Effects of Tax Evasion in the United States

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Abstract

This study identifies, highlights and approaches the economic impact imposed by tax evasion. Tax evasion is overlooked as a common matter, but the economic consequences of not alleviating evasion can be deadly. This paper utilizes a collection of research to define tax evasion. From the literature it will provide a history of income taxation in the United States as it relates to tax evasion. The effect of tax havens have on the amount of tax evasion is approached according to literature. Specific cases of evasion are mentioned to further evaluate the effect of tax evasion on the United States economy. An explanation of why tax evasion is a concern for citizens of the United States is discussed. The findings suggest a negative economic impact of tax evasion being ignored. Solutions are presented that will aid our country in neutralizing this impact.

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Introduction

Every year in late winter and throughout spring there is a certain task that all Americans must consider doing, and in most cases are obligated to do. This task is filing a tax return. Whether it be for federal, state or local governments, it is a civic duty required by us to pay taxes that fund the operations of the government.

However, every year brings about new changes in the tax laws and policies, with some years more so than others. Every year with these changes the IRS faces new challenges in combatting the criminals of tax evasion. Each year the government loses billions of dollars due to this epidemic. If this problem were to be diminished by stricter enforcement of filing or stronger international policy, or other means, the government would be better at generating funds for activities, such as helping the poor, giving relief towards those pursuing higher education, or training the military.

Throughout this thesis I will discuss the various aspects of tax evasion, specific cases including an in-depth analysis of the UBS scandal that occurred in 2011 and what the future outlook is with regards to the pursuit of tax evaders and potential solutions for diminishing this issue on the United States economy.

Tax Evasion, What Is It and Why Do People Do It?

In order for there to be an understanding of tax evasion and its damage caused to the government, tax evasion needs to be defined and explained in basic terms. Dictionary.com defines tax evasion as “the nonpayment of taxes, as through the failure to report taxable income.”

Cornell University Law School goes further to describe this nonpayment as “using illegal means to avoid paying taxes”, which can involve “an individual or corporation misrepresenting their income to the Internal Revenue Service.” So from this it can be said that tax evasion is the act of an individual who conscientiously refuses in some or many ways or means to pay taxes owed to a governmental entity (Cornell University Law School, 2015 and Dictionary.com, 2015).

Cornell University is right to specify the illegality of matters regarding avoidance tactics. Currently, under United States law, tax avoidance is a completely legal practice, but the caveat to avoidance is where the line is drawn between avoidance and evasion. This line can be quite blurry and an individual trying to legally pay less taxes than they owe can be hurt if they are not too careful. The bigger issue is why is this line not more clearly drawn? The government makes it easy for individuals to fall into a ‘gray area’ of legality and this is cause for concern.

To clear matters up, an article posted on Bizfilings.com, a tax self-help site, explains this difference: “Tax avoidance lowers your tax bill by structuring your transactions so that you reap the largest tax benefits. Tax avoidance is completely legal—and extremely wise. Tax evasion, on the other hand, is an attempt to reduce your tax liability by deceit, subterfuge, or concealment. Tax evasion is a crime.” Avoidance is the ability to utilize the tax code to your advantage and lower your amount of liability by being fully aware of the tax implications of your activities throughout the year. Evasion must have intent of deceit, such as misrepresenting how much was earned on your return or omitting income altogether. Other methods involving individuals would be claiming extra deductions, whereas corporations and sole proprietors could do such things as hide certain assets, claim personal expenses as business expenses, falsify journal entries, create fake transactions, etc. So there are numerous ways tax evasion could occur depending on if it is a business entity or an individual (Bizfilings, 2015).

According to Section 7201 of the Internal Revenue Code, “Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.” As you can see, an evasive act can be restricted to action that is committed with the intention and full knowledge that the act is illegal and aids an individual or a corporation in evading or eliminating taxes owed. Penalties are somewhat severe for violators of this section, but are reasonable enough to deter these actions again by the individual or business. Besides the sentences that can occur due to conviction of an investigation, a business or individual could face damages to reputation severe enough either to ruin a career or an entire brand a company represents (Internal Revenue Service, 2015 and Cornell University Law School, 2015).

