The Phenomenon of Trade Mispricing: Untying the Knot for a Legal Analysis

Juan A. Argibay Molina

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Faculty of Law
McGill University, Montreal

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Abstract

This thesis evaluates the phenomenon of trade mispricing from a criminal law perspective. In particular, this research explores trade mispricing as a business practice performed within the international exchange of goods and services. The main contribution is to understand whether trade mispricing is a plausible phenomenon in the world of business; then, to discover whether it has been legally categorized incorrectly, that is, whether trade mispricing could involve criminal conduct and, consequently, a need for a different approach to propose an effective solution to deter this practice.

The thesis proposes the analysis of hypothetical scenarios to illustrate how trade mispricing can be carried out and to discuss whether it can be conceptualized as a crime. The evaluation will, first, involve reviewing the previous academic work on the topic to assess the conceptualization of the phenomenon. Then, the thesis will explain how trade mispricing can hypothetically be done. This example will illustrate not only what mispricing exports involves, but also how transportation rates, as an accessory transaction, can be mispriced. The analysis of these examples will reveal trade mispricing as a business practice that causes harm to the public interest. Therefore, the thesis will describe the negative effects of trade mispricing, which may have been, thus far, unduly ignored in legal scholarship. The difficulties to monitor or control trade mispricing may have shifted attention away from its legal considerations. However, the relevance of this study cannot be neglected, especially regarding the criminal law perspective. This thesis illustrates how complex but current the issue of trade mispricing is and, by doing so, demonstrates why is important to consider it seriously.

This thesis assesses the implications that trade mispricing has in the fields of tax evasion, fraud, perjury and money laundering. These multiple perspectives need to be scrutinized, since most of the work already done on trade mispricing focuses on the economic effects or the

way to measure trade mispricing, but there has been no legal conceptualization of trade mispricing.

Résumé

Cette thèse propose d'apprécier le phénomène de falsification des prix de transaction depuis un point de vue juridique. Plus particulièrement, ce projet de recherche envisage l'étude de la falsification comme étant une pratique commerciale effectuée dans le cadre des échanges internationaux de biens et services. L'apport principal de la recherche porte sur la question de savoir si la falsification des prix de transaction est admissible dans la sphère commerciale. Pour cela, la question est posée de savoir si cette notion n'est pas légalement mal interprétée, c'est-à-dire, qu'elle semblerait impliquer un comportement criminel, et qu'ainsi, il faille approcher la notion d'une manière alternative afin de proposer une solution efficace pour dissuader ce genre de pratique.

Cette thèse propose d'analyser plusieurs scénarios hypothétiques, afin d'illustrer la mise à exécution de la falsification des prix, puis d'argumenter si cette pratique peut être conceptualisée comme étant un crime. Pour cela, l'étude impliquera premièrement la revue des travaux académiques précédemment effectués sur le sujet, afin d'évaluer la conceptualisation de ce phénomène. Par la suite, la thèse proposera une explication sur l'hypothèse de réalisation de la falsification des prix de transaction. Cet exemple illustrera, non seulement ce que la falsification des prix sur les exportations implique, mais également la falsification des taux de transport, en tant qu'accessoire à la transaction. L'analyse de ces exemples révélera que la falsification des prix de transaction, en tant que pratique commerciale, est préjudiciable à l'intérêt public. Ainsi, cette thèse décrira les effets négatifs de la falsification des prix de transaction, qui ont été, jusqu'à maintenant, excessivement ignorés par la doctrine juridique. La difficulté pour détecter et contrôler la falsification des prix de transaction a probablement été à l'origine de l'absence d'étude juridique sur le sujet. Cependant, la pertinence d'une telle étude ne doit pas être laissée à l'abandon, spécialement du point de vue du droit pénal. Cette thèse démontrera à quel point le problème de falsification des prix de

transaction est complexe et actuel à la fois. Elle démontrera à quel point il est important d'examiner ce problème sérieusement.

Enfin, cette thèse mesure les conséquences de la falsification des prix de transaction en matière d'évasion fiscale, de fraude, de parjure et de blanchiment d'argent. Ces multiples idées doivent être examinées minutieusement. En effet, pour le moment, la majorité des études effectuées sur la falsification des prix de transaction s'est orientée sur les effets économiques de cette pratique, ainsi que les méthodes pour la quantifier, mais aucune ne porte sur une conceptualisation de cette pratique depuis un point de vue juridique.

Acknowledgements

I want to express my sincere gratitude to Mr. Raymond Baker from Global Financial Integrity for taking the time to meet with me, but especially for opening my eyes and interest to the phenomenon of trade mispricing. His masterpiece, *Capitalism´s Achilles Heel*, struck me deeply because I had, like Baker, the opportunity to work as a businessman in the field of cross-border transactions for a small company in Argentina, my homeland.

However, having had the opportunity to work as a criminal lawyer before trudging through business mud helped me to ask in this thesis some difficult questions that real businessmen would never dare ask. They would never dare because sometimes the line between legal and illegal is too blurry to be defined.

Be that as it may, it was only due to the given order of these two facts in my own life (my criminal law adventure and my business experience) that trade mispricing was brought so intensely to my attention. Whether it had been otherwise, I would probably still be giving up my ideas and dreams for those of a greedy businessman, who seeks only to get as rich as possible, as long as he does it anonymously and in the shadows.

Paradoxically, when I worked as a criminal lawyer I dealt with moral questions about what I was doing. Now, after knowing what business can be, I am grateful to PRAM, who led my first steps in the world of criminal law, but also to EKO, who made me go back to my path after showing me a world that I did not want.

I would like to thank my supervisor, Professor Allison Christians, for her thoughtful comments and for her patience during the process of defining my ideas. Similarly, I am thankful to Thomas Etienne for helping to translate into French the abstract of this thesis and to Richard Cooper for his proofreading.

Finally, I am grateful to Maria, my wife. As Mario Benedetti once said “in the street, arm in arm, we are many more than two.”[1]

1 Mario Benedetti, *Inventario Uno, Una Poesía Completa 1950-1985* (Buenos Aires, Espasa Calpe, 1997), at 316. The translation is by the present author.

Something is rotten in the state of Denmark.

- *Hamlet* (1.4.90), Marcellus to Horatio

Chapter I

1.1 Introduction

In 2008, the Republic of Zambia exported half of its copper to the Swiss Confederation. However, the copper never arrived at its destination.[2] Curiously, the price by which the copper was exported was six times lower than the international market price. Zambia´s GDP for that year was approximately 14 billion dollars and the probable loss facilitated by this pricing structure was around 11 billion dollars.[3]

At the beginning of June 2013, Neymar da Silva Santos Junior, known as Neymar, a twenty-one-year-old Brazilian football player was transferred from the Santos Futebol Clube (Sao Pablo, Brazil) to the

2 For a proper understanding of the role of Switzerland in the re-export of commodities, see: Alex Cobham, Petr Janský & Alex Prats, "Swiss-Ploitation? The Swiss Role in Commodity Trade", Christian Aid Occasional Paper Number 10, (May, 2013), online: Christian Aid <http://www.christianaid.org.uk/images/caw-swissploitation-may-2013.pdf>. (last visited 12/Aug/2013) . Cobham, Janský & Prats maintain that "…developing countries could have lost more than $500 billion in 'Swiss-ploitation': capital shifts to Switzerland over 2007-2010, hidden in the manipulated pricing of commodity trade. For context, this would exceed the entire official development aid budget over the period. Our most conservative estimates suggest a loss of around a tenth of this scale, but imply that there is systematic illicit capital flowing into Switzerland through over-pricing of (re-)exports." [Cobham, Janský & Prats]

3 Khadija Sharife, "'Transparency' hides Zambia's lost billions" Aljazeera (18 June 2011) online: Aljazeera <http://www.aljazeera.com/indepth/opinion/2011/06/20116188244589715.html>. (last visited 12/Aug/2013). This example came through during a conversation with Raymond Baker in the Washington DC offices of Global Financial Integrity, in May 2013.

The article asserts the following:

> Zambia's government acknowledged that the country missed cashing in on the 2004-2008 commodity boom, when copper prices more than tripled. But companies like MCM don't have to pay the new royalty rates of three per cent - as 20 year stability clauses from secretive development agreements issued soon after privatisation provided the company with arguably the world's lowest royalty rate at 0.6 per cent. This agreement will remain in force until the year 2020. Worse still, had these agreements not been leaked, it would never have come to light that corporate tax rates were effectively zero, thanks to deferments and royalties.
>
> MCM is the largest copper mining operation in Zambia - and Glencore certainly stands to benefit from locking down the copper market, not simply because copper underwires the modern world, but also because it is fundamental to renewable energy. In fact, shortages are estimated to drive up the price of copper from it current historic high at $9,000 per tonne, to that of about $11,000 by 2013, elevated in large parts by the demands of emerging nations such as China, the world's largest consumer.

Futbol Club Barcelona (Barcelona, Spain).[4] Days after the transaction became public, the vice President of FC Barcelona announced that the Neymar´s transfer cost $57 million euros.[5] Surprisingly, the Board of the Brazilian football organization informed the public that they received only $17 million euros, from which $8 million were to be paid to the two corporations that owned part of the player´s rights.[6] The question now is, where did the rest of the money go?[7]

A recent empirical study on China and Norway´s mutual exchange demonstrated that there was a remarkable difference between the 2009-import/export data from both countries. The Chinese data shows that the exports to Norway were estimated to be 2.6 billion dollars; paradoxically, the Norwegian data estimated the imports from China to be 5.3 billion dollars.[8]

4 "Neymar: I want to make my mark at Barça" AFP (6 June 2013) online: FIFA <http://www.fifa.com/worldfootball/clubfootball/news/newsid=2103455.html> (last visited 12/Aug/2013).

5 Anna Segura, "Bartomeu: 'Neymar cost 57 million euros'" online: FC Barcelona <http://www.fcbarcelona.com/football/first-team/detail/article/bartomeu-neymar-cost-57-million-euros> (last visited 12/Aug/2013).

6 "Document shows Santos earned just 9m from Neymar transfer" (10 July 2013) online: AS.com <http://as.com/diarioas/2013/07/10/english/1373467340_820194.html> (last visited 12/Aug/2013).

7 Tariq Panja, "Neymar Investor Meeting Santos for Answers on Barcelona Move" (12 July 2013) online: Bloomberg <http://www.bloomberg.com/news/2013-07-11/neymar-investor-seeks-contract-after-collecting-8-9-million-fee.html> (last visited 12/Aug/2013).The Article maintains that:

> Barcelona vice president Josep Maria Bartomeu said at a June 3 news conference he couldn't disclose the breakdown of the Spanish champion's 57 million euro outlay, citing a confidentiality agreement. Folha de Sao Paulo reported 40 million euros was paid to Neymar as a signing fee. Where the money went is "a good question," Hase said. "Because it didn't go to Santos."

8 Darja Olsevakaja, "Trade Mispricing and Misreporting, a Study of China's Foreign Trade 1998-2008"(Master´s Thesis in Philosophy of Economics, University of Oslo 2013) Universitetet I Oslo, online: <https://www.duo.uio.no/bitstream/handle/10852/34591/olsevskaja-darja.pdf?sequence=2> (last visited 12/Aug/2013).
The abstract of Olsevakaja´s work asserts the following,

> According to common sense, China's exports to Norway should be the same as Norway's imports from China. However, if we look at the data reported by China and Norway, we find a huge gap. Comparing reported exports and imports, we have what is called mirror data on international trade. Looking at such data for many countries, we find a shocking dispersion of values. In this thesis, we review the theoretical and empirical literature relevant for the
> analysis of mirror data, and we undertake an empirical study of mirror data on China's trade with 147 countries in the world during 1998-2009. We use a new approach of decomposing the bilateral value of the CIF-FOB ratio into a CIF-FOB price index and a quantity ratio for each trade partner. The main finding of the paper is that price effect, which is related to trade mispricing, is an important factor explaining mirror data variation in case of Chinese exports.
> While quantity effect, which is related to misreporting of origin, explains the larger part of variation in mirror data for Chinese imports.

The above examples reveal a shocking event: there is something obscure going on in the way business is carried out nowadays. At first sight, the examples evidence a certain discrepancy between the real prices[9] of the goods or services traded and what is later stated in the documentation that supports the transactions. These kinds of inconsistencies can be grouped within a phenomenon called trade mispricing or trade mis-invoicing, which involves the deliberate over-invoicing of imports or under-invoicing of exports, generally, for illegal ends such as tax evasion, capital flight, fraud, etc.[10] The examples lead one to think that this practice may be more widespread than these isolated cases.

The deliberate price divergence is, in fact, evident in the case of the Zambian copper that was sold for six times less than the international market price for that commodity, but it can be also inferred from the case of Neymar. It is important to note that only 17 million euros were received in Brazil when 57 billion were transferred out of Spain for the same transaction. There is still not enough information available as a result of the confidentially agreements, but this example could reveal how the same transaction can be under-invoiced from one side and over-invoiced from the other.

In the case of the data concerning the commercial exchange between China and Norway, the discrepancy reflects a difference of approximately $2.5 billion. Essentially, half of the total amount exchanged between both countries was lost somewhere. This example should be considered as an alarm bell because it inclines one to think that trade mispricing can reach unbelievable levels.

These cases probably are not enough to argue whether or not what is going on within international trading in goods and services is reflected

9 A real price means here a fair market price.

10 See *Infra*, Chapter 2.

by these examples; whether or not it is detrimental to the public good; or even whether or not it is worth paying attention to.

Therefore, the first methodological warning that needs to be issued is that this thesis does not aim to empirically gauge or measure the extent of trade mispricing. That challenge remains open for economists who devote time and resources to finding a proper method for estimating trade mispricing. Instead, this thesis seeks to show that trade mispricing is a plausible phenomenon; and, therefore, it supports the assumption that there is sufficient reason to devote a legal analysis to it.

The theoretical framework from which this thesis will assess the legal analysis of the phenomenon of trade mispricing will follow the new legal realism approach to law, as Professor Macaulay proposes.[11] In this sense, "the goal [of this thesis] is not to produce certain fixed truths about human society. Rather, [it will] seek to understand the present and anticipate the future with a greater probability of accuracy, understanding that our knowledge can be only tentative."[12] The key here, and within Macaulay's scope, is to get the greatest evidential support of "what is going on in view of what is being studied."[13] However, this is a complicated task when dealing with analysis trade mispricing, since there is a logical,

11 Victoria Nourse & Gregory Shaffer, "Varieties of New Legal Realism: Can a New World Order Prompt a New Legal Theory?" (2010) 95:1 Cornell LJ 61 at 79. [Nourse & Shaffer] Nourse & Shaffer encompass Macaulay´s approach within a "contextualist" legal realism. They maintain there that

> Macaulay has deployed the term "law in action" to capture Wisconsin's variety of new legal realism that emphasizes the importance of an empiricism that adopts anthropological and sociological approaches, in which academics leave their universities and investigate the world. Statistical studies are not enough for this version of "new legal realism"; indeed, such studies can be sorely misleading if used without proper caveats and care. What many (although not all) contexualists require is some variant of sympathetic engagement in the subject matter akin to ethnography—what Max Weber called Verstehen. Macaulay's canonical study of how businessmen make bargains (largely in complete disregard of the law) is the starting but not the ending point of this model. In a related vein, Mertz, a leading new legal realist in the contextualist vein, has argued that law's language depends on contextualization to convey its meaning. Building on research in anthropological linguistics, she has closely analyzed the language used in law schools. We call this work, for purposes of distinguishing it from other forms of empiricism, "action studies," reflecting the subject of study—the law in action.

12 Stewart Macaulay, "The New Versus the Old Legal Realism: 'Things Ain't What They Used to Be'" (2005) Wis L Rev 365, note 3. Citing Roscoe Pound in the *Spirit of the Common Law* 213-14 (1921), Macaulay asserts that "[b]efore we have sound theories here we need facts on which to build them. Even after we get sound theories, we shall need facts to enable us to apply them."

13 *Ibid* at 396.

and—unfortunately—unavoidable lack of information regarding the elements of this phenomenon.

Generally, the information available regarding commercial transactions, for the authorities and for the public, is incomplete, and sometimes excludes details on the components of the agreement that may reveal intricate moral or legal dilemmas. The dichotomy arises from what is reported about the business transaction, and what then really happens. This dichotomy cannot be denied. This gap between reported business transactions and real business transactions allows recalling Macaulay´s claim regarding what is known as "law in action" and/or "living law". He acknowledges that:

> The living law is that law which is not imprisoned in rules of law, but which dominates life itself. The sources of its knowledge are above all the modern documents, and also immediate study of life itself, of commerce, of customs and usage, and of all sorts of organizations, including those which are recognized by the law, and, indeed, those which are disapproved by the law.[14]

Then, Macaulay identifies the difference between "law in action" and "living law" by saying that:

> Professor David Nelkin untangles some confusion between Professor Roscoe Pound´s idea of "the law in action" and Ehrlich´s "living law." "Law in action," for Pound, focuses on the gap between the law in the books and the actual practices of legal officials and the public in cases of disputes. The "living law" refers mainly to the "norms recognised as obligatory by citizens in their capacity as members of associations." Law in action pushes us toward studies of gaps between what we teach in law schools and what goes on in the world. Living law would take us toward the norms, sanction systems, and institutions that actually exist in various groups in society.[15]

Basically, this thesis will adopt what Professor Macaulay asserts in his paper regarding the assessment of the truth under the realist approach to law. Macaulay is right when he says that "[o]ften, the best we can offer is a provisional and qualified picture of the world as our best guess of what

14 Eugen Ehrlich, *Fundamental Principles of the Sociology of Law* (1936) cited in *Ibid* at 368.

15 *Ibid*, at 385-386.

others would find if they looked at what we examined."[16] The goal of this thesis, as stated above, is to show that trade mispricing is a plausible phenomenon; and if that is true, then it would be worthwhile to assess this phenomenon legally, because it might be of harm to the public good. Therefore, the analysis will assume that there is something wrong happening that needs to be discussed legally. Achieving this goal will require demonstrating that businesses in the real world do not conclude what contracts or documents supporting business allocate. There is a bigger sphere, a shadow that needs to be explored.

Legal realism, then, seems to be the best approach to navigate these turbulent waters and to start a discussion from the assumption that there is something wrong happening in the real world of business that needs to be taken seriously by legal academia:

> [s]ometimes a new legal realism will not be able to claim to be only a disinterested, neutral, nonpartisan pursuit of the facts. Sometimes looking at the law in action will carry a political message. Looking at law from the bottom up will often show that things are not as most people think they should be. Some studies may serve a muckraking function whether this is the intention of the researcher. Even the best studies may draw return fire.[17]

There is certain ambiguity, though, in what the term legal realism refers to, or even where to identify Macaulay´s legal realism (whether it is a new or old version of legal realism). A clear distinction among new and old legal realism was drawn by Tracey E. George, Mitu Gulati and Ann C. McGinley. They have recently asserted that:

> [t]he Legal Realists' original idea was to understand law by looking at how it worked in the real world. The Old Realism was premised on the idea that legal scholars should go out into the field and collect data (although the original scholars often included more arguments for empirical work than actual examples of it). In recent years, building on the increasing influence of both political science and economics on legal scholarship, a New Legal Realism has emerged whose proponents are often skilled empiricists and whose focus is

16 *Ibid*, at 396.

17 *Ibid*, at 392.

> on how lawyers and judges in fact operate in context. New Legal Realists look at lawyers and judges in context and seek to test models of judicial behavior, the most common being that judicial behavior is driven by judges' policy preferences. Broadly speaking, the New Legal Realism generally has a top-down feel to it: the scholars posit models based on theory and then collect data to test the model. […] The Old Realism was more oriented toward studying law from the bottom up: the researcher looked to the actions and perspectives of individuals to help understand how law operated. It was not about understanding judicial behavior and courts in context but rather about the operation of law in context.[18]

This thesis adopts the old version of legal realism. However, the scope of the approach needs to be understood as Nourse and Shaffer's "contextualist" form of legal realism. They believe that:

> contextualists ground their theory on the Jamesian/Deweyan pragmatist insight that theory must come from the world; that only theory that works has established its truth; and that there is no way to divorce theory from fact: indeed, this is a false dichotomy, as John Dewey once insisted. What stands out in much of the work under this variety of new legal realism is the combination of empirical engagement with recursivity: scholars study a real problem in the world (they do not start with a theory or a normative agenda), and as they encounter the problem, scholars emerge with different ideas and new strategies, learning from those who must deal with the problem (the "legal subjects"). In the view of many scholars who take this approach (including ourselves), the measure of the success of many studies is not "prediction" and verification (indeed, it can be viewed as the opposite of prediction). Rather, the measure is discovery—finding something that, in theory, was not thought, nor perhaps even "thinkable," within the existing paradigms of legal scholarship. These scholars stress, and provide numerous examples of, how "[l]eaving one's office and venturing into the field transforms one's core assumptions regarding one's subject of study" a methodology that we call "emergent analytics."[19]

What Nourse and Shaffer maintain is exactly what this thesis proposes to do: to uncover a social phenomenon and to initiate a discussion on the legal perspective of such a phenomenon—something that has not been done so far. The examples that work as the starting point of this thesis reveal only that something is going on in the way business is done nowadays. These examples may well not be representative of the global

18 Tracey E. George, Mitu Gulati & Ann C. McGinley, "The New Old Legal Realism" (2011) 105:2 *Nw UL* 689 at 691-692.

19 [Nourse & Shaffer] *Supra* note 11 at 84-85.

exchange of goods and services, but they are enough to show striking components of a business practice.

Logically, it is not reasonable to conclude that the particular circumstances of the transfer of Neymar, for example, are to be replicated in every footballer's transfer.[20] However, it is still important to consider what can be learned from the case in point, especially when, in the football business alone, there are over 2 billion dollars and over 11 thousand transactions a year at stake.[21]

The same can be said about the Zambian case and the transactions with commodities. It would be not logical to infer from the example that similar situations occur in other countries or with other commodities; the question, however, remains open. Is the Zambian case an exception? Are the parties involved in the "Zambian case" extracting or

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20 In terms of logical reasoning, without more information of the facts of the case, assuming that Neymar´s case is only the tip of the iceberg would be the same as assuming that it is only an isolated case; we cannot be certain.

It is important to consider in the evaluation, though, what recently happened with the Royal Bank of Canada, RBC, in Uruguay. The RBC has announced that it will close its branch in Montevideo, Uruguay, by the end of October of 2013 after having a raid on their own offices due to alleged connections with a money laundering scheme related to football players transfers in Argentina. The Bank informed to the public that it was leaving Uruguay due to a restructuration of its strategy in Latin America; however, confidential information may have been compromised during the raid. See "Canadian bank abandons Uruguay following raid on its office on request from Argentine judge" Mercopress (16 August 2013) Online: Mercopress <http://en.mercopress.com/2013/08/16/canadian-bank-abandons-uruguay-following-raid-on-its-office-on-request-from-argentine-judge> (last visited 12/Aug/2013).

See also, Nelsón Fernández, "Por Oyarbide, un banco deja Uruguay" *La Nación* (17 August 2013) online: La Nación <http://www.lanacion.com.ar/1611480-por-oyarbide-un-banco-deja-uruguay> (last visited 12/Aug/2013). Fernández states that the Royal Bank of Canada is leaving Uruguay since the judge running the investigation seized all the information available about all the customers of the bank in Uruguay, and not only the ones related to the football players transfers, making it impossible for the bank to guarantee the expected secrecy of the activity.

More information can be found in Charles Parkinson, "Argentine Soccer at Center of Major Money Laundering Network" (17 June 2013) online: Insight Crime <http://www.insightcrime.org/news-briefs/argentine-soccer-at-center-of-major-money-laundering-network>.

There Parkinson the following is asserted :

> Around 150 simultaneous raids last week targeted offices of major clubs and players' representatives and homes of club officials in Argentina and the offices of four major financial institutions, including the Royal Bank of Canada, in Uruguay. Judicial sources told newspaper La Nacion that the raids uncovered the "central office" for money laundering in Argentine soccer, alleged to have handled transfers worth tens of millions of dollars in recent years. According to La Nacion, the offices belong to Alhec Group, a finance company which operates in Argentina, Chile, and Uruguay and has handled many sales of Argentine players to foreign clubs. Ten people were arrested in Argentina, including two public officials, one of whom was the Inspector General of Currency Control.

