BEPS and Developing States: How developing states are using BEPS to justify aggressive amendments to domestic legislation

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1. Introduction

In this book in honour of the 25th anniversary of the establishment of the Tax Department of Maastricht University, we would like to take a look into one of the main current issues in the international tax arena: the OECD project on base erosion and profit shifting (hereafter: BEPS). Considering the breadth of the subject, we would like to focus in our contribution on the position of developing states in relation to the BEPS Action Plan and how these countries, notwithstanding their disagreement with some of the conclusions reached in the BEPS Reports, are using these reports as a justification for amendments in their domestic legislation even in cases that concern purely domestic situations. As an example, we will analyse a Provisional Measure recently proposed in Brazil, a G-20 Member, but not an OECD Member State, concerning the mandatory disclosure of tax planning activities.

This contribution is divided in 3 chapters. In the first chapter the authors analyse the OECD BEPS Action Plan, while in the second chapter it is discussed whether this plan is in line with the objective of granting source states more taxing rights, as desired by developing states. In the third chapter the authors dwell on the Brazilian Provisional Measure and analyse whether this measure is in line with the guidelines provided in the BEPS Reports.

2. BEPS Action Plan

As a consequence of the developments occurred in the past century, especially the technological ones, the manner in which enterprises developed their business has considerably changed. One of the main aspects of this change has been the ease for enterprises to develop economic activities cross-borderly; the economy, which was mainly based on industrial activities, on brick and mortar establishments, is now more focused on value creation derived from intellectual property and the provision of services. Nonetheless, countries are still trying to tax these activities based on principles established in the beginning of the 20th century, favouring exclusive residence taxation unless the activity is developed through a permanent establishment at source.

The constant development of economic activities abroad raises enormous possibilities for enterprises to develop tax planning strategies to take advantage of eventual mismatches between the tax legislation of the different countries in order to reduce their tax liabilities, achieving double non-taxation or an extremely low tax burden. On that matter, the fact that the current international tax systems favour taxation at residence facilitates the creation of homeless income[2], i.e. income not

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[2] Bret Wells, Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2380241>, accessed on 2 November 2015, p. 7.

taxed anywhere, as source states have their taxing rights restricted by double tax conventions while a considerable number of residence states do not tax income earned abroad anymore.

Although it could not quantify the losses incurred by countries due to base erosion and profit shifting, the OECD acknowledges that one of the main risks nowadays to countries is profit shifting[3], i.e. the transfer of profits earned in a high tax country to a low tax country, especially when this transfer is achieved through an artificial segregation of the income from the activity earning the income.

Accordingly, it is not surprising that this topic has raised to the forefront of the international tax discussions, enticing the OECD, together with the G-20, to analyse how to avoid the tax base erosion of countries. Acknowledging that to combat this issue it would be necessary to adopt a holistic approach,[4] and that the lack of action could worsen the situation, as countries would be tempted to unilaterally protect their tax bases creating the risk for increased double taxation, the OECD developed a comprehensive action plan on how countries should act against base erosion and profit shifting.[5]

First of all, it should be borne in mind that the seriousness of the problem led to the establishment of a really aggressive timeframe, with all reports being prepared in two years (from 2013 to 2015).[6] Also, with the intent of coming up with solutions that would be accepted not only by tax authorities but by third parties as well, the OECD opened the process for the input of the latter.

The BEPS Action Plan was divided in 15 Actions that each deals with a specific issue, although some of the actions are intrinsically related. Action 1 focuses on tax challenges from the digital economy, i.e. the increased possibility that, due to the current international rules being focused on the physical presence criterion, income earned in a jurisdiction will not be taxed therein.

Action 2 studies how to develop provisions to the OECD Model Tax Convention (hereafter: OECD MTC), as well as guidelines to domestic legislation, that take away eventual benefits such as double non-taxation, double deduction or long-term deferral achieved through the use of hybrid instruments and entities. This same objective is pursued by Action 6, which deals with the prevention of treaty abuse.

Actions 3 and 4 look to combat base erosion through domestic legislation, by, respectively, strengthening of controlled foreign company rules and restrictions on the use of interest deductions and financial payments.

