

A STUDY ON BANKS' ROLE IN AVERTING TAX EVASION IN INDIA

Dr. Reshmi A. Rajan, M.Com, M.Phil., MBA., Ph.D.

Associate Professor - MBA, SCMS School of Technology and Management, Prathap Nagar,
Muttom, Cochin - 683106

Dr. A. Nagalaxmi, M.Com., M.Phil., PGDPM & LL., Ph.D.

Associate Professor and Head In-Charge, Department of Commerce,
Suguna College of Arts and Science, Coimbatore - 641014

ABSTRACT

This paper aims to study the role of banks in averting tax evasion in India. This will be done by focusing on how money laundering activities are tied to the intent of tax evasion. So for this reason, other research papers will be analyzed for further insight into the concept and workings of money laundering. In the process of converting illegal income into clean cash, culprits use banks in their integration to convert the income to a legal source. Therefore the role of a banker is key in detecting such transactions that are being perpetuated. The paper concentrates on how money laundering robs the country of much-needed revenue from evading taxes and how the pervasiveness of the problem affects the country's overall growth and development.

Keywords: Money Laundering, Tax Evasion, Banks' Role in Avoiding Tax Evasion

1. INTRODUCTION

Tax evasion has been the goal of many an enterprise from time immemorial. More so the concealment of income whether legally or illegally earned has been the focus of many a business. Article 1 of EC Directive defines Money Laundering as "The conversion of property, knowing that such property is derived from serious crime, to conceal disguising the illicit origin of the property or of assisting any person who is involved in committing such an offense (s) to evade the legal consequences of his action, and the concealment or disguise of the true nature, source, location, disposition, movement, rights concerning, or ownership of property, knowing that such property is derived from serious crime."¹ Illegal activities like terrorism and arms sale, human trafficking, Benami transactions, illegal mining, and smuggling rack in large sums of money which need to be used without raising any suspicion.²

Criminal organizations need a safe way to be able to convert their dirty money into clean money without raising suspicion and look for safe havens to hide their illegal money and work to move

the money to a less conspicuous place. In the case of drug dealing, the profits are astronomically high as all transactions are in cash and this cash must find a way to become legitimate again³. They usually funnel this cash through businesses that mostly interact in cash and thereby making it legal. Once money becomes clean it is then brought to a bank and deposited without raising alarm. Money laundering is the clever use or misuse of loopholes in the existing financial system to the criminal's benefit.

1.1 MODUS OPERANDI

Here are a few ways money Laundering activities take place.⁴

- **Structuring:** In this method, the cash is broken into smaller units usually under the cash limit prescribed for reporting. This is chiefly to avoid suspicion and detection and is deposited in banks and financial institutions under various names.
- **Bulk cash smuggling:** This is seen used by drug cartels that use human pack mules to carry cash out of a jurisdiction or country border and deliver it to an accomplice who can easily convert that cash into clean money in another country.
- **Funding businesses:** Interestingly criminals use businesses as fronts to funnel their cash. They pick up businesses that mostly have their revenue come in as cash making it easy to inflate invoices and bring illegal cash into the business making it look like legitimate earnings. Most service-based businesses like bars, restaurants, and casinos are likely fronts for such endeavors.
- **Trade secrecy:** Mostly used with art trade where the valuation of the art piece is determined by the valuer and a deal is reached for the amount that needs to be converted rather than the actual value of the painting. In this trade buyers can anonymously place orders for art and sellers can remain hidden too making it an excellent getaway.
- **Tax haven:** Countries make themselves tax havens to encourage illegal cash to be converted into legal earnings through their laws when they are brought into the country. This is seen as revenue for the country.
- **Digital money:** This is an excellent avenue to transfer large sums of money without the identity of the bank accounts being revealed. Online gaming portals are the new target for such money laundering where players can convert money into virtual goods services or cash and then convert it back into money.⁵

In India, money laundering is done through political parties, fictitious companies, and investment into the share market ⁶. In 2002, The Indian parliament enacted The Prevention of Money Laundering Act, 2002. This was mainly to curb money laundering activities and gives the authority to law enforcement to confiscate property, cash, and other things used in the money laundering trade. A special mention of the Hawala trade is a must when dealing with Money Laundering. It is an informal value transfer system based not on the movement of cash, or telegraph or computer network wire transfers between banks, but instead on the performance and honor of a huge network of money brokers (known as *hawaladars*).⁷ With its roots firmly fixed in the Indian subcontinent, the working of the hawala system pretty much functions like a bank lending and having a remittance system. The system works to prevent the detection of cash transfers across countries and has been named the chief source of funding for terrorist activities in the Middle East. The trail of a hawala is so concealed that except the persons in the agreement no one else will know up the transfer.