21 FIFA, News Release "TMS annual review gives new insight into global transfer market" (16 April 2013) online: FIFA <http://www.fifa.com/aboutfifa/organisation/news/newsid=2059215/index.html> (last visited 12/Aug/2013). To give a magnitude order, the International Federation of Football Associations informed that during 2012 there were 11,552 transactions for a total value of USD 2.53 billion. These figures revealed an 11 per cent decrease in comparison with the transactions of 2011. According to the information available, the most active countries dealing with football transactions were Brazil and Portugal. However, the country with the most important number of nationals being transferred was Brazil.

trading copper from any other country? Are they working with other commodities in the same way?[22]

Evidently, all of the examples above are based on legitimate dealings; that is, simple or complicated business transactions between private enterprises or individuals, on a cross-border basis. The problem, then, is related to the legal implications of this type of business, which though initially legitimate, has consequences that might well not be. This thesis assesses the legal considerations that can be drawn through the analysis not only from factual examples such as those mentioned above, but also from the hypothetical scenarios that are described below.[23]

1.2 State, taxes and duties

Almost everyone would agree with the statement that maintains that in order to provide education, health care, justice, or any other public necessity, the state needs to collect taxes. Taxation, then, should be considered as a means to provide for social needs.[24] At first sight, there is no problem with such a proposition. However, the problem arises when one thinks about how to meet social needs in the modern world where

22 See, for instance, what happened in the Democratic Republic of Congo. The Tax Justice Network (30 July 2008), online: Tax Justice Network<http://taxjustice.blogspot.ca/2008/07/conning-congo-15-billion-in-capital.html> (last visited 12/Aug/2013.) Kar maintains there that "…[p]ervasive corruption, and trade mispricing in goods and services led to a per annum loss of nearly $600 million dollars from the DRC economy (…) With that money, the DRC could have paid off its entire external debt, which is $11.2 billion.

23 See *Infra*, chapter 3.

24 See also, Allison Christians, "Sovereignty, Taxation and Social Contract" (2009) 18 Minn J INT'L L 99 at 104-105. Christians asserts the following:

> [s]ince taxation is typically the main means by which governments support themselves and provide public goods, the ability and need of the state to tax is easily conflated with the concept of sovereignty— it is difficult to conceive of a modern nation-state that could sustain itself and protect its people from physical or economic harm without raising revenue through taxation of some kind. As a result, taxation seems plausibly identifiable as an inherent right or entitlement attaching to sovereign status. Further, some argue that taxation is so essential to sovereignty that autonomy in designing the tax system deserves greater protection than autonomy in other regulatory areas. The conflation of autonomy in designing the regulatory machinery of taxation with the political institution of sovereignty itself may not be universally supported by theory or historical fact, but the principle is generally accepted in the literature: sovereign status seems to include a right to tax in some form, so that infringing on the right of taxation is an infringement on sovereignty itself.

cross-border transactions keep increasing. Christians, Dean, Ring and Rosenzweig argue in this respect that:

> [c]ertainly no single state can exist as a going concern without raising revenues, and just as certainly it cannot raise revenues without some plausible connection to persons and property as revenue sources. Further, states cannot raise revenue effectively or fairly in the modern international economic regime without interacting with other states, and other citizens, as people, goods, services and capital increasingly cross global borders.[25]

This thesis will not define how states should conduct their tax collection within this globalized context. Instead, for present purposes, it is worth noting that such a context requires from states a certain cooperation with each other. Ideas on the extent of such cooperation will be presented later in this thesis. What is important to consider here is that if it is true that states need to collect taxes in order to support social needs, then, states cannot undermine the possibility of other states providing for such needs by not cooperating with their tax collection. This becomes more important when we acknowledge that there are states with different levels of development that would suffer in various ways from the neglected cooperation.

Recently, Álvaro de Vita argued in *Inequality and Poverty in Global Perspective* [26] whether there is such a thing as international social cooperation as a means of "international distributive justice". [27] The relevance of his work cannot be denied since he makes an argument

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25 Diane M. Ring, Allison Christians, Steven Dean & Adam Rosenzweig, "Taxation as Global Socio-Legal Phenomenon" (2008) 14:2 ILSAJ Int'l & Comp L 303 at 4-5. They propose that

> Approaching international taxation as an inherently global socio-legal phenomenon would require a departure from this approach, one in which the international tax regime is analyzed as the interaction of people, capital, business, other institutions, and states, rather than purely as a cost of global capital investment. Such an approach would require both a broadening of the scope of the literature incorporated in the tax law scholarship and a departure from the traditional baselines for analysis. For example, the literature could begin to incorporate the lessons from multiple areas of scholarship, including international relations theory, sovereignty theory, political philosophy, political economy, and behavioral game theory, so as to begin to understand the changing pressures on taxation that are emerging as a result of the increasingly complex relationship between states, markets, and people in the globalized world.

26 Álvaro de Vita, "Inequality and Poverty in Global Perspective" in Thomas Pogge & UNESCO eds, *Freedom from Poverty as a Human Right, Who Owes What to the Very Poor?* (Oxford: Oxford University Press, 2007) at 103-132.

27 *Ibid* at 125.

reviewing, essentially, what Rawls and Beitz discussed before on this topic. The main idea behind international social cooperation is related to the heart of this thesis because the collection of taxes, which are related to cross-border transactions, requires cooperation among states. In fact, de Vita quotes Beitz to describe what the latter thinks about international social cooperation. Beitz said:

> "The world is not made up of self-sufficient states. States participate in complex international economic, political, and cultural relationships that suggest the existence of a global scheme of social cooperation. As Kant notes, international economic cooperation creates a new basis for international morality. If social cooperation is the foundation of distributive justice, then one might think that international economic interdependence lends support to a principle of distributive justice similar to that which applies within domestic society (1999c: 143-4)".[28]

De Vita thinks that Beitz is wrong when he says that the world can be considered a scheme of social cooperation.[29] To support that statement de Vita analyses the argument of Brian Barry, that "[t]he world economy … not only could not be viewed as a cooperative venture but also, and more importantly, the economic redistribution implied by a global difference principle could not be shown to be advantageous to rich countries."[30] As de Vita acknowledges, Barry considers that there is no reciprocity or "mutual benefit" and that, therefore, there is no such thing as international social cooperation.

De Vita asserts in this respect:

> The argument that the world is a cooperative venture between five billion or so individuals, which is mutually advantageous because it produces benefits for all, is not compelling. The primary beneficiaries of international trade are multinational corporations, as Beitz himself notes, and through them the groups that comprise their stockholders. Economic gains from trade are often concentrated in the upper income elites within each state.… Accordingly, international trade and investment may not be a firm basis for regarding humanity as a

28 *Ibid* at 125.

29 *Ibid* at 126.

30 *Ibid* at 127.

> cooperative venture for mutual advantage. I thus share the view of those who deny the existence of a global cooperative enterprise sufficient to call for cosmopolitan duties of distributive justice (Opeskin 1996: 30).[31]

De Vita understands that inequality in distribution supports the existence of what he calls an "international basic structure", and that this structure is meant to correct or equalize the actual "unfairness" that societies experience. The argument is based on what de Vita calls the "duty of distributive justice". This notion refers to the duty of reversing the initial unfairness that affects society. Moreover, this notion can explain well why states should cooperate with each other to collect taxes that will then equalize the given unfairness.

In stark contradiction, de Vita considers what Walzer and Miller say in regard to international social cooperation. He asserts:

> [t]he nation-state is the community relevant to justice. "The only alternative to the political community", Walzer says in the chapter 1 of Spheres of Justice, "is humanity itself, the society of nations, the entire globe. But were we to take the globe as our setting, we would have to imagine what does not yet exist: a community that included all men and women everywhere. We would have to invent a set of common meanings for these people, avoiding if we could the stipulation of our own values." Later in in this book, he adds: "there cannot be a just society until there is a society" (1983: 29-30, 313). Miller argues along similar lines. He thinks that duties of justice, corresponding to notions of equals rights and equal treatment, arise only from membership of citizens in a nation-state (1999: 189).[32]

Following Henry Sue, de Vita believes that either creating an international society and a just society is possible when there is a consensus on "matters of rights and justice". He is right when saying so since even when there are no institutions or structures at the international level as there are at the national level, everyone would agree that any given inequality or unfair distribution needs to be somehow solved, somehow equalized.

31 *Ibid* 127-8.

32 *Ibid* at 131.

Instead, Miller and Oats consider taxation to be a system that makes public spending possible.[33] This conceptualization of taxation supports the justification of taxation as a means to achieve further ends, which citizens delegate to the state (i.e. education, health care, security, among others).[34] Murphy and Nagel argue that the purpose of taxation is not primarily public spending but the implementation of an economic or distributive justice. They have established that:

> Taxation has two primary functions. (1) It determines how much of a society´s resources will come under the control of government, for expenditure in accordance with some collective decision procedure, and how much will be left in the discretionary control of private individuals, as their personal property. Call this public-private division. (2) It plays a central role in determining how the social product is shared out among different individuals, both in the form of private property and in the form of publicly provided benefits. Call this distribution. [35]

Be that as it may, taxation relies on the idea of the duty of individuals or corporations to economically support the state through paying the taxes that are applicable to them. Thus, defining the extent of this duty is key for any further analysis of the legal consequences of failing to observe the general duty to support the state.

A first distinction was made by Orce and Trovato who established that "those who do not believe in the duty of supporting the state cannot

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33 See Angharad Miller & Lynne Oats, *Principles of International Taxation* (Haywards Heath, West Sussex: Bloomsbury Professional, 2012). [Miller & Oats]

They believe that

> There are generally considered to be three categories of government function that result in the need to impose taxes, the provision of public goods, the distribution of resources and economic stabilisation.
>
> The term public good, refers to goods and services that are not provided by the private market, usually because it is not efficient for them to do so. They are things that people want in their society, and so the government is left with the job of supplying them. Examples are protection of property rights through the police force and the legal system, utilities such as power, roads and street lights. These are often things that people are not prepared to pay for directly, and so the government must supply them free of charge.

34 See also Grant Richardson, "The Influence of Culture on Fiscal Corruption: Evidence Across Countries" in Miranda Stewart ed., *Tax Law and Political Institutions* (Australia: The Federation Press, 2006) 124-142 at 124 Richarson asserts the following:

> The collection of tax revenue is at the centre of government activity because it allows government to meet its responsibilities in terms of the provision of public goods and services in society (Musgrave and Musgrave, 1984.; Bowles, 1998). If a government fails to provide a satisfactory level of public goods and services, then the quality of life of the communities that it serves can be badly affected. This is particularly the situation in many developing countries (Frampton, 1993; Toye and Moore, 1998).

35 Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford: Oxford University Press, 2002) at 76. [Murphy & Nagel]

rationally pretend to ensure any of their own rights since the state is the only frame by which those rights exists."[36] Orce and Trovato use the comparison between filial duty and the duty to economically support the state in order to illustrate some differences between them. In this sense, Orce and Trovato specify that the duty to support the state is restricted only to supporting the state economically. Therefore, this duty does not extend to informing the state of any mistakes concerning the determination of a particular tax or to preventing someone from defrauding the state. They acknowledge that the latter element is particularly different in the case of filial duty, where a father has the duty to prevent others from defrauding his son.[37] These considerations will be analysed below when assessing the duties that apply primarily to businessmen within the habitual commercial exchange they practice.

Is important to consider that only after defining the nature of the duty of supporting the state economically, will it be possible to ascertain the effects of the infringement of this duty. Thus, as Orce and Trovato say, the duty to support the state economically is a positive duty.[38] Both the conceptualization of the state and the duty to support it economically tie the enforcement of the right to a prior recognition of the state as its main source. Even citizenship, and all the rights that it entails, depends on the existence of the state as such.[39] This assertion becomes particularly important when trying to define the extent of private property as a right, and whether there can be such a thing as private property without a state or independently of the state. It is important to consider this argument when discussing the legitimacy of the state's controlling or monitoring price structures in private transactions.

Orce and Trovato relied on the previous work of Murphy and Nagel to provide a philosophical framework for their argumentation. In fact,

36 Guillermo Orce & Gustavo Trovato, *Delitos tributarios. Estudio analítico del régimen penal de la ley 24.769* (Buenos Aires: Abeledo-Perrot, 2008) at 21 [Orce & Trovato] [translated by author]

37 *Ibid*.

38 *Ibid*.

39 *Ibid*.

Murphy and Nagel understand private property as a legal convention that cannot be considered something independent of the tax system. They state that:

> The conventional nature of property is both perfectly obvious and remarkably easy to forget. We are all born into an elaborately structured legal system governing the acquisition, exchange, and transmission of property rights, and ownership comes to seem the most natural thing in the world. But the modern economy in which we earn our salaries, own our homes, bank accounts, retirement savings, and personal possessions, and in which we can use our resources to consume or invest, would be impossible without the framework provided by government supported by taxes. This doesn't mean that taxes are beyond evaluation—only that the target of evaluation must be the system of property rights that they make possible. We cannot start by taking as given, and neither in need of justification nor subject to critical evaluation, some initial allocation of possessions—what people originally own, what is theirs, prior to government interference.[40]

This argument is relevant since the debate regarding the extent to which the state can possibly interfere (control or monitor, question or examine) in the decisions made by private enterprises in terms of price structures in international trade requires a clear definition of the role that private property as a right plays within the tax system.

In his famous book *Anarchy, State and Utopia*, Robert Nozick raises important questions in regard to the state. He wonders whether or not the state should exist at all, and whether or not the monopoly of the use of force by the state and the redistribution through a compulsory tax system are immoral.[41] Nozick issues an early warning in the preface of his book:

> Our main conclusions about the state are that a minimal state, limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on, is justified; that any more extensive state will violate person´s rights not to be forced to do certain things, and is unjustified; and that the minimal state is inspiring as well as right. Two noteworthy implications are that the state may not use its coercive apparatus for the purpose of getting

40 [Murphy & Nagel], *Supra* note 35 at 8.

41 Robert Nozick, *Anarchy, State and Utopia* (New York: Basic Book, 1974).

> some citizens to aid others, or in order to prohibit activities to people for their own good or protection.[42]

Nozick's argumentation is interesting since he argues in favour of a minimal or ultra-minimal state and questions the compulsory tax system as the financial source of such state. Reviewing his thoughts on both ideas may well help to draw the boundaries of private property, the expected role of the state, and the subsequent need for collecting taxes.

Basically, Nozick argues that only the members of a society who "purchase" the protection given by the state should receive its protection. The key distinction here is that Nozick introduces "freedom of choice" in order to decide whether anyone wants to receive the protection of the state. Therefore, Nozick is not really arguing against taxes as a legitimate source to finance the state, but rather in favour of the free choice of being protected, which may well be affected when the tax system is set on a compulsory basis, that is, when there is no other choice but to comply with the fixed taxes.

This thesis does not seek to answer whether Nozick's reasoning is right. Instead, Nozick's standpoint can help to understand to what extent there is the need for a state to achieve the public good and also to what extent achieving the public good requires the contribution of the members of the society. The analysis on the importance of the explicit or tacit "consent" of the members of the society will be given when discussing Marc Fleurbaey's work. Now, we will discuss two of Nozick's main conclusions: first, that there is a need for a state. We will not argue whether the state should be minimal or extensive, but rather whether there is a need of any state at all. Second, and without considering the extension of such a state, Nozick questions whether there is a need to finance the state´s mission through some kind of taxation. Nozick seems to lend more importance to the voluntary choice of the members of the society to receive the protection of the state. Here, we will consider only

42 *Ibid* at IX.

the fact that the state, voluntary or compulsory, needs somehow to be financed.

For Nozick utopia means that everyone can envisage the "best world imaginable" to live in and that everyone could decide whether or not to stay in such a world. The essential component of Nozick´s utopia is that we can decide to stay in or leave the world we or others have imagined as "the best world".[43] This is to be remarked since under this scenario everyone is capable of deciding what to do; everyone can decide whether to stay here or to stay in other possible worlds imagined by others.[44]

Nozick then introduces the idea of an "association" to refer to this world in which people decide to stay. He analyses how individuals would be related with the association. He asserts that:

> No association will admit me if I take more from the association than I give to it: they will not choose to lose by admitting me. What I take from the association is not the same as what I get from it; what I take is how much they value what they give me under the arrangement, what I get is how much I value my membership.[45]

The key here is to understand that Nozick believes that accepting such an association requires the acceptance of a "central authority" or "minimal state" which will provide the framework for Nozick´s utopia. As he argues,

> The minimal state treats us as inviolate individuals, who may not be used in certain ways by others as means or tools or instruments or resources; it treats us as persons having individual rights with the dignity this constitutes. Treating us with respect by respecting our rights, it allows us, individually or with whom we choose, to choose our life and to realize our ends and our conception of ourselves, insofar as we can, aided by the voluntary cooperation of other individuals possessing the same dignity.[46]

Nozick´s claim seeks to respect the dignity of everyone in the society. The idea behind not considering individuals as instruments or

43 *Ibid* at 298.

44 *Ibid* at 299.

45 *Ibid* at 301.

46 *Ibid* at 333-334.

resources to achieve any end (even the public good) seems to be based on the expected choice of the individuals to cooperate. Thus, it would be wrong to consider in Nozick´s utopia that any taxation (in order to achieve the public good) would be unfair if the individuals did not "consent" it. Instead, it seems more logical to consider that if anyone decides to be part of a society, there is an implicit consent to the mechanisms displayed in order to finance such an association. Nozick is right when he is putting as the heart of the society the "choice" of its members to be a part of it. This is so since respecting the "choice" of the individuals is the only way to recognize their dignity. However, and insofar as this thesis is concerned, Nozick´s work cannot be considered as a theoretical framework to disqualify the need of a state or to support it. Rather, he could not argue in depth the extent to which the individuals who decide to stay in a particular society need to support the central authority. That is precisely the discussion this thesis proposes to develop since the state (extended or minimal), whether or not we freely decide to be part of a particular society, helps to accomplish the collective goals and to equalize any unfair distribution that might affect the society.

It is important to point out what Marc Fleurbaey stated recently in regard to the legal consideration of poverty.[47] He questions whether poverty can be considered as a violation of human rights, and he seeks a theoretical answer to the economic inequalities in society. One might well ask why this discussion would be interesting for this thesis; but as will be described below, Fleurbaey reveals a tension between individual projects and collective projects. This discussion is relevant for the purposes of this thesis since the same tension appears when arguing in favour of or against the existence of the state and its financial support through a compulsory tax system. The problem for Fleurbaey is the conceptualization of poverty and fundamental human rights. However, if

47 Marc Fleurbaey, „Poverty as a Form of Oppresion", in *Freedom from Poverty as a Human Right, Who Owes What to the Very Poor?*, (Oxford: Oxford University Press, 2007).

we think of poverty as only one among other issues that people need to deal with collectively, it is possible to make a comparison and to use Fleurbaey´s arguments in the context of this thesis. If what Fleurbaey says in regard to poverty is true, we can then argue that those considerations could be applicable to other social issues that need to be approached collectively.

In fact, in the assessment of the libertarian approach to fundamental rights, Fleurbaey maintains that for libertarians "the only legitimate rights are purely negative."[48] This means, for Fleurbaey, that "they never make it possible to access to the resources of others without their consent". He believes that to reach the libertarian ideal, a state needs to be established and financed through compulsory taxes.[49] Fleurbaey maintains that the libertarian state consists of

> [a] society in which all the material resources are allotted in full property to single owners and these individuals are free to trade, give, or bequeath their property as they see fit. The only way to come into possession of someone else´s property is thus to obtain his consent, either for trade or simply as a voluntary gift.[50]

Fleurbaey is right when he says that for the libertarian institutions are based on the explicit or tacit consent of the members of the society.[51] As he explains, the rights of poor people would not be violated unless they were subject to "theft or violent aggression".[52] Therefore, for libertarians, there is no such thing as a duty to compulsorily assist the poor, and any assistance would be determined by the consent of the individuals giving.[53]

According to Fleurbaey the main problem with the libertarian ideal is that it, "ignores the existence of public goods and of externalities."[54] He believes, instead, that the members of the society could well be interested

48 *Ibid* at 134.

49 *Ibid* at 135.

50 *Ibid* at 134.

51 *Ibid* at 136.

52 *Ibid* at 134.

53 *Ibid*.

54 *Ibid* at 135.

in supporting with a "compulsory contribution" the generation of public good.[55] Therefore, the key to understanding the legitimacy of the institutions that libertarians would create in order to achieve the public good depends basically on the consent among the members of the society. Fleurbaey defines why the libertarian ideal is attractive:

> [It is] the possibility for individuals to meet and sign contracts or any other form of agreement, without having to submit to the control of a third party, and without having to give part of their joint profit to a third party. This possibility is indeed a real freedom, not only a formal one, which is curtailed by the intervention of the state. It is precisely because it infringes the ordinary freedom of owners to use their property as they wish that the state requires a special justification, as the arm implementing the collective projects of the population.[56]

He finally realizes that the tensions between individuals and the state reach extraordinary outcomes because "[t]his tension does not only put individuals and the state into opposition; it also resides within individuals who, for instance, can at the same time wish to reduce poverty and seek to pay fewer taxes."[57]

Later, Fleurbaey analyses what he describes as a "tension between rights of property and social rights"[58] in Rawls. According to Fleurbaey, Rawls gives more relevance to the property right than to any inequality issue that might affect the society. As Fleurbaey states,

> One can see the limits of the relevance of a theory that outlines an ideal society but hardly guides us on the political priorities on the ordinary circumstances of a very imperfect society. A right to subsistence would not be essential in an ideal society, but could well be essential to deal with the emergencies of a strongly unequal society. Rawls´s theory does not tell us anything on this subject.[59]

Fleurbaey's ideas on poverty become more interesting when he analyses how the market-based exchange works within this tension.

55 *Ibid* at 135.

56 *Ibid* at 138.

57 *Ibid* at 138.

58 *Ibid* at 138.

59 *Ibid* at 139.

Essentially, he claims, the market-based exchange by giving access to markets to the poor will help them to overcome their situation. Fleurbaey argues:

> The description of the market-based exchange that has been popularized by economic teaching since Pareto insists on the fact that the agreement between the two contractors is voluntary, which guarantees that, in normal circumstances where the contractors are fully and correctly informed, and rational, the exchange is beneficial for both. The universally beneficial nature of the market-based exchange, in the absence of external effects on third parties, is a remarkable property. This property gives us an intuitive understanding of why the market economy, in ideal conditions of information, rationality, competition, and absence of externalities, leads to an efficient distribution of resources. Any pocket of inefficiency will be systematically located by potential contractors who will spontaneously eliminate it, thus improving their own lot. This property also contributes to justifying freedom of trade in view of the possible harmful effects of public intervention, which always has a tendency, by clocking certain potential exchanges, to artificially maintain inefficient situations.[60]

Fleurbaey´s thesis challenges the assumption of the benefits of the market-based exchange because of unequal distribution of wealth, which may well affect the freedom of the parties involved in the exchange. He argues that even adopting a "just price" transaction may not be voluntary since as a result of the unequal distribution of wealth, the parties may be compelled to accept the offer of the other party in the exchange. This analysis is interesting because it seems that Fleurbaey is arguing in favour of levelling out "the trader´s wealth beforehand."[61] He understands this equalization as the "egalitarian ideal".

Fleurbaey then compares the libertarian ideal and the egalitarian ideal and establishes the main difference as the need to equalize the wealth of the parties involved in the exchange before the transaction. This differs from the libertarian ideal, which only requires "consent", the free choice of the parties.[62]

60 *Ibid* at 142.

61 *Ibid* at 152.

62 *Ibid* at 152.

What Fleurbaey is trying to demonstrate is that helping the poor may well require positive duties, which contradicts the libertarians' idea of negative rights. Even when he acknowledges the practical difficulties involved in the equalizing mission, Fleurbaey is making an important point. What he calls the "personal duty of equalization" is not only morally relevant, as he maintains; but Fleurbaey also demonstrates that there are certain social problems (or fundamental rights) that require more than a passive response from the members of the society. Personal duties may arise; and if that is the case, the libertarian demand for voluntarism or freedom of choice would not be enough.

Fleurbaey´s argument can be extended to other fundamental rights, such as education or public health. And if what he says is true, one could reasonably argue that in order to guarantee these fundamental rights, the society has to demand from its members the duty to support economically the state in order to provide tools to "equalize" the wealth of the society. Then, by extension, it would be irrelevant whether or not the parties freely agreed to misprice a commercial transaction, because beyond their will there are collective actions that require that the parties in a transaction be sincere and honest when reporting the transaction.

Probably, Fleurbaey did not fully realize the relevance of his work. He worries about poverty and clearly establishes the differences between the libertarian and the egalitarian approaches. However, his work can also help to answer why the state can be involved in the details of private transactions. Fleurbaey's major achievement is that he demonstrates that property rights and the freedom of parties are not absolute. Both rights to property and freedom itself may well be relativized in order to achieve a higher ideal. Thus, this argument may lead one to think that there are reasons, important reasons, which could allow the state to "interfere" in private transactions.

