

# Tax evasion and money laundering: a complete framework

Tax evasion  
and money  
laundering

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## Abstract

**Purpose** – This paper aims to define the fundamental nexus between income tax evasion and money laundering. The G7 Financial Action Task Force (FATF) designates tax evasion as a predicate offense for money laundering. We determine whether this designation is complete from a conceptual standpoint, or whether there is a stronger connection between tax evasion and money laundering.

**Design/methodology/approach** – This paper applies the FATF definition for money laundering – as well as generally accepted definitions for tax evasion and for a standard predicate offense – to identify the necessary conditions for each crime. This paper then uses these conditions to test opposing hypotheses regarding the nexus between tax evasion and money laundering.

**Findings** – This paper demonstrates that tax evasion does not meet the conditions for a standard predicate offense, and treating it as if it were a standard predicate could be problematic in practice. Instead, it is concluded that the FATF's predicate label for tax evasion, together with tax evasion methods and objectives, imply that all tax evasion constitutes money laundering. In a single process, tax evasion generates both criminal tax savings and launders those criminal proceeds by concealing or disguising their unlawful origin.

**Practical implications** – The FATF could strengthen its framework by explicitly defining all tax evasion as money laundering. This would enable regulatory agencies to draw upon the full combined resources dedicated to either offense.

**Originality/value** – The analysis demonstrates that tax evasion completely incorporates money laundering as currently defined by the FATF.

**Keywords** Taxation, Money laundering, Tax evasion

**Paper type** Conceptual paper

## 1. Introduction

Income tax evasion and money laundering are both widespread and costly. Feige and Cebula (2011) estimate that tax evasion costs the US Treasury approximately US\$500bn in lost revenue per year. Murphy (2012) and Schneider *et al.* (2015) estimate the cost approaches US\$1tn per year in the European Union alone. This lost tax revenue strangles services, swells budget deficits, places an unfair burden on honest taxpayers and hurts the general welfare by distorting economic competition. In regard to money laundering, the United Nations Office on Drugs and Crime (2011) estimates that approximately US\$1.6tn in criminal gains were laundered in 2009, equal to 2.7% of global gross domestic product (GDP). These illicit funds distort resource allocation by crowding out licit sectors, while successful money laundering foments more criminal enterprise.



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Policymakers have long recognized that an overlap exists between tax evasion and money laundering. Both crimes are often concurrently committed and both crimes often rely upon similar techniques. Corporate shell companies and fraudulent business records/accounting journal entries are often the tools of both offenses. Further, both tax evasion and money laundering commonly use opaque offshore tax havens where offenders hide assets, estimated at 10% of global GDP (Alstadsaeter *et al.*, 2018). Given the interrelated nature of tax evasion and money laundering, prosecutors in many nations frequently initiate legal action by levying both charges (as well as fraud) for a single offense. To some degree, this array of charges reflects the ill-defined judicial boundaries between tax evasion and money laundering, which is at least partly because of an uncertain understanding of the fundamental nexus between the two crimes.

A disconnect between tax evasion and money laundering policy was recognized by the international community as early as 1998. At that time, G7 finance ministers noted that anti-money laundering systems could be effective in thwarting tax evasion. The G7 called for better international collaboration, urging governments to use an integrated approach to tackle both crimes. In 2012, the Financial Action Task Force on Money Laundering (FATF) took a concrete step by adding tax evasion to their official index of offenses “predicate” to money laundering. The revision was notable for placing tax evasion in the same tier as arms trafficking, drug trafficking, sex exploitation and other serious offenses whose proceeds are commonly laundered by criminals. The FATF’s aim was clear: designating tax evasion as a predicate offense for money laundering increases the number of tools regulators can use to combat tax crimes.

Despite the advantages, the FATF’s recommended predicate-offense approach has not been universally adopted. For example, US code does not consider tax evasion a “specified unlawful activity” intrinsic to money laundering (FATF, 2016, p. 68). As summarized by Maugeri (2018), many other observers have expressed concern regarding the treatment of tax evasion as a predicate crime. These concerns are largely unique to tax evasion; other predicate crimes recommended by the FATF have not faced such skepticism. Given the potential uniqueness of tax evasion, the question becomes whether it is reasonable to view tax evasion as a standard predicate for money laundering, or whether the predicate label alone mischaracterizes the complete nexus of tax evasion and money laundering.