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[3] OECD, *Addressing Base Erosion and Profit Shifting*, available at < http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm>, accessed on 2 November 2015, p. 5.

[4] OECD, (note 3), p. 7.

[5] OECD, Action Plan on Base Erosion and Profit Shifting, available at <http://www.oecd.org/ctp/BEPSActionPlan.pdf>, accessed on 2 November 2015.

[6] The final BEPS Reports have been published on 5 October 2015. For more information on the matter, see <http://www.oecd.org/tax/aggressive/beps-2015-final-reports.htm>.

Action 5 focuses on achieving best practices that increase transparency and, as a consequence, act as deterrent to harmful tax practices. This Action is in line with Action 12, which is based on the obligation that taxpayers disclose aggressive or abusive transactions.

The OECD MTC is at the heart of Actions 7 and 14, which call, correspondingly, for amendments to the PE definition in order to prevent its artificial avoidance and the development of a manner to make dispute resolution mechanisms, such as the mutual agreement procedure, more effective.

Actions 8, 9 and 10 have as their objective the creation of rules to prevent that group members engage in, respectively, the artificial transfer of intangibles, the artificial transfer of risks and capital and the development of transactions which would not be made between third parties. These actions are coupled with Action 13, which deals with the transfer pricing documentations.

Action 11 acts as a meta-language, as its objective is to devise an effective mechanism of evaluating the impact of BEPS and of the measures taken to combat it. At last, Action 15 intends to develop a multilateral instrument for the implementation of BEPS measures and for the amendment of existing bilateral tax treaties. As a side note, it is interesting to keep in mind that this idea of a multilateral instrument was already put forward by the League of Nations and the Working Parties of the OECD when drafting the 1963 OECD Draft MTC. There were even drafts of a multilateral convention,[7] but such a multilateral convention never came into existence.

3. BEPS and developing states

Even though the discussions that led to the BEPS occurred primarily between developed states, there is no question that the matter of base erosion and profit shifting is important for both developed and developing states.[8] Nonetheless, it is also undeniable that the subject affects developing states in a different matter.

Following the current system of international allocation of taxing rights based on the OECD MTC, developing states, mainly source states, have their taxing rights over business income restricted to situations in which the income is earned at source through a permanent establishment, while developed states, primarily residence states, have taxing rights over all income earned by residents, having to provide a credit or exempt income earned by residents abroad. Furthermore, based on the 'other income' article residence states have taxing rights over all income not mentioned in specific provisions of the tax treaty, i.e. residual income.

[7] League of Nations, *Double Taxation and Evasion*, Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Geneva, October 1928, document II, Economic and Financial 1928.II.49, p. 11.

[8] The position of developing countries as regards the BEPS initiative can be taken from answers to the questionnaire submitted by the UN Subcommittee on Base Erosion and Profit Shifting, in which developing states assured that base erosion and profit shifting was prejudicial to their tax collection, United Nations, Committee of Experts on International Cooperation in Tax Matters, *Responses to questionnaire for developing countries from the UN Subcommittee on Base Erosion and Profit Shifting*, Tenth Session, Geneva, 27-31 October 2014, E/C.18/2014/CRP.12, available at <http://www.un.org/esa/ffd/wp-content/uploads/2015/01/10STM_CRP12_BEPS.pdf>, accessed on 2 November 2015.

Hence, whenever a situation of base erosion and profit shifting arises it may be said that, in general, developed states are usually prevented from taxing income earned by their residents abroad while developing states are denied the possibility of taxing economic activities that are developed in their territories by non-residents. So, while the base erosion prevents the developed states from fully exercising worldwide taxation (some of them have already unilaterally given up on taxation of income earned by residents abroad), developing states have their source taxing rights hampered. Considering that source taxation is linked to the place in which income is earned, it may be said that the segregation between the income earned and the development of the economic activity is more visible in the case of developing states.