1.3 Globalization, international trade and economic growth.

According to the Financial Action Task Force, the global exchange of goods is worth approximately $9 trillion, and the global exchange of services is around $3 trillion.[63] This report is based on the assumption that most commercial exchanges can be attributed to the financial services that banks and financial institutions provide to individuals and corporations. Be that as it may, what is important to point out is that developed and developing countries have been more open to cross-border exchanges.[64] The steady increase in this type interaction across the world is not new. Miller and Oats recognize that the world has been experiencing an accelerated liberalizing process since the Second World War.[65] This liberalizing process is known as globalization and is marked by a notable increase in the international exchange of goods and services all over the world. Habermas has defined globalization as

> [t]he cumulative processes of a worldwide expansion of trade and production, commodity and financial markets, fashions, the media and computer programs, news and communications networks, transportation systems and flows of migration, the risks generated by large-scale technology, environmental damage and epidemics, as well as organized crime and terrorism.[66]

In fact, according to the World Trade Organization, the explosion of global trade shows that, measured in terms of volume, the global exchange of goods and services doubled between 1995 and 2011.[67] The benefits of the exchange increase cannot be neglected. In addition, the relationship between trade and economic growth is one of the most essential assumptions of modern economic theories.[68] However, there is

63 US, United States Department of the Treasury: Financial Crimes Enforcement Netwrok, Trade Based Money Laundering (Paris: FAFT Secretariat, 2006) online: FATF <http://www.fincen.gov/news_room/rp/files/fatf_typologies.pdf> (last visited 12/Aug/2013) at 2. [FAFT]

64 *Ibid*.

65 [Miller & Oats] *Supra* note 33, at 21.

66 Jurgen Habermas, *The Divided West* (Cambridge, Mass.: Polity Press, 2006) at 175.

67 WTO, *The Future of Trade: The Challenges of Convergence* (2013) at 17, online: WTO <http://www.wto.org/english/thewto_e/dg_e/dft_panel_e/future_of_trade_report_e.pdf> (last visited 12/Aug/2013).

68 See also: Joseph E. Stiglitz & Andrew Charlton, *Fair Trade For All. How Trade Can Promote Development* (New York: Oxford University Press, 2005) at 12. Stiglitz maintains that "…[t]he notion that trade —free trade, unencumbered by government restrictions— is welfare-enhancing is one of the most fundamental doctrines in modern economics, dating back at least to Adam Smith (1776) and David Ricardo (1816)." [Stiglitz & Charlton]

no consensus regarding the truth of this statement. As Stiglitz and Charlton argue, "the subject has always been marked by controversy because the issue facing most countries is not a binary choice of autarky (no trade) or free trade, but rather a choice among a spectrum of trade regimes with varying degrees of liberalization."[69] Stigliz and Charlton argue in favour of trade, but they do not forget about how trade should be done to the benefit of everyone.

In an earlier work, Stiglitz claimed that Western countries made developing countries remove trade barriers to increase the global exchange, but they did not do the same with their own.[70] He believes that this is essentially what makes globalization good for developed countries:

> The critics of globalization accuse Western countries of hypocrisy, and the critics are right. The Western countries have pushed poor countries to eliminate trade barriers, but kept up their own barriers, preventing developing countries from exporting their agricultural products and so depriving them of desperately needed export income.[71]

Stiglitz complaints can be seen as a more general critique of globalization, or even as not related to the subject of this thesis. However, if what Stiglitz argues is true, that is, that there is a "disproportionate share of benefits"[72] it is reasonable to say that the disproportionate share of benefits works as a strong reason to discuss the terms of trade. Stiglitz argues that:

> Looking at the "terms of trade"—the prices which developed and less developed countries get for the products they produce—after the last trade agreement in 1995 (the eight), the net effect was to lower the prices of some of the poorest countries in the world received relative to what they paid for their imports.[73]

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69 *Ibid* at 35 where Stiglitz & Charlton maintain that "…[t]he relationship between trade liberalization and growth is not simple. Preliminary research being conducted at Columbia University, for instance, suggests that trade liberalization may have positive effects on countries with low unemployment rates, but negative effects on countries with high unemployment rates. More generally, the empirical evidence supports the view that the benefits of trade liberalization depend on a range of other factors which are difficult to observe separately because of measurement problems and other econometric difficulties."

70 Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: Norton & Company, 2002) at 7-8.

71 *Ibid*.

72 *Ibid* at 8.

73 *Ibid* at 8.

What Stiglitz says can be only be understood as a broader reason to assess trade mispricing. He establishes that global prices between developed and developing countries differ. This makes the prices of the latter lower, so that the assessment of practices that might involve a misrepresentation of prices —which are already lower than they should be—worth analysing.

Recently, Mike Moore, the Director General of the World Trade Organization, diminished the importance of trade as a component of the economic growth of a country by saying that:

> Trade is one component of a policy framework for growth, poverty reduction and development. Trade must be part of the equation, but it is only a part of that framework. Sound macroeconomic policies, debt reduction, capacity building and good governance are critical to any programme of development and poverty reduction.[74]

Trade is, however, a key component in the equation. In fact, economists try to measure the relevance of the assumption and to ascertain whether the international exchange of goods and services is pivotal for the economic and financial growth of any country.

Generally, economists use the Gross Domestic Product (GDP) as a measure of the overall economic health of a country. This measure indicates that if the net export of a country is positive, the GDP of that country increases. There are, however, some who diminish the value of this method. For instance, Joseph Stiglitz criticizes the use of GDP as the sole indicator, since the outcome can be misleading. He believes that "GDP is a handy measure of economic growth, but it is not the be-all and end-all of development."[75] In *Fair Trade for All,* Stiglitz and Charlton

74 Donatella Alessandrini, *Developing Countries and the Multilateral Trade Regime* (Oregon: Hart Publishing, 2010) at 218, footnote 43. [Alessandrini]

75 Josepth E. Stiglitz, *Making Globalization Work* (London: Penguin Books, 2006), at 45. Stiglitz argues: "[t]he trouble with this is that what we measure is what we strive for. Sometimes, increases in GDP are associated with poverty reduction, as was the case in East Asia. But that was not an accident: governments designed policies to make sure that the poor shared in the benefits. Elsewhere, growth has often been accompanied by increased poverty and sometimes even lower income for individuals in the middle."

explain the essentials behind the idea of trade and development. They maintain that:

> The intuition behind the notion that trade is welfare-enhancing is simple. Imagine two people exchanging goods with each other. They would voluntarily trade their goods if and only if they both benefit from doing so. Thus government intervention to prohibit, restrict, or tax their trade restricts their ability to realize welfare gains from such mutually beneficial exchange.[76]

Therefore, trade happens, as Stiglitz and Charlton explain, basically because the parties involved in the transaction benefit from it. If we extend this idea, it is feasible to argue that nations indirectly benefit from the transactions carried out by its nationals. Indeed, Donatella Alessandrini explains in this respect that

> the theory of international specialisation as formulated by Adam Smith posits that nations can mutually benefit from trade by specialising in the production of certain goods when they differ in their cost ability to produce them. [77]

Alessandrini argues that the free-trade theory maintains that open markets are more efficient than states at allocating resources. She asserts,

> To put it simply, each country should specialise in the production of the good it produces at the lowest cost along its production possibilities frontier: as every country has a comparative advantage in producing something, in the international community will benefit equally from free trade.[78]

In her analysis Alessandrini emphasizes that this theory would only work if "market prices mirror real prices". Her argument is backed by Bhagwati´s proposal[79] for allowing the intervention of the state in order to restore the conditions for free trade when market prices differ from real prices. This is not the place to discuss the benefits of a free or regulated

76 [Stiglitz & Charlton] *Supra* note 68, at 24.

77 [Alessandrini] *Supra* note 74, at 222, footnote 60.

78 *Ibid*.

79 See also Jagdish N. Bhagwati, *Free Trade Today* (Princeton, N.J.: Princeton University Press, 2002).

market, but it is important to point out that free-trade theory is based on mirroring market prices with real prices since, as will be explained later, trade mispricing is a practice that involves over- or under-invoicing exports or imports. Therefore, regardless of the analysis of this practice from the legal point of view, it is important to consider that trade mispricing can also affect the general principles of a free and market-based economy since they work under the expectation that individuals or corporations will remain truthful in the description of the transactions they carry out.

1.4 How it is done matters

The question that arises now is, under what conditions can the economic theories based on international exchange work? Intuitively, one could argue that this statement will only be true when the terms of the exchange are sincere, fair and transparent; when the goods and services are traded and documented at a proper price. This is because, while doing so the parties involved will be happy with a transaction that sincerely reflects the agreement reached, but also because the related taxation can operate smoothly when the components of the transaction are well defined by the parties in the documents that support the transactions. After all, the state would be able to meet public needs through taxation if and only if enterprises or individuals remained truthful about the elements of the transactions they carried out.

Therefore, the idea that maximizing international trade is good for the economic and financial health of any country needs to be revised in the light of what is really happening in international trade, that is, in light of how business is done. Consequently, to analyse how business is done affects the law.[80] From this point of view, it is important to consider that most of the academic work on trade mispricing, so far, has focused on how to measure the effects of this practice. The complexity of this task is

80 Gregory Shaffer, "How Business Shapes Law: A Socio-Legal Framework" (2009) 42 Conn LRev 147 42 CTLR 147.

not minor since there are still no effective tools to grasp data in real time that would allow the authorities to monitor or control the terms of the transactions. However, the advances that have been made in the assessment of the effects of trade mispricing are enormous. A cautious study, for instance, considered that during "the period 2000-2008, developing countries lost between US$725 billion- US$810billion per annum"[81] due to illicit business practices by which goods and services were exported from them. Thus, it is relevant to expand the legal considerations of trade mispricing to re-examine the statement regarding economic and financial growth through the exchange of goods and services, for the manner by which that exchange is carried out can demonstrate its own inadequacy.

Recently, Kar and Freitas established that manipulation of prices is an important source of capital flight from developing countries to developed countries. [82] In their analysis, they identify that the most important incentives for businessmen to resort to this practice are "maximisation of net, rather than gross, global profit (whether through tax evasion or tax avoidance, in relation to customs duties or profit taxes, for example); or from the evasion or avoidance of other regulations, for example on profit reinvestment and repatriation or other forms of capital control."[83] The cited figures reveal the relevance of the topic and reinforce the need of more research to assert the legal perspective on trade mispricing.

1.5 Thesis structure

This thesis argues certain legal aspects of the business practice known as trade mispricing. Specifically, it first reviews the

81 Dev Kar & Karly Curcio, "Illicit Financial Flows from Developing Countries: 2000-2009", (2011), online: Global Financial Integrity <http://www.gfintegrity.org/storage/gfip/documents/reports/IFF2010/gfi_iff_update_report-web.pdf> (last visited 12/Aug/2013).

82. *Ibid*.

83 *Ibid*.

conceptualization of trade mispricing. Chapter II, then, focuses on different definitions of this phenomenon. The challenge is to find the one definition that grasps all the elements of this practice. However, it is probably necessary to provide a definition from the legal perspective and to analyse the distinctive elements of trade mispricing.

Chapter III is devoted to describing hypothetical scenarios of how trade mispricing can be carried out through the export of goods and through the transportation rates related to those transactions. That chapter aims to shed light on the structure and levels of complexity that may be involved in trade mispricing schemes. The explanation may also be useful for further analysis of the topic, so as to develop the necessary tools to monitor and combat this practice. Chapter IV comprises the analysis of ways that might help shape the behaviour of individuals and corporations in order to reduce mispriced transactions. It is not intended to be the solution for trade mispricing, but it does provide a description of measures or cases that could lead to a better understanding of this practice and perhaps to a mechanism to reduce its effects. The key question that the thesis attempts to answer is, how can the behaviour of businessmen be shaped? Finally, this thesis offers a conclusion.

Chapter II

2.1 Introduction

According to the Cambridge Dictionary, trade refers to "the activity of buying and selling, or exchanging, goods and/or services between people or countries."[84] Trade, in the broad sense, can embody numerous types of agreements and can adopt different forms; but, generally, it involves the transfer of ownership of good and services of some kind from one party to another.[85]

For this thesis, the type of trade that will be considered is international trade between non-related entities. That is, trade carried out on a cross-border basis between individuals or corporations that are not linked or related in any sense.

Theoretically, the type of goods or services to be traded or the particular characteristics of the agreement should make no difference in the analysis. If the proposition of this thesis is well structured, the conclusion should be applicable to the international exchange of copper, apples, or football players. It should also be applicable if the agreement of the parties was settled on a verbal or written basis, or if the agreement was settled on a consignment or firm price basis. The essential element to analyse is the "pricing" process or, more precisely, the "mispricing" process, that is, the deliberate manipulation of prices in international trade.

In the same way, this thesis will analyse the transactions that are carried out by individuals or corporations for whom commercial exchange is essentially their main business. Therefore, and even when it might be difficult to generalize transactions that could vary in uncountable ways, there are some characteristics to remark. First, this thesis focuses on transactions between professionals, that is, the exchange between parties

84 Cambridge Dictionary, online : Cambridge Dictionaries Online <http://dictionary.cambridge.org/dictionary/british/trade_1?q=trade> (last visited 12/Aug/2013).

85 Grady Miller, *The Legal and Economic Basis of International Trade* (Westport: Quorom Books, 1996) at 9.

that base their business on such transactions. This leaves out of the scope of the analysis occasional or infrequent deals and, on the contrary, demands a certain knowledge or expertise that guarantees that the transactions are supported by legal documentation supporting the terms and conditions of the type of exchange performed.

In "Non-Contractual Relations in Business: A Preliminary Study", an old but interesting paper, Stewart Macaulay discusses whether businesses are based on non-contractual relations. His reasoning can be applied to this thesis for two reasons. First, trade mispricing needs to be analysed as a part of a business relation, that is, as a practice that takes place in the context of commercial transactions. Second, a mispricing scheme, as is evident, will rarely be based on a contractual relation. Regardless of the type of commercial transaction, the specific agreement to misprice a transaction would probably involve certain criminal offences; and, therefore, it would be rare to find a contractual background for such agreement.

This thesis will adopt what Macaulay understands as "contract" as the same device that is behind trade mispricing. He considers that the term contract refers to "devices for conducting exchanges", and he adds that:

> Contract is not treated as synonymous with an exchange itself, which may or may not be characterized as contractual. Nor is contract used to refer to a writing recording an agreement. Contract, as I use the term here, involves two distinct elements: (a) Rational planning of the transaction with careful provision for as many future contingencies as can be foreseen, and (b) the existence or use of actual or potential legal sanctions to induce performance of the exchange or to compensate for non-performance.[86]

Macaulay believes that the parties involved in "exchange relationships" can construct their relationships to a greater or lesser level of detail

86 Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study" (1963) American Sociological Review, Vol. 28, No. 1., pp. 55-67.

depending on their own planning.[87] He understands that the parties involves in an exchange basically agree on the following: (1) "what each is to do or refrain from doing";[88] (2) "what effect certain contingencies are to have on their duties";[89] (3) "what is to happen if either of them fails to perform";[90] (4) what constitutes "their agreement so that it is a legally enforceable contract."[91] He believes that these agreements can differ on the level of planning and that they can be based on the following considerations: (1) "they may carefully and explicitly plan";[92] (2) "they may have a mutual but tacit understanding about an issue";[93] (3) "they may have two inconsistent unexpressed assumptions about an issue";[94] (4) "they may never have thought of the issue."[95]

Macaulay considers that, in general, individuals and corporations tend to plan their business carefully. He believes that "[i]mportant transactions not in the ordinary course of business are handled by a detailed contract", [96] and that depending on the importance of the transaction, the agreements may go through legal and financial review.[97] However, he asserts that:

> More routine transactions commonly are handled by what can be called standardized planning. A firm will have a set of terms and conditions for purchases, sales, or both printed on the business documents used in these exchanges. Thus the things to be sold and the price may be planned particularly for each transaction, but standard provisions will further elaborate the performances and cover the other in small type on the back of the forms.[98]

2.2 Definitions of Trade Mispricing

87 *Ibid* at 4.

88 *Ibid*.

89 *Ibid*.

90 *Ibid*.

91 *Ibid*.

92 *Ibid*.

93 *Ibid*.

94 *Ibid*.

95 *Ibid*.

96 *Ibid* at 5.

97 *Ibid*.

98 *Ibid*.

As stated earlier, the business practice under scrutiny is known as trade mispricing, but it is also referred to as "abnormal pricing" [99] or "misinvoicing."[100] Since most of the academic work on trade mispricing has focused on the financial or economic aspect of this issue, there is little work on the legal aspect. For the same reason, certain definitions of trade mispricing lack precision and, in some cases, emphasize non-essential elements of this phenomenon.

It is important to take into consideration that trade mispricing involves different actions that trigger different consequences. That is why it is worth analysing the different definitions available, in order to get a deeper understanding of the conceptualization of this phenomenon. In this section, I will consider certain definitions of trade mispricing as a business practice between at least two non-related corporations or/and individuals.

The above distinction stands in stark contrast to the conceptualization of transfer pricing, which refers to "prices in transactions between associated enterprises". [101] Transfer pricing will not be analysed in this paper. Nevertheless, it is perfectly possible that certain considerations regarding transfer pricing may be applicable or useful to grasp a better understanding of trade mispricing. If that is the case, the thesis will make use of those considerations.

A) Subjective

Sarah Freitas, an economist at Global Financial Integrity, argues that trade mispricing should be considered as "a phenomenon where

99 Maria E. de Boyrie, Simon J. Pak & John S. Zdanowicz, "Estimating the Magnitude of Capital Flight due to Abnormal Pricing in International Trade: The Russia–USA case" (2005), *Accounting Forum* Vol. 29, Issue 3, Pages 249–270, online: Science Direct, <http://www.sciencedirect.com/science/article/pii/S0155998205000268> (last visited: 12/Aug/2013) [de Boyrie, Pak & Zdanowicz]; Samuel McSkimming, "Trade-Based Money Laundering: Responding to an Emerging Threat" (2010) 15 Deakin L.Rev. 37 2010, at 43. [McSkimming]

100 Dev Kar & Sarah Freitas, "Ilicit Financial Flows From China and the Role of Trade Misinvoicing" (2012) online: Global Financial Intergrity <http://www.gfintegrity.org/storage/gfip/documents/reports/ChinaOct2012/gfi-china-oct2012-report-web.pdf> (last visited 12/Aug/2013).

101 Jens Wittndorff, *Transfer Pricing and the Arm´s Lenghth Principle in International Tax Law* (The Netherlands: Kluwer Law International, 2010).

individuals and corporations use fraudulent commercial invoices to smuggle money out of the country, usually in order to facilitate tax evasion."[102]

Freitas's work is devoted principally to measuring the outflows of capital from the Philippines, though she has examined this phenomenon in other developing countries as well.[103] However, there is no empirical evidence in Freitas's work regarding the motives that may underlie this phenomenon. Particular attention must be given to Freitas's choice of words, as she uses the adjective "fraudulent" to refer to the commercial invoices, but provides no further explanation for such an allegation. This is important to note because, as will be explained below, assuming that false statements in invoices can be considered a type of fraud is not free of theoretical complications.

On the other hand, Ann Hollingshead, also from Global Financial Integrity, has studied the tax revenue lost in developing countries as a result of mispricing. She points out that trade mispricing "refers to the deliberate overinvoicing of imports or underinvoicing of exports, usually for the purpose of tax evasion. This practice is a significant component of illicit financial outflows and a major conduit through which residents of developing countries transfer money abroad illegally."[104]Her work focuses on measuring the effects of this phenomenon. Thus, Hollingshead does not define all the elements of trade mispricing, nor does she provide any

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102 Sarah Freitas, "Philippines Lost $142 Billion In Illicit Financial Flows Between 2000 And 2009" (2011), online: Global Financial Integrity Finds <http://www.financialtaskforce.org/2011/12/12/philippines-lost-142-billion-in-illicit-financial-flows-between-2000-and-2009-global-financial-integrity-finds> (last visited 12/Aug/2013).

103 See Dev Kar & Sarah Freitas, "Illicit Financial Flows From Developing Countries: 2001-2010" (2012), para. 27 at 19, online: Global Financial Integrity <http://iff.gfintegrity.org/iff2012/2012report.html> (last visited 12/Aug/2013). Kar and Freitas concluded there that

> The private sector in developing countries transfers illicit capital into the global shadow financial system through different channels, depending on the country of origin. For instance, while trade mispricing is the preferred method of sending illicit funds out of China, the balance of payments (captured by the HMN method) is the major channel for transferring unrecorded capital from oil exporters such as Nigeria, the Russian Federation, Saudi Arabia, and Indonesia. Mexico and Malaysia are the only oil exporters where trade mispricing is the preferred method of transferring illicit capital abroad.

104 Ann Holingshead, "The Implied Tax Revenue Loss from Trade Mispricing" (2010), online: Global Financial Integrity <http://www.gfintegrity.org/storage/gfip/documents/reports/implied%20tax%20revenue%20loss%20report_final.pdf> (last visited 12/Aug/2013).

evidence to support her arguments. The value of her findings cannot be dismissed though.

De Boyrie, Pak and Zdanowicz also consider trade mispricing as a means to shift money abroad. In their empirical study of this phenomenon within the international trade between the US and Russia they argue that "Abnormal trade pricing may be the least risky technique for shifting capital across borders because many government agencies do not have the capability to analyse systematically import and export transactions and determine abnormal pricing."[105]They believe that in order to ascertain the actual motives for abnormal trade prices, further investigation on behalf of the government agencies is required. However, they suggest that two possible purposes could be money laundering or simply tax evasion.

B) Objective

Buehn and Eichler, two German economists, stipulate that "[t]rade misinvoicing occurs if the true value of exports or imports deviates from the amount of exports or imports businesses report to the authorities."[106]Their definition does not focus on the alleged purpose of this phenomenon, but on the objective divergence between the value of the exports or imports and what is reported to the authorities. This definition grasps the essential element of trade mispricing but does not aim to allocate a motive or purpose, which indeed could not actually be deduced without further investigation and more information.

It is likewise remarkable that Buehn and Eichler analyse the relevance of the risk of detection and the costs of punishment in order to determine the incentives for trade mispricing. They suggest that "Another

105 [de Boyrie, Pak & Zdanowicz] *Supra* note 99, at 253.

106 Andreas Buehn & Stefan Eichler, "Trade Misinvoicing: The Dark Side of World Trade" (2011) *The World Economy*, Vol. 34, Issue 8, pp. 1263-1287, online: SSRN, <http://ssrn.com/abstract=1916505 or http://dx.doi.org/10.1111/j.1467-9701.2011.01375.x> (last visited 12/Aug/2013).

way to increase the expected cost of misinvoicing is to lift the punishment cost directly, such as by raising fines or by decreasing corruption."[107]

Even though this thesis does not aim to find a solution to trade mispricing, it is worth noting the idea that Buehn and Eichler introduce in their article. In fact, their analysis in this respect can be considered in the light of the economics of crime and punishment theory, which has been strongly developed by Gary Becker.[108]

The latter theory seeks to discover the outcome of the trade-off between the size of legal sanctions and the probability of detection. Recently, Alon Harel has observed that:

> More generally, different legal ethos govern the size of legal sanctions and the probability of detection. The severity of the sanction reflects the seriousness of the offense; hence, the legal system is committed to consistency in infliction sanctions. Most importantly, it is committed to providing "fair warning" to criminals with respect to the size of the criminal sanctions. The sentencing guidelines are perhaps the most evident manifestation of the commitment to provide a fair and precise warning. On the other hand, the probability of detection is a function of pragmatic considerations, which change from time to time. The legal system rejects punishment roulettes and tries to provide certainty and predictability with respect to the size of the sanction. It does not, however, oppose detection roulettes where the probability of detection is subject to uncertainty.[109]

This subject will be considered more extensively in chapter IV.

C) By its legal consequences

Trade mispricing has been considered a type of international trade fraud. For instance, McSkimming (2010) notes in this respect that "[a]bnormal trade pricing occurs when the import or export price for a

107 *Ibid*.