To address this question, we examine two distinct hypotheses which could define the fundamental nexus between tax evasion and money laundering. The first hypothesis posits that tax evasion is indeed a standard predicate offense for money laundering, as suggested by the FATF’s recommended treatment of tax evasion. The second hypothesis posits that the actual link between tax evasion and money laundering goes deeper than a simple predicate relationship; namely, that all tax evasion is itself necessarily a form of money laundering.

To examine these hypotheses, we begin by using the FATF definition for money laundering and by using generally accepted definitions for tax evasion and for a standard predicate offense to identify the necessary conditions for each crime. Conceptually, we then assess each hypothesis. This conceptual approach is unique. Legal analyses typically focus on realism, judging statutory schemes according to their impact on criminal behavior and judicial administration. However, our objective is more fundamental. We aim to clearly define the nexus between tax evasion and money laundering within the FATF framework to help identify an internally consistent foundation for effective statutes.

As discussed later, the statutory definition of tax evasion is at least somewhat uniform across nations. The statutory definition of money laundering varies; some jurisdictions use a broader definition of money laundering than others. But as stated, our aim is to assess the

nexus of tax evasion and money laundering within the FATF framework. Therefore, we accept the core definition of money laundering adopted by the FATF, which states that money laundering is the act of processing criminal proceeds from a predicate crime to disguise their illegal origin (FATF Definitions). This core definition emphasizes conditions that are common to the statutes of virtually all jurisdictions; namely, there must be a criminal offense that produces unlawful proceeds, and there must be an effort to process the proceeds by concealing or disguising the proceeds' unlawful origin.

In regard to our first hypothesis, we conclude that tax evasion does not meet a key necessary condition to be considered a standard predicate offense for money laundering. Specifically, tax evasion does not require a distinct, subsequent money laundering process in every case. All other offenses predicate to money laundering require this process; therefore, the tax evasion predicate is in fact unique. Our second hypothesis, we conclude, is correct: tax evasion does not simply accompany money laundering, but when focusing on the FATF's definition of money laundering, tax evasion itself is a form of money laundering. In a single process, tax evasion both:

- produces criminal tax savings; and
- launders those criminal proceeds by concealing or disguising their unlawful origin.

As demonstrated in this analysis, this is true for all forms of tax evasion.

After completing the definitional necessary-condition analysis, we use economic models to help define the nexus between tax evasion and money laundering. Specifically, we reconcile the standard economic model for money laundering (Ferwerda, 2009) to the classic model for income tax evasion (Allingham and Sandmo, 1972). This reconciliation, accompanied by a supporting proof, provides additional rigor to our analysis and confirms the primary conclusion that all tax evasion meets the FATF definition of money laundering. The reconciliation also clarifies precisely how money laundering fits into the extensive tax-evasion literature.

We recognize that treating all tax evasion as *de facto* money laundering may not be compatible with existing statutes, particularly in jurisdictions such as the USA that use a narrower definition of money laundering than the FATF uses. Notwithstanding, statutes in many other jurisdictions may already be broad enough to prosecute all tax evasion as money laundering, such as in the European Union. Either way, we are unaware of any jurisdiction with a statute that explicitly declares that all tax evasion constitutes money laundering. Our analysis provides analytical support for such a statute, which could sharpen legislation, streamline prosecution and more effectively merge tax evasion and money laundering enforcement efforts. Indeed, regulators could draw on the full force of money laundering statutes and enforcement systems to address tax evasion. At a minimum, our analysis suggests that the FATF should clarify the link between tax evasion and money laundering. The FATF's current recommended predicate designation for tax evasion is incomplete, which could help explain the reluctance of some jurisdictions to adopt it.

## 2. Definitions and necessary conditions

This section defines the terms *tax evasion*, *money laundering* and *standard predicate offense*, and it identifies the necessary conditions for each offense.

### 2.1 Tax evasion

Tax evasion is the act of using unlawful means to avoid paying taxes (Legal Information Institute; Slemrod and Yitzhaki, 2002, p. 1428). Tax evasion is often defined in contrast to

tax avoidance. Per the US [Internal Revenue Service Manual \(2014\)](#) (25.1.1.2.4, 01-23-2014): “Avoidance of tax is not a criminal offense. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and preplans events to reduce or eliminate tax liability within the parameters of the law.” By contrast, “evasion involves some affirmative act to evade or defeat a tax, or payment of tax. Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are.” Thus, tax avoidance is based on lawful use of strategies and statutes to reduce taxes, whereas tax evasion is based on unlawful concealment and false representation.

