Research on the Dilemma of Anti-Tax Avoidance Measures in Developing Countries and Their Response

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Abstract. Nowadays, tax avoidance measures that MNEs used have brought negative effects to different countries of various degrees, especially the developing countries, whose loss is much bigger than developed countries. This paper firstly concludes with anti-avoidance measures that developing countries use generally and then uses Brazil and India as examples to do the research. The study finds out that current anti-avoidance measures in many developing countries are characterized by insufficient legislative and administrative enforcement capacity, overly aggressive regulation in some cases and mostly reactive governments. Based on this, these problems can be attributed to the social structure of developing countries, their economic structure, and the current state of the international community. Then through the analysis of the current advanced international anti-avoidance measures, what developing countries can learn can be discussed including carrying out administrative reform, setting up a reasonable structure to enhance tax information exchange and participating in international cooperation more actively. On the premise of balancing the tax avoidance regulations on MNEs and promoting the development of the countries, this paper discusses how developing countries apply these advanced measures to optimize their anti-avoidance regulations and minimize the loss including increasing regulation of corporate tax avoidance in the natural resources sector to ensure sustainable development in advantageous areas.

Keywords: Anti-Tax Avoidance; Developing Countries; International Tax Avoidance.

1. Introduction

Under economic globalization, the flow of capital, technology, personnel, and other factors is becoming easier and easier. Though it brings great convenience to the global economy and promotes technological exchanges as well as a better allocation of various resources, it also raises international taxation issues, especially tax avoidance or even tax evasion of MNEs. As MNEs' status in the global economy is becoming stronger, this phenomenon can no longer be ignored. Developing countries are facing greater challenges in anti-avoidance than developed countries due to many reasons. This paper summarizes the reasons including inadequate legislation capacity and administrative enforcement, lack of funding and technology, unstable social environment, weak economic base. How to find efficient methods to help developing countries better tackle tax avoidance and minimize their loss has received great attention from the international community. Nowadays, there are many scholars who have studied this field and found some methods mainly based on OECD’s suggestions such as improving anti-avoidance provisions like GAAR and signing up tax treaties according to Dr. Patricia Lampreave. [1] Establishing transfer pricing rules and adding penalty clauses are also effective to regulate tax avoidance. [2] At the same time, it is proven that international and regional cooperation and building a multilateral anti-tax avoidance platform can benefit. [3] Therefore, this paper concludes some general anti-avoidance measures and problems in developing countries, and then finds methods for them to better deal with tax avoidance based on international advanced experience.

2. Major anti-avoidance measures of developing countries

Strategies that MNEs use to avoid tax bring continuous tax leakage to both developed countries and developing countries. But for developing countries, there is no doubt that they suffer more losses than developed countries. Nowadays, developing countries use various measures to deal with MNEs’ tax avoidance, which can be summarized to the measures as follows.

Improving domestic anti-avoidance legislation is probably the most fundamental and widely employed measure. Many developing countries have already formulated anti-avoidance regulations. It is not difficult to discover that the anti-avoidance legislation of different countries is increasingly converging due to globalization, especially in specific fields such as transfer pricing and thin capitalization. These countries established their own anti-avoidance rules based on international cooperation. For example, research by the United Nation suggested that countries like Egypt, Mexico, and Brazil have formulated transfer pricing tax systems, among which Brazil is relatively more mature than the others. [4] It applies the general approach of the OECD and then specifies it according to its national circumstances in order to make it more efficient. For example, the Brazilian government established a law on transfer pricing called Law n. 9430/1996 aiming at curbing tax avoidance and tax evasion. [5] According to the law and regulations, there are specific procedures for both import and export transactions. Brazilian economic entities are required to use traditional price-based methods such as the comparable uncontrolled price method, the resale price method, and the cost-plus method when they purchase property, services and concessions from affiliates. Furthermore, Brazil also applies a method known as the Sixth Method which is exclusively for those import and export commodities and it can be regarded as a variant of the comparable uncontrolled price method. However, this method is inconsistent with what was written in BEPS Action Plan and it may have a risk to result in double non-taxation or double taxation. [6]

