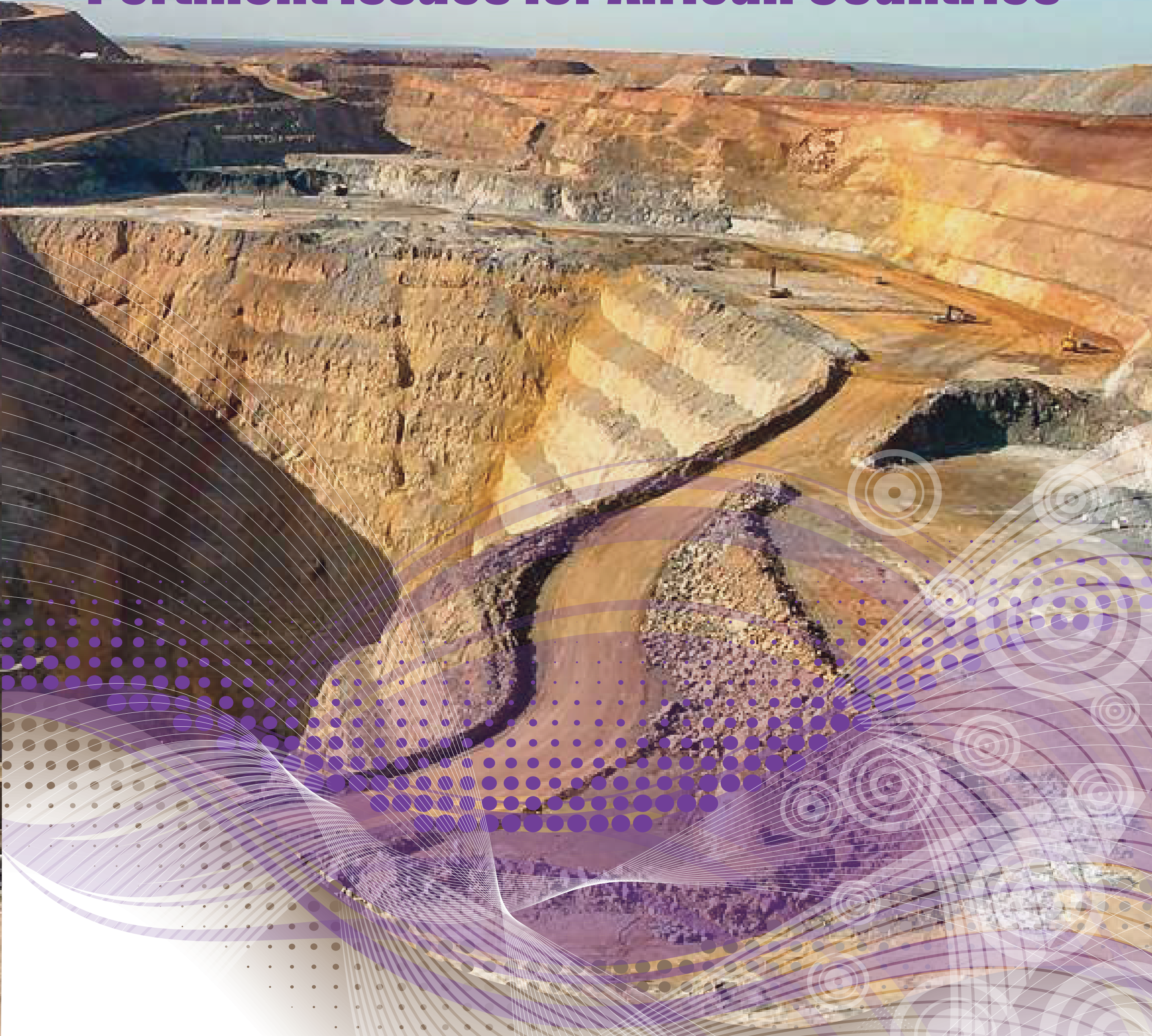
A POLICY BRIEFING PAPER

Current International Political and Policy PROCESSES IN TRANSFER PRICING Pertinent Issues for African Countries



tax justice network - Africa

Tax Justice Network-Africa (TJN-A) is a Pan-African initiative and a member of the Global Alliance for Tax Justice. TJN-A seeks to promote socially just and progressive taxation systems in Africa, advocating for pro-poor tax regimes and the strengthening of tax regimes to enhance domestic resource mobilisation.