These tax evasion definitions highlight two necessary conditions for tax evasion. First, there must be a deliberate underpayment of taxes. Second, there must be a false representation of taxable income. If there is no underpayment of taxes, tax evasion has not occurred. If there is no false representation of taxable income (at a minimum, on a tax return itself), tax evasion has not occurred. Letting  $\neg$  denote “not” and  $\Rightarrow$  denote “implies,” the two necessary conditions are:

Condition 1:  $\neg$  Deliberate Tax Underpayment  $\Rightarrow$   $\neg$  Tax evasion

Condition 2:  $\neg$  False Representation of Taxable Income  $\Rightarrow$   $\neg$  Tax evasion

Tax evasion techniques can be as simple as understating service revenue or overstating tax deductions, or they can be as complex as creating layered tax haven entities. Regardless of the specific method used, meeting both conditions is sufficient to establish tax evasion.

## 2.2 Money laundering

Per the FATF, money laundering is the act of processing criminal proceeds from a predicate crime to disguise their illegal origin (FATF Definitions). This broad definition is shared by virtually all nations. However, some nations impose additional conditions. The USA, for example, requires proof of a distinct transaction which is “designed in whole or in part to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of a specified unlawful activity,” where the specified unlawful activity is the predicate crime (18 U.S.C. §1956 (a)(1)(B)). The FATF, by contrast, simply refers to “processing” the criminal proceeds. There is no explicit requirement for a distinct transaction.

Consistent with the FATF, Article 3(1)(b) of European Directive 2018/1673 specifies that money laundering includes “the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, knowing that such property is derived from criminal activity.” This definition is broad enough to encompass any deliberate action taken to conceal or to disguise the unlawful origin of predicate proceeds, which is not limited to a distinct money laundering transaction.

Money laundering, like tax evasion, is accomplished in countless ways. Nevertheless, money laundering schemes often follow three basic steps: placement, layering and integration (US Comptroller of the Currency, 2002). First, the offender places unlawful funds into the lawful economy via deposit or other means. Second, the offender uses layers of secretive financial transactions to falsely represent the funds’ true origin. Third, the offender uses additional processing to reintegrate funds back into the lawful economy – e.g. by purchase of business assets – such that the “dirty” money appears clean. Although money laundering often includes these three steps, not all schemes necessarily reflect these stages and they are not always required to establish the offense (De Koker, 2019). The FATF places no restrictions on the form of actions taken to conceal or disguise the unlawful origin of predicate proceeds.

Although the precise definition of money laundering varies across nations, all definitions share two necessary conditions:

- (1) a predicate offense that produces unlawful proceeds; and
- (2) the concealment or disguise of the proceeds' unlawful origin.

That is:

Condition 1:  $\neg$  Serious Predicate Offense with Unlawful Proceeds  $\Rightarrow$   $\neg$  Money Laundering

Condition 2:  $\neg$  Conceal or Disguise the Nature of Unlawful Proceeds  $\Rightarrow$   $\neg$  Money Laundering

Of course, fulfilling conditions (1) and (2) is not sufficient to meet the definition of money laundering in all jurisdictions. However, it is sufficient to meet the European Union's definition in Directive 2018/1673. More importantly, it is sufficient to meet the FATF's definition of money laundering. The FATF has chosen to designate tax evasion as a predicate to money laundering, and as noted in the introduction, it is our aim to assess whether this designation is complete and internally consistent within the broader FATF context.

### 2.3 Standard predicate offense

The concept of a conventional or "standard" predicate offense for money laundering began to take shape in the late 1980s when the USA passed the Money Laundering Control Act of 1986. Under this Act, a money laundering conviction generally requires the commission of a specified serious unlawful activity (a predicate) followed by an intentional act meant to conceal or disguise the proceeds from the predicate activity. Similarly, Article 3 of the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances requires a serious predicate offense (drug trafficking) plus the concealment or disguise of the true nature of the resulting illicit funds. Thus, the US Act and the United Nations Convention both feature two necessary conditions that, taken together, form the original standard for a predicate offense. First, the offense must be a serious offense that produces unlawful proceeds. Second, the unlawful proceeds must require laundering by means of a distinct second step.

Condition 1:  $\neg$  Serious Offense with Unlawful Proceeds  $\Rightarrow$   $\neg$  Standard Predicate

Condition 2:  $\neg$  Distinct Laundering Required  $\Rightarrow$   $\neg$  Standard Predicate

Meeting both necessary conditions is sufficient to confirm a standard predicate offense.

