individual investors from the later scheme exceed the fiscal benefits at a company level.

The Brazilian MNCs

Within the legal framework revised in the previous section and as also mentioned above, only six companies headquartered in Brazil do appear on the Forbes´ list of biggest MNCs. There is no definite empirical evidence that the financial institutions Cielo and neither Ambev have participated in or have employed mechanisms for the purpose of avoiding or evading the full compliance of their tax obligations.

Itau Unibanco and Bradesco, two of the big financial corporations in Brazil, have been subject though to a series of investigations held by the Federal Police, the Brazilian Internal Revenue Service, the Federal Public Prosecutor´s Office and the Internal Affairs Office of the Ministry of Treasury under the name of "Operation Zelotes". The key component of this evasion scheme consists in supposed bribery of the tax authorities (namely, CARF which stands for Administrative Tax Appeals Council) aimed at reducing and/or avoiding the payment of solid amounts of taxes due (Semeraro, 2017). The bribery is allegedly composed of a percentage of the "savings" resulting from taxes not paid. The process has not concluded yet.

Ambev SA, which is the Brazilian subsidiary of the brewer group Anheuser-Busch InBev NV, has been underway a series of tax disputes with the local tax authorities since 2005 (Stupples, 2017). The origin of these disputes lies in the very complex tax regimes that characterize this Latin American economy, as mentioned in the previous section. Due to the modes the company has complied with the tax legislation, it has been subject to investigations and has seen itself involved in numerous cases that might consume considerable time to be settled, not least due to the formidable bureaucracy of the tax system.

On the other hand, Vale SA, the world number one iron ore mining company, has faced in 2012 an extensive investigation of its operations set in Switzerland. The Brazilian company opened a commercial office in this European country in 2006. The problem arose when, instead of declaring the profits corresponding only to its Swiss operations and thus legally enjoying a tax exempt, Vale registered gains attributable to this office for US$5.6 billion in the same 2006 (Dorot & Bensimon PL, 2012). The rationale behind the movement lied in their intention to get advantage of the favorable tax regime in Switzerland by redirecting worldwide profits, instead of sticking to the initial agreement, according to the tax authorities involved in the process of revision. Later on

within the same 2012, the dispute was settled with Vale sentenced to pay almost US$232 million to the Swiss authorities (Jamasmie, 2012). Another case that comes to question the ethical behaviour of the miner company had been the one originated by the dispute with their home country´s government about taxes due. In accordance with the Brazilian legislation, mining companies have to give back to the government authorities and to the land owner (whenever it applies) a certain percentage of their net income as a result of the exploitation of the natural resources (INESC P&D Brazil, 2014). Under the concept of Financial Compensation for Mineral Resources Exploitation (CFEM), the payment is basically a type of royalty that varies depending on the mineral. For instance, a mining company dedicated to the extraction of aluminum ore or manganese, will be a subject to a 3% rate, while for the iron the rate decreases to 2% and for gold the rate is 1% (INESC P&D Brazil, 2014). Nonetheless the straightforwardness of the law that backs up the royalties and their determination, there is certainly room for abuse as the law permits the deduction of some expenses, including logistics and insurance ones as INESC P&D Brazil affirms (2014). Through this loop, the companies might actually take advantage and deduct as many expenses as possible in order to declare less gross profit and, subsequently, pay less taxes. Precisely this had been the source of the dispute of Vale with the Government authorities, a conflict that Vale lost too as it had been solved in 2011 in favor of the Brazilian government to which the mining corporation remained in paying US$674 million due to improper deduction of transportation-related services (Jamasmie, 2012).