Similar to Brazil, India also has transfer pricing regulations which are based on the arm's length principle. What cannot be ignored is that the transfer pricing of companies has brought many disputes. It also has negative effects on the investment environment of the country. The Indian Revenue Service is aware of this situation. Therefore, there are some initiatives such as using the Mutual Agreement Procedure (MAP) as well as establishing various instructions on transfer pricing to provide clarity on transfer pricing issues. For example, it is said that any income from the international transaction between associated enterprises should be calculated in accordance with the arm's length pricing (ALP). It is possible that taxpayers have debates on the adjustments of the transfer pricing tax system, so they can present a proposed objected order from the Dispute Resolution Committee. Then the officers will announce the final command based on the instructions given by the Committee. Once the command is introduced, taxpayers cannot make further appeals to it. [1]

Besides, many developing countries use the General Anti-Avoidance Rules (GAAR) as a bottom line. The Indian government applies General Anti-Avoidance Rules (GAAR). At the very beginning, several officers were worried that whether GAAR could be put into comprehensive and effective practice while taxpayers strongly objected to it because the aim of GAAR was to prevent the abuse of enterprises' building up structures to avoid taxation. [7] Though the government revised the legislation later, some suggestions of the Committee were not adopted by the government such as GAAR should only be applied to cases of abuses and artificial arrangements. [8]

What's more, many developing countries have adopted international cooperation to regulate MNEs' tax avoidance such as promoting cooperation between developed countries and developing countries or among developing countries to tackle BEPS jointly. 141 countries and jurisdictions are currently a part of the BEPS Action Plan implemented by the OECD to combat base erosion while also ensuring a transparent tax environment. Particularly, developing nations such as India and China have been deeply involved in this program, which demonstrates that developing countries are making positive efforts in the anti-avoidance area. [9] In addition to this, the ATAF is another good example of developing countries participating in international tax cooperation. It is to encourage African countries to work together to establish an orderly system of regulation and tax utilization.

3. The problems and reasons for the current anti-avoidance measures

3.1 The problems and deficiencies

Developing countries are facing a more severe revenue loss than developed countries due to MNEs' tax avoidance. Fortunately, their awareness of anti-avoidance is strengthening. Many countries have already made progress on anti-avoidance legislation. Yet, there are still some shortcomings and problems existing.

From the internal perspective, firstly, inadequate legislative capability and administrative enforcement are the most common points. Many developing countries introduce their regulations mostly in the 20th and 21st centuries. For example, Chinese anti-avoidance legislation started in 1987 with the introduction of the *Implementation Measures for the Tax Administration of Business Transactions of Foreign Enterprises and Affiliated Companies in the Shenzhen Special Economic Zone*. Meanwhile, the Indian transfer pricing regulations entered into force in 2001. Besides, the history of their utilization and the tendency to apply GAAR into practice can date back to 2009 when the Direct Tax Code (DTC09) was published for open consultation. Then, the government reviewed some clauses and revised some legislation in 2012. The new rules that applied only to arrangements where the primary purpose was to gain tax benefits came into effect on 1 April 2017. When it comes to administrative enforcement, corruption in tax authorities cannot be ignored. This phenomenon adds uncertainty to the implementation of anti-avoidance rules. Latin America is a typical example. The Panama Report released in 2016 revealed that Latin American and Caribbean countries' leaders used offshore shell companies to launder money, covering Argentina, Brazil, Ecuador, Mexico Panama, etc. [10]

In addition, not all the regulations are reasonable, some of them are even too aggressive. The Indian Revenue Service (IRS)has long been famous for its aggressive enforcement, which has left a negative impression on the tax environment and business environment in India among MNEs while the 50-year statute of limitations has also caused dissatisfaction among MNEs. One of the most famous cases is the case of Vodafone transferred equity interest indirectly. The Supreme Court ruled in favor of Vodafone in 2012, so the IRS instigated the government to revise the Income Tax law to clarify that indirect transfers of property in India through the transfer of equity in foreign companies are taxable in India while the law will be backdated by 50 years. [11]

From the external perspective, governments are very passive mostly. Their anti-avoidance efforts mainly come at a time of increasing social scrutiny and criticism of corporate affairs. Just like in Brazil, the introduction of national policies to improve tax governance is mostly due to pressure from the public. It seems that many developing countries need a push when making policies.