For decades the FATF adhered to these two conditions when designating predicate offenses. Both conditions have played an important role in enforcement and prosecution. The serious crime condition ensures that complex money laundering charges do not attach to innumerable petty crimes. The need-for-distinct-laundering condition creates a process whereby two separate crimes incur two separate penalties: one penalty for the predicate serious crime, and one penalty for the distinct money laundering. Isolating the predicate offense from the laundering activity avoids double jeopardy: the fundamental *ne bis in idem* prohibition against imposing two separate punishments for the same offense. Double jeopardy could also violate the principle of proportionality, whereby a penalty is required to "fit the crime."

### 3. Understanding the nexus

A coherent legal framework for tax evasion and money laundering requires a clear understanding of the nexus between the two crimes. This section addresses two possible hypotheses.

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### 3.1 *Standard predicate offense*

The first hypothesis – that tax evasion is a standard predicate offense for money laundering – is reflected in the FATF’s 40 Recommendations for law enforcement countermeasures against money laundering. In 2012, the FATF revised their Recommendations, adding tax evasion as the 21st designated predicate offense. This raises the question of whether this newly designated offense should be viewed as a standard (versus unique) predicate in criminal statutes. The FATF stated this change brings “the proceeds of tax crimes within the scope of the powers and authorities used to investigate money laundering” (FATF Media Narrative, 2012). To some degree, the change has met its objective. Despite the benefits, it does not follow that tax evasion is necessarily a standard predicate offense. To earn that label, tax evasion must (a) be a serious crime that produces unlawful proceeds, and (b) those unlawful proceeds must require laundering via a second distinct step.

In regard to the first condition, there is growing international consensus that tax evasion is a serious crime, although this view is not universal. Many jurisdictions do not view tax evasion in the same light as other crimes like drug trafficking or sex exploitation, and the perceived seriousness of tax evasion varies widely across nations. For example, [Alm and Torgler \(2006\)](#) find that tax morale (i.e. the average individual’s willingness to pay taxes) is almost twice as high in the USA, Switzerland and Austria as it is in Belgium, Portugal and Finland. Despite this variation in tax morale, the global financial crisis of 2008–2009 graphically proved the danger of tax evasion ([International Monetary Fund, 2015](#), p. 12). Today, there is substantial agreement among governments and regulators that tax evasion in significant amount is a major crime. Thus, we conclude that tax evasion meets the serious offense condition necessary for a standard predicate.

In regard to the second condition, however, we conclude that tax evasion does not necessarily require a distinct money-laundering process. To illustrate, it should be noted that the criminal proceeds from tax evasion are tax savings ([Maugeri, 2018](#), pp. 88–94). If tax evasion is to be deemed a standard predicate offense for money laundering, then it must also be necessary to disguise the origin of the unlawful tax savings afterward, in all cases.

In practice, disguising the origin of the tax savings in a distinct step is generally unnecessary. Tax evaders make false representations of income and tax liability during the evasion process itself. If the evasion is successful, unwitting tax authorities acquiesce, and illicit tax savings are produced and cleaned in a single step. At that point the offense is complete, and there is no need for required subsequent laundering of the proceeds. Of course, a tax audit notice after a filing date will often prompt the evader to backtrack and further obfuscate the income trail. But tax authorities view these efforts as a constituent of the evasion itself. Thus, unlike other predicate offenses, there is no clear marker to separate the end of tax evasion process and the beginning of a distinct money laundering step. Therefore, we conclude that tax evasion fails the second necessary condition for a standard predicate offense:

#### Tax Evasion ≠ Standard Predicate Offense

There is little doubt that tax evasion is a significant crime commensurate with the gravity of other standard predicate offenses. However, despite its harm, simply designating tax evasion as a predicate for money laundering as the FATF has done is problematic because tax evasion is not a prerequisite for any subsequent offense. In this light, the reluctance of some jurisdictions (including the USA) to adopt the FATF recommendation is understandable.



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### 3.2 Tax evasion as a form of money laundering

Our second hypothesis is that all tax evasion constitutes money laundering [1]. We recognize the conventional assumption is that it does not. Unlike tax evasion, traditional money laundering requires a previous offense that generates unlawful gains. Therefore, observers such as Storm (2013) have concluded that “tax evasion does not necessarily constitute the act of money laundering.”

