

THE EFFECTS OF INTERNATIONAL TRADE ON INTERNATIONAL MONEY LAUNDERING FROM THE PERSPECTIVES OF INTERNATIONAL LAW AND INTERNATIONAL TRADE IN TURKEY

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Abstract

Globalization has influences on economies of all countries. Not only the capital but commodities became very important part of global mobility. Many countries tried to cooperate and collaborate to adopt their own national law and principles for both capital mobility and commodity mobility. However, in international trade, there are observations about trade of either illegal goods or trading international but caused to international money laundering. This paper will analyse money laundering mechanism based on the trade of goods and services, commonly known as trade based money laundering. Specifically, Turkey will be the specific case.

Keywords: International money laundering , international trade, capital movement

Introduction

Money laundering is defined as the conversion of criminal incomes into assets that cannot be traced back to the underlying crimes. The number and scope of laws and regulations for overcoming money laundering have expanded dramatically within last decades.

Money laundering is conventionally divided into three phases: placement of funds derived from illegal activity layering of those funds by passing them through many institutions and jurisdictions to disguise their origin and integration of the funds into an economy where they appear to be legitimate. Although, the anti-money laundering regime has many objectives including the goals of reducing crime, preserving financial system integrity and controlling terrorism corruption and failed states.

In this paper, the money laundering activities through international trade will be analysed. The main focus will be on Turkish economy.

Trade based money laundering

Many criminals seek to disguise the origins of their criminally derived funds by engaging in money laundering to enable them to benefit from their criminals and avoid detection by the authorities. Organized criminals follow their benefits to money laundering to enhance their lifestyle and to the profits of their crimes to be reinvested in future criminal activities or in legitimate business operations.

Trade based money laundering (TBML) is to disguise proceeds of crime and to mask legitimately obtained funds that are directed towards terrorism and other criminal activity (Sullivan and Smith, 2013). TBML techniques vary from simple fraud such as the misrepresentation of prices, quantity or quality of goods on an invoice to complex networks of trade and financial transactions. While TBML schemes most commonly involve the

misinterpretation of price, quantity or the type of merchandise, trade in intangibles (such as information and services) is emerging as a significant new TBML frontier also known as service based money laundering. Trade based money laundering obscure the true origin of funds. TBML does not include transportation of cash and bearer negotiable instruments and the services provided by alternative remittance dealers. The growth in volume and value of world trade and the relative ease of disguising the true nature of the trade and the relative ease of disguising the true nature of the trade made attractive money launderer very attractive (Sullivan and Smith, 2013). Increased reporting and analysis of financial transactions as a result of anti-money laundering counter terrorism financing initiatives made trade more attractive as a vehicle for money laundering(Financial Action Task Force, FATF, 2006).

Trade based money laundering includes a variety of schemes that enable the cash to be separated from the crime early in the money laundering process. The most common methods of trade based money laundering in the USA was the Black Market Peso Exchange (BMPE) in which Colombian drug trafficker swap illicit dollars in the United States for clean pesos in Colombia. Other methods include manipulating trade documents to over or under pay imports and exports and using criminal proceeds to buy gems or precious metals.

Trade based money laundering schemes often allow criminals to distance themselves from the money laundering process, complicating law enforcement investigations. Immigration and Customs Enforcement (ICE) in the USA analysed outbound trade data and financial and payment data including forms mandated by the Currency Report, Report of International Transportation of Currency or Monetary Instruments, Report of Cash Payments over \$10,000 received in a trade or Business and the Suspicious Activity Report in an effort to spot the anomalies that would indicate trade based money laundering. The Drug Enforcement Administration investigates narcotics money laundering, regularly

Criminal Organization may resort to a number of alternatives to the BMPE for transferring value into or out of the country. Each of these methods based on the misuse of international trade documents. Among the most frequently encountered schemes are over and undervaluation, misclassification and double invoicing. Each of these schemes is a separate offense that may also be an element of the crime of money laundering

Two of the most common schemes on money laundering are over and under valuation. If the invoice overstates the true value of the related merchandise, it means the importers pay more for the merchandise than it is truly worth. This is considered as justification for the importer to move money offshore for the imported goods. An undervaluation scheme is the same thing in reverse. An importer receives merchandise that is worth more than declared in the invoice. When the importer sells the undervalued merchandise, he receives more than the value reflected in the official documentation. If the transferred value represents illicit proceeds, the result is money laundering. Business have attempted to over and under value trade goods in an effort to dodge government trade deficit, taxes or other fees based on the value of the merchandise sent or received.