Now, as far as Petrobras or Petroleo Brasileiro SA is concerned, it is in its majority a publicly-held company which operations focus on the oil, natural gas and energy industries in accordance with information from their official website (petrobras.com.br, 2018). The enterprise is comprised of 13 stakeholders (incl. civil society organizations, communities, public authorities, workforce, investors, etc.) with an audit committee in the role of a maximum internal control organism. Other control tools within their structure include an Executive Governance and Compliance Board, a Program for Corruption Prevention, Compliance Policy and an Administrative Accountability Process, among others. Apart from the extraction of raw material, the complementary lines of business of Petrobras are the distribution (operating as Petrobras Distribuidora), the transportation of oil, gas and derivatives (under the name of Petrobras Transporte SA) and the construction of gas network through Gaspetro. Altogether, there are 23 more companies operating under the control umbrella of Petrobras (petrobras.com.br, 2018).

The turmoils of this Brazilian giant started emerging on the surface in 2013 when it reported a balance exceeding the $135bn in gross debt – more than any other player in the oil industry at that time (Leahy, 2016). By the spring of 2014, the company faced a vast series of investigations for suspects of corruption hold under the name “Car Wash” as well as the arrest of its former Supply Director Paulo Roberto Costa. The alleged scheme employed by Petrobras consisted in authorizing big contracts to a list of companies (including the construction industry) in exchange for millions of dollars returned to officials of the company and politicians, mainly from the at that time ruling Workers´ Party as well as as the Progressive Party (Sotero, 2018). What Petrobras was essentially doing, according to the investigations underway (Rapoza, 2017), was over pricing projects and its own purchases. Under the mechanism, a company that won a contract was achieving between 10%

and 20% of Budget Difference Income, with 3% additional income being paid back as a bribe to the above-mentioned political parties through a vicious circle of false invoices, offshore companies and accounts in international banks (de Almeida and Zagaris, 2015). The red light of this scheme was casted on when analysts from the financial intelligence organism COAF (Council for Control of Financial Activities) in Brazil warned the Federal police in this same 2014 about numerous transactions for substantial amounts of money repeated with observable and suspicious consistency between companies that were doing business with Petrobras. What made the whole set of actions even more suspicious was that many of those companies, according to de Almeida and Zagaris (2015) were missing the required technical and operations-related know how as to justify such a large-scale business relation with the Brazilian oil giant. However, the reach of the fraud did not terminate there. The deepening of the investigation revealed further illegal actions from many of the involved. Thanks to the plea bargains employed as part of the process, it was discovered that some of the suspects carried out overseas bribery transactions in an attempt to diminish the time and reach of their sentence (de Almeida and Zagaris, 2015).

Conclusions

The fraud described above in the Petrobras fraudulent modus operandi has more straightforward demonstration of a far-reaching, pervasive corruption practice and the weaknesses of a supervision framework rather than of a tax avoidance itself. Nevertheless, the final consequences are without any doubt linked to the illegal reduction of the tax liabilities. What makes the matter even worse in this case is the involvement of public institutions and authorities, those that are supposed to facilitate and be the paradigm of transparency and high morale.

Furthermore, the Petrobras case has implications for many other multinational companies (incl. Rolls-Royce, Maersk, SBM Offshore, among others) involved in the scandal. This opens the question as to which jurisdiction will determine the penalties for them (de Almeida and Zagaris, 2015). Certainly, disposing of a universal one, out of the jurisdictional boundaries of any particular country, might make the matters much easier whenever the per se challenging business world is experiencing such a startling example of a multinational corporate failure.

The remaining global-scale corporations revised in this article, serve as an evidence of, first, their willingness to embrace any possible loopholes in the applicable legislation in an attempt to pay less taxes even in the face of a threat of considerable damage on their finances and reputation.

Second, it becomes clear that the Brazilian tax system has vast improvement opportunity areas in terms of its structure, control and transparency. If the motor of the economic growth of Brazil are the private companies, how can it be that, on average, they have to spend 1,958 hrs. every year just for the purpose of complying with the payment of taxes and dedicate 68.4% of their profits to paying taxes and other contributions. If a fiscal system implies elevated complexity, the propensity to incur in bribery, i.e. corruption in order to speed up procedures will be much higher. Brazil definitely needs to give priority in its economic agenda to the implementation of further reforms

in the country´s fiscal framework in order to to improve the business climate and demonstrate ability to attract more foreign investment and spur on the domestic market expansion.

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