Although Storm’s view is common, equating tax evasion with money laundering is not without precedent. Since 1986, US criminal code has provided that any evasion of taxes on unlawful gains generated by a separate offense is to be treated as a form of money laundering (18 U.S.C. §1956(a)(1)(A)(ii)). This provision does not pertain to the evasion of taxes on lawful gains, but it is sufficient to raise the question of whether tax evasion satisfies the two-prong test for money laundering:

- (1) there must be a serious offense that produces unlawful proceeds; and
- (2) there must be a willful attempt to falsely represent the truth by concealing or disguising the unlawful origin of the proceeds.

In regard to the serious-offense condition, the FATF affirms that tax evasion is a serious predicate offense that generates unlawful proceeds; specifically, illicit tax savings. All tax evasion produces such unlawful proceeds, whether the evasion involves underreporting income or over-reporting deductible expenses. Thus, adopting the FATF recommendation satisfies the first condition of money laundering. As discussed in Section 3.1, tax evasion is not a standard predicate, but that does not bar tax evasion from playing a meaningful role as a nonstandard predicate in a broader framework that accommodates its unique character.

In regard to the false representation condition, tax evasion always involves some form of deliberate deceit. This false representation may include the intentional understatement or omission of income, claiming fictitious or improper deductions or falsely allocating income. Supporting activities typically include false accounting records, hidden transactions and/or transfers among entities.

The more effort that goes into these tax evasion techniques, the less likely the tax evasion will be detected (Kaplow, 1990). However, the mere act of underreporting taxable income on a tax return is sufficient to meet the false representation condition for money laundering. This minimal effort for tax evasion is similar to the minimal effort required for certain forms of traditional money laundering, such as simply using peer-to-peer transfers to avoid detection. The act of underreporting taxable income, regardless of the amount of effort that occurs behind the scenes, represents a deliberate effort to disguise the unlawful nature of the resulting tax savings so the taxpayer may use the tax savings cleanly, which is money laundering in action.

In addition to meeting both necessary conditions for money laundering, tax evaders commonly use the following three basic steps of money laundering:

- (1) placing unlawful proceeds in the financial system;
- (2) using layers of complex or secretive transactions to obscure the funds’ true origin; and
- (3) integrating the proceeds back into the lawful economy. Using these steps is not necessary to establish money laundering (De Koker, 2019), but it is instructive.

To illustrate, we first note that tax evasion produces illicit tax savings that are placed in the financial system. Illicit tax savings constitute unlawful gains and enrich the accounts of the tax evader: an individual or business entity who maintains financial assets within the lawful

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economy. Second, tax evaders commonly employ complex or secretive transactions to disguise the unlawful tax savings. Layered cash transfers, opaque tax havens and the use of multiple entities are common, but not always necessary, for successful tax evasion. Neither, however, are these techniques always necessary for successful money laundering. Finally, successful tax evasion automatically integrates unlawful tax savings back into the lawful economy. The unlawful tax savings take the form of cash and/or business assets which enrich the evader, who is free to use the proceeds without penalty once the tax authority acquiesces.

We thus conclude that tax evasion is, in fact, a form of money laundering, at least according to the FATF's rather broad definition of money laundering. Simply put: proving tax evasion proves money laundering, or:

Tax Evasion  $\Rightarrow$  Money Laundering

To provide additional context for this result, consider the undeclared taxable income associated with tax evasion. As Yaniv (1999) emphasizes, a tax evader must either launder or hide the undeclared income in order to protect the illicit tax savings from tax auditors. For tax evasion to constitute money laundering as we have concluded, it must be true that both laundering undeclared income and simply hiding undeclared income constitute money laundering.

Laundering undeclared taxable income is often accomplished by using fraudulent transactions and/or documents to mischaracterize the income as a tax-exempt gift, tax-exempt inheritance or other tax-exempt income (Yaniv, p. 28). This laundering process is central to the tax evasion process. It accomplishes two objectives. First, it disguises the proper tax status of the undeclared taxable income, such that the income can be used cleanly. Second, it disguises the illicit nature of the tax-savings proceeds, such that they too can be used cleanly. In regard to the first objective, if the undeclared taxable income is from a lawful source, disguising its tax status does not constitute traditional money laundering *per se*; the undeclared income itself does not represent unlawful predicate proceeds. However, under the FATF recommendation, tax savings acquired through evasion are themselves unlawful and are generated by means of a predicate crime. Therefore, in regard to the second objective, laundering the undeclared taxable income to camouflage the unlawful nature of the tax savings does constitute money laundering.

