Follow the Money: Uncovering the Tax Side of Illicit Trade

Center Forward Basics

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Overview

Tax avoidance and evasion sit at the intersection of legality and illegality, shaping how individuals, corporations, and governments interact with the global economy. While tax avoidance uses legal mechanisms to minimize liability, tax evasion crosses into criminal behavior that conceals income and erodes public revenue. The blurred line between these practices makes them difficult to regulate and central to the growth of illicit trade. By exploiting loopholes, inconsistent tax regimes, and weak enforcement, bad actors can move legitimate goods through illegitimate channels, undermining fair competition and depriving governments of billions in tax revenue. This Basic explores how tax avoidance and evasion intersect with illicit trade, the economic and regulatory consequences of these practices, and the coordinated public-private efforts aimed at closing enforcement gaps and improving transparency.

What is Tax Avoidance and Evasion?

Corporations and individuals engage in **tax avoidance** by claiming deductions, credits, and adjustments to their taxable income. The tax code gives filers ways to minimize their tax bills. Tax shelters, as the term suggests, shelter assets to decrease taxable income. Examples of legal tax shelters include retirement accounts, foreign investments, municipal bonds, mutual funds, and real estate.

Tax arbitrage, a form of tax avoidance, is the practice of utilizing legal loopholes to minimize the tax burden on income, capital gains, and transactions. Corporations and individuals can profit from spreading their transactions across tax systems, treatments, and rates. This practice is legal, stemming from a complex system of tax codes that spans states and the globe.

In contrast, **tax evasion** is the illegal practice of failing to report taxable income accurately and honestly. When done deliberately, individuals or corporations might hide income, offshore income in noncompliant jurisdictions, falsify tax records, or inflate expenses. Hidden income might include revenue from illicit activities, such as gambling or selling stolen goods.

The line between illegal tax evasion and legal tax avoidance is thin, so legitimate companies take care to maintain compliance even when engaging in tax arbitrage. Illicit actors, however, do not take these precautions.

Two forms of tax avoidance exist in the context of illicit trade. Customers can

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Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org

Key Definitions:

- **Tax avoidance:** An action taken to lessen tax liability and maximize after-tax income
- **Tax arbitrage**: The practice of profiting from differences that arise from the ways various types of income, capital gains, and transactions are taxed.
- **Tax evasion:** The failure to pay or a deliberate underpayment of taxes

legally purchase goods from lower-tax jurisdictions to avoid higher taxes elsewhere, or bad actors can establish an illegal market, selling goods with little to no tax. For example, a smuggler might buy cigarettes in a lower-tax state, such as Virginia, to then sell them in a higher-tax state, such as New York.

The **International Monetary Fund (IMF)** considers tax evasion an illicit financial flow due to its illegal nature. Other illicit financial flows include corruption and smuggling—illegal in the money's source—and terrorist financing—illegal in the money's use.

Tax avoidance and evasion are closely tied to illicit trade, as they distort legitimate markets and enable criminal networks. Bad actors exploit differences in tax regimes and weak enforcement to avoid paying taxes altogether or to profit from arbitrage opportunities.

For example, organized criminal groups frequently use tax-motivated smuggling to move tobacco, alcohol, or fuel across borders. These activities deprive governments of revenue while undercutting legitimate businesses that comply with tax laws. In some cases, legitimate goods are used as a means to facilitate broader illicit trade schemes, such as money laundering or the concealment of counterfeit products.

Illicit trade thrives in environments where tax systems are inconsistent or overly complex. Disparities between jurisdictions create incentives for tax arbitrage, while weak oversight allows tax evasion to go undetected. As a result, tax evasion acts as both a driver and a byproduct of illicit trade.

- **International Monetary Fund (IMF)**: A global organization that works to achieve sustainable growth and prosperity for all of its 191 member countries by supporting economic policies that promote financial stability and monetary cooperation
- **Organization for Economic Cooperation and Development (OECD)**: a unique forum where the governments of 37 democracies with market-based economies collaborate to develop policy standards to promote sustainable economic growth
- **Track-and-trace systems**: a system for monitoring in real time the movement of products throughout all stages of the supply chain, from production or import sites to retail outlets, and for identifying where illicit activity has occurred

The consequences of tax avoidance and evasion are significant for both the public and private sectors. For governments, lost tax revenue translates into fewer resources for infrastructure, social programs, and law enforcement. In lower-income countries, these losses represent a substantial share of potential public spending, further exacerbating inequality and limiting development. For businesses, illicit tax activities distort competition. Law-abiding companies face higher relative costs, while illicit traders can undercut market prices by avoiding taxes. This creates an uneven playing field, discourages compliance, and erodes trust in regulatory systems. In sectors such as tobacco, alcohol, and fuel, where taxes comprise a significant portion of the retail price, tax evasion directly undermines legitimate markets. Multinational firms now face growing pressure from consumers, investors, and governments to disclose tax practices and align with global transparency standards.