Considering that the objective of BEPS is to prevent this segregation, it could be expected that the BEPS Action Plan and the corresponding reports would analyse situations that lead to base erosion in developing states and propose an allocation of taxing rights that diminishes the possibility for such erosion. However, this position is not taken in the BEPS Action Plan and the subsequent reports.

As a matter of fact, the documents are straightforward in asserting that it is not within their scope to discuss the current allocation of taxing rights between source and residence states, although it might happen that in some situations source states will, as a result of BEPS, achieve more source taxing rights.[9] An eventual increase of taxing rights by source states is not a consequence of a tax policy decision to favour source states, but of the measures adopted to prevent base erosion and profit shifting.

Furthermore, the BEPS Actions fail to address one of the main sources of base erosion and profit shifting in developing states, i.e. the taxation of the provision of services. Considering that states signed a tax treaty in accordance with the OECD MTC, taxation of services will only occur at source if these services are provided through a PE in the source state. Nevertheless, irrespective of the actual taxation of this income at source, the payer of the services would, most likely, be able to deduct from his income tax the payments made for the services. As a consequence, the source state would have its tax base eroded and the profits earned through the provision of services would be shifted abroad,

The fact that the BEPS Action Plan does not deal with the base erosion and profit shifting arising from the provision of services demonstrates that once again the international discussion is not in line with the interest of developing states;[10] it does not take into account the issues that matter the most for developing states.

As for the subjects effectively discussed in the reports, some of the matters are more important to developing states than others, e.g. the taxation of the digital economy and the prevention of artificial

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[9] OECD, (note 5), p. 11.

[10] Shee Boon, Law, "Base Erosion and Profit Shifting – An Action Plan for Developing Countries", *Bulletin for International Taxation*, Vol. 68, n. 1, IBFD, Amsterdam, 2014, p. 41.

avoidance of a PE in the source state.[11] But even in these cases the recommendations of the BEPS Actions do not favour these states, as they are not looking into the root of the problem, i.e. the current allocation of taxing rights that restrict source taxation, but rather on common schemes currently applied.

In order for developing countries to adhere to the BEPS work, it would be paramount that the work developed indeed looked at the issue of source taxation of income earned therein, irrespective of the physical presence of the enterprise that earns the income.

As a consequence, even if these recommendations are adopted it is only a matter of time until taxpayers discover new manners to avoid source taxation of income through the segregation of the income earning activity and the income.

Accordingly, it is questionable whether the work developed in the BEPS Reports will serve as a new compromise for the taxation of international income in the 21st century. On the other hand, the BEPS work may be used in an unintended manner, serving as justification for the amendment of domestic legislation which is not in line with the guidelines prescribed by the reports. This matter will be discussed in the following section by reference to a measure recently proposed in Brazil.

4. Action 12 and the Brazilian provisional measure 685/15

As mentioned before, Action 12 of the BEPS Action Plan stipulates that countries should strive for the design of mandatory disclosure rules in order to curb aggressive tax planning. On that matter, the report on Action 12[12] prescribes that such rules need to be as clear as possible, so the taxpayer won't have doubts whether the disclosure is necessary,[13] should be restricted to specific situations, as a wide obligation to disclosure would be impractical[14] and would make it harder for the tax authority to focus on the important base erosion scheme, apart from increasing the costs of compliance to taxpayers and the administration,[15] and should focus on international operations.[16]

Taking the discussions on Action 12 into consideration, the Brazilian Government recently proposed a Provisional Measure which prescribed a mandatory disclosure regime, as follows:

" Article 7 - The taxpayer must disclose the operations undertaken in a calendar year which lead to the suppression, reduction or deferral of taxes before the 30th September of the following year when:

[11] In the responses to the questionnaire of the UN Subcommittee these were two of the actions considered highly relevant to the developing states, United Nations, (note 8).
[12] OECD, Mandatory Disclosure Rules, Action 12 – 2015 Final Report, available at <www.oecd.org/tax/mandatory-disclosure-rules-action-12-2015-final-report-9789264241442-en.htm>, accessed on 2 November 2015.
[13] OECD, (note 12), par. 9, p. 19.
[14] OECD, (note 12), par. 22, p. 20.
[15] OECD, (note 12), par. 85, pp. 37-38.
[16] OECD, (note 12), par. 6, p. 14.