Using a tax haven or other means to simply hide undeclared taxable income is also central to the tax evasion process. Hiding the undeclared income disguises the illicit nature of the tax savings proceeds. As discussed above, this camouflaging technique constitutes money laundering and enables the evader to use the tax savings cleanly. Therefore, even if a tax evader simply hides the undeclared taxable income, disguising the true nature of the tax savings proceeds is sufficient to constitute money laundering.

Ultimately, successful tax evasion fulfills the same objective as money laundering: to integrate dirty money into the legitimate financial system. This remains true regardless of whether an offender evades taxes on dirty money generated by some other unlawful activity, or whether an offender evades taxes on proceeds generated by a lawful activity. We arrive at this conclusion by acknowledging that the unlawful tax savings are themselves dirty money, regardless of whether the taxable income is generated by lawful means or by an unlawful activity.

Our conclusion that tax evasion is a composite, one-step form of money laundering relies on the FATF's decision to designate tax evasion as a predicate offense, which enables tax evasion to meet the first necessary condition for money laundering. Regulators could find it easier to implement this approach in jurisdictions which currently follow the FATF recommendation. Even in such jurisdictions, however, equating tax evasion with money



laundering might require a changed approach. Statutes must reflect that both (a) the predicate offense; and (b) the associated deceptive activity can occur simultaneously in one set of actions.

Making modifications to squarely treat tax evasion as a composite, one-step form of money laundering could yield at least three practical benefits. First, it would allow jurisdictions to tailor laws to combat either tax evasion or money laundering (as currently defined) by the same means of prosecution. This approach would sidestep two concerns [Maugeri \(2018\)](#) raises regarding the FATF's current predicate treatment for tax evasion, which are (a) the disproportionality of sanctions; and (b) violation of the *ne bis in idem* principle, whereby double jeopardy must not attach for the same offense. Second, such treatment could spread collaboration between tax and money laundering authorities in a combined offensive against a single, more broadly defined crime. And, third, such treatment could dispel legal inconsistency and confusion by aligning a jurisdiction's statutory framework with a more rational understanding of the nexus that exists between tax evasion and money laundering.

#### 4. Economic models

To further clarify the nexus between tax evasion and money laundering, we reconcile the economic model for money laundering to the model for tax evasion, we examine the role for tax evasion efforts and costs and relate these efforts to money laundering, and we provide a short analytical proof. This reconciliation and proof provide additional confirmation that all tax evasion meets the FATF definition of money laundering. It also clarifies how money laundering ties into the extensive tax-evasion economic literature.

##### 4.1 Reconciliation

To begin, consider a potential money launderer deciding whether or not to commit a crime and launder the proceeds. If the individual's preferences are complete and transitive and otherwise consistent with expected utility, then [Ferwerda's \(2009\)](#) standard expected utility function can be used to model the preferences. The decision-maker's problem is to maximize expected utility by (a) committing a predicate crime and laundering the unlawful proceeds; or by (b) committing no crime:

$$E[U] = qU(y - f_o) + (1 - q)pzU(y - f_o - f_{ml} - tc) + (1 - q)p(1 - z)U(y - f_{ml} - tc) + (1 - q)(1 - p)U(y - tc). \quad (1)$$

where:

$y$  is the unlawful proceeds from a crime predicate to money laundering;

$f_o$  is the punishment for the predicate crime;

$q$  is the probability of being detected and punished for the predicate crime;

$tc$  is the cost/effort required to launder the unlawful proceeds;

$f_{ml}$  is the punishment for money laundering;

$p$  is the probability of being detected and punished for money laundering; and

$z$  is the conditional probability that if money laundering is detected and punished, the predicate crime will then also be detected and punished.

[Equation \(1\)](#) predicts the decision-maker will choose to commit the offense when  $E[U] > 0$ .

As discussed in Section 3, traditional money laundering anticipates a two-step process of a predicate offense followed by the actual laundering of the unlawful proceeds acquired

from the predicate offense. This two-step process is expressed by the four terms in [equation \(1\)](#). The first term, equal to  $qU(y - f_o)$ , accounts for the net utility of being detected and sanctioned for the predicate crime only. The second term, equal to  $(1 - q)pzU(y - f_o - f_{ml} - tc)$ , accounts for the net utility of being detected and sanctioned for both the money laundering and the predicate crimes. The third term, equal to  $(1 - q)p(1 - z)U(y - f_o - f_{ml} - tc)$ , accounts for net utility of being detected and sanctioned for money laundering only. The fourth term, equal to  $(1 - q)(1 - p)U(y - tc)$ , accounts for the net utility of avoiding detection altogether.