1.2 STATEMENT OF THE PROBLEM

Taxation is the method through which the government of a country gets its revenue to run itself and to meet the country's needs. For the tax to be calculated income earned must be fully disclosed and this is where much of the fraud takes place. Income can be earned through legal or illegal means. To avoid taxation even legal income is declared less than what is earned, this is to reduce the amount of tax. Illegal income on the other hand goes through a process of money laundering where the money finds a safe placement and is layered and concealed to look legitimate and then gets integrated⁸. In both forms of income tax evasion is possible. The focus of the study is to find how banks can help with curbing money laundering and alerting suspicious activities and how this can ultimately result in preventing tax from being evaded.

1.3 OBJECTIVES OF THE STUDY

The objectives of the study areas stated here

- To understand the concept of money laundering and its various modus operandi.
- To assess the role of banks in curbing money laundering, which will in turn prevent tax evasion.
- To know the effects of tax evasion and money laundering on the economy of the country.

2. REVIEW OF LITERATURE

Paridhi Saxena (2015)⁹this paper details the different initiatives put out by the Indian government under The Prevention of Money Laundering Act, 2002. The researcher has detailed the process and techniques employed by criminals who engage in these activities. Not to forget the paper also makes mention of how money laundering has a greater impact on the nation's growth and financial health. A further attempt was made by the researcher to identify how criminals use loopholes in these acts such as obsolete laws, lax banking regulations, and lack of coordination between the various law enforcement agencies to carry on their crimes unhindered.

V. Kalpana, (2015)¹⁰the researcher has elucidated the threat to a country's growth by the evil of tax evasion. Efforts have been made to find the causes and remedies for this problem. Tax evasion as the law states is a criminal offense as the persons engaging in it are making deliberate efforts to hide, omit, and leave off payment of taxes on income earned. This can be done by showing the income to be less than what was earned or hiding sources of income leading to mass accumulation of black money. Some of the causes identified for tax evasion are high tax rates, complex tax procedures, a corrupt government, lax penalties, and the failure to feel a sense of responsibility by the taxpayer. Overall when corruption on the part of the government and the taxpayer are high, the economic development of the country suffers the most.

B. Viritha et al, (2015)¹¹the study is a kind of endeavor to assess the compliance of commercial banks in India with the guidelines put under the anti-money laundering reform. For this research 392 employees from all sectors were chosen by the Snowball sampling method. Data was collected by a questionnaire administered to the participants. The results showed that banks in general were largely complying when it came to guidelines on continuous KYC updation and customer identification procedures. However the employees were not able to practically customize anti-money laundering policy to match the bank's evolving regulatory obligations. The reason for this was said to be a lack of resources and support and knowledge about the AML practices among the employees. This study can surely be commended for being one of the few to attempt to assess the effectiveness and implementation of AML practices in Indian banks.

Dr. Brigitte Unger, (2017)¹²the researcher has tried to find the relationship between money laundering and tax evasion. She states that in rich economies, money laundering is done to evade taxes whereas in poor economies money laundering is done to convert income from illegal

activities into clean money activities like income from crime human trafficking, and drugs. For this reason, the researcher suggests that a proper definition of what constitutes tax crime or tax fraud, or tax evasion is necessary for the EU. This is currently nonexistent among the penal codes of the EU. Unless money laundering is seen as an activity leading to tax evasion, bringing offenders to justice will be a losing battle. Lax penalties and various loopholes in the definition of money laundering has caused crimes to continue unabated.

M. Chandrappa, (2016)¹³ the study was done to find how black money is generated and if tax evasion was the reason behind it. Most of the income earned in India is unaccounted for and thereby become black money. Culprits use various loopholes in the Indian tax system to hide their income whether earned legally or illegally. It is said that most income is hidden because of the source from which it is generated like illegal mining, liquor trade, narcotics, human trafficking, financial fraud, and embezzlement. Even in the case of legal income, it is accounted as a loss like in the case of business, the company accounts are manipulated with fraudulent sales and receipts and underreporting of production and inflating of expenses are all ways in which income is reduced or written as a loss. Because of black money and tax evasion, the impacts on the Indian economy are vast right from high inflation to mass poverty and corruption, and has led to the transfer of Indian money to tax havens offshore. All these funds could have been used for the development of the country. High taxation rates, corruption in public and tax offices were some of the reasons said for the tax evasion.