108 Gary Becker et al, *Essays in the economics of crime and punishment* (New York: Columbia University Press, 1974), at 3. [Becker]

109 Alon Harel, "Economic Analysis of Criminal Law: a Survey" in Alon Harel & Keith H. Hylton ed., *Research Handbook on the Economics of Criminal Law* (Cheltenham, UK: Edward Elgar, 2012), at 41.

particular good is invoiced at a level that either exceeds the market price (over- invoicing) or is below the market price (under-invoicing)."[110]

McSkimming argues that transactions, as such, may simultaneously reveal different crimes, such as tax fraud, smuggling, money laundering, capital flight, and others.[111] In his work, he also proposes taking into account the relationship between abnormal prices and the political or economic turbulence that countries might experience. McSkimming implies that states with tight exchange controls are more capable of having trade mispricing. To illustrate how trade mispricing can be carried out, McSkimming says:

> The exporter sells goods to the importer for a below-market, discounted price. On receipt of the goods, the importer resells them and pockets the difference between the invoiced price and the sale price. The exporter has successfully transferred value overseas, with both parties being able to point to an ostensibly legitimate trade to justify the transaction. The importer, in particular, is able to explain the receipt of illicit funds by an actual market transaction with an unrelated third party.
>
> This phenomenon … has the following advantages, each party benefits from reduced taxation and, therefore, lower transaction costs. Lower revenue for the exporter will minimise its taxable income (or even give it a tax loss) whereas the importer will reduce the import tariff (if any) levied on the goods (although it may be liable for income tax on abnormal profits).[112]

McSkimming also maintains that the same phenomenon (i.e. transferring value) but with a different outcome can be achieved through over-invoicing imports. As is described in his paper:

> In an over-invoiced transaction, the amount transferred is the difference between the market price in the import country and the invoice price. The taxation implications of the transaction are generally undesirable as the importing firm will pay higher duties and the exporting firm will pay higher income taxes.[113]

110 [McSkimming] *Supra* note 99, at 10.

111 *Ibid*.

112 *Ibid*, at 44.

113 *Ibid*.

McSkimming sees as benefits of the aforementioned procedure the increments of the cost for the importer and the logical reduction of the income tax burden, and for the exporter the possibility to claim an illegal tax credit.[114] The essential element of trade mispricing, for McSkimming, is that the invoice is "defective,"[115] which means that the price reported on the commercial invoice is not representative of the real price. However, his study lacks any further explanation about what happens after the first transaction is concluded. McSkimming seems to leave to the reader´s imagination the elucidation of what could happen with the profit made abroad and how the exporter might make use of that money.

A different, but still interesting, approach can be found in Raymond Baker's *Capitalism´s Achilles Heel*. [116] Because of his non-legal background, the author fails to give a detailed and complete legal consideration of trade mispricing. Nevertheless, Baker, who has dedicated his whole life to the analysis of this practice, proposes seeing the abusive transfer-pricing phenomenon as a crime under US legislation. His analysis could be evaluated as extremely imprecise since the focus on the relevant US legislation is not followed by a strong analysis of how the law relates to the scenario Baker describes. However, Baker´s conclusion can help in understanding the phenomenon and sets the stage for a later comparison with other legislation applicable to a similar scenario.

Baker offers an example and tries to demonstrate that this hypothetical scenario could reveal the violation of certain US criminal legislation, such as a scheme to defraud, mail fraud, wire fraud, filing a false customs declaration, and general false statements. His example is reproduced below:

> Suppose your company has an established manufacturing subsidiary in, for example, Malaysia. In connection with new products to be

114 *Ibid*.

115 *Ibid*.

116 Raymond Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System* (Hoboken, NJ: John Wiley & Sons, 2005). [Baker]

> produced there, new materials are to be shipped from the United States. Operation profits are high in the United States, and taxes are low in Malaysia, because you still have a couple of years to run on the tax incentives given to establish your business in Kuala Lumpur. Malaysian customs duties on the imports will be 15 percent. Given these factors, a decision is made to shave profits in the United States by selling the new supplies at a low price to the subsidiary. You and several colleagues meet to discuss the matter and decide on charging 60 percent of the price at which the items are sold to several other subsidiaries around the world. This price may not even cover all production costs in your U.S. plant. Commercial invoices are prepared, shipping documents drawn, the subsidiary is advised by telephone what the price will be, papers are mailed to the parent company. These kinds of conversations, decisions, communications, and financial arrangements are common in thousands of companies every day.[117]

Baker´s example refers to transfer pricing, which, as stated earlier, is a commercial practice between related entities, and which is ruled by the arm´s length principle. Although this thesis will not argue this matter, if what Baker says is true, the validity of his argument could be perfectly suited to a similar situation between non-related entities. Therefore, it is worth analysing Baker´s argument on transfer pricing since, at first sight, there is no reason to believe that the conclusions he draws are not applicable to trade mispricing transactions between non-related entities.

First, Baker argues that any fraud involves a misrepresentation of a fact with knowledge of the false representation, and that the case in point may be such an example. The misrepresentation here is related to the price reported for the transaction, which differs from the real price. Then, Baker recalls the conspiracy statute, which states that, "if two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both."[118] Even though Baker does not explicitly say so, the consideration of conspiracy in regard to the example

117 *Ibid*, at 196.

118 *Ibid*, at 197 referring to the conspiracy statute (18 U.S.C. §371).

refers to the necessary agreement between two or more people behind a mispriced transaction.

Later, Baker considers that, under US legislation, it is a crime to use the US postal service to carry out a scheme to defraud.[119] Such an offense is known as "mail fraud" and, as Baker states, it involves, essentially, "whoever, having devised or intending to devise any scheme or artifice to defraud … places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service…."[120] There is no further explanation on why this might be relevant to the analysis of the example.

Baker, then, considers the wire fraud statute and establishes that the scope of that offence includes "foreign commerce". He argues that this statute has been applied to cases that took place within the United States, outside the United States, and even to money laundering cases where transactions were routed from the United States.[121]

Finally, Baker considers filing a false statement to customs as a possible crime under US legislation. To do so, he describes how every import or export in the US needs to be supported by a customs declaration that states the classification of the goods traded and their value.[122] As Baker explains:

> When a company has a normal price of 1X and then trades overseas sometimes at 0.1X and sometimes at 10X, you would think somewhere, someone is filing a false customs declaration. How can $0.1, $1.00, and $10.00 all be accurately stated prices for the same thing?[123]

Baker believes that there are three reasons that explain why this can happen without any control by the authorities. First, he considers that customs is more interested in imports than in exports, because of the

119 *Ibid*, at 197.

120 *Ibid*, at 197 referring to the mail fraud (18 U.S.C. § 1341).

121 *Ibid*, at 197 referring to the wire fraud (18 U.S.C. § 1343).

122 *Ibid*, at 198.

123 *Ibid*, at 198.

collection of duties entailed by imports. Second, Baker understands that customs does not consider whether the price is the real price of the transaction, but whether it is "acceptable", where "acceptable" entails that "the relationship between the buyer and seller did not influence the price actually paid or payable."[124] Lastly, Baker considers that customs neglects certain export regulations designed to ascertain that "no person may make any false or misleading representation, statement, or certification in connection with export documentation".[125]

Baker also considers that the legislation concerning general false statements can be applicable to the example he offers, which, even though it is not supposed to tackle false statements specifically in customs declarations, rules against any false representation in general.[126]

The conclusion at which Baker arrives after considering the example through these pieces of legislation is somewhat disappointing. He argues that even when the example may reveal that a felony was committed, US customs probably will not be interested in prosecuting it. Therefore, it would be up to individuals or corporations to run the risk of committing a felony, in spite of the fact that the authorities might not be interested in prosecuting it.

Baker´s analysis seems to be too simplistic. By offering a hypothetical scenario and mentioning legislation that could possibly be applicable to that scenario, Baker seeks to illustrate the legal issues at stake in a mispriced transaction. Even though this analysis fails to consider seriously the legal implications of trade mispricing, Baker raises pertinent questions that need to be addressed. Can price be the subject of false statements? Is an "acceptable" price the same as the real price? How can a price be measured to ascertain whether or not it is real? If a mispriced transaction is carried out, who is the alleged victim of the transaction?

124 *Ibid*, at 198.

125 *Ibid*, at 198.

126 *Ibid*, at 198 referring to the false statement (18 U.S.C. §1001).

Alternatively, trade mispricing has been considered a type of mechanism used to launder money, that is, "the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origin."[127] In this sense, the Financial Action Task Force (2006) has established that:

> Money laundering through the over- and under-invoicing of goods and services, which is one of the oldest methods of fraudulently transferring value across borders, remains a common practice today. The key element of definition is the misrepresentation of the price of the good or service in order to transfer additional value between the importer and exporter. By invoicing the good or service at a price below the "fair market" price, the exporter is able to transfer value to the importer, as the payment for the good or service will be lower than the value that the importer receives when it is sold on the open market. Alternatively, by invoicing the good or service at a price above the fair market price, the exporter is able to receive value from the importer, as the payment for the good or service is higher than the value that the importer will receive when it is sold on the open market.[128]

This definition needs to be highlighted, since for the first time there is an attempt to encompass the entirety of possible criminal conducts related to trade mispricing. However, as will be discussed below, there is a mistaken approach to the relationship between the conducts involved in trade mispricing. In this respect, the Financial Action Task Force fails to explore, describe and analyse the link between the effects of trade mispricing and tax fraud and also neglects to consider the disguising of the proceeds of tax fraud through financial institutions.

2.3 Analysis of the elements of trade mispricing

A) Scope

127 [FAFT] *Supra* note 63, at 35.

128 [FAFT] *Supra* note 63, at 4.

The first distinction that needs to be made is that trade mispricing is a phenomenon that occurs within global trade. In particular, trade mispricing can be considered a commercial practice that takes place between non-related entities within international trade. This categorization leaves behind the considerations regarding the commercial transactions between related entities, which should be analysed within a different framework (i.e. transfer pricing; arm´s length principle, etc).

It is also perfectly possible to misprice trade within the borders of a country, but for the purposes of this paper we will deal only with mispricing of trade in cross-border transactions. Trade, in this sense, needs to be considered as widely as possible since the practice under revision affects the exchange of goods and services of all kind. As it will be shown later in this thesis, it is possible to misprice a commercial export of lemons, but it is also possible to misprice the transportation costs of the same transaction.

B) Legal framework

The second distinction that needs to be made is connected to the legal framework within which trade mispricing is analysed. The question worth asking here is whether it is necessary to take any particular legal system as a basis in order to determine or define the essential elements of trade mispricing. An example may help to illustrate the complexity of the problem: do we need to know any Zambian law before claiming that trading of copper at six times less its global market price can be encompassed as a model of mispricing commodities? The answer, probably, is yes. It is vital to know more about tax regulations in Zambia in order to acknowledge the effects that trading mispriced copper might have on tax revenue. Similarly, understanding how the misrepresentation of price on a commercial invoice is understood as a criminal act in Zambia, if such is the case, is also essential. However, this thesis is trying to define

what trade mispricing is. That is, to conceptualize it and not to state whether trade mispricing in any particular instance was in fact verified or whether any crime was actually committed. Therefore, a valid theoretical understanding of trade mispricing would be applicable to this phenomenon regardless of where it took place or between whom. Nevertheless, any attempt to analyse trade mispricing through concrete cases would require relating the case facts to the applicable and relevant laws.

C) Distinctive elements of trade mispricing

C.1 Misrepresentation of price and the "victim"

The main characteristic of trade mispricing is the misrepresentation of price in a commercial transaction. The two common alternatives for misrepresenting price are underinvoicing exports or overinvoicing imports. By doing so the involved parties are able to transfer value abroad without going through the formal channels. This misrepresentation is a deception, a false statement.

While analysing maritime fraud, Paul Todd remarks:

> Common to all definitions of fraud is that a representation is made (or at least initiated) by the fraudster, that is intended to be, and is in fact, relied upon by the victim to his detriment. […] All frauds involve a deception, and therefore a statement or representation which is incorrect, but which is relied upon. The idea of fraud also implies dishonesty, but the nature of this dishonesty varies depending on the action. […] The most serious frauds involve representations which are made deliberately, in the knowledge that they are incorrect, with a motive which is known to be dishonest, which are intended to be and are relied upon by the victim, to the victim´s detriment and to the fraudster´s gain.[129]

The problem here, though, is that trade mispricing is not intended to affect the parties in the commercial transaction. Both parties in the exchange

129 Paul Todd, *Maritime Fraud* (London: MPG Books, 2003), at 2.

agree on the price for the goods or services, but instead they state on the commercial invoice a price that is not accurate. Therefore, the victim of the misrepresentation in trade mispricing is not one of the parties involved in the commercial transaction, but the authorities that rely on commercial invoices to determine consequent taxes. For instance, the tax revenue of the country of the exporter will be affected by underinvoicing exports. In the same way, the tax revenue of the country of the exporter will be affected by underpricing exports if there are established export taxes on the value of the exports. Using Todd's reasoning, the misrepresentation of the price involves the deliberate statement of something incorrect, in this case the price. This scheme affects the state´s capacity to collect taxes since the agencies in charge of collection rely of the statements and documents (commercial invoices) presented by the taxpayers.

The assessment of such scheme is what needs to be done now. Therefore, it is worth resorting to the analysis of Charles Clark on the conceptualization of schemes to defraud. Although Clark´s paper focuses on the US legislation, it is possible to make some comparisons that will allow a better understanding of the misrepresentation of price in a commercial transaction. Charles Clark states that:

> This most important element [of the scheme to defraud] has been described as "a departure from fundamental honesty, moral uprightness, and candid dealings in the general life of the community." Generally, a scheme to defraud involves depriving a person of "something of value by trick, deceit, chicane, or overreaching." Some courts have even found a scheme to defraud upon proof of conduct that is intended or reasonably calculated to deceive ordinary people. The flexibility of this language, simply put, makes these statutes a favorite weapon of the government.[130]

130 Charles Clark, "Schemes to Defraud under the Federal Mail and Wire Fraud Statutes: Development of a Working Definition" (2009-2010), 4 *Charleston L. Rev.* 679, at 684. Clark proposes the following definition:

> "Scheme or artifice to defraud" is to be judged by standards of morality, fundamental honesty, fair play and right dealing in the general and business life of members of society. All that is necessary is that it be a scheme reasonably calculated to deceive ordinary persons, including the government or foreign governments, in order to obtain tangible property or to deprive them of honest services. The scheme need not be based upon the use of the mails or wires, and need not be practicable or successful as intended by the perpetrator in its planning stages. If the fraud is completed before the use of the mails or wires, it is not governed by the statute.

A mispriced transaction, as mentioned above, stems from the agreement between the parties involved in the transaction. Therefore, the ultimate party affected by the scheme in the transaction is the government that is affected in its capacity to collect taxes related to the transaction because of the dishonesty of the parties.

Recently, the United States Court of Appeals for the Fourth District asserted in the case of *United States v. Errick Redmond*, which discusses the application of the wire fraud statute that:

> Wire fraud under 18U.S.C. § 1343 has "two essential elements: (1) the existence of a scheme to defraud and (2) the use of . . . wire communication in furtherance of the scheme." United States v. Curry, 461 F.3d 452, 457 (4th Cir. 2006). The scheme to defraud "can be in the form of an assertion of a material falsehood with the intent to deceive or active concealment of a material fact with the intent to deceive." United States v. Pasquantino, 336 F.3d 321, 333 (4th Cir. 2003) (en banc). To establish a scheme to defraud, the Government must prove beyond a reasonable doubt that Redmond acted with the specific intent to defraud, which "may be inferred from the totality of the circumstances and need not be proven by direct evidence." United States v. Ham, 998 F.2d 1247, 1254 (4th Cir.1993). The specific intent may be proven by circumstantial evidence and by inferences drawn from the facts and situations. United States v. Bales, 813 F.2d 1289, 1294 (4th Cir. 1987). [131]

The question that arises here is whether the prices can be subject to a "material falsehood", and also whether such falsehood is sufficient to be a scheme to defraud.[132] The assumption here is that price, like any other

131 *US v Errick Redmond*, 104523.U (4th Cir 2012)

132 It is worth noting what have been said in regard to the scheme to defraud so as to be able to reveal if a misrepresentation on price can be considered a "scheme to defraud". In this respect, it is interesting what Charles Doyle establishes.
See US, US Library of Congress, Congressional Research Service, "Mail and Wire Fraud: A Brief Overview of Federal Criminal Law" (2011), at 3, online: Congressional Research Service, <http://www.fas.org/sgp/crs/misc/R41930.pdf> (last visited 12/Aug/2013) He maintains there that

> The mail and wire fraud statutes "both prohibit, in pertinent part, 'any scheme or artifice to defraud[,]' or to obtain money or property 'by means of false or fraudulent pretenses, representations, or promises," or deprive another of the right to honest services by such means. From the beginning, Congress intended to reach a wide range of schemes to defraud, and has expanded the concept whenever doubts arose. It added the second prong – obtaining money or property by false pretenses, representations, or promises – after defendants had suggested that the term "scheme to defraud" covered false pretenses concerning present conditions but not representations or promises of future conditions. More recently, it added Section 1346 to make it clear the term "scheme to defraud" encompassed schemes to defraud another of

component of a transaction, can be subject to falsehood since there is no theoretical reason, at least at first glances, that permits assuming the contrary. Any person can misrepresent the price for a transaction by reporting one that is not the real—i.e. the fair market price—in the documentation that supports the transaction.

C.2 The empirical difficulties of assessing prices: Real prices vs. false prices

It is important to establish whether assessing prices, or the method used to evaluate, could be considered a matter of fact or evidence and, therefore, beyond the scope of the thesis. It is, consequently, of great significance to recognize the difficulties involved in this task.

As noted earlier, the key component of trade mispricing is the misrepresentation of price in the documentation that supports the commercial transaction. The question, though, is how to determine when a price is being misrepresented. The answer to this question seems to be intuitive, especially in cases like that of Zambian copper being sold at six times less than the market price. However, to discern a false price when the difference is not outrageous could be extremely complicated.

The price for the same product can vary for different reasons. Everyone would agree that according to the particular market, city or

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the right to honest services. Even before that adornment, the words were understood to "refer 'to wronging one in his property rights by dishonest methods or schemes,' and 'usually signify the deprivation of something of value by trick, deceit, chicane or overreaching. ///The statutes condemn schemes to defraud – both the successful and the unsuccessful. Nevertheless, there may be some question whether the statutes reach those schemes designed to deceive the gullible though they could not ensnare the reasonably prudent. It is not uncommon for the courts to declare that to demonstrate a scheme to defraud the government needs to show that the defendant's "communications were reasonably calculated to deceive persons of ordinary prudence and comprehension." One court considered these statements no more than an identification of a point at which the government has satisfied its burden in a particular case, without addressing whether a lesser quantum of evidence might suffice in other cases. In any event, the question may be more clearly present in the context of the defendant's intent and the materiality of deception, matters discussed below.n may be more clearly present in the context of the defendant's intent and the materiality of deception, matters discussed below.

country in which items are traded the prices might vary. There are different studies based on price comparison. For instance, economists use the "Big Mac" index as a method to compare currencies through the comparison of the price of the "Big Mac" burger in each country.[133] Thus, it should be empirically possible to ascertain whether the price declared for the transaction differs from the real price of the goods or services exchanged.

In an interesting study done for the World Bank, Fuest and Riedel construe the difficulties that arise when analysing prices.[134] First, they observe that sometimes the difference in price reveals only a difference in the quality of the products. Fuest and Riedel think that the trend for developing countries is to export "low-end products at low prices" and for developed countries "high-end products at high prices". The warning they issue is perfectly valid: the prices to be compared need to be compared fairly. If not, the outcome could be misleading. As they argue:

> [H]ow this affects the results of income shifting calculations depends on whether or not the trade volumes of different countries in a given product group are considered jointly to identify mispricing. If they are considered jointly and if the quality pattern is as described above, the mispricing approach systematically overestimates income shifting from developing to developed countries. If they are considered separately, this cannot happen, but, in this case, goods that are classified as overpriced in one country may be counted as underpriced in another country. This is inconsistent. As long as it is not possible to disentangle quality differences and income shifting, the interpretation of numbers generated by the mispricing approach is difficult.[135]

Following their analysis, any attempt to identify mispricing through the recognition of the "highest and the lowest quartile of observed prices" could also be misleading since it would demand taking into account every

133 See also The Economist, "The Big Mac index", online: The Economist, <http://www.economist.com/content/big-mac-index> (last visited 20/07/2013) The Big Mac index "is based on the theory of purchasing-power parity (PPP), the notion that in the long run exchange rates should move towards the rate that would equalise the prices of an identical basket of goods and services (in this case, a burger) in any two countries. For example, the average price of a Big Mac in America in July 2013 was $4.56; in China it was only $2.61 at market exchange rates. So the 'raw' Big Mac index says that the yuan was undervalued by 43% at that time."

134 Clemens Fuest & Nadine Riedel, "Tax Evasion and Tax Avoidance: The Role of International Profit Sharing", in Peter Reuter ed., *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, (Washington: The World Bank, 2012), at 109, online: World Bank <https://openknowledge.worldbank.org/bitstream/handle/10986/2242/668150PUB0EPI0067848B09780821388693.pdf> (last visited 12/Aug/2013).

135 *Ibid*.

variation in price as a possible mispricing event, when the fluctuation could well be based on other reasons. For example, A could be more efficient than B; and, therefore, A would be able to reduce the price for product X more than B. Focusing only in the highest and lowest could lead one to think that A might be mispricing product X when he would only be making use of comparative advantage. As Fuest and Riedel state:

> Empirical analysis should normally allow for the possibility that a hypothesis—in this case, the hypothesis that income is shifted from developing to developed countries—is not supported by the data. This is excluded by assumption, unless all prices within a commodity group are identical.[136]

Fuest and Riedel then argue that this methodology can be also misleading since it has no properly defined counterfactual. They propose the following example:

> Assume that, in one period, there is only one transaction in the upper quartile price range and only one transaction in the lower quartile price range. All other transactions are priced below the upper quartile price and above the lower quartile price. In this case, the counterfactual, which is a hypothetical situation without mispricing, should be that the two mispriced transactions disappear or their prices are adjusted to within the inner quartile price range. But now assume that, in the next period, the two transactions identified as mispriced in the first period take place at corrected prices, which are between the upper and lower quartile prices identified for the preceding period; everything else remains the same. In this case, the quartile price ranges for the second period would change, and transactions that were not identified as mispriced in the previous period are now identified as mispriced. This inconsistency occurs because there is no well-defined counterfactual.[137]

Fuest and Riedel complain about the "price filter method" that is sometimes used, because, as they acknowledge, the method recognizes the "income shifting in two directions: into and out of the country under consideration." However, they believe that many studies use this method to consider only the data "in one direction" and that, therefore, the results of such studies are incomplete since they disregard the data regarding the

136 *Ibid*.

137 *Ibid*.

other direction.[138] The argument here goes without saying since even if it were true that the method used to gauge trade mispricing was missing "one direction", the logical implication of that statement would be that a second state was affected and that we missed the opportunity to measure it. At the end, if trade mispricing harms, it will also affect the state of this second "direction". Fuest & Riedel propose the following example to clarify their argument:

> Assume that there are three exporters of a good in country A. Firm 1 exports the good at a price of 4; firm 2 exports the good at a price of 8; and firm 3 exports the good at a price of 12. The mispricing approach would identify the transaction at a price of 4 as underpriced and the transaction at a price of 12 as overpriced. Assume, further, that all firms have costs of 4 in country A that are deductible from the profit tax base in country A. The goods are exported to country B, where all three are sold at a price of 14 to consumers in country B. In this example, the aggregate corporate income tax base in country A is equal to 12. Firm 1 shifts income out of country A, and firm 3 shifts income into country A. In the absence of trade mispricing, the tax base in country A would be the same. The tax revenue loss of country A because of mispricing is equal to 0. A method that only takes into account firm 1 and neglects the implications of mispricing by firm 3 is clearly misleading. The same applies to the impact of income shifting on country B. For illustrative purposes, one might, for instance, consider a developing country with a weak political system and a low corporate tax rate. While some firms may be willing to shift profits into that country to exploit the low corporate tax rate, others may consider it beneficial to transfer profits out of the country to hedge against expropriation risks. This might give rise to the heterogeneous transfer price distortions laid out above. While we do not necessarily want to suggest that income is, in reality, shifted into developing countries, we nonetheless consider that an empirical identification approach should allow for the possibility that this might take place. This hypothesis could then be rejected as a result of the analysis.[139]

Fuest and Riedel's conclusion leads one to think that determining the real price of a false price is a complicated task, and that depending on the selected method there are some particular concerns that need to be taken into account. Specifically, they worry about the outcome of considering income flight in only one way, and not in a global manner.

138 *Ibid*.

139 *Ibid*.

They assume that this type of analysis may be misleading and inappropriate.[140]

C.3 Harm

As has been clearly established by Orce and Trovato, the distinctive element of any fraud is the reduction of the property of the victim as a result of the deception caused.[141] In the case of mispricing, the state sees its capacity to collect taxes diminished due to the misrepresentation of the price in the commercial invoices of the exporter, for example, when the goods traded are underpriced.

The harm that mispriced transactions cause cannot be accurately estimated in the abstract. Nevertheless, and to illustrate with an example, we can imagine that A exports goods to B in one year for 40 million dollars, and that A and B underinvoice the total amount by 20%. That means that the real total amount exchanged between A and B is worth, in fact, 48 million dollars. Thus, A will state 8 million dollars less in income than the real transaction would have earned. Therefore, the state's collection of taxes will be reduced by the conduct adopted by A and B, causing harm to the state coffers.