Although traditional money laundering typically involves two distinct steps – a predicate offense followed by the laundering process itself – money laundering does not by FATF definition require the predicate offense to be distinct from the laundering process. Effective criminal statutes could define a unique composite crime, as discussed in Section 3. Likewise, the money-laundering utility function in (1) can accommodate a single composite crime.

To illustrate, let  $z = 1$ ,  $q = 0$ , and  $f = f_o + f_{ml}$ . For a single composite crime,  $z = 1$ ; the detection and sanction of the predicate offense and the money laundering cannot be disentangled. Likewise, for a single composite crime,  $q = 0$ ; the predicate cannot be separately detected from the money laundering. Detecting evidence of tax evasion (money laundering) also detects evidence of money laundering (tax evasion). Finally,  $f = f_o + f_{ml}$ ; with effective legislation, there is one combined penalty for the single composite crime. Performing these substitutions yields:

$$E[U] = pU(y - f - tc) + (1 - p)U(y - tc) \quad (2)$$

where  $p$  represents the probability of being detected and punished for the single composite crime of a predicate plus money laundering.

In contrast to the four terms employed by [equation \(1\)](#), [equation \(2\)](#) uses only two terms. The first term in [equation \(2\)](#), equal to  $pU(y - tc - f)$ , describes the net utility of detection and of sanction for the composite crime. The second term, equal to  $(1 - p)U(y - tc)$ , reflects the net utility of avoiding both detection and sanction. The composite offense described by [equation \(2\)](#) is a special one-step form of the more general money laundering function in [equation \(1\)](#).

The variables in [equation \(2\)](#) are broad enough to account for a variety of predicate crimes, with different sources of unlawful proceeds ( $y$ ) and different penalties ( $f$ ). If tax evasion is the predicate, it is useful to let  $y = \theta(W - X)$ , where  $\theta$  is the tax rate faced by the decision maker,  $W$  is true taxable income and  $X$  is declared taxable income.  $y$  then represents the amount of unlawful tax savings produced from the undeclared taxable income. It also is useful to let  $f = \pi(W - X)$ , where  $\pi$  is the penalty rate the decision-maker must pay on undeclared income if detected, where this penalty rate ( $\pi$ ) accounts for the normal required tax rate ( $\theta$ ) plus any penalty, so  $\pi > \theta$ . This definition for  $f$  reflects the fact that jurisdictions typically impose monetary and even criminal penalties on tax evaders that increase in the amount of undeclared taxable income.

Making these substitutions yields:

$$E[U] = pU(\theta(W - X) - \pi(W - X - tc)) + (1 - p)U(\theta(W - X) - tc) \quad (3)$$

Framing the problem in this manner allows the decision-maker to choose a level of crime from a continuous set of options by choosing an amount of taxable income to declare ( $X$ ), which determines the amount of taxes to evade ( $\theta(W - X)$ ).

The final step required to reconcile [equation \(1\)](#) to tax-evasion models is to add an initial endowment that the decision-maker receives in any state. The natural choice for this initial endowment is  $W - \theta W$ , which is equal to the decision-maker's after-tax income when abiding by the law and paying taxes in full. Adding this quantity to both arguments of the utility function and simplifying yields:

$$E[U] = (1 - p)U(W - \theta X - tc) + pU(W - \theta X - \pi(W - X - tc)) \quad (4)$$

Maximizing  $E[U]$  as given by [equation \(4\)](#) is largely the same as maximizing total expected wealth by choosing  $X$ , the amount of taxable income to declare.

Tellingly, [equation \(4\)](#) is essentially equal to the tax evasion model proposed by Allingham and Sandmo (1972). We derived the specific tax-evasion function in (4) from the broad money-laundering function in (1), which illustrates that tax evasion can indeed be viewed as a special case of money laundering. The reconciliation of these two equations highlights three points. First, tax evasion is a composite, one-step form of money laundering. Second, the unlawful predicate proceeds from tax evasion are equal to  $\theta(W - X)$ , the tax savings from the evasion. Third, tax evaders and money launderers face the same general set of choices and incentives.

#### 4.2 Concealment costs and efforts

Although [equation \(4\)](#) is essentially equivalent to the model in Allingham and Sandmo (1972), there is one important difference. The early tax-evasion model in Allingham and Sandmo ignores  $tc$ , the cost of concealment.  $tc$  reflects the cost of efforts to disguise the underpayment of tax, which is central to the composite crime of tax evasion and money laundering. Therefore, the absence of  $tc$  is conspicuous.