3.2 Analyze the reasons for the problems mentioned above

What may explain the problems mentioned above are multiple. Firstly, the anti-avoidance legislation capability of developing countries is limited because the legislation started later than in developed countries. The late start of legislation not only reflects the lack of relevant professionals but also means the legal provisions are simpler than those in developed countries. As a result, there is a certain degree of discretion of the court, bringing uncertainty to the whole process of enforcement. The cases of various MNEs avoiding tax show that their tax avoidance techniques are endless, which makes it harder for governments to respond timely and precisely.

Secondly, lack of extensive experience is another important reason that results in inadequate administrative enforcement. In order to enforce the law effectively, the tax authorities' officers not only need to be very familiar with their domestic anti-avoidance rules but also need to have a knowledge of other countries' tax laws and even the business strategies of MNEs. However, due to the late start of legislation, they do not accumulate enough relevant anti-avoidance enforcement experience. Besides, there is a close connection between the domestic administrative environment and its enforcement ability. Anti-avoidance enforcement ability is the fundamental guarantee that relevant legislation is enforced. Some officers from tax authorities and governments in developing countries have serious corruption because of their low quality and less income. The most fundamental reason for this is the instability of society. In many developing countries, the modern public education system is difficult to establish. Therefore, both the national educational level and quality are generally low, which results in corruption in government and the instability of society. Corruption has led to a situation where the implementation of tax transparency legislation and standards in some areas remains very limited. [12]

In addition, efficient enforcement requires a large amount of technical and financial investment, which the majority of developing countries lack. This is relevant to their economic characteristics. Firstly, developing countries mostly have low productivity and labor productivity. This is because many countries had been colonized by developed countries in the past and it led to a weak economic base. Even though the economy makes some progress later, the GNP per capita is still low due to the late start and rapid population growth. Secondly, the socio-economic patterns of developing countries are diverse. There are state-owned capital, private capital, and foreign capital in the market economy, among which state-owned capital is supposed to play a major role in supporting the national economy. Yet, many of them suffer from inefficiency and serious losses. As a consequence of a weak foundation and limited capacity, many private small and medium-sized enterprises develop slowly and have a smaller impact on the rate of the development of the economy. Another situation is that the economic structure of many developing countries is too homogeneous. These countries have a rich diversity of natural resources and crops. However, because of being colonized, they have formed a homogeneous production structure. The export products on which the country depends become the main source of income. The terms of trade in international markets deteriorate, prices of agricultural products and other products fluctuate increase the uncertainty of economic development. All these factors make many developing countries fail to have the ability to concentrate so much money and techniques to support it because they may focus more on their domestic development and different kinds of social issues.

What’s more, due to the lack of experience, they are eager to find the most direct and effective approaches to regulate tax avoidance when problems arise. For instance, the Indian government revised its tax law in 2012, which caused much dissatisfaction. It reflects that these governments lack multiple considerations.

Another point worth mentioning is that international organizations are largely dominated by developed countries. Thus, the current international taxation environment seems to be unfair to the developing countries because of their lack of discourse right. This may reduce inclusiveness when international anti-avoidance standards are put into practice. The unfair comparative tax environment and the existence of tax heaven lead to developing countries being threatened with higher tax benefits by MNEs. This may go to an extreme like the Vodafone case and the Indian government's reaction to it.

Moving back to the specific example mentioned previously. Firstly, Brazil is the ninth-largest economy in the world, yet it is still a divided country which deeply affected by guns and drugs. Brazil is rich in mineral and water resources, as a result, the country has experienced tremendous growth since the 1990s and it has been listed as one of the BRICS countries. However, before the 1980s, it developed its industry vigorously, with little accumulation of local enterprises, resulting in many foreign investments occupying the local market. When the military government was overthrown in 1985, the country called for "de-industrialization" and turned the focus on the development of bulk products and agricultural exports, which was even more detrimental to the survival of the already immature local industries and small and medium-sized enterprises. This action has led to a high unemployment rate in the country. A large amount of wealth is in the hands of a very small number of capitalists, and the income of the people at the bottom is negligible, further exacerbating the gap between the rich and the poor. Social factors have led to corruption which makes the capacity of the government and authorities in tax transparency legislation and enforcement remain limited. The impact of anti-avoidance policies is very small compared to that of European and American countries, so the government is in a reactive position, which increases the uncertainty of the implementation of some tax governance policies like anti-avoidance policies. What’s more, Latin American countries are capital-importing economies that mostly rely on MNEs operating in the region. Therefore, the introduced policies should be favorable to attract foreign investments. However, the current Brazilian tax system is complex, so the capacity in policymaking is still very limited. The country needs to do a better job of simplifying tax measures and improving tax governance according to Daniel Hora do Paco, tax manager at Petrobras. [13]