Another question to present is the motivations behind evasion. Why bother with intentionally make illegal decisions? Especially when these decisions aid our government to stay afloat? Well, many people feel that their dollar can be better spent elsewhere, and others would argue that they see little benefit of their tax dollars at work. According to Kim Bloomquist, “taxpayer dissatisfaction may arise from several sources: the perception of unfair treatment, the complexity and burden of the tax system, and the perception that the value of public goods and services received is less than taxes paid”. People feel entitled to the money that they earn, whether directly like a wage or salary or indirectly like dividend payments or selling off investments. Other individuals may evade because their income is illegal itself and they are paranoid about getting caught by the government for the illegal act and framed for money laundering illegally earned funds. The irony of this is by wanting to not get caught for illegal behavior these individuals are again pursuing illegal motives by not paying tax entirely. They can get away with it most of the time too, because evaders utilize a risk-reward model that can help predict the probability of being caught vs. how much money can be kept in their pocket. I will go more into detail concerning this idea later on in the "What Can Be Done to Alleviate the Effects?" section (Bloomquist, 2003).

Tax in the United States: A Brief History

From the very beginning of this country, tax evasion has been a prevalent factor. The reason the colonies separated from Great Britain was the absurd pressure to pay taxes owed to the mother country that would raise funds for European conflicts Great Britain faced. It all started with the Stamp Act of 1765, which was a tax placed on postage. Another important tax was the excise tax on tea and related goods. Rather than pay for tea imported from Great Britain, and the associated taxes, Americans gathered in the Boston Harbor and dumped thousands of boxes of tea into the water, claiming "taxation without representation". This public display of evasion generated an entire Revolution that united the colonists and eventually caused the creation of a more just system of government that all citizens would believe in.

Since then, the tax code and policy has changed numerous times depending on wars, political activists, and recessions. Initially America raised revenues primarily on excise tax of certain goods, such as tobacco and whiskey. Farmers in Pennsylvania detested the tax specifically imposed on whiskey, and formed a rebellion in 1794. Washington, in order to suppress this from getting out of control, sent troops. This instance of authority reinforced the Federal government's ability to enforce its revenue policy (US Department of the Treasury, 2003).

More importantly with today's issues concerning tax evasion is the evolution of income tax, starting from the Civil War and on. The main reason for this creation was because of this war, considering how costly it had been daily ($2 million!). The first income tax imposed was an amount of 3% with all incomes higher than $800. Even then the first amount of income collected was not until a year following the issuance of the new policy (US Department of the Treasury, 2003).

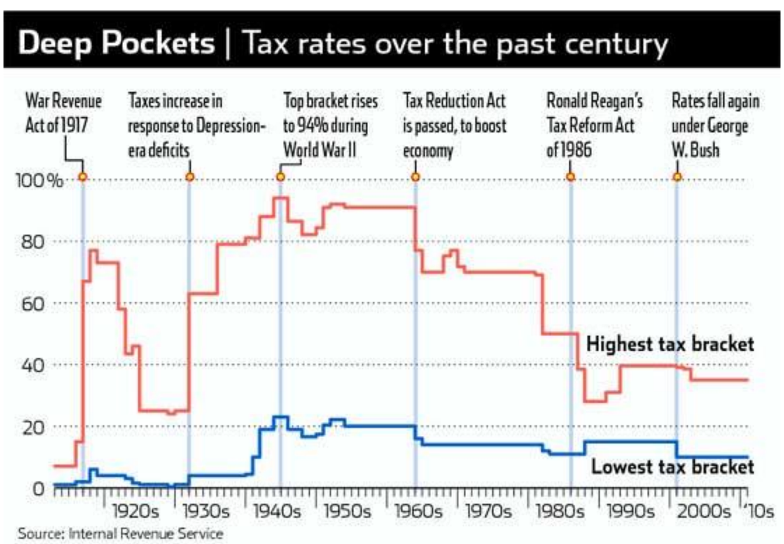
In 1862 the law had changed to become two-tiered, where the first tier was 3% rates up to $10,000 and 5% on all income above $10,000. A standard deduction was enacted at $600, and deductions existed for things such as rental housing, repairs, losses, and other taxes. After the war much of the revenue raised was unneeded and the federal government lessened the amount of taxes. By 1868 most revenue came from excise taxes of tobacco and liquor (US Department of the Treasury, 2003).