Foreign Trade Zones application is another method for facilitate money laundering. Although, original it aims to promote manufacturing in the host country. When the manufacturers import parts and materials outside of a Foreign Trade Zone they pay import duties based on the value of the finished product rather than the value of the components parts. Manufacturers defer, reduce or even eliminated the Customs duties at foreign trade s zone. Total value of money laundering as in free trade zone in the USA was considered \$250 billion at 2006. Often criminal operations within Free Trade Zone involve some type of import export scheme. False documentation involves fabricated Bills of Lading and fictitious names and addresses are used to misrepresents imports and exports often with customers broker who is in collusion with the criminals, “brokering” the documents.

Transfer pricing as a means of shifting taxable income from the country in which it was earned to another country in order to minimize tax (Boyrie et al, 2005)

Precious commodities and metals can be used as alternative to cash to transfer value across borders. Like gold and other precious metals, diamonds are attractive to money launderers because they are easily concealed and transported and because they are mined in remote areas of the world and are virtually untraceable to their original source. Even when diamonds are transported openly, it is relatively easy to mislabel the quality value of a diamond for money laundering purposes. There is growing worldwide recognition of the need to scrutinize unusual trade patterns involving commodities. An example is “conflict diamonds” emerging from West African do not have resources of diamond countries and exported to Belgium (FATF :50) . The FATF report explains money laundering as follows:

Payments to vendor made in cash by unrelated third parties

Payments to vendor made via wire transfers from unrelated third parties

Payments to vendor made via checks, bank drafts or postal money orders from unrelated third parties

False reporting: such as commodity misclassification, commodity over-valuation or under-valuation

Carousel transactions: the repeated importation and exportation of the same high-value commodity

Commodities being traded do not match the business involved

Unusual shipping routes or trans-shipment points

Packaging inconsistent with commodity or shipping method (FATC, 2008)

Studies on trade based money laundering

Lall (1973) investigated over-invoicing by a small sample of Colombian pharmaceutical firms with foreign affiliates. The governmental restrictions on profit repatriation were important issue in international trade. Foreign exchange and capital controls in Colombia during the 1960s stimulated multinational firms to raise their intra-firm prices above the arm’s-length level as a means of transferring profits out of the country. Lall finds that related-party prices ranged 33 to 300 per cent higher than arm’s-length prices in local, regional and world markets during 1968 to 1970.

At 2001, Swenson studied the relationship between country corporate tax (and tariff) rates and transfer prices. Swenson (2001), using annual U.S. import data for five countries during the 1980s, analysed the response of average unit values across all (unobserved) transactions within country-product pairs to variations in U.S. import tariffs and foreign tax rates. She finds evidence that changes in prices are consistent with incentives based on taxes and tariffs but that the economic magnitudes are small.¹⁶

Clausing (2003) used data on import and export product prices collected by the Bureau of Labour Statistics (BLS) from 1997 to 1999 to investigate the effect of country corporate tax rates on related-party prices. The BLS data separately identify intra-firm and arm’s-length transactions. Clausing found out price responses in the expected directions, i.e., higher taxes abroad are associated with higher export prices and lower import prices for related-party transactions. She estimates suggest that a 1 per cent drop in taxes abroad reduces U.S. export prices between related parties by 0.9 to 1.8 percent.¹

Anti -money laundering legislation

The anti- money laundering effort by the United States began with the passage in 1970 of the Bank Secrecy Act, which was largely domestic in nature and covered only depository institutions. The 1970 Bank Secrecy as amended by the USA. Patriot Act forms the legal framework for governmental bodies to implement the country’s anti money laundering policies. Initially, US Money Laundering (AML) focused on organized crime groups in

particular, war on drug. After September 11, 2001, terrorist financing activities received more attention. This change in emphasis had several motivations, some well-intentioned and others more cynical- simply seizing on anxiety over national security to strengthen US AML that many specialists had been seeking for years.