India used to be a British colony. Under the colonial influence, the country is left with a decision-making mechanism that has a very complex structure and lacks efficiency as well as a low value-added economic base. Therefore, it is difficult for India to develop a high value-added industry system, so it has to turn to the electronic services industry. However, the impact of e-sourcing services is very small. India has hundreds of millions of populations. Although more and more people are becoming middle class through the e-services industry, there are still a larger number of people living at the bottom of the social ladder. At the same time, the privileged class is widespread in the country, which results in an extremely divided social structure. Consequently, the elected political elites are often privileged classes, whose policies are formulated and implemented to reflect the interest of this class. Policies that work for the benefit of the public are often difficult to implement. This kind of social structure leads to weak government control over local areas because the ruling party has to concede to powerful social forces in order to obtain social resources. Although the country has spent years of effort, the dominance of the privileged class in the regime is still very common, which leads to the tendency to favor this class's interests when it comes to the implementation of policies including the low enforcement of tax authorities. [14]

4. Optimization of Anti-Tax Avoidance Measures in Developing Countries

4.1 Advanced anti-avoidance measures

In order to better tackle BEPS caused by tax avoidance, the OECD has carried out the BEPS Action Plan. Each action plan addresses the weakness in current regulations and rules, which is more precise. In the process of implementation in each country or jurisdiction, OECD suggests that multilateral instruments and bilateral tax agreements should be formulated and revised. For example, the new agreement between the Chinese government and the Indian government for the avoidance of double taxation and the prevention of tax avoidance and evasion came into effect in 2019. [15]

Besides, according to the EU's experience, detailed codified anti-avoidance rules are essential. The EU establishes the Anti-Tax Avoidance Directive (ATAD). When making laws, interest deducibility limitation, CFC rules and other relevant factors should be included. One point worth mentioning is that anti-avoidance provisions should obey the proportionality principle, both the strength and scope should not be excessive. [16]

Many developed countries have participated in international tax cooperation, among which international tax information exchange is a specific measure that is worth mentioning. Due to the different tax systems among countries, MNEs often make use of loopholes to avoid taxation. The experience of the U.S can be used as a reference. It introduces the *Model Tax Information Exchange Agreement and the Tax Haven Abuse Prohibition*, which was intended to emphasize the exchange of tax information with other countries through detailed legal provisions. It also forms a clear institutional structure for tax information exchange, with the Federal Tax Administration being responsible for the overall management and a number of functional departments including the Administrative Review Department and a Management Department under these departments. [17] Besides, establishing an international tax intelligence sharing database to provide convenience to the exchange of information is a helpful method. From developing countries' perspectives, they can take the initiative to sign tax information exchange agreements with countries or regions in international tax havens based on improving their own legal protection systems and carrying out international tax cooperation. In this way, they can reduce the losses caused by lagging information.

4.2 Discuss what developing countries can learn from and how to apply them to balance the regulation on MNEs' tax avoidance and promote countries' development

4.2.1 Improve legislation and enhance administrative enforcement capabilities

The current international program or reports such as Developing Countries and the OECD/G20 Inclusive Framework on BEPS offer many valuable experiences for developing countries to study. [18] In conjunction with the lack of legislative capacity mentioned before, these articles provide a model for domestic legislation.