Until 1913 little was changed and the government continued to generate revenue from excise taxes. During this year though, the 16th Amendment was passed, which would allow the federal government to impose an income tax (it was deemed unconstitutional in 1894 and again in 1895). The income tax at this point was structured as it is today, with brackets that increase in %

owed as income increases. The early progressive structure imposed much lower rates, from 1% to 7% for incomes greater than $500,000, and only 1% of the population agreed to report any income at all. This year the federal Form 1040 was introduced too, and is still used as the main filing form for returns (US Department of the Treasury, 2003).

These rates have fluctuated drastically depending on the economic status of the country. At its highest during World War II, a taxpayer who earned greater than $1 million would be facing rates of 94%! The biggest change in tax policy was during the Reagan Administration, which in order to adjust for inflation and avoid another serious recession, the government would focus more on the marginal dollar of the taxpayer, compared to a focus on the average tax rate in place prior. This drew attention to the last dollar earned rather than the first dollar earned by a taxpayer, which encouraged individuals to pursue taxable activities. This theory is shown evident in future presidencies, with minor changes up to now (US Department of the Treasury, 2003).

A graphical representation created by individuals at the Internal Revenue Service in 2011 shows the changing amounts of the low and high brackets of income tax over the past century.



This graph shows how wars and recessions have played a significant role in the administration of the marginal tax rate. Since the 1930's both brackets are at their lowest level in recent years.

The reason all of this is important is throughout American history there have been differing kinds of tax and different measures of enforcement. With these evolving rates and complexities of the tax system, the ways of tax evasion have also evolved. During prohibition there were many people who earned money from illegal means and thus would not report any of that income. In another instance, taxpayers during World War II were supposed to pay 94 cents for every dollar earned in excess of $1 million. Rates such as this would encourage evasive behaviors for top wage earners. With the large amount of items involved with tax returns nowadays too, tax evaders have greater opportunities now more than ever to commit their crime.

The Effect of Tax Havens

The most common strategy people employ when evading taxation is shifting income to a country whose tax policies provide for lower rates or even no income tax at all. This is a matter of avoidance, since it is a legal measure that can be taken by individuals and corporations. If an individual or corporation used an offshore bank to hide a certain type of income from the government, then it crosses the line of evasion. A certain study by Joseph Guttentag and Reuven Avi-Yonah estimates that the use of tax havens by individuals has an economical reduction of $40 to $70 billion year (Guttentag and Avi-Yonah, 2005).

Havens allow for individuals to escape income that would be taxed at regular rates by withholding the information from their returns filed for the United States government. For instance, an individual makes investments and cashes out his/her earnings from those investments but chooses to put the earnings into a foreign account, and neglects to report the any of the actions above to the United States government (Gravelle, 2015).

A large reason why these tax havens are in existence and allow for such individuals and businesses to hide income is because of lack of transparency and bank secrecy. These issues arise from foreign policies not addressing the issues relating to tax evasion, partly because it generates revenue for that country and also a general sense of apathy towards the morality of tax collection. Countries do not want to share information with each other regarding investigations of evasion because of invasion of privacy and laws put in place in the contracts conducted when establishing the financial instruments of evaders (Gravelle, 2015).

Some countries used as havens are as follows: Cayman Islands, Dominica, Grenada, St. Kitts, Belize, Costa Rica, Hong Kong, Singapore, Cyprus, Gibraltar, Luxembourg, Malta, Monaco, Switzerland, Lebanon, Bermuda, Liberia, and others (Government Accountability Office, 2008).