Uniqueness of Illicit Tax Activities

Unlike other illicit activities, such as counterfeiting or smuggling, illicit tax activity can involve avoiding taxes on legitimate products or income. A legal good, such as tobacco or fuel, can enter an illicit market simply through misdeclared value, fraudulent invoicing, or sale in a jurisdiction intended to avoid taxes.

This blurring of lines between legal and illegal behavior makes enforcement particularly challenging. Tax arbitrage often operates in gray areas of law, exploiting differences between national tax codes without necessarily breaking them. As a result, combating illicit trade tied to taxation requires coordinated policy across borders and sectors.

Public-Private Response

Governments and international organizations are increasingly aware of the intersection between tax evasion and illicit trade. The IMF supports several global initiatives that promote transparency, enforcement, and cooperation among tax authorities.

The Financial Action Task Force (FATF) leads international efforts to combat money laundering and terrorist financing, both of which often overlap with illicit tax flows. The Global Forum on Transparency and Exchange of Information for Tax Purposes promotes the exchange of tax information between jurisdictions, enabling authorities to detect and deter tax evasion schemes more effectively. The **Organization for Economic Cooperation and Development (OECD)** Inclusive Framework on Base Erosion and Profit Shifting (BEPS), which includes more than 145 member countries, works to close gaps in international tax rules that enable companies to shift profits and avoid taxes across borders. In sectors particularly vulnerable to corruption and tax evasion, such as natural resources, the Extractive Industries Transparency Initiative (EITI) improves accountability by requiring companies and governments to disclose key financial information.

Many governments have also implemented domestic measures to strengthen enforcement and improve oversight. These include the creation of beneficial ownership registries, which help identify the actual owners of corporations and assets, and the automatic exchange of financial information among national tax authorities. Governments have further increased penalties for tax evasion, expanded digital reporting requirements, and invested in advanced customs and border technologies to detect smuggling related to tax avoidance and illicit trade. Collectively, these measures are designed to close the gaps that allow illicit financial flows to operate undetected.

In addition to governmental actions, private companies play a critical role in advancing tax transparency and compliance. Many multinational corporations recognize that ethical tax conduct is essential to long-term sustainability and public trust. By disclosing their tax practices and payments across jurisdictions, companies can demonstrate their commitment to integrity while reducing exposure to legal and reputational risks.

Industries that are particularly vulnerable to illicit trade, such as tobacco, alcohol, and pharmaceuticals, have also taken proactive steps to support enforcement efforts. These companies frequently collaborate with governments and international organizations to strengthen supply chain integrity through tools such as **track-and-trace systems**, which monitor product movement from manufacturers to points of sale. Public-private partnerships have also been established to share data, identify high-risk transactions, and assist law enforcement in detecting tax evasion schemes.

Financial institutions have also become increasingly important partners in this effort. Banks and investment firms are improving their compliance and due diligence systems to identify suspicious financial activity associated with tax evasion and illicit trade. By adhering to global anti-money laundering standards and enhancing internal transparency, the private sector complements governmental initiatives aimed at disrupting illicit financial networks.

Together, these public and private efforts are creating a more unified approach to addressing tax evasion and avoidance within the broader fight against illicit trade. International cooperation, coupled with shared accountability between sectors, remains essential to ensuring a fair, transparent, and resilient global tax system.

Tax avoidance and evasion occupy a complex intersection between legality and illegality. While avoidance can be a lawful response to the tax code, its misuse—and outright evasion—undermines government revenue, distorts fair competition, and fuels illicit trade. Addressing these challenges requires coordinated public-private action: transparent reporting, cross-border information sharing, and harmonization of tax rules.

Only through consistent global cooperation can policymakers and businesses reduce the incentives that allow illicit financial flows to thrive under the guise of legitimate commerce.

Links to Other Resources

- Campaign for Tobacco-Free Kids – Track and Trace Systems to Address the Illicit Trade of Tobacco Products: Best Practices & Country Experiences
- Internal Revenue Service – The Difference Between Tax Avoidance and Tax Evasion
- International Monetary Fund – The IMF and the Fight Against Illicit Financial Flows
- Investopedia – Tax Arbitrage
- OECD – Base erosion and profit shifting (BEPS)
- Tax Foundation – Taxes and Illicit Trade