3. THEORETICAL ANALYSIS

Tax evasion has led many to the murky waters of money laundering. Research has shown that the richer the country the stronger its parallel economy which is the black money market¹⁴ whenever people want to avoid tax the first thing they resort to is underreporting of income and concealing of entire income sources to launder them and convert them into clean cash.

- **Fixing Loopholes in the System.** The black money market thrives on corruption and uses the loopholes of the existing financial and accounting systems to continue undetected. Law enforcement is thoroughly under-equipped to meet such a systemic problem. The vastness of this separate economy is a clear sign of the crime and laxity in the laws of the land. It is easier said than done to remove corruption from the grassroots to the higher-ups as it will

require drastic measures to plug the leak in governance which only a government that is free of corruption itself can achieve.

- **Connecting Money Laundering and Tax Evasion.** All activities leading to money laundering eventually leads to **tax evasion**. The example of legal income that is being rerouted offshore to evade tax, is a good example of connecting tax evasion to money laundering. When laws become clearer in their definition of how money laundering is an effort to deliberately evade tax then stringent actions and penalties can be laid on a variety of money laundering activities. This can start only when the letter of the law is clear on its definition of tax crimes, tax fraud, and tax evasion¹⁵.
- **Crime and Money Laundry.** Most of the money laundering in India arises out of crime and illegal activities. The underbelly of this economy is a tangled knot of violence, corruption, and taking the law into one's hands. To curb this, The Financial Intelligence Unit India was set up in 2002 to put up the framework to help control and detect money laundering activities in the country. Along with it the government also enacted The Prevention of Money Laundering act 2002 which consists of specific laws and guidelines that give the appropriate agencies the needed power to counter money laundering in the country. But unfortunately from the observation, we deduce even with laws in place crime thrives if one should ask why the reason is simple the different agencies of the government have breakdown communication and working relationship making it easy for crime to continue.

3.1 ROLE OF THE BANK IN PREVENTING MONEY LAUNDERING WHICH IN TURN PREVENTS TAX EVASION.

With thousands of transactions that the bank has to handle it can be quite challenging for the bank to trace the source of alleged laundered money. for the bank to make this work easy anti-money laundering legislation has been put up by the government so that the bank can concentrate on following the guidelines which will eventually help them spot the red flags in the transactions that they deal in.

- **KYC Policy Know your customer**

This is the first place of establishing the identity of the customer. KYC norms require the banker to collect information on the customer like their name, occupation, contact information, and address. Details like the nature of the account, details of the business

transacted, and the source of their funds and the countries in which they hold business all of these must be duly collected by the bank in its KYC requirement. Banks are encouraged to frame their own KYC rules based on four elements, Customer acceptance policy, and Customer identification procedures, Monitoring of transactions, and Risk management¹⁶.

- **Compliance with Laws:** The onus is on the bank to monitor financial transactions according to the banking regulations put in place if any transaction arises suspicion the bank is required to think that the money could be used for money laundering and that is a justified reason enough to investigate that red flag. This is so the money trail is caught when it is fresh.
- **Link up with Law Enforcement Agencies:** Banks are the first link in the detection of money laundering. It is said that in the later stages in the money laundering trial it becomes very difficult to trace the source of the money. Therefore law enforcement relating to finance like the Income Tax Directorate, Central Bureau of Investigation and The Financial Intelligence Unit of India all work in coordination with the bank when suspicion is aroused and these agencies look into the Matter.
- **Provide AML Training for Personnel:** Crime detection has come to rely on technology to a great extent. Despite their use of these technologies it can never fully eliminate direct human involvement in crime detection. The bank personnel is the first to detect and stop any fraud therefore training them appropriately in the Anti-Money Laundering guidelines. In a study done to find the effectiveness of the bank's compliance to the AML policies in India, it was found that the bank employees lacked the needed training to know how to use guidelines in a practical way¹⁷.