Nowadays, developing countries can introduce their regulations based on the OECD's recommendations. For example, Brazil forms the transfer pricing tax system and applies the CFC Rules. The government introduced Provisional Measure NO. 627 in 2013 and the CFC Rules are a part of it. However, the CFC Rules in Brazil are different from BEPS Action Plan carried out by the OECD. According to the MP, the earnings of controlled foreign companies are considered to be the profits of Brazilian parent companies. The new rules that are introduced in the MP prescribe different tax treatments in different cases. This means any investments to the controlled foreign companies are required to adjust annually. The government's intention to tax controlled foreign companies is obvious because these rules are suitable for any controlled foreign companies in Brazil. The CFC rules are more of a general regulation than special anti-avoidance rules because the standards are so wide. [6] When it comes to the lack of detailed provisions in the legislation, in addition to adjusting the tax payment, clear penalty provisions such as stricter fines can be added to the existing anti-avoidance regulations. [19]

The governments can make administrative reforms as well as improve the tax supervision system to enhance administrative enforcement ability. [20] The implementation of all the tax policies depends on an effective administration. Countries that are able to do so can increase investment in the field of education, train more talents in related areas, and improve the quality of tax authorities' personnel to reduce corruption. Particularly in those lower-income countries, corruption must be regulated to form an enforcement environment with high efficiency and more transparency. The reform will also enhance the trust between tax authorities and taxpayers. Besides, tax reform is required. Today, many tax systems in developing countries are too complex. In order to improve management efficiency and help attract foreign investment and add certainty for taxpayers, simplifying the tax system is a good choice. It will be a virtuous circle. What's more, when it comes to discretion, the proportionality principle should be obeyed. [21]

When making tax laws, the principle of non-retroactivity should be included. The country cannot use current laws to guide and punish people's past behavior. When the law is found to be no longer applicable, it should be revised in a timely manner. It is mentioned that some rules are too aggressive just like Indian tax law used to backdate by 50 years and then the Indian Revenue Service (IRS) revised the Income Tax law on 4 August 2021. The lack of appropriate anti-avoidance rules in Indian tax laws at the time the transfer of equity occurred has led to a constant debate between the company and IRS. Thus, the government responded to the outside call for tax law changes in September 2021, clarifying that the indirect transfers of Indian property occurring before 28 May 2012 do not need to pay any tax in India, which has strengthened the external confidence in Indian tax environment and business environment.

4.2.2 Strengthen the advantageous sector regulation

Governments should pay more attention to anti-avoidance legislation in their advantageous sectors and strengthen regulations for them to ensure that MNEs whose businesses are involved in these areas are taxed. Many developing countries are rich in natural resources, which is more vulnerable to BEPS. The financial revenue of abundant resources fails to meet expectations. Thus, the government can introduce laws that specifically target these sectors and set up departments to supervise MNEs' tax avoidance behaviors. In this way, the country can not only regulate tax avoidance but also ensure the sustainability of advantageous sectors. [22]

4.2.3 Strengthen the construction of the information exchange mechanism

Developing countries can also participate in international or regional cooperation more actively. It can not only be beneficial to anti-avoidance but also strengthen their discourse rights in the international community. For instance, Zambia has received long-term support from OECD and ATAF. The IMF also offers short-term and long-term technical assistance for anti-avoidance enforcement capacity for its member states. Besides, as mentioned previously, developing countries should attach great importance to forming a tax information exchange system. They can take the initiative to sign tax information exchange agreements with countries or regions in international tax havens based on improving their own legal protection systems and carry out international tax cooperation to reduce the losses caused by lagging information. Governments can set up a scientific and reasonable organizational structure under the premise of unified management of the tax authorities. Setting up a number of independent management departments with clear functions is a good choice and then set up a separate international tax information exchange center to improve efficiency.

5. Conclusions

This paper has discussed some general anti-avoidance measures that developing countries use and analyzed their problems and the reasons behind them. It has tried to find some methods for developing countries to better improve their anti-avoidance abilities. Developing countries have different characteristics in terms of natural conditions, history, economic conditions and social structure, so a major limitation of this study is that it cannot be very specific to every country's situation. The study contributes to people's understanding of the current deficiencies in the anti-avoidance regulation of many developing countries including inadequate legislation capacity and administrative enforcement, lack of finance and technology, or being too aggressive. Meanwhile, the analysis of the problems can help people gain a deeper insight into the issues of social and economic structure including the unstable social environment and low productivity. This study has found that generally, as developing countries continue to accumulate experience in anti-avoidance practices and learn from advanced international experience, it is feasible for them to enhance their anti-avoidance capabilities by improving legislation and its supporting rules. At the same time, administrative reforms and participation in international cooperation can also be improved. However, whether these methods are suitable for every developing country still needs more research and practices to determine.

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