The 2005 Money Laundering Threat Assessment is the first government wide analysis of money laundering in the United States. The report is the product of an interagency working group composed of experts from the spectrum of US Government. In the USA, comparing domestic and foreign import-export data to detect discrepancies in the Harmonized Tariff Schedule, country of origin, manufacturer, importer-exporter, ultimate consignee, broker, unit price, commodity activity by the time period, and port of import –export.

Analysing financial information collected to identify patterns of activity involving the importation –exportation of currency, deposits of currency in financial institutions, reports of suspicious financial activities and the identity of parties to these transactions. Examining domestic import data with an automated technique, such as Unit Price Analysis to compare the average unit price for a particular commodity and identify traders who are importing commodities at a substantially higher or lower price than the world market.

Comparing information such as the origin, description and value of the goods, particulars of the consignee and consignor and the route of shipment with intelligence information in existing databases to detect any irregularities, targets or risk indicators.

Using statistical analysis methods such as linear regression models, on trade data concerning individual non aggregated imports and exports.

Comparing export information with tax declarations to detect discrepancies.

Paying particular attention to trade transactions that display known flag indicators of TBML FT activity.

Cross comparing known typologies of risk with trade data, information on cross border monetary transfers associated with the payment of goods, intelligence tax and wealth information

After recognizing anomalies and discrepancies in trade and financial transactions are identified, appropriate follow up action could involve asking the trader for further explanation and supporting documents, auditing traders who have presented discrepancies to check the volume of their business regularity of their operations, the kind of goods exported and connections with organized crime or any other illicit activity, and or making the completed analysis available to the investigate authorities(Financial Action Task Force (FATF), 2006) In the European Union, the money laundering has been accepted an evident influence on the rise of organized crime in general and drug trafficking in particular, whereas there is more and more awareness that combating money laundering is one of the most effective means of opposing this form of criminal activity which constitutes a particular threat to Member States societies.

Whereas money laundering must be combated mainly by penal means and within the framework of international cooperation among judicial and law enforcement authorities as has been undertaken in the field of drugs by the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic, Substances adopted on December 1988 in Vienna and more generally in relation to all criminal activities by the Council of Europe Convention on laundering, tracing, seizure and confiscation of proceeds of crime, opened for signature on 8 November 1990 in Strasburg. The recommendation of the Council of Europe 27 June 1980 and to the declaration of principles adopted in December 1988 in Basle by the banking supervisory authorities of the Group of Ten

In the European Union Countries, the money laundering means the following conduct when committed intentionally: the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any

person who is involved in the commission of such activity to evade the legal consequences of his action.

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 or from an act of participation in such activity.

The acquisition, possession or use of property, knowing at the time of receipt that such property was derived from criminal activity or from act of participation in such activity.

In this Directive property defined as assets of every kind, whether corporeal, movable or immovable, tangible or intangible and legal documents or instruments evidencing title or interest in such assets.

Member States shall ensure that credit and financial institution require identification of their customers by means of supporting evidence when entering into business relations, particularly when opening a deposit account or savings accounts or when offering safe custody facilities.

The identification requirement shall also apply for transaction with customers other than those referred to in paragraph 1, involving a sum amounting ECU 15000, whether transaction is carried out single operation or in several operations which seem to be linked. Where the sum is not known at the time when the transaction is undertaken, the institution concerned shall proceed with identification as soon as it is appraised of the document.