If the state also taxes the exports[142] with a price rate (20% of the stated price of the exports), then the state will also be affected by the action of A and B since the tax burden will have been reduced by 20%

140 *Ibid*.

141 [Orce & Trovato] *Supra* note 36, at 24.

142 [Stiglitz & Charlton] at 27-28. They argue there that

> [t]he need for government revenue can also, in some circumstances, provide a rationale for trade taxes. One corollary of the classic Diamond-Mirrlees production efficiency theorem (1971) is that it is optimal in a small open economy for the government to raise revenue from tax on the net demand of households rather than from border taxes (see Dixit and Norma 1980). But the conditions under which this is true are very restrictive, and especially do not hold in most developing countries (Dasgupta and Stiglitz 1972) In many developing countries, moreover, tariffs are the main source of government revenue, and where this is the case, the optima tariff structure may not be uniform (Dasgupta and Stiglitz 1974). Max Corden (1974) argues that, particularly in developing countries, the collection costs associated with trade taxes are likely to be much smaller than those of income and commodity taxes. Where this is true, trade taxes might be the best revenue-raising device.

through the misrepresented price on the invoice presented to the authorities. Therefore, as Orce and Trovato maintain, the distinctive element of any tax fraud is that the taxpayer pays less than he should. The taxpayer pays less according to the real price structure; and, thus, the harm is confirmed by the reduction in the state's tax collection. It is important to acknowledge that despite the effects on tax collection, the state is also affected when its citizens make untruthful declarations to the tax authorities.

Finally, Orce and Trovato are right when they state that it makes no difference how the harm is done. In the end, it is the same if harm is produced by the victim´s property dispossession triggered by the deception or by the victim´s reduction in the collection of revenue. Orce and Trovato illustrate this with an example: A sells gold ingots to B. The price agreed is $1000 for 100 kg of gold. A offers 100 kg of gold and the weight is certified in a document presented by A. However, the real weight of the gold is 95 kg. Orce and Trovato wonder whether the harm is caused because: 1) B paid more than it should ($1000 instead of $950); or 2) B received less than it should (95 kg instead of 100 kg).[143] The central issue here is that the state has the right to collect more taxes than those that were actually collected in consequence of the misrepresentation of the price on the commercial invoices.

There is also a secondary or residual effect of trade mispricing, which impacts the financial system, specifically the money multiplier phenomenon, which cannot be neglected. Chad Ralston clarifies how the money multiplier phenomenon works with a simple example:

> Suppose an individual, Ashley, deposits $1000 in a federally insured bank. The U.S. Federal Reserve sets a reserve requirement for the bank—in this example, 10% of reserves. This reserve means that the bank must keep 10% of all of its customers´ deposits in the bank. Thus, the bank will be able to lend out a maximum of $900 of Asley´s money to Bloom. The bank, attempting to maximize its profit, lends out the entire $900 to Bloom. Bloom in turn buys a moped from

143 [Orce & Trovato] *Supra* note 36, at 26.

> Caulfield for $900. Caulfield then deposits the $900 with another bank, which can then lend out $810 to Darl, according to the 10% reserve requirement. The cycle thus continues until the sum deposited is so negligible that the depository bank cannot effectively lend the money. All told, given the 10% reserve requirement and a $1000 initial deposit by Ashley, domestic banks´ credit increases by nine-fold, to $9000. Thus, ceteris paribus, the multiplier effect in the example generated $8000 in additional wealth within the country.[144]

Even when it may be difficult to ascertain the exact amount of harm caused by mispricing practices, the effect on the financial system cannot be denied. As Ralston maintains, this practice may well affect wealth creation since the money that is channelled out of the country could no longer be lent by the domestic banks; and, therefore, the money multiplier effect would be frustrated.

C.4 Corporate engineering

Trade mispricing cannot be considered solely as the misrepresentation of the price of the exports/imports of goods or services as a means to transfer wealth.

For instance, McSkimming fails to describe precisely the complete structure of trade mispricing.[145] In his explanation and illustration, McSkimming simplifies the scenario by saying that in the case of underinvoicing of trade goods, the exporter sells for $1000 and the importer remits for $2000. McSkimming avoids further explanation of such a transaction, such as how is it done, where the money is transferred. This failure is not a minor issue. What would be the interest of any exporter in underinvoicing exports to then receive the price difference in the same account where it will receive the outstanding invoice? It makes no sense if it is assumed that the additional price is returned to the exporting country since the controls on the exporter will easily realize that the exporters

144 Chad P Ralston, "Going it Alone: a Pragmatic Approach To Combating Foreign-Effected Tax Evasion" (2010) 24 Emory Int'l LRev 873, at 882. [Ralston]

145 [McSkimming] *Supra* note 99, at 45.

receive more money than the one it was invoiced. As McSkimming well recognizes, countries under the threat of expropriation, fiscal deficit, currency devaluation, economic uncertainty and political risk and insecurity[146] are more likely to shift capital through trade mispricing. Thus, it is, at least, incoherent to argue that people would underinvoice exports to then bring back capital to a country with those characteristics.

On the contrary, trade mispricing consists of the agreement between the parties within a commercial exchange. The key component of the agreement is that the parties settle on a price that differs from the one declared in the commercial invoice related to that transaction. The difference, or spread, is, therefore, somehow transferred to a foreign account of the exporter, which remains hidden from the authorities of state of the exporter. This means that the exporter creates or owns a corporate structure abroad, usually located in a tax haven, which would keep the information safe from disclosure. This sophistication is a distinctive element of trade mispricing. In order to make use of the profits generated from this practice, the parties need a foreign corporation to disguise the proceeds. The creation, control and direction of corporate structures in order to receive the funds and profit of mispricing invoices demonstrates a knowledge of the phenomenon and its consequences and, therefore, dispels doubt about the awareness of the parties involved in these practices.

The main idea behind the corporate structuring is to facilitate the disguising of the proceeds of trade mispricing. This means creating the possibility of transferring wealth through the scheme of a commercial transaction to a foreign account. What makes trade mispricing a complicated phenomenon to analyse, precisely, is that the legitimate business behind the scheme misleads and generates difficulties in distinguishing between the proceeds from a crime and the profits from a legal transaction.

146 *Ibid*, at 58.

As will be explained with the hypothetical scenarios later on this thesis, there are multiple ways to ascertain the legal implications of a mispriced transaction. Thus, depending on how we understand it legally, the interaction of the different legal perspectives of the transaction may vary. For instance, consider the example given above of the football player who was transferred from one team to another. If the parties agree to misprice the transaction in order to reduce the declared income of the club, which is owner of the rights on the football player, then, how should the "money" generated by this transaction be legally considered? The conduct of the individuals and/or financial institutions that help to transfer that "money" abroad -into a foreign bank account-, how should be legally considered? And why are these questions relevant?

One could argue that the misrepresentation of the price in a commercial transaction should be construed as a "scheme to defraud" the tax authorities that would later levy taxes on the transaction; thus, the money hidden from the authorities cannot be considered as anything other than the proceeds of fraud. If that is the case, there will be a cascade effect starting with the false statement evidenced in the commercial invoice, which will establish a price that differs from the real and fair market price for the transaction. Then, the income declared by the seller who misprices the transaction will be reduced in the amount shifted abroad. This situation will affect not only the tax related to the income declared, but also the trustworthiness of the tax file, making it subject to falsehood. At the same time, part of the money shifted abroad and which remains hidden from the authorities should be subject to taxes; thus, if we consider this money to be the proceeds of a crime, what happens to it later is also legally relevant. This is so because the financial institutions that receive this money are somehow helping to conserve and make use of it.

In *United States v. Yusuf*[147] the United States Court of Appeals for the Third Circuit established that "[s]imply because funds are originally

147 *United States v Yusuf*, 536 F.3d 178, 189–90 (3d Cir. 2008) citing *Pasquantino v United States*, 544 U.S. 349 (2005).

procured through lawful activity does not mean that one cannot thereafter convert those same funds into proceeds of an unlawful activity, as required to support a money laundering conviction." [148] This ruling is interesting since it defines clearly the term "proceeds" as the "criminal profit […] derived from a specified unlawful activity;" [149] and this equalization of proceeds and profits helps to understand how the profits generated by a mispriced transaction should be considered. If this interpretation is true, financial institutions should re-evaluate the assistance and services they may be providing at present to businesses involved in mispriced transactions. Essentially, this is because it is not possible to separate such financial activities from the fact that the money they generate is the proceeds of a crime.

In Yusuf it was established that "[u]n paid taxes which were unlawfully disguised and retained by means of filling of false tax returns through U.S. mail constituted 'proceed' of mail fraud for purposes of supporting a charge of federal money laundering."[150] The Court elaborates that:

> [T]he use of the mail to file fraudulent tax returns and fail to pay all taxes owed was not only incident to an essential part of the scheme because such mailing were the defendant´s way to concealing the scheme itself by making the fraudulently reported gross receipts seem legitimate.[151]

Even if this case belongs to the US legislation, and specifically to the mail fraud statute, it is possible to compare the way both types of conduct relate to each other. In this way, whether there is an established link between a false statement, fraud, and tax evasion, it is complicated to neglect the legal consequences of such a determination in regard to proceeds from those crimes. If this link can be made evident, the legal

148 *Ibid.*

149 *Ibid.*

150 *Ibid.*

151 *Ibid.*

consideration of this practice will not end with the parties of the transaction, but may well affect any financial institutions that receive and deal with the proceeds of criminal activity.

The United States Court of Appeals of the Nine Circuit in *United States v. Mirza Ali*, asserted the following:

> In order to show money laundering, 18 USC § 1956 (a) (1) requires the Government to prove that a defendant participated in a financial transaction using the "proceeds" of an unlawful activity. "Proceeds" generally means "that which is obtained… by any transaction."[152]

This reasoning yields the idea that there might be unexpected effects of trade mispricing transactions, whether or not we acknowledge them as criminal.

C.5 Trust

Trade mispricing is a phenomenon that, as stated above, takes place within the exchange of goods or services between non-related entities. That is, an agreement between two non-related entities for whatever reason (tax evasion, laundering money, shift capital abroad, etc.) that implies the underinvoicing of exports or the overinvoicing of imports. Such an agreement would not be free of risks. In the case of overinvoicing imports, the exporter will benefit from said transaction by being able to claim a more valuable transaction than the real one. In the case of underinvoicing exports, the importer will have conceded the benefit of diminishing the value of the transaction, in case of a hypothetical litigation.

This type of relational behaviour, which has certain effects linked to it, or possible effects in case of litigation, needs to be explained through the notions of trust and being trustworthy. According to Carol A. Heimer, the idea of trust is linked to social interactions and vulnerability. She maintains that:

152 *United States v Mirza Ali*, 620 F.3d 1062, at 11 (9th Cir 2010).

> In all social life actors are vulnerable to each other. Although some social interactions yield rewards for all participants, many involve rewards for some at a cost to others. To the extent that the interests of all parties do not coincide perfectly (and social norms are unable to correct the misalignment), people may be motivated, both consciously and unconsciously, to take advantage of each other. Social interaction is risky, and people have ample cause to be uncertain about each other´s intentions and the probable outcome of their encounters. Beyond some irreducible minimal level, however, interaction is optional. When it is not possible to trust others, those who have no effective way to reduce uncertainty or vulnerability may conclude that the costs of interaction outweigh the benefits.[153]

Heimer then explains that:

> By uncertainty [she] mean[s] the inability of an actor to predict the outcome of an event because he or she lacks information about the intentions and competence of another actor who directly controls this outcome. Vulnerability has to do with the amount of risk an actor incurs by engaging in a particular interaction and is a function (nonlinear and increasing) of the proportion of the actor´s total assets that are at stake in the interaction.[154]

The ways in which the parties behave in transactions that involve misinvoicing prices requires a certain degree of trust among the parties in order to ignore the risks implicit in the transaction. Seeking an explanation for the existence of such transactions in spite of the risks, Robert Gibbons maintains that the key is to consider the "economic motivation" of future transactions between the parties involved. Gibbons, quoting Mark Granovetter, argues that:

> Individuals with whom one has a continuing relation have an economic motivation to be trustworthy, so as not to discourage future transactions; and departing from pure economic motives, continuing economic relations often become overlaid with social content that carries strong expectations of trust and abstention from opportunism.[155]

153 Carol A. Heimer, "Solving the Problem of Trust" in *Trust in Society*, (New York: Russel Sage Foundation, 2001), at 43.

154 *Ibid*, at 43-44.

155 Robert Gibbons, "Trust in Social Structures: Hobbes and Coase Meet Repeated Games", in *Trust in Society*, (Russel Sage Foundation, New York, 2001), at 332.

Gibbons draws a line between formal contracts and relational contracts. The main difference between them, according to Gibbons, is that formal contracts "must be specified *ex ante* in terms that can be verified *ex post* by a third party (such as a court), while a relational contract can be based on outcomes that cannot be verified *ex post*, and also on outcomes that are prohibitively costly to specify *ex ante*." Gibbons maintains that third parties (such as a court) cannot apply relational contracts and that these types of contracts are self-enforcing, since the parties do not want to "lose their reputation by reneging".[156] The key in Gibbons' analysis is that the "relational" structure implies that the parties will "continue to interact for the foreseeable future".[157]

The incentives to misprice exports or imports are, evidently, greater than the risks involved in the transaction. However, adopting Gibbons' explanation on relational social structures makes it possible to understand why someone would agree to establish this type of commercial relation.

Gibbons' analysis finds support in what Macaulay said much earlier about non-contractual relationships in business. Macaulay discusses how businesses rely, in various ways, on non-contractual relations. This idea adopts the behavioural conceptualization of relations in business. Essentially, what Macaulay argues is that businessmen tend to behave properly with their counterparts in order to continue the relationship or increase their business with the orders from the other party. He says:

> Both business units involved in the exchange desire to continue successfully in business and will avoid conduct which might interfere with attaining this goal. One is concerned with both the reaction of the other party in the particular exchange and with his own general business reputation. Obviously, the buyer gains sanctions insofar as the seller wants payments until sellers have performed to their satisfaction. If a seller has a great deal of money tied up in his performance which he must recover quickly, he will go a long way to please the buyer in order to be paid. Moreover, buyers who are dissatisfied may cancel and cause sellers to lose the cost of what they have done up to cancellation. Furthermore, sellers hope to

156 *Ibid*, at 340.

157 *Ibid*, at 341.

> repeat for orders, and one gets few of these from unhappy customers. […] Not only do the particular business units in a given exchange want to deal with each other again, they also want to deal with other business units in the future. And the way one behaves in a particular transaction, or a series of transactions, will color his general business reputation. Blacklisting can be formal or informal. Buyers who fail to pay their bills on time risk a bad report in credit rating services such as Dun and Bradstreet. Sellers who do not satisfy their customers become the subject of discussion in the gossip exchanged by purchasing agents and salesmen, at meetings of purchasing agents´ associations and trade associations, or even at country clubs or social gatherings where members of top management meet.[158]

It is worth noting that mispricing practices need to be based on these kinds of relationships among businessmen since, as thus far, there has been a small risk of detection and significant profits at stake.

C.6 Intent vs. Motive

It is known that trade mispricing is based on the misrepresentation of the price stated on a commercial invoice. It is also known that such a practice requires a previous agreement between non-related parties in order to preserve the profits generated from the commercial transaction from tax controls. Generally, these types of agreements involve establishing corporate structures abroad that are prepared to channel the profits and disguise their origin. Therefore, everyone would agree that such an act could only be committed purposely. But what does it mean legally to act purposely?

Since this section is devoted to describing the main elements of trade mispricing, there is no attempt to link the definitions to any particular legislation. And even if the definitions of acting purposefully or recklessly can vary from country to country, it is important to review some definitions that may help us understand more clearly what acting purposely involves. In this sense, and according to the American´s Law Institute *Model Penal*

158 Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study", American Sociological Review, Vol. 28, No. 1. (1963), at 15.

Code:

> A person acts purposely with respect to a material element of an offense when:
> if the element involves the nature of his conduct or a result thereof, it is his conscious object to engage in conduct of that nature or to cause such a result; and
> if the element involves the attendant circumstances, he is aware of the existence of such circumstances or he believes or hopes that they exist.[159]

The *Model Penal Code* distinguishes acting purposely from acting knowingly by stating that:

> A person acts knowingly with respect to a material element of an offense when:
> if the element involves the nature of his conduct or the attendant circumstances he is aware that his conduct is of that nature or that such circumstances exist; and,
> if the element involves a result of his conduct, he is aware that it is practically certain that his conduct will cause such a result.[160]

Finally, the *Model Penal Code* defines recklessly:

> A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor´s conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor´s situation.[161]

The *Model Penal Code,* then, stipulates that "when the culpability sufficient to establish a material element of an offense is not prescribed by law, such element is established if a person acts purposely, knowingly or recklessly with respect thereto."[162] Logically, the *Model* concludes that if acting recklessly is sufficient to establish an element of crime, that element is

159 American Law Institute, *Model Penal Code*, (Philadelphia, Pa.: The Institute, 1980-1985), at 21.

160 *Ibid* at 21.

161 *Ibid* at 21.

162 *Ibid* at 22.

established whether the person acts purposely or knowingly. This relation does not work the other way around. If to establish an element is required to act purposely, acting knowingly or recklessly is not enough to establish that element as a crime.

Since mispriced transactions require a kind of certain sophistication, which may involve agreements between non-related entities, misrepresentations or false statements, corporate structures created or wire-transfers, it is difficult to assume that orchestrating this kind of plot could be done otherwise than purposely. Most of the legislation concerning tax evasion or money laundering, however, requires at least reckless conduct.

The question that still remains open is whether special consideration should be given when a particular motive lies behind a mispriced transaction. That is, for example, whether it should be considered equally when an individual or corporation misprices export/import transactions to shift money abroad or when an individual or corporation misprices export/import transactions to reduce its tax burden. For instance, it is possible to imagine a scenario in which an exporter, A, is looking forward to shifting money abroad to a safer financial market because of economic and political issues in the country where A's business is established. To do so, A agrees to underprice by 10 per cent all the goods exported to B. Now, at the end of the year the total amount exported from A to B is around US$100 million, but the total amount invoiced is around $US90 million. A obtains as a result of the scheme a profit of approximately $US10 million, which is transferred to a foreign account in a tax haven and is not subject to any taxes.

Such a scenario could indicate the commission of offences such as aggravated tax fraud, false statements, etc, under the legislation of A's country. However, A was not anticipating committing that felony; A was, on the contrary, merely shifting his profit abroad. Does this example allow for a different interpretation of the conduct of mispricing the exports? It is not

merely that it would be difficult to ascertain the particular motive behind trade mispricing that it would not be recommended to expand the argument in that direction. The truth is that the particular motives that may lead a party to misprice a transaction do not contribute to a better understanding of the phenomenon, nor do they change the legal responsibilities that may be entailed in it. The motive should not be considered as an element of the conduct. It has long be a matter of principle that:

> In ordinary parlance, the words "intent" and "motive" are frequently used interchangeably, but in the criminal law they are distinct. In most criminal trials, the mental element, the mens rea with which the Court is concerned, relates to "intent", i.e., the exercise of a free will to use particular means to produce a particular result, rather than with "motive", i.e., that which precedes and induces the exercise of the will. The mental element of a crime ordinarily involves no reference to motive.[163]

Therefore, what is relevant for understanding trade mispricing is that the parties involved in the conduct understand the risks entailed and disregard them. The motive is irrelevant to the analysis of the criminal responsibilities that may derive from trade mispricing. This is particularly important when considering the situation, for example, of the importer in the case of underinvoicing exports. The tax revenue affected by a mispriced transaction will be the one of the exporter country; and, therefore, the importer may well consider that there is no duty to prevent or avoid a fraud that affects a foreign country. The importer may well be indifferent to such conduct.

In relation to purpose, the Supreme Court of Canada had the opportunity to discuss the meaning of "purpose" in R. v Hibbert.[164] There, Justice Lamer stated that:

163 *Lewis v The Queen*, [1979] 2 SCR 821 at 831.

164 *R. v Hibbert*, [1995] 2 SCR 973.

> It is impossible to ascribe a single fixed meaning to the term "purpose". In ordinary usage, the word is employed in two distinct senses. One can speak of an actor doing something "on purpose" (as opposed to by accident) thereby equating purpose with "immediate intention". The term is also used, however, to indicate the ultimate ends an actor seeks to achieve, which imports the idea of "desire" into the definition. This dual sense is apparent in the word's dictionary definition. For instance, the Oxford English Dictionary (2nd ed. 1989) defines "purpose" alternatively as "[t]hat which one sets before oneself as a thing to be done or attained; the object which one has in view" and as "[t]he action or fact of intending or meaning to do something; intention, resolution, determination". The first of these definitions reflects the notion of one's "purpose" as relating to one's ultimate object or desire, while the latter conveys the notion of "purpose" as being synonymous with "intention".[165]

Justice Lamer finds that to equate "purpose" as "desire" is problematic. To make his point Lamer, following Colvin,[166] considers that no one could be guilty of aiding the commission of a crime when the aider is internally opposed or indifferent to the crime. As Lamer acknowledges, adopting an example of Mewett and Manning,[167] it would be absurd to reject the responsibility of the aider because of his internal reasons. As Lamer recalls, Mewett and Manning sustain that:

> [T]he distinction between purpose/intent and knowledge/intent does not work, because if there is, given an awareness of the consequences of an act, a freedom of choice as to whether one acts or not, by choosing to act those consequences have been chosen. If intent is the choosing of consequences, it does not make any difference to the existence of the intent whether the accused wants those consequences to follow or merely knows that they will follow, without necessarily desiring them to do so.
>
> "Intent", is not a very descriptive word. Mens rea connotes volition on the part of the accused, that is to say, given an awareness that certain consequences will follow (or will probably follow) if he acts, an accused who chooses to act when he has the alternative of

165 *Ibid* at 27.

166 *Ibid*, at 28. See Eric Colvin, *Principles of Criminal Law*, 2nd ed. (Scarborough, Ont.: Thomson Professional Publishing Canada, 1991). Colvin maintains that "[t]he terms 'direct intention' and 'desire' are sometimes used instead of purpose. The latter term, however, best describes the relevant state of mind. In ordinary language descriptions of action, the concept of purpose usually refers to an actor's reasons for doing what he did."

167 *Ibid*, at 32. Alan W Mewett and Morris Manning, *Criminal Law*, 2nd ed. (Toronto: Butterworths, 1985). "If a man is approached by a friend who tells him that he is going to rob a bank and would like to use his car as a getaway vehicle for which he will pay him $100, when that person is charged under s.21 for doing something for the purpose of aiding his friend to commit the offence, can he say "My purpose was not to aid the robbery but to make $100"? His argument would be that while he knew that he was helping the robbery, his desire was to obtain the $100 and he did not care one way or the other whether the robbery was successful or not."

> not acting "intends" those consequences in the sense of choosing to bring them about. It seems not only unnecessary but also positively misleading to attempt to distinguish between purpose/intent and knowledge/intent. (Criminal Law (2nd ed. 1985), at p. 113.)[168]

That being said, what is relevant for the analysis is the choice that actors make to act and to make certain consequences occur. This idea applies to all the parties involved in a mispriced transaction, and it makes no difference whether the harm of the conduct affects only the country of one of the parties. Whether the other party in the transaction is aware of the possible consequences of the transaction, the fact of being internally opposed or indifferent to the outcome makes no difference to the criminal law analysis.

168 *Ibid*, at 29.

Chapter III: Hypothetical Scenarios[169]

3.1 Introduction

This chapter seeks to describe different hypothetical scenarios in order to clarify how trade mispricing works.[170] The point here is to demonstrate how trade mispricing can be done. The examples are not intended as a recipe for businessmen to explain how they can engage in a questionable practice, but as a description of the phenomenon that would eventually help to find the best approach for a solution.

First, this chapter offers an example of a legitimate or ideal transaction, that is, a typical commercial transaction between non-related entities. Then, it provides an example of mispricing by way of underpricing exports. Therefore, the deception in the example relates to the price at which the goods are traded. There is a divergence between the real price and the one declared in the supporting documentation of the transaction. The third example shows how transportation can be mispriced as well, and the fourth example reveals how this phenomenon can differ depending on whether the transaction is settled under FOB (Free On Board) or CIF (Cost, Insurance and Freight) conditions.

Then, this chapter provides an example of a random organizational structure to describe the different areas of a corporation involved and the responsibilities of the people who belong to those areas. This will help in understanding the complexity and sophistication of these schemes, and it will probably help in further analyses seeking to understand different levels of responsibilities and involvement.