Our vision is a new Africa in which tax justice prevails and ensures an equitable, inclusive and sustainable development which enables all its citizens to lead a dignified and fulfilled life.

TJN-A's mission is to spearhead tax justice in Africa's development by enabling citizens and institutions to promote equitable tax systems. We do this through applied research, capacity building and policy influencing.

We work with members in Africa and partners in other parts of the world.

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Tax Justice Network-Africa (TJN-A)
P. O. Box 25112-00100
Nairobi, Kenya
Tel: + 254 (0)20 247 3373
Email: info@taxjusticeafrica.net

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info@azlvisions.com | +254 (0) 722 916859

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Contents

Acronyms

FDI	Foreign Direct Investment
MNE	Multi National Enterprises
US$	United States Dollars (Currency)
MDG	Millennium Development Goals
GDP	Gross Domestic Product
ODA	Overseas Development Assistance
GFI	Global Financial Integrity
OECD	Organization fof Economic Cooperation and Development
UN	United Nations
UNDP	United Nations Development Programme
ECOWAS	Economic Community Of West African States
EAC	East African Community

Executive Summary

Currently, there are various levels at which the development of Transfer Pricing (TP) governance framework is at in Africa, ranging from no transfer policy to fully functional dispensations in some jurisdictions. This has in part been influenced by the deep seated apprehension that instituting a stringent transfer pricing regulatory framework may affect Africa's attractiveness as a destination for FDI. African countries have also engaged in tax competition and transfer pricing regulations may seem to negate the objectives in this regard.

The need for instituting policy change on TP stems from the realization that whereas most African countries barely have a framework to stem abusive TP practices, the major investors and traders in Africa are MNEs which control more than 60% of both the global and African trade. Lack of a functioning framework is not only untenable but also self-defeating for Africa. Secondly, Africa has engaged in economic integration efforts which are to be realized through increased cooperation in trade and investment, regional infrastructural projects, harmonization of fiscal policies and practices. There are also some declining but significant tax competition ventures. All these factors however indicate the urgent need for Africa to institute robust legislative and administrative measures to tackle Transfer Pricing to protect the continent's revenue/tax base and in the same vein ensure fitting facilitation of FDI and international and/or cross-border trade.

The policy options recommended to combat abusive TP practices in Africa include the following:

(a) Governance and Regulatory Framework: this includes elements such as a transfer pricing policy, legislation and accompanying regulations, and a strong and functioning tax administration. This will also require the subsisting tax administrations to be strengthened, as a precursor to instituting appropriate governance and regulatory framework in the complex area of Transfer Pricing.

(b) Building Transfer Pricing Capacity: this is a policy option that is ancillary to the governance and regulatory framework. In order to stand up to the well-resourced MNEs with competent and professional manpower and up to date technology and information management systems, the African tax administrations would need to build a commensurate pool of resources.

(c) Tax Competition: which is acontradictory and fallacious fiscal policy pursued by a number of African countries, involves granting of unjustifiable tax incentives and exemptions and investor friendly regulatory framework to potential investors on the presumption that this 'soft' offer will influence the investors' decision to bring FDI in the country. Research has disproved the premise on which this policy is predicated and Governments will need to disabuse themselves of this policy.

(d) Rethinking Liberalization:is a policy option that has recognized that current economic policies based on liberalization and globalization are not sustainable and need to be reviewed to ensure more equitable distribution of the benefits from economic growth and development.

(e) Exchange of Information between Countries and Revenue Authorities:is a critical policy consideration that is necessary if appropriate decisions on combating transfer pricing abuses are to be realized.