Switzerland is an example of special case. Switzerland's banking institution could be recognized as facilitators of the movement and the repositories of capital from other countries. In 1998, Switzerland broadened the reach of its Code of Conduct on due diligence and the money laundering policy to include not only banks but the entire financial sector as well. This act had been put into effect by 1998 (Boyrie et al 2005)

Transfer pricing in the Middle East region has special importance in terms of money laundering through Multi-National Companies (MNC)s. In this region, the large numbers of Multi-National companies based on European and the USA and Canada operate. The Middle East region is at the initial stage of the transfer pricing lifecycle where transfer pricing and international tax regimes were being developed (Axelsen and Rossel, 2012: 4). Favourable taxing principles in the Middle East Region offer opportunity for multi-national companies. High domestic withholding tax rates compared to domestic rates of corporate taxation and lack of a treaty network within the Middle East region attract high levels of taxation at source and scrutiny under audit. If an MNC's operating companies are set up as full risk and therefore subject to various outbound transactions within the country of operation, all such transactions are subject to relatively high domestic withholding tax rates which in many instances will not be eligible for treaty relief. Tax Law allows the arm's length principle as stated by Article 9 of the OECD Model Tax Convention on Income and on Capital and thus general acceptance of many of their standard and global transfer pricing policies. The reality is that tax authority acceptance of the arm's length principle throughout the region is mixed and as a general rule form over substance tends to prevail. As such presence of a legal contract and documentation supporting the charges and illustrating that the legal contract and policy has been administered as intended are often more important than trying to explain the substance of a transactions. It can be challenging to explain that a limited risk distributor should earn an arm's length operating margin and cost of goods sold is valued accordingly in an effort to target such a margin as opposed to being able to tie the transaction back to a schedule of actual costs and profits earned by the seller of the goods. The legal contract alone, if interpreted by a tax authority as " reasonable and " arm's length agreement may suffice.

Money Laundering in Turkish Economy and Transfer Pricing

Turkey became the part of Vienna Convention on money laundering illegal drug traffic and Psychotrop at 1995. Although, the first initiatives started by membership to FATF

at 1991. However, Turkey did not sign the Strasbourg Convention on money laundering on criminal gains. These were just after first experience of Turkish economy on fraud in export by untrue export of furniture at 19175 (Hurriyet , 2012).

2007, the transfer pricing rules have been put into effect in Turkish economy by 2007.

The Article 13 of the Corporate Income Tax Law (CITL No.5520) under the title of “Disguised Profit Distribution through Transfer Pricing” states the arm’s length principles. The regulations under Article 13 follow the arm’s length principle, established by the Organisation for Economic Cooperation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines, 2013) and are applicable to all financial, economic and commercial transactions and employment relations between related parties. As follows: the term corporation covers: capital stock companies, cooperatives; public economic enterprises; economic enterprises of associations or foundations and joint ventures.

Related party definition of the Turkish Transfer Pricing regulations is very broad and it included direct or indirect involvement in the management or control in addition to the existence of shareholder- ownership relationship. In addition to transactions with foreign group companies, it also includes transactions with entities that are based in tax havens or in jurisdictions that are considered to be harmful tax regimes by the Turkish government. Within the framework, the concept of related party is broadly defined under Article 13 of CTIL No.5520

The concepts of ‘related party’ covers shareholders of the corporation, legal entities or individuals related to the corporation or its shareholders; legal entities or individuals related to the corporation or its shareholders. Legal entities or individuals which control the corporation directly in terms of management, supervision or capita; legal entities or individuals which are controlled by the corporation directly or indirectly in terms of management, supervision or capital.

The Transfer Pricing rules define certain methods for the determination of arm’s length transfer prices. The methods adopted are comprehensively explained by the OECD Guidelines are as follows: Comparable uncontrolled price method; Cost plus method, resale price method. In the case where these methods cannot be applied, the company may apply other methods: profit split method and transactional net margin method.