UBS Evasive Scandal

In 2007, the United States were informed by Bradley Birkenfeld, a UBS banker, that there was some issues pertaining to the use of UBS accounts as tax shelters. This usage allowed many Americans to hide income from the IRS, in some cases for years. Normally this would constitute as an avoidance scheme, but Birkenfeld had explained to the IRS that UBS (including himself) had aided in hiding taxable assets by creating offshore accounts. The country with responsible for allowing the bank to conduct shady business on such a large scale was Switzerland. With this scandal alone, Birkenfeld had estimated that Americans had evaded $20 billion tax dollars (Najera, 2011).

One year later, the U. S. government accused UBS of tax evasion through the use of bank accounts in Switzerland (which are famous for their privacy and confidentiality, thus concealing any information relating to one’s assets held no matter who is asking for them). Eventually the persistence of the idea of tax fraud reached the ears of the public, who pressured UBS to go against their privacy laws concerning bank information. The Swiss government, although hesitant, agreed to provide information of all American UBS clients that were of reasonable suspect of tax fraud, and whose accounts were greater than $1 million Swiss francs (Najera, 2011).

The IRS, after this incident in 2007, had since become acutely aware of this issue. The pressure to catch criminals in the acts of tax evasion by these means grew. Switzerland too was more aware of these issues, and to avoid further scrutiny from the public, many banks had closed access to Americans who wished to establish accounts in Switzerland. Despite this amount of criminal activity, the actual Swiss government still holds firm on its bank-client confidentiality, and had threatened “to take control of the data at UBS to prevent the bank from handing over its accounts to the Americans” (Najera, 2011).

This investigation convinced the IRS to create a program in late 2009 for finding any tax evaders, namely the Voluntary Disclosure Program. As an incentive, the penalties of prosecution would be significantly reduced for those who voluntarily disclose foreign accounts that were held. The window was narrow for disclosure, and roughly 1500 U. S. taxpayers decided to come out of hiding, from over 70 countries. This has turned into a battle of international courts. It is estimated that over 19,000 Americans were hiding income in UBS and one other Swiss bank (Najera, 2011 and Myers, 2015).

Other Special Cases Concerning Tax Evasion

Every year the IRS publishes a list of cases relating to tax fraud and evasion. In 2014, there were 105 cases posted on their website, of which 10 specifically state evasion in the description. Other cases labeled as tax fraud were also indicative of evasion, because they implied a lack of reporting income to the government. This accounted for another 25 cases.

The most recent prosecution was in December 15, 2014 for a New Jersey man who failed to file income earned during the year from his sole proprietorship Silver Creek. His business was primarily landscaping and snow removal services, and he would deposit funds related to his business in three bank accounts. He only reported income that he deposited in one of the three accounts on the Schedule C form. This instance showed for a discrepancy on his return of over $1 million in income that was not reported.

Another case involved a Lindora Elizabeth Forrest, who ran Just For You Daycare II, LLC in Columbus, Ohio. Two governmental entities had provided her with funds for operating her daycare, totaling almost $2 million from 2009 to 2011. Instead of using the majority of funds for improvements to the daycare, she decided to give herself a hefty raise. In 2010 she reported her income but underreported what she earned and overstated her business expenses, which allowed for an amount over 80,000 in tax dollars evaded. In 2009 and 2011, she neglected to file any returns whatsoever. In all this caused a loss of revenue for the IRS of $326,553.

Unfortunately for Myong Ho Pak, a restaurant owner in Vegas, the IRS had finally caught up to him this year. During 2008 through 2010, Pak had neglected to report any cash receipts made from his restaurant to his accountant and instead deposited these receipts into his personal bank account. The court ruled a sentence of 6 months home confinement, 3 years' probation, $244,045 in restitution of unpaid taxes and the maximum of $250,000.

The information from this section was obtained from the Internal Revenue Service's webpage listing Criminal Investigations relating to tax issues. These are real people that wanted to keep money to themselves rather than pay the appropriate amounts of tax owed, and they have been prosecuted for their actions. Many evaders have still not been caught. With these few reported ones the amount of revenue the government has regained is over $1 million. This is small in comparison to what the government budget is, but only because these are the individuals who were caught in the act. All of these individuals were caught for hiding income from domestic business. The bigger issue is the lack of cases relating to individuals who hide income internationally to evade taxes.