I – there is no relevant extra fiscal motive for the operations;

II – the structure of the operations or the contract entered into by the parties is atypical or linked to an indirect legal transaction; or

III – the operations are listed by the Federal Revenue as operations which demand disclosure[17]*(translated by the authors)*

Interestingly enough, in the Explanatory Notes to this provision, the tax authorities made express reference to the BEPS Action Plan, stating that the objective of the provision is to provide timely information to the tax authorities in order to curb aggressive or abusive transactions and to provide certainty to taxpayers,[18] which would not be obliged to pay a fine in case the structure was not accepted; in that case, the taxpayer would have to pay the tax due plus interest accrued.

Despite the reference made to the OECD BEPS Action Plan, it remains clear that the Provisional Measure was not in line with the recommendations provided for in the BEPS Report. First of all, the provision was extremely broad, as in the *caput* it was prescribed that all transactions that lead to a reduction of a person's tax liability should be disclosed. On that matter, the rule was much more similar to a General Anti-Avoidance Rule (hereafter: GAAR) than to the mandatory disclosure studied in BEPS Action 12.

Furthermore, the following paragraphs, which were supposed to narrow down the scope of the obligation to disclose, did not provide certainty to taxpayers as regards the obligation to disclose, as there was no definition of what would amount to relevant extra fiscal motives or atypical operations or contracts.

The only actual guidance provided to taxpayers was that the Federal Revenue would prepare a list of operations which had to be disclosed. Nonetheless, in spite of the fact that this obligation was already in force since 22 July 2015 and the submission of such list was due 30 September 2015, no such list has been drafted. Additionally, if the taxpayer failed to disclose the information regarding its tax planning activities, he was subject to a penalty of up to 150% of the taxes suppressed/deferred.

Interestingly, when the Provisional Measure was analysed by the Brazilian Congress and converted on the Ordinary Law n. 13.202/15, the article transcribed above was supressed and no official explanation was given for its deletion. However, by the analysis of the amendments proposed to this provision it can be ascertained that the congressmen decided for its withdrawal based on the uncertainty of the measure and the harshness of its penalties, and that no reference was made to BEPS Action 12 and the actual compatibility of the provision with such action.

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[17] Provisional Measure n. 685/15, Article 7, available at < http://www.planalto.gov.br/ccivil_03/_Ato2015-2018/2015/Mpv/mpv685.htm>, accessed on 2 November 2015.

[18] Explanatory Notes to Provisional Measure n. 685/15, par. 6, available at < http://www.planalto.gov.br/ccivil_03/_Ato2015-2018/2015/Mpv/mpv685.htm>, accessed on 2 November 2015.

Bearing in mind the aforementioned, there is no question that the Brazilian legislation was not in line with the principles that guided the mandatory disclosure rules of BEPS Action 12 (certainty, clarity, practicability). As a matter of fact, it seems that the Brazilian legislator was taking advantage of the BEPS discussions in order to introduce in the legal system, disguised as a mandatory disclosure rule, a GAAR.

5. Conclusion

In this article the authors endeavoured to analyse the BEPS Action Plan and discuss its shortcomings in relation to developing states. After establishing that the BEPS Actions were not effectively tackling the main problem that causes base erosion and profit shifting, the current allocation of taxing rights in tax treaties, the authors focused on showing how in spite of eventual disagreements with the conclusions included in the BEPS Reports, Brazil, a developing country member of the G-20, is using the BEPS discussions as an excuse to amend its domestic legislation, trying to introduce a mandatory disclosure rule which was not in line with the recommendations of BEPS Action 12 itself and that was applicable even in situations in which no base erosion can arise.

Fortunately, this provision was not included in the law enacted, but the intention of the Brazilian government to justify a harsher tax measure under the grounds of its alleged compatibility with the BEPS initiative is an example of how developing countries may make recourse to the BEPS actions as means of increasing their taxing powers, even when the actions taken do not really comply with the guidelines of the BEPS Reports.