In the comparable uncontrolled price methods, if the internal comparable are sufficient to reach an arm’s length price, there is no need to find an external comparable. If there is no internal comparable, external comparable should be used after making a comparability analysis and the necessary adjustments.

In addition to the specific transfer pricing regulations, additional requirements or rule covering transfer pricing contained in other legislation include: Turkish tax procedural law article with regard to the determination of the market value of goods and Turkish value added tax law article stating if the tax base for goods and services is unknown, the market prices based on the nature of the transactions will be the tax base.

In recent years, the Turkish Ministry of Finance significantly increased its number of transfer pricing audits against companies with a particular emphasis on the pharmaceutical, automotive and fast moving consumer goods sector. In the course of these audits, the Ministry of Finance has focused on the following transfer pricing issues

Pricing of raw materials traded amongst related parties, with the government relying on industrial benchmarking studies that omit relevant risk and functions.

Continuous losses in previous years by companies that operate primarily through related companies abroad.

Management fees and indirect cost allocation.

Yearend adjustments.

would be considered some methods of money laundering (Price Water House Coopers Consulting, 2013)

WTO groups the measures against subsidies, all anti-dumping provisions to protect local producers as well as all protection and surveillance measures under the heading of “trade policy defence tools”. In this respect, Turkey started surveillance on imports starting from generally regardless of country of origin. However, considering the fact that domestic producers are faced with heightened competitive pressure from imports originating especially from China, the majority of the imported products subject to surveillance can be through of China origin.

Measures against subsidies, all anti-dumping provisions to protect local producer, as well as all protection and surveillance measures under the heading of “trade policy defence tools were grouped by World Trade Organization. Turkey only started surveillance on imports at 2004.

Decree on import surveillance issued by May 29, 2004 states the methods and principles of closely monitoring the developments in the imports of products in consideration (Decree with number, 2004). The decree on surveillance assigns a committee to examine import practice and its possible threats. Especially import from China is very important threat to Turkish economy. After surveillance is imposed to a particular product, a documentation system is put into practice. The surveillance form includes the number, place and date of importation, the nature, origin and commercial definition of the product, the name of the exporting/importing firm, quantity, value and price of the transaction. In order to fulfil the requirements to get this form, importers should provide some standard documents before the Ministry of Economy In their studies, Aktas and Aldan (2013) analysed the mismatch in international trade of Turkey through import surveillance. The main argument on their studies was the surveillance practice results in higher than real CIF values. According to their studies, the import surveillance has worsening impact on total import bill. One of the important reasons was cheap imports are recorded at higher prices than their actual worth. The other one was the fact that importers would like to avoid documentation work, importer pay different amount other than the amount stated in the invoice. This in turn would add a positive amount to net errors and omissions. Indeed, net errors and omissions, which fluctuated around zero in the period of 1992-2002, are positive straight since 2004, indicating systematic disturbance of which import surveillance practice might be one of the potential causes (Aktas and Aldan, 2013:8). Aktas and Aldan found out significant effect of import surveillance on import prices, that is, over invoicing of imports. The effect is clearer in the trade data with China. They suggest that, Turkish import figures could be inflated about 2 to 3 billion dollars as of 2011 and rising since total imports are increasing due to economic growth and the number of commodities under surveillance system.

In Turkey, Aktas and Aldan (2013) studied the net errors and omission in the analysis of the balance of payments in Turkey. They explained the data of 1995. In 1995, the Central Bank of Turkey explained the other income in balance of payments. 3.5 billion USD is construction and freight income, the other remaining is 0.5 billion TL income held in consulates, commission revenue; 2.4 billion USD was declared as income by the people who are resident in Turkey and exchanged their foreign exchange to TL. However, they assumed that 1.5 million USD is the amount that cannot be announced and basically the money transferred Turkey to launder. The German authorities also announced more than 1 billion Deutsche Mark was transferred as cash by the individual at 1995. Similarly, at 1998, the total amount of money transferred to Turkey by illegal methods was considered as 100 trillion USD. The source of income was not inquired in those years where the need for capital was so high in Turkey. The announcement made by the Central Bank of Turkey also confirms the 2.4 billion USD dollar is the money which the source is unknown and cannot be explained. The former President of the Central Bank estimated the amount of money transferred for