3.2 CASE EXAMPLE OF HOW BANKS PLAYED A ROLE IN BRINGING MONEY INTO ARGENTINA.

Money laundering is no longer restricted to just one country but a global problem. In this case, we will see how banks played a big role in preventing tax evasion in Argentina. In 2016 Argentina launched an amnesty program hoping to bring back billions of dollars which its rich citizens had stashed abroad. It was estimated that around 400 billion dollars were being held in offshore accounts and in the wake of the recession the government wanted funds to be able to face the challenges in the country. Two of the largest offshore bank accounts namely JP Morgan Chase and Co and UBS AG issued letters requiring their customers to declare these assets in

offshore accounts to the tax authorities. Overnight this sent a widespread action and by the year's end 97 billion dollars were declared and taxes paid on them. Despite the government rolling out the tax amnesty plan it would not have worked without the banks enforcing the declaration of assets on its clients. In the past banks have been known to only take a passive approach to such government regulations but on this occasion, the banks notified their clients to confirm if the assets were declared and if they had the certification of an accountant and so required the clients to permit them to relay the information to the authorities. Transparency and clear guidelines were some of the attributing factors in the crackdown on tax evasion¹⁸.

3.3 EFFECTS OF TAX EVASION ON THE NATION AT LARGE

- **In Equilibrium in Economic Condition:** When taxes are not paid it's the economy that suffers in the end making the rich richer and the poor even poorer. Making it difficult for businesses, entrepreneurs, and wage earners as the money in their hand reduces¹⁹.
- **Uncontrolled Inflation:** Because of the black money in the system from the laundering, the prices of commodities increase as there is more money in the hand to buy things at a higher price. Any measure of the government to try to control the credit flow into the market will be offset by the black money in the parallel system²⁰.
- **Increase in Corruption:** With black money in their hand, they use it to fund crime and corruption in the country. It becomes easy to fund terrorism and high-level illegal activities with large sums of black money as they are difficult to trace does it source. Money under the table is how people bribe officials to get approvals and permissions that go against the law²¹.
- **Increase in Land and House Prices:** The black money from the laundering is used to purchase land and houses driving up the pricing of the houses and land. The seller will sell to the highest bidder and the house will be registered for less than the actual sale price thereby the black money further feeds a system problem of overvaluation of property prices but tax is evaded on the rest.²²
- **Destroys the Morale of the Nation.** People no longer desire to be honest when they find that corruption is rampant and illegal money has a greater say in getting things done on a day to day basis. The breaking of this morale is the worst of its kind as this would indicate that corruption has seeped into all walks of life.

- **Increased Rate of Tax:** To bridge the Tax gap the government will be forced to increase tax rates thereby placing the burden on those who pay taxes instead of the offender being punished. This causes us to question the fairness of the whole tax system and making it unfair on honest taxpayers as the rich take their money elsewhere to avoid taxation²³.

4. FINDINGS AND SUGGESTIONS

- The impact of money laundering on society at large is so pervasive. From the loss of tax revenue to an increase in crime and to the feeling of a parallel economy through the flourishing black money market, all this coming to hinder the growth and development of the country.

A weakness of the Law

- The problem with pinning the culprits in the money laundering trade is great as its top masterminds rarely do the actual dirty job and hence their trail is well hidden and they continue their work through other people. Like in the case of Al Capone in the US, there was no proof of him masterminding the crimes so the Supreme Court charged him for not declaring illegal income and thereby charging him on tax evasion charges²⁴.
- Criminals have learned to break up their transaction amounts to be under the reporting threshold of the banks. This is where the weakness of the law is highlighted as the culprit can restructure the transaction to work to his advantage such restructuring should be outlawed as a crime and reporting must be enforced to look at all transactions and not as a separate transaction.
- From the bank's perspective, the best approach is human surveillance and for this reason, their employees are trained regularly in the Anti-Money laundering guidelines.

Use of technology for crime

- To circumvent the Anti-Money laundering laws in place in Banks, criminals have taken to cyber-currencies known as Bitcoins which have their value and their exchange portals much like a bank. Though they are required to register with the government and must comply with AML laws, yet the transparency factor is low and large volumes of currencies can be bought and sold with very little trace left online²⁵. Stricter laws to regulate this market will be the need of the hour.

- Most of the illegal activities find their workings on the Dark web, which is the portion of the internet that is intentionally hidden from search engines, uses masked IP addresses, and is accessible only with a special web browser²⁶. It makes staying anonymous and carrying of illegal activities easy. To monitor the dark web the Ministry of Home Affairs has amended laws to protect cyber hackers, which law enforcement agencies use to counter the Dark Web transactions.

Corruption in the Government

- It's not just the public who are corrupt but even government agencies partner with political parties and crime nexus to perpetuate illegal activities. Money laundering in India is routinely carried out with political backing with law enforcement turning a blind eye to it. Even with laws in place, the corrupt officers fail in their duty to safeguard the welfare of the people.