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169 All the illustrations and diagrams offered in this section were created by the present author.

170 These examples are offered as an anecdote from the practice of the author, and have been confirmed as familiar through conversations with businessmen and researchers on the topic. The practice of the author, basically, consisted in working during for four years as the sales manager for a corporation that grows and exports apples and pears from Argentina to more than forty countries around the world. During this time, the author was able to see how the corporations among the industry worked, and to talk about this phenomenon of trade mispricing several times with agricultural businessmen. This practice, though, was prior to my graduate studies at McGill.

Finally, this chapter will provide a description of how communications could possibly be established following the examples described. The goal of this description is to reveal the complexity of the communications sphere, which is tied to the business transactions and also to the scheme. The inevitable level of "formalization" of communications will help to distinguish the different levels of knowledge in regard to the components of the mispriced transaction.

3.2 An example of a legitimate export transaction between an Argentinian corporation and a US corporation

What follows is an example of a commercial transaction between two parties, A and B. This is a legitimate commercial transaction. This means that A is a corporation registered under the Argentinian legislation before the Public Registry of Commerce and the Federal Revenue Administration. A has apples to sell and is legally authorized to export them. B is a corporation registered under the US legislation and is interested in importing apples. B is legally authorized to import. A and B are not related companies.

In Argentina, A will be subject to various taxes. However, the relevant taxes for the sake of the argument will be the Income Tax and the Export Tax. The first establishes that A has to pay Income Tax on all the income obtained in certain period of time, i.e. the fiscal year.[171] This tax is determined by applying a 35% rate on the net income obtained by A. [172] Moreover, A is responsible for the determination and payment of the tax by preparing and filing a tax return.[173] Income Tax has to be paid in a

171 The assessment of the income tax here follows the report made by Beccar Varela called "Doing Business in Argentina" (2006). Online: World Service Group, available at: http://www.worldservicesgroup.com/guides/Doing%20Business%20in%20Argentina.pdf (last visited 12/Aug/2013) at 14.
The goal here is to exemplify how certain income could work in the scenario proposed in the example. The author is aware of slight differences that can arise when comparing with the actual income tax regime in Argentina. However, more detailed analysis of the Argentine legal framework is not needed here.

172 *Ibid.*

173 *Ibid.*

twelve-month advanced payment and one more payment for the remaining balance of the corresponding Income Tax, which may still be pending after the payment of such advances.[174]

A must also pay the Export Tax[175] (also known as Rights to Export or Trade Tax) on all export transactions made by the corporation. The Export Tax is determined by applying a rate (%) on the FOB price declared by A to the Public Revenue Federal Administration (AFIP) for the export transaction. For instance, for apples and pears the rate is set at 5% of the FOB price, although it varies for other commodities; for example, for soybeans it is set at 45% of the price.[176]

This example concerns the export of apples from Argentina to the US. The authorities would trust that the price declared by the exporter on the commercial invoice is correct. Thus, the system is supported by the expected trust and confidence that parties will behave honestly. In any case, the Argentinian government imposes an obligation on all exporters to bring into the country, through the financial institutions, the total amount of money invoiced for the export transaction. Therefore, the payments to cancel the invoices issued by exporters must be done through the Argentinian banks with which the exporter has an account. If after one year the exporter has not entered the total amount of money invoiced for an export transaction, the exporter may be criminally liable under

174 *Ibid*.

175 US, United States Trade Commission, at 2, online: US Trade Commission: <http://www.usitc.gov/publications/332/journals/export_taxes_model_soybeans.pdf> (last visited 12/Aug/2013). Export taxes are defined there as:

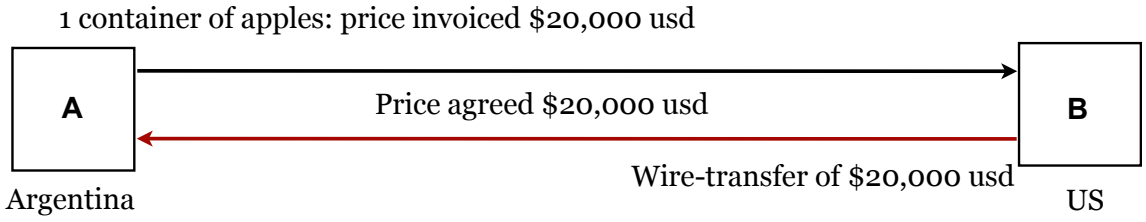
> Export taxes are taxes that domestic governments impose on products destined for sale abroad; they are applied either as a percentage of product value (an ad valorem tax) or as a fixed rate per physical unit of product (a specific tax) (OECD 2006, 4; Kazeki 2006) Export taxes are sometimes referred to as export duties, export charges, export fees, customs duties on exportation, export tariffs, or export levies (Kazeki 2006, 178-179). Frequently cited justifications for imposing export taxes include generating government revenues, promoting downstream processing industries, and more recently protecting the environment and preserving natural resources. Other objectives are price stabilization, domestic food security, resource allocation, and income distribution (Piermartini 2004, 7-15). Developing countries are the primary users of export taxes because they are simple to apply and potentially produce significant revenue.

176 The rates vary with commodity and from year to year; thus, consider the ones mentioned above as illustrative, and not as the real ones. The truth of the argument is not tied to the rate amount, but to the existence of such export taxes. The only thing that could change whether we consider any different rate of the export tax is the ultimate harm caused by trade mispricing. However, this thesis does not aim to measure trade mispricing, but to show that is a plausible phenomenon among businesses.

Argentinean law.

Communications between A and B are done via e-mail exchange. In the exchange, the parties set out the details of the goods to be purchased and the transaction conditions. Thus, the parties will describe the type of product, the amount of product, the freight options, the ruling incoterm, the quality of the product—if there is more than one available—the packaging, etc. The parties will also stipulate the agreed price. Generally, the parties will fix the price (including the method in order to fix the price, either consignment or firm final price), the payment currency, the amount of money, the payment conditions and the bank account details, interest rate, etc. All this information is clearly described in the purchase order (PO) and in the confirmation of the PO issued by the seller. Take the example of the parties agreeing to purchase one container of apples for a firm price of $20,000 usd to be paid in advance of loading. A would issue a commercial invoice for the total amount agreed (i.e. $20,000 usd).

Once the deal is agreed, the parties would proceed to carry out the contract to meet their commitment: A would make available the goods in their facilities, would take the goods to the port or ship the goods according to the transportation agreement; B would issue an order to the bank where B has an account to transfer the amount of money agreed on as the price to the account given by A.

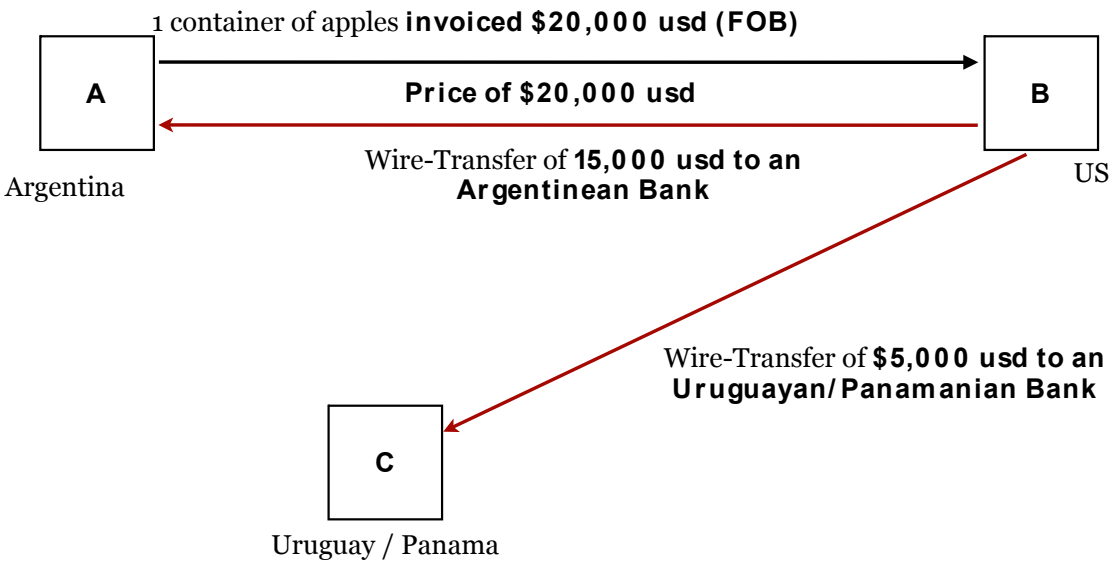


3.3 An example of a non-legitimate export transaction between an Argentinian corporation and a US corporation: Mispricing by underinvoicing the export of commodities

All the information given above regarding A and B is applicable to this example. There is a transaction between them, which can be described as follows. The parties agree to purchase one container of apples for a firm price of $20,000 usd to be paid in advance of loading, but it would be better to deposit part of the payment in a foreign account. Thus, instead of issuing a commercial invoice for the amount agreed (i.e. $20,000 usd), A would issue an invoice for $15,000 usd, which is 25% less than the price agreed. B would send the outstanding balance ($5,000 usd) to a foreign account that A has in a tax haven (Panamá, Uruguay, etc). Once the deal is agreed upon, the parties would perform the contract to meet their commitment: A would make available the goods in their facilities, would take the goods to the port or ship the goods according to the transportation agreement; B would issue an order to the bank where B has an account to transfer the amount of money agreed as the price to the account in Argentina given by A.

Following the payment structure created by the exporter and importer, B would cancel the payment of the invoice issued by the exporter authorizing a payment for the total amount of the invoice to the account that the exporter has in an Argentinian financial institution. Then, B would order his Bank to pay the remaining amount to the foreign account of A. The account where the outstanding balance of the price is transferred is not formally linked with A. There is no formal relationship between A and the owner of the account where the money is transferred, and there is little to no chance of the customs authorities of A's country relating them.

C owns the account where B transfers the balance. C is a shell corporation established in a tax haven; as such it has no commercial operations or assets. Probably, certain directors and/or employees of A created C in order to disguise the real stakeholders. Neither C nor C's account in the tax haven is declared to the authorities in Argentina.



3.4 An example of a non-legitimate transportation transaction between an Argentinian corporation and a US corporation: Mispricing by overinvoicing the freight

This example begins once the deal between A and B has been agreed and the parties wish to perform the contract to meet their commitment. Therefore, A makes the goods available in their facilities, takes the goods to the port or ships the goods according to the transportation agreement; B issues an order to the bank where B has an account to transfer the amount of money agreed as the price to the account given by A. According to the Incoterm ruling the transaction, either A or B needs to deal with the freight costs. To negotiate better rates, A creates a group of corporations that have the same transportation needs (A2, A3, etc.) and a new related corporation, D. D Is a corporation (SA) registered under Argentinian law before the Public Registry of Commerce and the Federal Revenue Administration. The main goal of D is to group the exporter companies in order to build up leverage in the negotiation of freight rates and volume contracts with E, the carrier. E, a branch of a multinational corporation, is registered under Argentinian law before the

Public Registry of Commerce and the Federal Revenue Administration. E provides the transportation for the goods that A (A2, A3, etc.) ship to B. To facilitate and organize the contractual relationship with E, D uses an intermediary corporation, F.

F is a Dutch corporation, structured as a Besloten Vennootschap (BV), that is a private limited liability company. F is created to act as an intermediary in freight transactions. This means that when freight rates and volume contracts are agreed between D and E, F receives the payments for the invoiced freights (from A or B) to then pay E for the real freight charges. F has an account in a Dutch bank where F receives the money for the freight invoices and from where F later pays the carrier. F would charge a small commission on every transaction done through its bank account. Therefore, D and E negotiate the price for the freight and then they agree to declare a higher price than the one agreed. F invoices the higher price to the individual corporations that comprise D (i.e. A, A2, A3).

The difference between the price agreed between D and E and the price that F invoices to A, A2 or A3 is later distributed by F to C (C2 or C3).

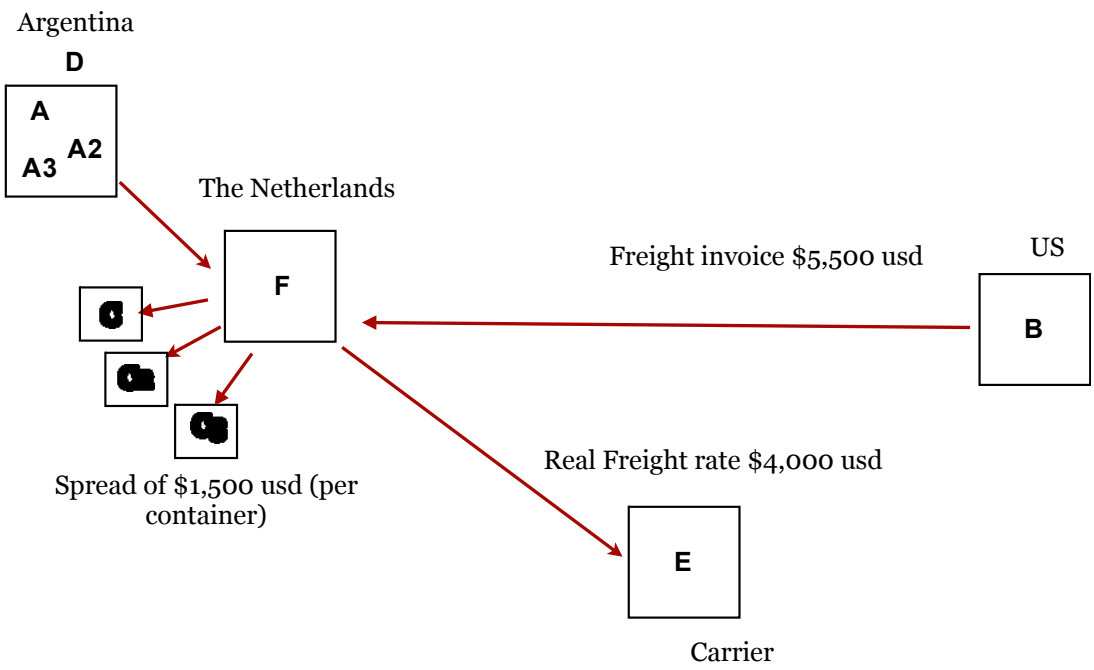
C is a shell corporation established in a tax haven; as such it has no commercial operations or assets. C is registered in a tax haven such as Uruguay or Panama. C owns the account where F transfers the balance or difference between the real price for freight and the invoiced price. As in the prior example, certain directors or employees of A created C. Neither the existence of C nor the account of C in the tax haven is declared to the authorities in Argentina.

The table below shows how the freight can be mispriced and how the difference between the real and the invoiced price can be transferred to C. As will be explained later, the following illustration reflects information that D, F, E and A need to know in detail to work together. Thus, this information has somehow to be shared, which would demonstrate the

levels of shared knowledge of the scheme among the parties involved.

F will :				
PORT OF ORIGIN	PORT OF DESTINY	TO INVOICE A or B	REAL PRICE TO PAY to E	TO TRANSFER to C
BUENOS AIRES	ROTTERDAM	5000	3500	1500
BUENOS AIRES	BARCELONA	4000	3000	1000
BUENOS AIRES	HELSINKI	4500	4000	500
BUENOS AIRES	TILBURY	3500	2500	1000
BUENOS AIRES	FOS SUR MER	3500	2000	1500
BUENOS AIRES	PHILADELPHIA	5500	4000	1500
BUENOS AIRES	QUEBEC	6000	4000	2000

The figure below shows D, the corporation in charge of negotiating freight rates with E, and the participation of F in order to disguise the proceeds of the profits of the transaction. F appears as an intermediary that collects the money invoiced for freight from A or B and then transfers the difference between the real price and the invoiced price to C.



3.5 FOB vs. CFR/CIF

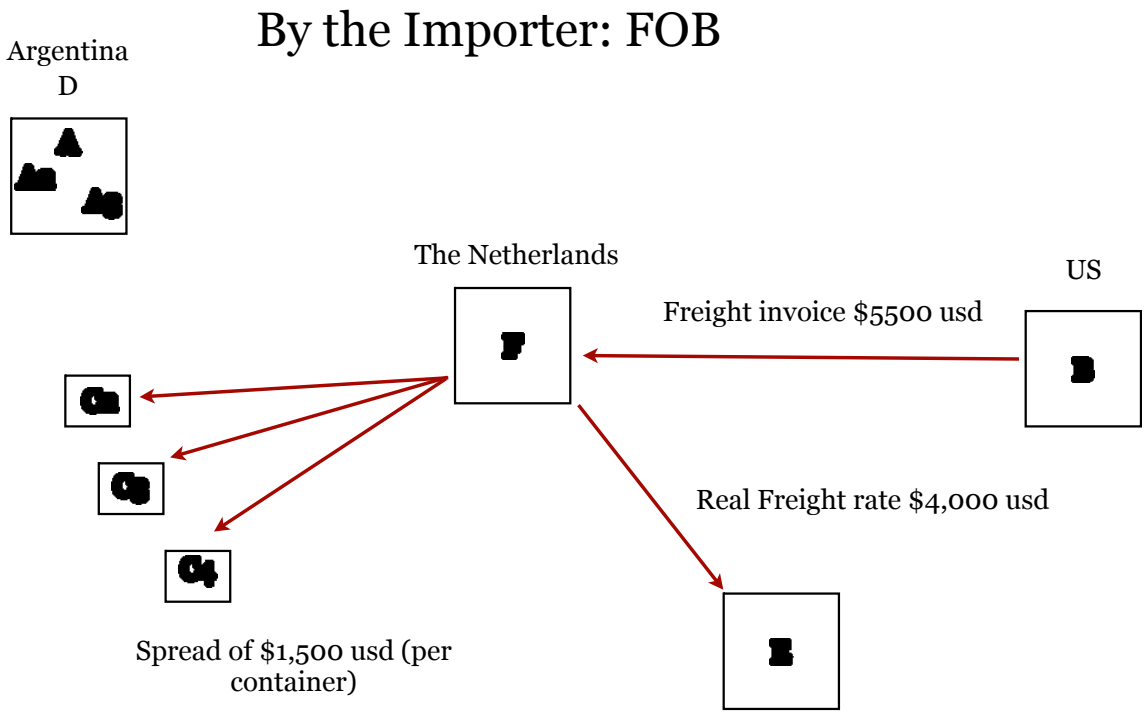
According to the Incoterm ruling the commercial transaction, the scheme described above could have different outcomes.

Assuming that A and B work on an FOB basis (Free On Board), B will pay F for the freight that E will transport. F will mark up the price that B is going to pay, and then the difference or spread will be transferred by F to C. B does not know or care about the mark up. B works on the basis of the freight price structure that A declared.

It is important to distinguish that here B is paying more than he should for the freight; he does not know or care about this since, probably, the total cost for the transaction is still interesting for B. Businessmen would probably use this opportunity to negotiate the price in a different way since they could reduce the price of the goods and make B feel that he is winning, but they would still be making a profit from the mark-up on the freight. This strategy is known as the simultaneously equivalent offers, and it allows A to offer a reduced price on the goods, but to realize the

same final price by marking up the freight cost.

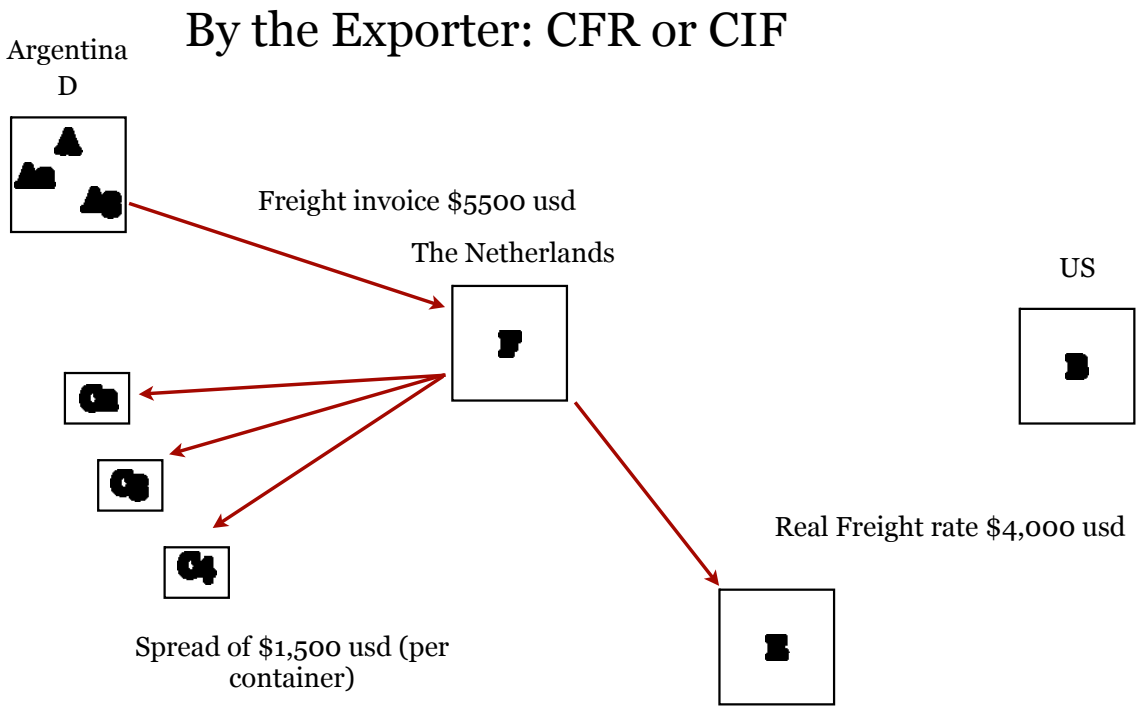
It could be argued that B is globally interested in the transaction, and that there is therefore a certain consent on the final number. However, it could also be argued that the misrepresentation of the price of the freight is a sort of fraud against B, who is paying more that he should for the same service (freight). This possible analysis is interesting since E is somehow participating in a scheme that A, D and F arranged.



Assuming that A and B are working under CFR (Cost and Freight) or CIF (Cost, Insurance and Freight) conditions, A would be responsible for paying F the marked-up price. The scheme depicted above will help A shift money abroad and reduce his Income Tax burden at the same time by deducting the freight charges that were marked up by F. This example also affects B since B is paying more than he should in terms of price; but as noted before, the global cost is still interesting to B; and he is, therefore, still willing to do the exchange. However, A is being dishonest with B and provides B with defective information regarding the cost of the

freight. The fact that B is still interested in going ahead with the transaction does not change the fact that B has received defective information.

This example offers a scenario whereby B is not the only one affected, since the tax authorities of A will not only be reducing the tax burden with the increased invoice cost of freight, but also will be shifting the spread elsewhere abroad.



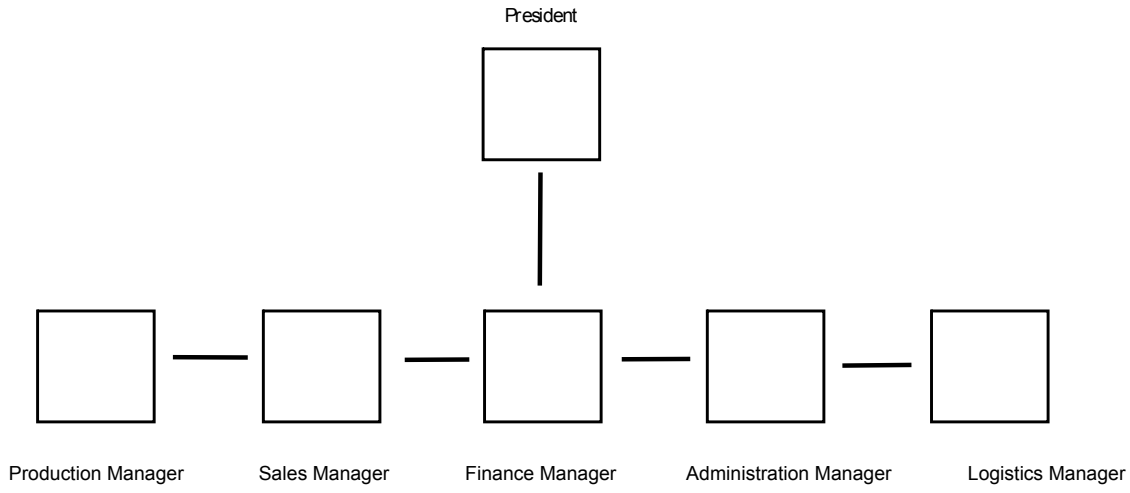
3.6 Organizational structure

Whether we think of a small/medium corporation or a large multinational corporation, any mispricing scheme will necessarily involve certain kinds of conduct that need to be described in order to completely understand the examples above. The following is a description of a possible, but necessary organizational scenario. This does not means that the description follows any legal categorization of the structure of any corporation under a given legal regime (e.g. the Argentinian legislation on corporations, the Dutch legislation on corporations, etc.). Instead, the description reflects only the roles that are necessarily played in a

mispriced transaction, no matter what the legislation under which a corporation is registered. Here, again, we are not trying to assess the legal responsibility of a given case, but to reveal the areas, departments, and people that are necessarily part of this mispriced practice. This is relevant since, as will be explained later, mispricing in cross-border transactions is a collaborative event that requires from more than one person.