By contrast, more recent tax-evasion models and experiments incorporate this cost. For example, Kaplow's tax-evasion model (1990) posits that taxpayer expenditures on concealment efforts reduce the likelihood that authorities will detect any tax evasion. In regard to [equation \(4\)](#), this indicates that  $p$  would decrease in  $tc$ . Similarly, [Cramer and Gahvari \(1994\)](#) posit that evaders can influence the probability of being caught, if audited, through expenditures on concealment. More recently, the experiment in [Bayer and Sutter \(2009\)](#) focuses directly on the tax-evasion concealment efforts and addresses the social welfare costs of these activities. If a nation adopts the FATF recommendation to treat tax evasion as a predicate offense, then the concealment costs and efforts reported in these studies fulfill condition (2) of money laundering (Section 2.2); they have the goal of disguising the unlawful nature of savings obtained from the predicate offense. Hence, the  $tc$  measure in [equation \(4\)](#) is the term that binds tax evasion to money laundering directly.

#### 4.3 Proof

To more directly demonstrate that tax evasion constitutes money laundering, consider the two necessary conditions for money laundering. The first condition is that there must be a serious predicate offense that produces unlawful proceeds. The second condition is that there must be an effort to conceal or disguise the unlawful nature of the proceeds. In terms of [equation \(4\)](#), these conditions can be expressed as follows:

Condition 1 (Unlawful Predicate Proceeds):  $\theta(W - X) > 0$

Condition 2 (Effort to Conceal or Disguise Unlawful Proceeds):  $tc > 0$

If all tax evasion meets both of these conditions, then tax evasion constitutes money laundering.

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To consider these conditions, first note that if an individual engages in tax evasion, then by the definition of tax evasion, there must be an underpayment of taxes. Hence, tax evasion ensures that  $\theta(W - X) > 0$ . This underpayment fulfills the requirement for the production of unlawful predicate proceeds, the first condition of money laundering.

To examine the second condition for money laundering that  $tc > 0$ , suppose by way of contradiction that  $tc = 0$ , meaning there is no effort to conceal or disguise true taxable income from authorities. In this contrary case,  $X = W$ , or reported taxable income equals true taxable income.  $X$  must equal  $W$  in this case because it is not possible to underreport taxable income without expending at least some effort to do so. As discussed in Section 3.2, this is true even if that effort is limited to the mere act of choosing which items to underreport on a tax return in a strategic manner. In this minimal-effort case,  $tc$  is small but positive, and even this small effort is meant to disguise the unlawful nature of the resulting tax savings. However, if  $tc = 0$  and therefore  $X = W$ , then  $\theta(W - X) = \theta(X - X) = 0$ , which contradicts the known underpayment of taxes. We therefore conclude that  $tc > 0$ . Successful tax evasion requires at least some effort, so  $tc$  must be positive, and the second condition of money laundering is satisfied.

Because both conditions for money laundering are satisfied, it follows that tax evasion always constitutes money laundering. By contrast, money laundering does not necessarily imply tax evasion because money launderers sometimes pay full taxes on unlawful predicate proceeds, in which case  $\theta(W - X) = 0$ ; there are no tax savings.

## 5. Conclusions and implications

In conclusion, the FATF's current broad definition for money laundering and its recommendation to treat tax evasion as a predicate offense implies an unstated conclusion, which is that all tax evasion is a composite, one-step form of money laundering. This presents the FATF with the opportunity to embrace this conclusion and openly recognize all tax evasion as a form of money laundering that both produces and cleans criminal proceeds. Of course, this position would be at odds with any existing legal systems that require two distinct steps of a predicate offense followed by a subsequent money-laundering transaction, so adopting it would require a shift in legal paradigms. Nevertheless, the current statutory links between tax evasion and money laundering are not wholly satisfying and have been controversial, partly because they do not account for the whole relationship. Therefore, taking steps to explicitly recognize tax evasion as money laundering could lead to a more coherent legal framework with more effective enforcement and prosecution, and it would enhance the internal consistency of the FATF definitions and recommendations. At a minimum, our analysis suggests the FATF could aid legislators and law enforcement officials by more precisely specifying the definitions of money laundering, tax evasion, and predicate offenses, clarifying the links among them.

### Note

1. It is well understood that the converse hypothesis that all money laundering is a form of tax evasion is not true because offenders often intentionally pay taxes on unlawful proceeds to help legitimize them (Schlenger, 2013, p. 131).

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