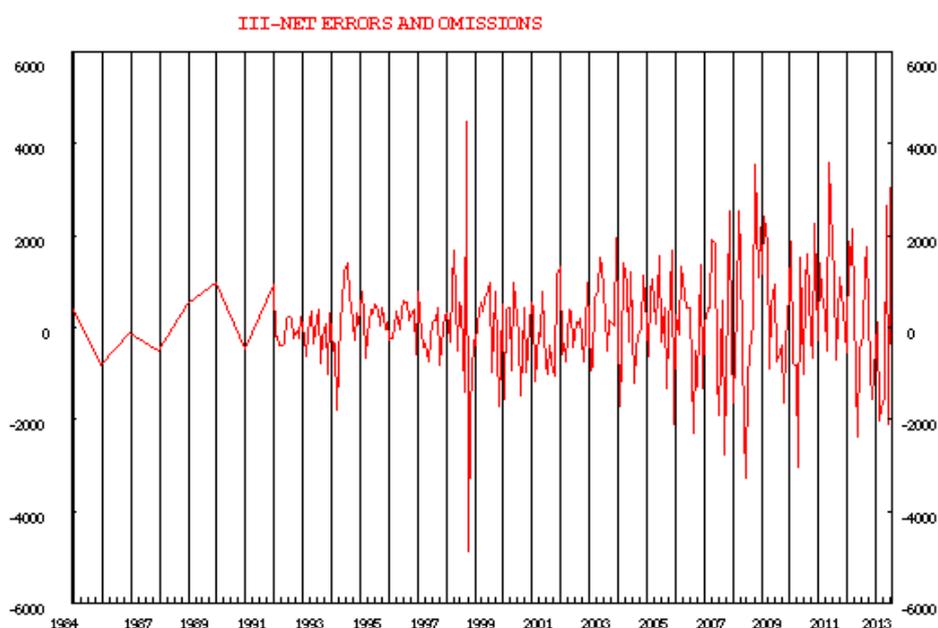
laundering purposes as 1.5 billion USD \$ or more at 1996. Similarly this amount was estimated as 100 trillion TL (375 billion USD \$) at 1998

- foreign exchange of labour working abroad
- tourism income
- income obtained from construction business abroad.
- freight income

People who are residence in foreign countries were allowed to have a Deutsche Mark currency deposit account with the limit of DM 50.000. as long as they invest to this account , they were allowed to buy automobile free of charges. Total value of the accounts which are open to get benefit of the decree with the number of 1996 8486 was 1.772.524.404 DM at 1998.

Here, in this paper, the net error and omission information have been analysed. Larger time period had been taken into consideration in the graph below (Graph 1), the data for net error and omissions from 1984 to 2013 have been represented. Accordingly, due to liberalisation policies starting by 1980's, the net error and omission part of the balance of payments of Turkey has been raising tremendously. Early years of liberalisation, the net error and omission were less than the recent years.

Graph 1: Net Errors and Omission in Balance of Payments in Turkey



Source: The Central Bank of Republic of Turkey <http://evds.tcmb.gov.tr/yeni/cbt-uk.html>

Concluding Remarks

Combating with money laundering is important issue in all economies. Due to globalization, international mobility of commodity and capital increased, the raising mobility also raised the number of transactions and documentation. Sometimes some of the companies may overprice their invoices. Turkey has been considered as one of the area money laundering is possible. Although, all related regulations and legislation have been made, still certain amount of money laundering could be forecasted under the net errors and omission of balance of payments of Turkey. The analysis made in this paper showed that the net error and omission of the balance of payment in Turkey has been increasing since 1984. The large part of these bias have been considered due to the over-invoicing. This is one of the money laundering through international trade.

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