Essentially, the organization of any corporation dealing with cross-border transactions consists, at least, of a president on the top the structure of the corporation. The president is the head of the administration. Generally, the president of any corporation deals with the general strategy and manages the organization.

Below the president there are different managers who deal with clearly defined tasks. For instance, corporations have managers in charge of sales, administration, finance, logistics, and production, among many others.



If we consider a legitimate transaction like the one presented in 3.2 above, we notice that the agreement on the transaction is held, basically, by two sales managers: one from A and one from B.

According to the internal organization of the corporation, both sales managers need to be accountable to a higher level of governance of the

corporation. Assuming that there is such a hierarchy, the sales manager would report to the sales VP or to the president himself, depending on the size of the corporation. The kinds of decisions that would require supervision or final approval from the higher governance relevant to this thesis are those related to pricing structures. Therefore, the final price for a transaction will be a matter of discussion at this level of the organization.

In the example of a legitimate transaction, the price agreed by A and B is the fair market price for the goods reflected in the supporting documentation of the transaction, but it also has to have the consent of the higher level of governance of the sales manager who made the arrangement.

If we examine the example of a non-legitimate transaction between an Argentinian corporation and a US corporation presented in 3.3, we realize that now A and B are not the only corporations involved. In fact, C also plays a key role in the scheme since it is the shell corporation that receives the difference between the real price and the price reported on the invoice. As noted above, A and B will agree on the details of the purchase, but they will also agree on how to misrepresent certain components of the transactions for further ends. The misrepresentation that is of interest to this thesis is the one that affects the declared price of the transaction. Here, again, the sales managers of A and B play a key role. They deal with the complicated task of agreeing, on the one hand, on a fair price for the goods; but, also, on the misrepresentation of certain components of the transaction in the supporting documentation and on the particular details and procedures to deal with the scheme.

It is important to understand that according to the example in 3.3, A agrees with B on the price ($US20,000), but only part of the price will be sent to the A´s account in its country (Argentina), while part of it will be sent abroad to C (Uruguay). Thus, A needs to be sure that B will follow the steps agreed upon and that all the money will be collected at the end of

the day. B also needs to get a clear understanding of how to proceed to avoid mistakes.

The example reveals something else. Both A and B would require the involvement of other managers than those in charge of sales. At least, the administration and the finance managers need to be aware of such an agreement. This is so for many reasons, but basically because, first, A is interested in having control of its sales manager. Secondly, the administration of A needs to be aware of the pricing structure to ensure such control, but also to avoid the price structure falling under the scrutiny of the authorities.[177] Finally, the finance manager needs to be aware of the agreement since he usually controls and provides the bank details of C to the sales manager, who then provides the details to B. The same process applies to B since the sales manager needs to inform, at least, his finance manager to which accounts and what amounts to pay to A and C. Therefore, even when the base trade agreement is settled by the sales managers, the content of the agreement needs to be shared with the other managers in order to complete the operation successfully and to have control over the people involved in the transactions.

The question whether the level or knowledge that is supplied stays only on the manager level, goes up to the President or, eventually, goes to the VP of each department of the corporation cannot be answered here. This could vary from case to case.

However, it would be rare that such a procedure could be done effectively without the knowledge of the head of the administration. It is possible to imagine schemes arranged without the knowledge of the head of the administration with the purpose of embezzling from the corporation, but it would be unusual to identify them since they would involve the cooperation of different areas or departments of the corporation. An example would be a sales manager who agrees to sell at a lower price the

177 In terms of pricing, if the spread between the real price agreed and the price reported in the supporting documentation of the transaction is to big, the authorities could be suspicious about the transaction. That is why, generally, the prices go through the assessment of the administration manager to be sure that the agreement will not attract the attention of the authorities.

goods to be exchanged and receives a bribe from his counterpart in the transaction. These kinds of practices may occur in the sales world, but they are not really worth noting for the argument of this thesis.

According to the example of a non-legitimate transaction between an Argentinian corporation and a US corporation through mispricing freight (3.4), the commercial transaction between A and B is already set. In this example, D appears as the structure from which A, A2, and A3 negotiate together freight rates. The organizational structure of D is, for the purposes of this thesis, similar or comparable to what was said earlier regarding A and B. The main difference to be remarked is that D, even when it is created under the law of the country and has a role to play in the negotiation of freight rates, has as its main task to work as an intermediary to misprice the freight invoices.

Therefore, the organizational structure of D is small and simple because the main concern of D is only to negotiate freight rates. Thus, there is no need to have a big structure. The sales manager here is the key player since he is the one leading the agreements and the one who will settle the particular conditions under which freight rates will be agreed upon and invoiced. In this example, F appears as an essential corporation. The organizational structure of F is similar to D's since F is an intermediary in the transaction and therefore does not need to have a big structure. Generally, this type of corporation has a head and several employees who help with the administration. This is so since, in fact, the service that F provides might well be considered illegal, and that is why F needs to be small and controllable. D and F are fully aware of the scheme, and they work as the disguisers of the proceeds.

The analysis of the organizational structure of E is even more interesting. Generally, the corporations behind freight, the freight providers, are large multinational companies. They have, therefore, well defined departments in charge of different tasks. The sales managers of E

are the ones who negotiate freight rates with D and who accept involving F in the transaction.

What needs to be pointed out here is that E knows who and what D and F are, and also that they are involved in the transaction. It does not matter whether E accepts D and F's purposes. E may or may not know D and F's purposes, but in any case E does not care about them. The role of E is not neutral, though. Accepting the involvement of D and F does not free E of further legal analysis.

3.7 Communications

The above examples explain how trade mispricing can be done in cross-border transactions. It is worth noting that even when this practice is based on trust between the parties involved, it is not possible to imagine such a scenario as being free of any kind of explicit communication. Especially, businessmen would like to have any written confirmation that acknowledges the terms of the agreement. Thus, even when the parties would try to avoid creating explicit evidence of an agreement that may well not be legal, there is also a concrete need of some supporting documentation.

It is important to point out that behind trade mispricing there is a commercial transaction, which is not free from commercial discussions, claims, and even litigation. Thus, the parties involved need to deal with a complicated task of establishing the terms of trade, the terms of the misrepresentation, and the terms of the execution of the plan so that the authorities cannot easily ascertain what is happening.

In the past, communications were not as efficient as the ones we have today. Mail changed to phones, and phones later changed to electronic mail. Offers and counteroffers, confirmations and refusals, and claims, among others, are now conveyed in emails. Small, medium and especially large corporations establish in various ways their means of

communication while negotiating cross-border transactions. To assume that trade mispricing is based solely on the trust among the parties involved in the transaction and on non-written agreements seems, at least, naïve. Behind trade mispricing there are individuals or corporations that run a legitimate business. Therefore, it is not reasonable to assume that these individuals or corporations will conduct their business with levels of informality more propitious for criminal agreements. For instance, it would be not logical to expect finding a written contract between a gang of criminals in which it is defined clearly that the proceeds of each robbery committed will be divided in equal parts among the members of the gang. Criminals may have problems in distinguishing moral choices, but they are not stupid. Nor are businessmen. The formality of cross-border transactions and the self-preservation instinct of businessmen demand fixing in writing certain clauses in their agreements. Therefore, following the examples above, sales managers would need to engage in their communication exchanges with their counterparts, on the whole, by email. According to their level of improvisation, sales managers would use the official email of the corporation they represent or they would use a different or perhaps personal account in order to avoid leaving traces on the official communications.

The internal communication among the different managers of a corporation in these types of transactions also needs to be somehow orchestrated in writing. Such is the case even when the agreement between A and B, or better between the sales manager of A and the sales manager of B, is not concretized in the official channels of communication of the corporation. The control of the transactions by the administration manager or the instructions and information of the bank account details given by the finance manager need to be sent through email. The same applies to D and F in the examples above. In the case of F, the intermediary Dutch corporation, F would require instructions in order to transfer money to the foreign accounts of A, A2, and A3. Thus, even when

the parties involved would like to reduce the levels of communication to the minimum, they could never reach zero. F would require a certain degree of formality in orders for receiving or sending money. It would not be logical to assume that a phone order would be enough since we are talking about millions of dollars that move from one place to another. This also applies to D when thinking about how to deal with two freight rates, the real price and the invoiced price. If D agrees with E that the rates to be invoiced to F will be different from the real ones, D needs to offer certain supporting documentation to A, A2, A3 so that they can complete their business. This supporting documentation, such as a list of different ports and the rates and costs agreed, needs to be communicated from D to A, A2, A3. Likewise, the same thing happens in the agreement between F and E. They need to proceed with a certain degree of formality to establish the obligations of both parties. This is especially so since E is a large multinational corporation that has many administrative controls and in which most of the departments are accountable to higher levels of governance.

It is also interesting how A communicates with C or with the bank that C deals with abroad to understand that even in the best disguised scenario, there are certain communications that cannot be avoided. From the official channels of communications of A, or from an alternative channel, A needs to send instructions to C or the bank where C has an account in order to control and transfer the money that is deposited there. The instructions need to be channelized in writing or, at least, by email. It is not possible to imagine a bank dealing with money owned by their customers that is transferred without an explicit order.

One may ask why the way businessmen communicate is relevant to this thesis. The answer to found in the knowledge of the elements of this practice, the different areas or departments that are necessarily involved in it, and the trail that trade mispricing leaves which cannot be erased.

Chapter IV: Shaping Corporate Behaviour: More Questions

4.1 Introduction

This chapter will assess the basic questions and distinctions that are tied to the phenomenon of trade mispricing. Only after being clearly identified can these questions and distinctions lead to further and better research and analysis on the best approach to a solution of this problem. This chapter, however, is not intended to provide a solution to the problem introduced in this thesis, namely, the legal analysis that is missing in regard to trade mispricing. Instead, this chapter deals with certain intricate questions, such as defining whether or not trade mispricing is crime; or if it is considered a crime, whether or not it should be punished harshly, along with other questions.

First, this chapter will discuss the dichotomy between tax avoidance and tax evasion. Why? The answer is simple. To establish such a distinction is relevant for the purposes of this thesis since trade mispricing could be considered to be either; but if trade mispricing is considered to be tax evasion, the consequences of such conduct are dramatically different than if it is considered to be a non-punishable activity. Therefore, setting a standard or criterion is needed to define where trade mispricing should be categorized.

Then, this chapter will argue the difference between the size of punishment and the probability of detection as a means of reducing trade mispricing. The assessment of this dichotomy is based on the economic theory of crime, which provides a theoretical framework for understanding the possible responses to crime and the logical effects of such responses. Later, this chapter will analyse certain particular approaches to reduce tax evasion adopted by some countries, such as the US and Germany, that will illustrate how the use of certain incentives shapes the behaviour of the members of this global society. This brief description exemplifies certain

practical approaches used to fight tax evasion. Finally, this chapter will provide an analysis of a leading case of the Supreme Court of Justice of the United States, which established some distinctions that cannot be neglected when trying to assess trade mispricing, such as delimiting the concept of property, tax collection, the harm in tax fraud, and the enforcement of the law as a means of reducing the amount of tax evasion. The decision occurs in *Pasquantino v. United States*[178] and reveals the expected behaviour of neighbouring countries in the control, prosecution and convictions of crimes that mutually affect the countries.

4.2 Tax Avoidance and Tax Evasion

The conceptualization of trade mispricing triggers the question of whether it should be considered a means of tax avoidance or a means of tax evasion. The distinction between both categories has been widely discussed within legal academia, and that is why reviewing what has already been said will help to understand under which category mispricing should be encompassed.

In this line of thought, Chad Ralston analyses this distinction in the United States and concludes that:

> [w]hile tax avoidance is the "act of taking advantage of legally available tax-planning opportunities in order to minimize one's tax liability," tax evasion is the "willful attempt to defeat or circumvent the tax law [of the United States] in order to illegally reduce one's tax liability." Both criminal and civil prosecutions are available in tax evasion cases.[179]

Ralston believes that to get a conviction in a tax evasion case in the United States, the evidence needs to reveal “a tax discrepancy”, an “act showing the individual´s attempt to evade, or actual evasion of, taxes”,

178 *Pasquantino v United States*, (03-725) 544 US 349 (2005).

179 [Ralston] Supra note 144, at 878.

and that "the individual willfully committed the act".[180] The key component of tax evasion is the act that reveals the attempt to evade or the evasion of taxes taking place. Unfortunately, Ralston does not offer more tools to determine how to assess the act that reveals the attempt. If we think about the examples in Chapter III, we are not able to determine which of them, or all them, provides evidence of an evasion attempt that would distinguish it from tax avoidance.

In the United States, as Orce and Trovato acknowledge, what distinguishes tax avoidance from tax evasion is, essentially, that the latter is criminally punished.[181] On the contrary, tax avoidance constitutes a legally permitted conduct. Orce and Trovato opt for a black-and-white distinction: the conduct is either a crime or it is not. Whether we call the latter, tax avoidance or a permitted conduct makes no sense to them. It is worth noting that the criterion here is essentially the criminal law, and they do not see any other component of conduct as relevant to the analysis. They understand that the US Supreme Court, in 1873, when deciding the case known as Isham, was the first to draw the distinction.[182] The Court considered there that any performance within the legal form of an action was not fraudulent.[183] The discussion in the case concerned the issuance of two checks for the amount of 10 dollars to avoid paying the tax that had been established for checks of 20 dollars or more.[184] The Court considered that this performance was not fraudulent within the legal form of the action; and that, therefore, there was no need to ascertain the purpose behind the act.[185]

On the other hand, Carlos A. Leite finds that the distinction between tax avoidance and tax fraud was clearly stated by the British House of

180 *Ibid,* at 878. There Ralston maintains that "[i]n 1976, the Supreme Court [of the United States] made clear that the element of willfulness does not require a showing of 'bad purpose'; it instead merely requires 'an intentional violation of a known legal duty'.*United States v Pomponio*, 429 U.S. 10, 11-12 (1976)."

181 [Orce & Trovato] *Supra* note 36, at 73.

182 *Ibid*.

183 *Ibid*.

184 *Ibid*.

185 *Ibid*.

Lords in *IRC v. Duke of Westminster*. [186] That case concerned the remuneration made by a taxpayer to his domestic employees in the form of "deeds of covenant".[187] The House of Lords supported the principle that anyone can arrange his or her affairs in the most efficient way.[188] As Leite recalls, Lord Tomlin stated that "[e]very man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be." [189] Leite considers that tax evasion involves something else, a component of illegality that makes tax evasion morally worse than tax avoidance. The central issue here is how to identify and describe the "component of illegality". In this regard, Leite fails to explain how to ascertain the distinctive element he mentions.

Orce and Trovato, instead, resort to what Justice Oliver Wendell Holmes ruled in *Bullen v. State of Wisconsin* to draw the line between tax avoidance and tax evasion.[190] Holmes argued that

> We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side, it is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law.

Orce and Trovato understand that after Holmes´s decision the discussion related to the distinction between tax evasion and tax avoidance shifted to the question whether or not the legal transaction should be taxed as the taxpayer wants. [191] The proposal they made, following Holmes's argumentation, seems to be right. However, acknowledging the possibility to tax otherwise than what the taxpayer wants because of the election of a

186 Carlos A. Leite, "The Role of Transfer Pricing in Illicit Financial Flows", in Peter Reuter ed., *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*, (Washington: The World Bank, 2012), at 235, online: World Bank <https://openknowledge.worldbank.org/bitstream/handle/10986/2242/668150PUB0EPI0067848B09780821388693.pdf> (last visited 12/Aug/2013).

187 *Ibid*.

188 *Ibid*.

189 *Ibid*.

190 [Orce & Trovato] *Supra* note 36, at 73 citing *Bullen v State of Wisconsin*, 240 US 625.

191 *Ibid*.

particular form for the legal transaction does not help to distinguish when, i.e. under what circumstances, tax authorities should re-tax the transaction and when they should initiate a criminal prosecution.

Nevertheless, Orce and Trovato consider that the essential distinction is based on the fact that tax avoidance is legitimate whereas tax evasion is not. They argue that "all the conducts that purposely look forward to reducing tax burden are not criminal, unless these conducts violate the information duty to the state regarding the legal transaction that is taking place."[192] They emphasize that the performance of this duty, i.e. the information duty, is the relevant criterion to distinguish tax evasion from tax avoidance. They believe that the duty should be considered satisfied when the authorities are informed about the form of the legal transaction.[193] Thus, under this assumption, there is no need to inform the authorities about the motives behind a particular choice of form that individuals and corporations may make. They maintain that there is no legal duty to inform about the motives behind a legal transaction, and that there is no fraud against the state when the motives behind a legal transaction differ from the ones that are normally expected from that transaction.[194] The key for Orce and Trovato is that the information that is not disclosed to the authorities by the parties in the transaction is not subject to a legal obligation of disclosure to the authorities. The argumentation is simple and can be elucidated as follows: tax fraud will only occur when the taxpayer violates the information duty to the state. The duty is accomplish by informing about the legal form of the transaction being carried out. There is, however, no duty to inform about the motives behind the legal transaction.

When one tries to apply this model to the phenomenon of trade mispricing, problems arise. For instance, everyone would agree that trade mispricing is, generally, based on a legitimate transaction, which conceals

192 *Ibid*, at 75. [translated by author].

193 *Ibid*, at 76.

194 *Ibid*.

a deception in regard to the price at which the transaction is carried out. This means that the parties in a mispriced transaction will report to the authorities the legal form of the transaction, which would include the supporting documentation, for example, the commercial invoice that reflects the terms of the operation. The question Orce and Trovato do not answer is whether such a level of information is enough to establish the distinction?

In a hypothetical mispriced transaction, the information regarding the terms of the transaction would be available and duly presented to the authorities, who would be able to check it. Therefore, the question has, at least, two possible answers. One way to approach the question would be to consider that if the information is available for the authorities, the authorities would be able to control the information, and they could disagree with the taxation sought by the taxpayer to re-determine the taxes if such were the case. This alternative would thus consider trade mispricing as legitimate conduct and not subject to criminal liability. Another way to analyse this issue is to consider that when a deception involves the information given to the authorities, there is no need for further analysis since a deception affecting the information given to the authorities *de facto* involves a crime. There is no need to distinguish whether the information given concerns the legal form or the purpose of the transaction. This second alternative allows one to consider that any false statement related to the information given to the authorities would be enough to categorize the conduct as tax evasion.

Beyond the empirical difficulties concerning the assessment of false statements that affect prices, which were mentioned above, following the criterion that Orce and Trovato propose, acknowledging a price as a false price could be crucial for the next level of analysis. If Orce and Trovato are right, obtaining a false price could have criminal consequences in regard to the legal understanding of the transaction and its proceeds. Businessmen might reconsider resorting to pricing structures orientated to

shift wealth abroad if they understood that a false price could be considered a failure of the duty of information to the authorities and, therefore, a crime.

When we understand trade mispricing as a scheme that reveals the failure of the taxpayer in the duty of information to the state´s authorities, the problem that arises is how to shape the behaviour of individuals and corporations that are used to dealing with commercial transactions that may or may not involve a misrepresentation of price.

4.3 Detection vs. severity of punishment

One could argue that acknowledging trade mispricing as a common phenomenon within the global exchange of goods and services, even when it might cause harm to the society, it is not sufficient reason to resort to the criminal law as a valid response to this phenomenon. It is for this reason that discussing what the criminal law seeks in general is an inevitable step for anyone who claims that the enforcement of the criminal law could be useful in order to deter trade mispricing.

The criminal law is to be applied as the ultimate response of the state, after having tried and instrumented other alternatives through state channels that were unsuccessful. In particular, the framework within which it is relevant to analyse criminal law, as is the purpose of this thesis, is the economic analysis of criminal law. This theory considers the criminal law sanctions as incentives that guide social behaviour. In this respect, Gary Becker argues that "crime is an economically important activity or industry",[195] and that is why he devotes his study the cost of crimes as well as to estimating the cost of enforcement of the law ("*precautions against crime"*). Becker discusses how there is a close link between the probability of conviction or punishment and a decrease in the number of offences. To

195 [Becker] Supra note 108, at 3.

support this general assumption Becker recalls to what Lord Shawness once said:

> "Some judges preoccupy themselves with methods of punishment. This is their job. But in preventing crime it is of less significance than they like to think. Certainty of detection is far more important than severity of punishment."[196]

This argument supports the idea of the importance of focusing on monitoring, controlling, and prosecuting the cases that involve trade mispricing structures, in stark contrast to focusing mainly on the size of the legal sanctions for cases that involve trade mispricing. People do not care if the punishment established for a tax fraud is 10, 20 or 30 years; they tend to look at the rates of detection since that will be the only variable that might change their actual behaviour. Therefore, regardless of the lack of consensus on how to measure effectively trade mispricing's detrimental effects on society, the state should develop agencies and tools to reinforce the controls on business transactions.

Moreover, traditional criminal law sanctions are considered to be retribution for an agent's previous behaviour, the payback from the community to those who behave contrary to the rules of the state. In sharp contrast to these ideas, an economic analysis of criminal law understands the punishment as an incentive for the future behaviour of the agent. That it is a way "to influence future behaviour (typically by deterring and also incapacitating criminals)".[197] Therefore, it is possible to argue that the behaviour of individuals and corporations can be shaped through the influence generated by criminal punishment, assuming criminal punishment is an incentive to avoid certain conducts previously and clearly defined.

196 *Ibid*, at 9.

197 Alon Harel, "Economic Analysis of Criminal Law: A Survey", in Alon Harel & Keith N. Hylton, *Research Handbook on the Economics of Criminal Law* (Cheltenham, UK: 2012), at 10.

Trying to delimit the uses that the criminal law might or might not have, Harel observes:

> The classical criminal law doctrine is based on retributive values. The traditional legal theorist believes that the criminal law sanction ought to be imposed only on the guilty and that its severity ought to reflect the degree of wrongfulness of the act and the culpability of the actor. Furthermore, some retributivists oppose the use of criminal law for the sake of deterrence, as such a use violates the basic Kantian principle under which one ought not use a person as a means (not even as a means to deter crimes).[198]

When focusing on trade mispricing, the main concern encompasses both the retribution for what was done and the deterrence of such business practices that cause harm to the society. Thus, considering trade mispricing as a crime and suitable for punishment could well affect a decision maker to avoid such conduct. That is why the goal of defining the legal perspectives on trade mispricing becomes relevant not only for scholars, but also for the people dealing with this type of transaction who do not have a clear framework to understand what this phenomenon means. Essentially, following the economic analysis of the criminal law could be of use as a framework for understanding the role that it can play in order to shape the behaviour of individuals and corporations; that is, in other words, to see how trade mispricing can be punished when detected (past), and how it can be deterred or reduced (future). This statement might seem intuitive or too simplistic; but considering the analysis given of trade mispricing by legal academia so far, it should not be considered such. It is obvious that if any conduct is considered a crime, it should be punished. However, the problem here is that there is no consensus on whether trade mispricing may involve a crime. Thus, if the phenomenon of trade mispricing can be legally categorized as a crime, the criminal response to it could be of use to shape future behaviour.

So far, the understanding of trade mispricing allows accepting the idea that corporations could cause harm to society even through profitable

198 *Ibid*.

acts, such as mispriced business transactions. The problem that arises is how to increase the levels of detection, and thus how to approach the conduct of corporations, unlike the conduct of individuals, especially within the global exchange of goods and services that might involve actions taking place in different countries, among different corporations, and involving complex transactions. There are certain studies that propose involving the corporations in the fight for a solution to trade mispricing, basically because the corporations are the ones closer to the possible problems, and consequently they may be closer to solving them.[199] It is worth noting that this does not deny what was said previously about the need for enhancing controls and prosecution of trade mispricing. On the contrary, involving the corporations in the fight can align perfectly well with such a goal, offering the opportunity to corporations to enable mechanisms to monitor and control themselves.