5. CONCLUSION

Crime, money laundering, and tax evasion often go hand in hand. In this study we have been able to go into depth on how these topics are interconnected to each other and yet it is just a scratch on the surface of this widespread issue. Crime can be reduced but can it be eliminated? Though steps can be taken to realize a utopian expectation for a country, the fact is a crime will rear its head. Surely changes can be made to better society and all is not lost. The first aspect of reducing money laundering is to plug the loopholes in the laws in existence and make them stringent enough to enforce penalties on tax evaders and money launders. Banks can do play a great role in implementing Anti-Money Laundering guidelines which will help them be the first line of defense to detect fraud and raise suspicion. Money laundering has its roots in criminal activities and even if it's illegal income when discovered tax must be levied along with fines.

REFERENCE

1. Interpol General Secretariat Assembly in 1995 <http://www.interpol.int/Crime-areas/Financial-crime/Moneylaundering>.
2. FATF-GAFI, Financial Action Task Force on Money Laundering. "Basic Facts about Money Laundering".
3. Michael Levi, Money Laundering and Its Regulation, *Annals of the American Academy of Political and Social Science*, Vol. 582, Cross-National Drug Policy (Jul., 2002), pp. 181-194. <http://www.int-comp.org/what-is-money-laundering>.
4. https://en.wikipedia.org/wiki/Money_laundering
5. Solon, Olivia (October 2013). "Cybercriminals launder money using in-game currencies". *Wired*. Retrieved 22 October 2013.
6. See <https://www.caclubindia.com/articles/financial-intelligence-unit-india>
7. See <https://en.wikipedia.org/wiki/Hawala>
8. See <https://www.investopedia.com/terms/m/moneylaundering>.
9. Paridhi Saxena, Student, 4th Year, BA.LLB. (H), Hidayatullah National Law University, Raipur.
10. V. Kalpana. (2016). Tax Evasion - A Major Threat to Economic Development and Growth – Causes and Remedies. *International Journal of Scientific Engineering and Research (IJSER)*. 4 (5), 54-56.
11. B. Viritha et al. (2015). Combating money laundering by the banks in India: compliance and challenges. *Journal of Investment Compliance*. 16 (4), 78-95.
12. Dr. Brigitte Unger. (2017). Money Laundering and Tax Evasion. *Coffers, EU Horizon 2020 Project*. 1 (1), 1-35.
13. M. Chandrappa. (2016). Tax Evasion and Black Money in India: Causes and Remedies. *IJMRR*. 6 (10), 1376-1381.
14. Dr. Brigitte Unger. (2017). Money Laundering and Tax Evasion. *Coffers, EU Horizon 2020 Project*. 1 (1), 1-35.
15. Dr. Brigitte Unger. (2017). Money Laundering and Tax Evasion. *Coffers, EU Horizon 2020 Project*. 1 (1), 1-35.
16. Master Circular on Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating Financing of Terrorism (CFT)/Obligation of banks and financial institutions under Prevention of Money Laundering Act, (PMLA), 2002, <http://www.iibf.org.in/documents/kyc-aml-cft-pmla.pdf>.

17. Viritha et al. (2015). Combating money laundering by the banks in India: compliance and challenges. *Journal of Investment Compliance*. 16 (4), 78-95.
18. See <https://www.reuters.com/article/us-latam-taxamnesty-banks-idUSKBN1500KQ>
19. See <https://www.theguardian.com/inequality/2017/jun/14/tax-evaders-exposed-why-super-rich-are-even-richer-than-we-thought>.
20. See <https://www.sciencedirect.com/science/article/abs/pii/S0304387894900256#aep-keywords-id8>
21. See <https://www.emerald.com/insight/content/doi/10.1108/JMLC-01-2018-0001/full/html>
22. V. Kalpana. (2016). Tax Evasion - A Major Threat to Economic Development and Growth – Causes and Remedies. *International Journal of Scientific Engineering and Research (IJSER)*. 4 (5), 54-56.
23. See <https://www.brookings.edu/blog/up-front/2019/04/09/how-big-is-the-problem-of-tax-evasion/>
24. See <http://www.politico.com/story/2013/05/this-day-in-politics-91424.html> [Accessed July 13, 2015].
25. See <http://arstechnica.com/tech-policy/2013/03/us-regulator-bitcoin-exchanges-must-comply-with-money-laundering-laws/> [Accessed July 13, 2015]. 106
26. See <https://www.dictionary.com/browse/dark-web>