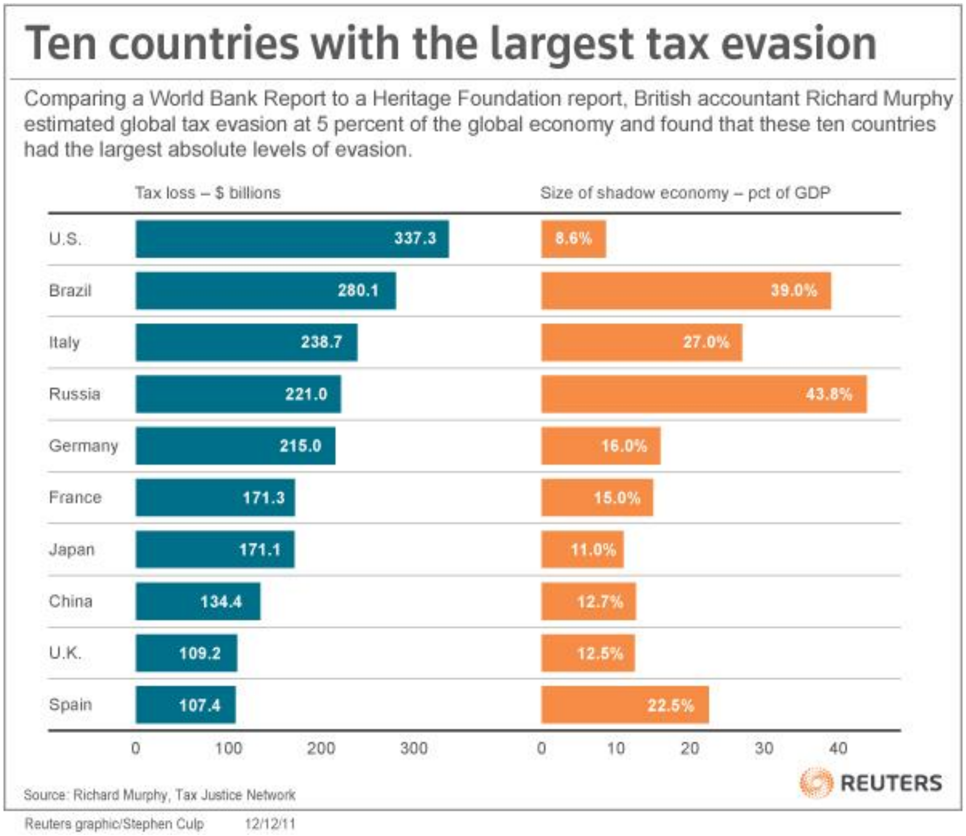
Why Does This Problem Concern Us?

Tax evasion is an epidemic on our nation's ability to operate. If this problem were to be alleviated in any way, our government would do better at serving as our government. A study from Demos showed the results from 2000-2010 of the financial effects of tax revenue lost to evasion (Demos, 2011).

Over time, if this issue were to persist, the amount of money lost each year from this would continue to grow. A pressing issue relating to this is the growing deficit of our government. If we as citizens of this country and businesses would take more responsibility by paying our share of taxes to the government, the country would be less at risk of bankruptcy and default.

According to Kimberly Amadeo, fiscal year budget deficit is at $474 billion. The article explains these deficits as a result of Obama's economic stimulus package, the recession and the War on Terror. Now all of these things would definitely effect federal income and spending habits, but overall the idea remains the same. If we filed our taxes to a greater extent as a population and as business entities, the ability of our government to pay for these things would increase (Amadeo, 2015).

Another chart worth mentioning in this section is an analysis by Richard Murphy, produced by Thomas Reuters in 2011.



From this analysis, Murphy provides a monetary value of tax evasion according to the highest amounts of evasion present. The United States is at the top of the list of tax revenue lost. Although the percentage of GDP effect is only 8.9%, the billions of dollars lost due to evasion, $337.3 in 2011, is staggering.