These theories put special emphasis on the possibility of preventing harm through corporate investment in preventive measures, such as enhancing internal controls, establishing codes of conduct, and even reporting suspicious conduct. Involving corporations in the monitoring or control of their own activity is something to promote, and it can never be wrong. As said before, trade-mispricing transactions involve the coordination of many departments of any corporation, such as the sales department, the legal department, the administrative department, and the financial department, among others that may play a role in cross-border transactions. Thus, many people from different areas of the corporation are somehow related to the transactions that the corporation carries out. Therefore, enhancing controls can help to build global awareness of the effects of such a practice; and the decisions involving mispricing structures would go not only through the administrative heads of sales managers, but also through other members of the corporations, such as the

199 Jennifer Arlen, "Corporate Liability: Theory and Evidence", in Alon Harel & Keith N. Hylton ed., *Research Handbook on the Economics of Criminal Law* (Cheltenham, UK: Edward Elgar, 2012), at 144.

administration manager, who might rethink aiding the corporation in conducts that might well have non-desirable legal consequences.

For this reason, involving corporations in the control and monitoring of their own activity helps to create a general consensus regarding "good practices" and, probably, would reduce wrongdoing in direct relation to the intensity and seriousness of the investment made by the corporation on this matter. The problem that arises is what to do with the corporations that are basing their core business on illegal practices, like trade mispricing, that is, corporations that habitually misprice transactions. For these kinds of corporations, expecting collaboration from their employees would be, at least, naïve. However, developing knowledge about the consequences that trade mispricing has, insofar as this would involve the corporations in monitoring or controlling what they do, would help to create greater consciousness of how corporations have acted to prevent such practices, and how the employees of such corporations have behaved when they knew about such practices.

In the same line of thought, Jenifer Arlen proposes another serious alternative. She believes that "[i]n order to optimally deter corporate crime, the state generally needs to impose both individual and corporate criminal liability."[200] This idea implies punishing not only the individuals behind a corporation, but punishing the corporation as well. This idea, however, needs to be understood in light of the possible punishments that could be applicable to practices like trade mispricing (fines, suspension, reputation punishments, etc.), but, especially, according to Becker's doctrine regarding the greater effect created by the probability of punishment than the amount of punishment. Analysing the essentials of crime, Arlen argues that:

> Pure individual crimes generally involve an individual seeking to benefit from imposing harm on a third party. The central goal of individual liability is to deter all crimes which impose social costs

200 *Ibid, a 144.*

> greater than the benefit of the crime. Individual criminal liability can achieve this goal by imposing sanctions directly on the individual wrongdoer whose expected cost equals the social cost of crime. When individual actors have limited assets, the state may need to spend resources on detection or on non-monetary sanctions such as prison (Becker, 1968).[201]

However, in regard to the idea of corporate liability and the role that a corporation can play before and after a crime is committed through the corporation, she says,

> Corporate crimes differ from these simple individual crimes because they involve an additional actor, the firm, which can intervene to deter (or encourage) crime both ex ante and ex post. Firms can deter crime ex ante by adopting measures that lower the expected benefit of crime to employees or increase the direct costs of its commission. Corporations have direct control over the expected benefit of crime—control that even the state does not have—because the wrongdoers generally benefit from corporate crimes indirectly, through the compensation and other benefits they obtain from actions that increase the firm´s profits. Firms thus are uniquely positioned to intervene ex ante to deter crime through their ability to structure compensation and promotion policies so as to make crime less profitable. Firms also can intervene ex ante in other ways that increase the direct cost of committing crimes, interventions we refer to as "prevention measures" (Arlen and Kraakman 1997). Corporations also can help deter crime by intervening to increase the probability that the government detects and sanctions wrongdoers. Firms can do this by undertaking ex ante monitoring, ex post investigation, and cooperation to increase the probability that the government detects the wrong, identifies the individuals responsible, and obtains the evidence needed to convict them. [202]

Arlen appears to be right when she maintains that the corporations are in a better position to help the authorities to prevent crimes. However, this idea does not fit well with the problem that arises when the whole corporation is structured to misprice transactions. It is important to think of the example given in Chapter III regarding the intermediaries in the freight rate transactions. These intermediaries have no role to play in the commercial chain, but they provide a tool to misprice the freight rate and to shift money abroad. Therefore, even if Arlen is right that those types of

201 *Ibid, at 144.*

202 *Ibid*.

corporations are the ones close to the problem, and the ones that can work ex ante (to prevent) or ex post (to cooperate) to deter trade mispricing, it seems at least naïve to expect this to happen when a corporation is created solely for the means of mispricing transactions.

This thesis does not propose any special way to tackle the phenomenon of trade mispricing. However, bringing attention to the issues that are tied to this phenomenon will, probably, contribute to a better understanding and, perhaps, to better approach to the problem.

4.4 Incentives

Raymond Baker correctly states that the only way to reduce trade mispricing without regulating prices simply requires honesty in pricing.[203] The problem is that, sometimes, the incentive to act otherwise is extremely tempting. In countries that have established severe controls on the exchange of currency, like Argentina[204] and Venezuela,[205] businessmen can find within cross-border transactions the financial tools to circumvent the controls on currency exchange established by the authorities. Imagine, for example, what happens in Argentina, where the official exchange rate between the Argentinian peso and the US dollar is fixed at approximately 5,575 pesos = 1 dollar.[206] All the exports from Argentina that are agreed in foreign currency, for instance a container of apples for $25,000, are

203 [Baker] Supra note 116, at 348.

204 See also *The Economist*, online: The Economist: <http://www.economist.com/blogs/americasview/2011/11/argentina's-currency-controls> (last visited 12/Aug/2013). This article is from November 2011 and states that 1 peso bought 24 American cents. Today, according to the Banco de la Nación Argentina, 1 peso buys 17 American cents. See also Banco de la Nación Argentina, online: Banco de la Nación Argentina: <http://www.bna.com.ar> (last visited 12/Aug/2013). However, these figures only tell about the official market. On the unofficial market, the black market or, as it is called in Buenos Aires, the "blue market" 1 peso buys 11 American cents. When the author of this thesis arrived in Canada, on September 2012, in the blue market 1 peso bought 22 American cents.

205 See also *The Economist*, online: The Economist: <http://www.economist.com/blogs/americasview/2013/02/venezuela's-currency> (last visited 12/Aug/2013). *The Economist* explains about Venezuela that

In 2003 the government tried to stem capital flight by imposing stringent exchange controls. Since then, ordinary Venezuelan citizens and businesses have faced limits on the amount of foreign currency they can acquired at the heavily subsidised official rate, while the well-connected have made fortunes by exploiting the system. To meet the rest of their foreign-currency needs, many Venezuelans have had to turn to a flourishing black market, where the bolívar has traded at a fraction of its official value. These restrictions have contributed to ever-worsening shortages of essential goods.

206 Banco de la Nación Argentina, online: Banco de la Nación Argentina: <http://www.bna.com.ar> (last visited 12/Aug/2013).

changed to pesos when paid. The exchange will be done considering the official rate of exchange (5,575 pesos /1 American dollar). However, the black market or, as the Argentines call it, the "blue market" pays much more (8,92 pesos/1 American dollar). Exporters, then, have a strong incentive to misprice exports and deposit the foreign currency abroad.

When these incentives are significant to the economic and financial stability of the business behind the export, Baker´s honesty claim is revised under different standards, which are not exclusively moral or legal. That is why the balance between Baker´s honesty in pricing and the incentive that individuals and corporations have to misprice transactions makes the choice easier for those who, at the end of the day, seek only an increase in their profits. Baker´s claim is not wrong. On the contrary, he is perfectly right when he asks for more honesty from businessmen. The problem is that the appeal for honesty seems not to be enough.

Baker is also right when he considers that tax efficiency should not be a determining factor in price structures "[p]rices should be based on costs, commercial opportunities, and uncertainties".[207] The problem then is how to get the legal and moral questions concerning mispriced transactions on the businessmen's agenda. It is not reasonable to expect that someone in the business world would ever suspect that manipulating prices could be considered a crime, especially since there is not enough academic work to clearly demonstrate the legal implications of this practice. Thus, education about the legal implications that trade mispricing can have may be a good way to start creating consciousness about the consequences of this practice. Eventually, increasing understanding of what trade mispricing encompasses, it is hoped, will help to reduce or deter this practice. This educational process could also be increased through making public the investigations, prosecutions and convictions that states achieve in this area.

207 [Baker] Supra note 116, at 349.

The leading step, in this respect, was made by the US, which has demonstrated a strong interest in reducing the amount of tax evasion at any cost. In 2010, the US Justice Department, which is targeting taxpayers who fail to declared foreign accounts, informed the public that:

> In April 2009, Robert Moran pleaded guilty to filing a false income tax return and admitted to concealing more than $3 million in a secret bank account at UBS. He was sentenced to two months in prison.
>
> In July 2009, Jeffrey Chernick, of Stanfordville, N.Y., pleaded guilty to filing a false tax return, and was sentenced to three months in prison, six months of house arrest, and six months of probation
>
> In August 2009, former UBS banker Bradley Birkenfeld was sentenced to 40 months in prison for helping an American billionaire real estate developer evade taxes.
>
> In January 2010, Juergen Homann, of Saddle River, N.J., was sentenced to five years probation for failure to file a Report of Foreign Bank or Financial Accounts (FBAR). Homann concealed more than $6.1 million in Swiss bank accounts.
>
> In January 2010, Roberto Cittadini, of Bellevue, Washington, was sentenced to six months of home confinement for failing to report income from secret UBS bank accounts under his control.
>
> In February 2010, Dr. Andrew Silva of Sterling, Va., pleaded guilty to conspiracy to defraud the United States and making a false statement regarding an undeclared foreign bank.[208]

These examples can be read as, merely, a few cases in which the US prosecutors achieved convictions. However, what we can learn from these examples is much deeper. Failing to be truthful in one's declaration to the authorities will be punished, at least in the US. Connecting the above idea with Baker´s claim for honesty, the legal consequences of being untruthful with authorities (false statement), and considering false prices as a failure of the information duty, as Orce and Trovato argue, could lead one to think that trade mispricing can be approached differently, namely, as a crime with a real punishment.

Furthermore, as stated earlier, detection appears to be more important than the "severity" of punishment. Individuals and corporations consider more the possibilities of being detected rather the size of the

208 US, United States Justice Department, "Justice Department Highlights Tax Enforcement Results", online: US Justice Department: <http://www.justice.gov/tax/txdv10378.htm> (last visited 12/Aug/2013).

punishment. If the possibilities are low, they are more likely to disregard the law. Some of the Department of Justice's examples can be interpreted as mild punishments, for instance, spending two months in prison. However, the message this kind of punishment sends to society will probably affect the future behaviour not only of those who are punished, but also of others who see that detection works. Finally, if people acknowledge that deceit of the authorities can result in time in prison, this is a very eloquent way to discourage practices such as trade mispricing. This lesson can be applied to both pricing structures and mispricing structures. If individuals or corporations understand that the authorities are able to detect manipulated prices, they have a stronger incentive to avoid such practices. The key, then, is to develop tools in order to control and monitor the information that is given to the authorities, and to prosecute and punish those cases that involve criminal conduct affecting the country in which the investigation takes place or any other country that might be affected as a result of this practice.

In the following section, this thesis will assess the approach taken by the US Supreme Court in a case of tax fraud committed within the US that affected tax collection of Canada. Even though it does not strictly concern trade mispricing, the US Supreme Court's decision establishes some guidelines that are worth reviewing when analysing the phenomenon of trade mispricing.

4.5 Pasquantino

In *Pasquantino v. United States*[209] the Supreme Court of United States had the opportunity to discuss a case concerning the extraterritorial effects of a tax fraud committed within the US. The importance of this case cannot be underestimated. *Pasquantino* is usually presented as a case in

209 Pasquantino v United States, (03-725) 544 US 349 (2005). [Pasquantino]

which the application and extent of the revenue rule[210] were discussed. However, some sustain that the revenue rule is not the essential matter of discussion in *Pasquantino*.[211] This thesis will not argue that aspect, since much has already been said on the subject. Moreover, focusing on the revenue rule in *Pasquantino* would diminish Pasquantino´s true relevance. As will be explained below, *Pasquantino* has, perhaps accidentally, established the bases from which the effects of trade mispricing should be considered.

The facts of the case can be summarized as follows: The US citizens Carl J. Pasquantino, David B. Pasquantino and Arthur Hilts were accused and sentenced under the wire fraud statute for carrying out a scheme to smuggle large quantities of liquor into Canada from the United States.[212] Essentially, the scheme was orchestrated to avoid paying duty taxes in Canada. The question that the Supreme Court answered in *Pasquantino* was not whether a scheme, in general, can affect the tax revenue of a foreign country, but whether Pasquantino´s scheme, in the concrete, was committed as a crime completely within the territory of the US.

The Court faced difficult questions in this respect. First, there was the issue of whether the conduct fell under the wire fraud statute. The petitioners claimed that there was no "scheme or artifice to defraud" nor was there an "object of the fraud … be [money or] property". The Court understood that both elements were probed, and they explained that:

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210 The revenue rule refers to, as the Court established in Pasquantino, the prohibition of the enforcement of "tax liabilities of one sovereign in the courts of another sovereign."

211 See also Brenda Mallinak, "The Revenue Rule: A Common Law Doctrine for the Twenty-First Century" (2006), 16 *Duke J. Comp. & Int'L L.* 79, 88-92, at 114. Mallinak maintains there that

> [i]n Pasquantino, the Court found that a wire fraud prosecution did not implicate the revenue rule's concern that courts will become involved in international relations best left to the other branches of government, that courts will be placed in the position of making public policy decisions about foreign revenue laws at the risk of offending foreign governments, or that courts will have to exhaust excessive judicial resources in comprehending foreign revenue laws. A criminal fraud that occurred partially within the United States in violation of a federal statute was not allowed to escape prosecution because the harm intended was aimed at a foreign government and its public law for the collection of revenue. The Court's decision did not place new limits on the revenue rule. Neither did the opinion expressly state the full scope of the revenue rule.

212 [Pasquantino] *Supra* note 208, at I.

> Taking the latter element first, Canada´s right to uncollected excise taxes on the liquor petitioners imported into Canada is "property" in its hands. This right is an entitlement to collect money from petitioners, the possession of which is "something of value" to the Government of Canada.[213]

The proposition of the Court is relevant since what was established was that the right of a foreign country to collect its taxes can satisfy the element of "property" required by the wire fraud statute. The Court established that "tax evasion deprived Canada of that money, inflicting an economic injury"; and that the conduct of the petitioner was directed, precisely, to deprive Canada of the "money legally due".

Regarding the second complaint of the petitioners, the Court established that they could be convicted under the wire fraud statute since their conduct could be considered "defraud by representations … and, therefore, a scheme or artifice to defraud Canada of taxes due on the smuggled goods."[214] This is interesting because the petitioners were trying to convince the Court that there were treaties or even statutes better suited to the facts of the case; and, therefore, that the application of the wire fraud statute was, at least, wrong. The Court, in the leading vote of Justice Thomas, established with no hesitation that

> Unlike the treaties and the antismuggling statute, the wire fraud statute punishes fraudulent use of domestic wires, whether or not such conduct constitutes smuggling, occurs aboard a vessel, or evades foreign taxes.[215]

Interestingly, the Court considered that from the moment the petitioners executed the scheme within the United States, the offence was completed, and that the ruling in *Pasquantino* did not give an extraterritorial effect to the wire fraud statute. This is not the same as saying that the fraud committed had no extraterritorial effects since the Court recognized the right of the Canadian government to collect taxes, which was affected by

213 *Ibid*, at 4.

214 *Ibid*, at 6.

215 *Ibid*, at 7.

the conduct completed in the US. The Court acknowledged that the wire fraud statute punishes the execution of a scheme and not its success; therefore, the conduct punished under the US legislation was deemed completed. The Court recognized that the ruling in *Pasquantino* in a certain manner enforced the tax revenue laws of Canada, but this enforcement was indirect since the Court was only punishing a crime committed within the territory of the US. The Court made a curious acknowledgment in their ruling when they stated that,

> It may seem an odd use of the Federal Government´s resources to prosecute a US citizen for smuggling cheap liquor into Canada. But the broad language of the wire fraud statute authorizes it to do so and no canon of statutory construction permits us to read the statute more narrowly.[216]

Even though *Pasquantino* was meant to be the starting point for further prosecutions of criminal fraud connected in some way with the US but affecting the revenue of other countries, there were not many follow-ups. At least, there were not as many as expected. It may be that the discussion regarding the effects of the doctrine of *Pasquantino* as a way to challenge indirectly the revenue rule is why there were not many more prosecutions following the guidelines set.

For instance, the United States Court of Appeal for the Second Circuit had the opportunity to decide a case with a different factual background but one which still allowed the comparison since it was based on what was decided in *Pasquantino*. This case was *United States v. Bengis*[217] and concerned a restitution award in favour of the Republic of South Africa after a guilty plea in a case of illegal harvesting in South African waters of lobsters that were later exported to the United States. Fundamentally, the discussion in *United States v. Bengis* was about the legal categorization of the lobsters, namely, whether they were "property" of the Republic of South Africa, and whether the guilty plea, if such were

216 *Ibid*, at 21.

217 *United States v Arnold Maurice Bengis*, 631 F.3d 33.

the case, would allow a restitution award to South Africa. The Court established that:

> Like the defendants in Pasquantino, Arnold Bengis, Jeffrey Noll, and David Bengis' conspiracy to conceal their illegal trade in lobster deprived South Africa of money it was due. Had the defendants not undertaken efforts to conceal their overharvesting, including off-loading overharvested lobsters at night and under-reporting the amounts of their catch to South African authorities, those lobsters caught in excess of the legal limits would have been seized and sold by the government. As a consequence, the defendants' conduct deprived South Africa of proceeds from the sale of the illegally harvested lobsters, i.e., "money to which it was entitled by law." Id. Just as in Pasquantino, "had [defendants] complied with [their] legal obligation, they would have paid money to [South Africa]." Like Canada's entitlement to its uncollected excise tax revenue in Pasquantino, South Africa's entitlement to the revenue from the lobsters that were taken illegally does constitute "property." The defendants' conduct in depriving South Africa of that revenue is, therefore, an offense against property.[218]

The equalization of property and the South African lobsters can be extended to tax collection, and to the right on the part of other states to collect revenue. The Supreme Court of the United States in *Pasquantino* carefully established that the case was about the enforcement of domestic law, and not about the revenue rule. However, the legal interpretation of the facts either in *Pasquantino*, or in *Bengis* would help other states to accomplish their collection of revenue.

What *Pasquantino* or *Bengis* maintains, at the end of the day, is that conducts that fall under domestic criminal law, but which affect foreign states can be prosecuted and convicted under the domestic law of the country where they take place. This scenario is not minor since it opens the door for the indirect cooperation of states that prosecute certain crimes even when they affect other states.

The United States Court of Appeals in *Bengis* established also that the Republic of South Africa, following the reasoning in regard to the conceptualization of "property" mentioned above, could be considered a "victim", that is, the person harmed by the crime. This is again an

218 *Ibid*.

important statement since, with *Pasquantino*, *Bengis* reinforces the idea that the right to the tax collection is assimilated to property for those states whose taxes have been evaded, and that there is no limitation on prosecuting such rights of foreign states affected by conduct subject to domestic criminal law.

The liquor in *Pasquantino* and the lobsters in *Bengis* are only two examples of how trade can lead to criminal activity which may well affect a state´s property. Thus, establishing a link or connection between trade mispricing and tax fraud, the guidelines set by the Supreme Court of the US would be applicable to mispricing schemes. In particular, this applies to the considerations of the Court regarding the conceptualization of the collection of taxes as property, in the hands of the state, which could be affected by mispriced transactions. The path that *Pasquantino* offers is not complicated. States should enforce their own domestic criminal law, even when the effects of the criminal conduct affect foreign countries. Achieving this goal would eventually help to the mutual cooperation of states in the prosecution of crimes with transnational effects. Any state should be interested in prosecuting criminal conduct that affects the tax collection of its neighbours, as in *Pasquantino*, because doing so would probably be mirrored by other states in the future.

The low levels of detection and the evident carelessness of countries about crimes that affect foreign countries have so far sent an unclear message to the businessmen who were sure that would never be subject to the justice systems of Zambia, Argentina or Zimbabwe. However, if such businessmen acknowledge that the criminal justice of their own country might be interested in prosecution schemes that affect the countries from or with which they build business relations, their conduct might change.

Conclusion

This thesis has aimed to explore a business practice—trade mispricing—that is a concrete and sometimes complicated phenomenon occurring in the real world, and that has so far been ignored by legal academia, though it has been evaluated by some economists (Baker, Freitas, de Boyrie, Pak, Zdanowicz, Buenh and Eichler, among other). The standpoint from which this exploration started was that such a phenomenon could be of harm to the public good; that, eventually, it might undermine the economic development of the affected countries; and that, therefore, there was a need to examine the phenomenon of trade mispricing and to assess its legal implications.

The methodology of this thesis follows the legal realism approach, as Macaulay conceives it, for many reasons, but essentially because this thesis is based on a social phenomenon, on a fact; trade mispricing is occurring in the real world of business, but in "the shadow of the law". Thus, the idea of building theory from the given facts or hypothetical scenarios challenges the formalities sometimes required to select certain facts as objects of study. The key, however, is that this thesis confirms that something is happening and that there is a need to assess how the law operates in regard to what is happening. The social and economic contexts in which trade mispricing operates become relevant in order to assess this phenomenon under this approach.

The review of what has been said so far in regard to trade mispricing in this thesis ratifies the need for more and better research on the conceptualization and legal consequences of trade mispricing. This thesis reveals that most of the definitions discussed regarding trade mispricing are incomplete (McSkimming), or that they only partially comprehend the phenomenon (Hollingshead). The evaluation that economists (Freitas, Hollingshead, Buehn and Eichler, de Boyrie, Pak and Zdanowicz, Baker) give to the phenomenon lacks the legal perspective

and tends to demonstrate that what is empirically proven (the trade mispricing phenomenon, e.g. the China-Norway mutual exchange) will not be solved or reduced unless it is properly addressed by legal scholars. This is so since the appropriate way to approach the issue of trade mispricing will follow from the full comprehension of what this phenomenon involves, not the other way around.

As a result of the demonstration of the plausibility of trade mispricing, basic principles that are universally accepted, such as the economic advantages of increasing cross-border exchange from any country, were challenged because of the effects of carrying out transactions that do not reveal their real terms. This means that there are multiple and diverse effects tied to trade mispricing, which could be correctly assessed once the understanding of the phenomenon is deepened and awareness of it created.

The thesis has scrutinized the concepts of state, taxes, and duties following the connections that Christians, da Vita, Murphy and Nagel have established among them. It has also maintained the understanding that Orce and Trovato give to the duty to support the state economically, and it has supported Nozick´s counterarguments against the state and the compulsory tax collection system. To do so, this thesis has drawn a line between Nozick´s claim for autonomy or free choice versus the need to support the state in order to ensure everybody´s rights. Finally, the thesis discusses indirectly the egalitarian or distributive tax purpose that may also be affected by trade mispricing.

The empirical issue affecting the collecting of the kind of information that generally remains secretive was solved in this thesis through the assessment of hypothetical examples that reveal scenarios in which trade mispriced operations might have operated or could possibly operate. These examples show through factual and hypothetical scenarios that trade mispricing is a plausible phenomenon.

The assessment of the harm caused by trade mispricing follows Orce and Trovato's understanding of the reduction of property, and the definitions related to property and harm given by the United States Supreme Court in *Pasquantino*. Both tend to confirm that the entitlement of collecting taxes can be assimilated to property in the hands of the state. In this way, this thesis tends to confirm that the related taxes affected by trade mispricing practices can affect the state´s property and therefore fulfil the conditions of fraud under each state's definition of the crime.

The essential distinction between tax avoidance and tax evasion in this thesis follows Orce and Trovato, and this interpretation leads one to think that the discrepancy in price, the false statement, confirms that mispricing transactions exceed what is legally permitted, and that they could be, eventually, criminally punished. Orce and Trovato's understanding of the information duty clarifies any possible doubt regarding the behaviour expected from the citizens of the state.

Finally, the assessment of Gary Becker´s economic theory of criminal law helps to define possible lines of thought to approach trade mispricing in order to reduce it. The dichotomy between detection and size of punishment is not new; however, in the field of trade mispricing and the lack of information involved with it, increasing the levels of detection seems to be a possible approach. The decision in *Pasquantino*, apart from defining many components of trade mispricing that suit perfectly well with criminal fraud in the US, tend to confirm that detection and enforcing domestic law, even in crimes with transnational elements, seems to be the best approach to reduce this practice.

Something is going on in the way business is done nowadays, and what is going on deserves the attention of legal academia for the many reasons given throughout this thesis. However, it cannot be neglected that trade mispricing concerns tax collection, the enforcement of the criminal law, and the economic development the state. This thesis should therefore be considered as an invitation to devote more attention to the analysis of

trade mispricing and to the assessment of how “law works” in regard to a phenomenon that takes place in law’s shadow.