Effects on the United States Economy

The United States deficit is the main concern for economic effects. With a growing national debt, our ability as a nation to provide jobs, healthcare, international relations, and unemployment relief diminishes substantially. If the deficit continues to grow in this nature, our nation will be in serious trouble.

The problem with discerning an economic effect and tax evasion is that it can only be speculative at this point. There are few studies relating to the subject and they are outdated. The issue can still logically point to a collapse of the national government by the widening tax gap (the amount of tax not collected each year due to either fraud or evasion), and further to the extent of a butterfly effect. If one nation were to collapse due to its inability to cover losses generated by lack of tax collected, other nations would lose opportunities to do business with that nation, thus causing those nations to lose revenue generated by tax collection.

In order to catch evaders in the act, the government must use resources. These resources could be used for other purposes such as school development and road maintenance. Gregory Hamel goes on to explain "an efficient capitalist economy relies on competition between businesses, but when one company is evading taxes and another is not, it creates an artificial advantage for the company evading taxes. This could lead to companies with less business practices outlasting those with more efficient practices, which would be detrimental to the economy." He also states that economically, taxes are inefficient. This is because of the idea that businesses are incapable to provide benefits for the public good and governments are necessary to step in and collect taxes to do this without bias (Hamel, 2015).

What Can Be Done to Alleviate the Effects?

There are a few options that can be done to decrease tax evasion's effects. These are creating new international policies with tax haven nations, increase the statute of limitations, increase penalties of evasion offenders and increase enforcement of collection.

Carolyn Najera provides an analysis of this specifically relating to Switzerland. With this country the United States could create a new code of ethics when doing business in Switzerland that holds US citizens responsible for all their income. This new agreement could be stretched to include all US business operations in tax havens. The problem with this is that these nations have differing opinions on tax evasion than that of the United States government, and any agreement established would remain unenforced (Najera, 2011).

Another possibility relates to the statute of limitations. The IRS is only allowed 3 years to prosecute evaders. If this was increased, offenders would be more likely to get caught. Some countries are not responsible for reporting any American investments, and the extra time to get these countries to cooperate with our investigations would help substantially. The problem with this could be an increase of spending by the government to pursue these criminals (Najera, 2011).

An increase of penalties would help to raise tax compliance overall. This related to the risk – reward concepts of evaders. Individuals and companies alike will be less likely to commit to tax evasion if the stakes of being caught were higher. Since most issues are related to international business activities, an increase of cases specific to foreign transactions would help diminish evasion effects. This ties into the enforcement of offenders as well. If the government were to increase enforcement efforts, the probability of detecting evaders would also increase. The problem again with this is a matter of government spending. The United States would have to increase costs of prosecuting tax offenders, and the benefits of prosecution may not exceed these costs (Najera , 2011).

Conclusion

The effects of tax evasion are evident every year, and the amount of federal revenue lost is substantial enough to raise concern of the public. If the government could improve its abilities to collect income taxes from businesses and individuals, we as a nation would be better off. Roads would be properly maintained, schools would be improved, healthcare could be offered nationwide, and we could afford to defend this country in times of war.

From my careful consideration of what the government can do, I would have to say prosecution efforts and enforcement may be the best way to alleviate damage done by tax evasion. Most of this work could be done by either creating new laws or editing current ones pertaining to evasion. If the laws concerning penalties of evasion were stricter and more severe, individuals and companies would be less likely to evade taxes overall.

As far as costs are concerned with increasing enforcement, these would be initial effects of eliminating tax evasion altogether. Over time these costs would decrease to a more reasonable amount as more and more evaders were caught and prosecuted. With more evaders showing up in the media, the idea of evasion would become a poor decision with a high likelihood of being caught. The risks would outweigh the benefits of an evader. Eventually the percentage of revenue collected would increase and the amount of enforcement would decrease because less resources would be needed to capture less evaders. Even with an increase of stricter foreign business policies would be appropriate to help discourage evasive behavior.

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