(f) Labour and Skills:is an important policy, especially as it is used to combat the abuse on intellectual property or intangible economy. Using labour and skills biases and/or tilts the determination of transfer prices to the developed countries who have well-developed and established resources. More often intellectual property skews taxable income from developing countries to developed countries.

(g) Transparency:is a policy recommendation that is part of governance but obliges African governments to handle public business in a transparent manner. This is primarily because contracts between MNEs and governments are often subject to strong secrecy or confidentiality clauses by the MNEs/investors, governments, and banks. African governments need to enhance their capacity to negotiate contracts that allow them to generate a fair share of rents from natural resource extraction.

(h) Double Taxation Agreements:which preempt double taxation, are intended to help countries to share appropriate information. Double taxation treaties also support participating nations to gain experience in treaty negotiations and develop expertise in common issues that arise based on competing interests

The ultimate objective of TP efforts is to maintain a delicate balance between attracting investment and ensuring sustainable flow of domestic revenue to meet national development objectives. This can only be realized if both governments of the host country and the home country of the MNEs, together with the MNEs as the principal stakeholders ensure that these competing objectives are attained at the most economic compliance cost.

1.0. Introduction

"Africa has lost its tolerance for being exploited. I urge the G20 leaders to tackle issues such as transfer mispricing…."
Kofi Annan, April 2013

"It is a contradiction to support increased development assistance, yet turn a blind eye to actions by multinationals and others that undermine the tax base of a developing country…."
Trevor Manuel, (former) Minister of Finance, South Africa and Special Envoy of the UN Secretary General on Financing for Development

"The issue that has to be wrestled with is this – what is the fair price for those transactions, in particular (from the development perspective) when you bear in mind the real economic engagement of the multinational in a particular developing country, and where the multinational's profits are truly being made. If transfer pricing does not reflect the true profits earned in that country, the country is unfairly deprived of funds and opportunities for development. And, of course, it is ultimately the people of that country who bear the costs, in food, water, health and education especially".
Jomo Kwame Sundaram, Assistant Secretary-General for Economic Development, UN-DESA, 2011

This policy brief on **"Current International Political and Policy Processes in Transfer Pricing: Pertinent Issues for African Countries"** was predicated on the Policy Round Table meeting under the theme:**"Curtailing Transfer Mispricing: Africa's Response to Global Challenges"** in Nairobi Kenya from 28th - 29th November 2013 under the auspices of Tax Justice Network- Africa.

The meeting was precipitated by the recognition that whereas Africa was encouraged to fully liberalize their economies in a bid to attract investment and trade as vehicles for attaining national socio-economic development, they were not fully prepared for the inherent manipulative transfer pricing through which Africa is losing substantial resources. It is accordingly no longer sufficient for Africa to sit back under the guise that the international politico-economic system under the globalization dispensation has an enabling self-checking/adjusting mechanism that on the balance will enable Africa to benefit from the system. Africa therefore needs to actively seek ways of stemming the hemorrhage of revenue that would support the national development programmes.

1.1. Background

African countries need to strengthen their tax systems, augment the tax base and increase domestic revenues if they are to meet the Millennium Development Goals[1] (MDGs) which were designed to tackle the extreme and debilitating poverty bedeviling the developing (or least developed) countries and support the equitable sharing of the benefits from globalization. This scenario is precipitated by the fact that out of the 48 least developed countries in the world today, 33 countries (69%) are from Africa[2]; and the categorization of countries based on their level of human development shows that 37 African countries (76%) out of the 49 countries on the continent that participated in the survey belong to lowest category of low development countries[3] . Almost half of the population in Sub-Saharan Africa, that is 48%, is surviving on less than US$1.25 per day; and this is the only region that saw the number of people living in extreme poverty rise steadily, from 290 million in 1990 to 414 million in 2010, which is more than a third of the impoverished people in the world. Even worse, this is projected to rise to 40% by 2015[4] .

The widely held view is that Africa will only get out of these mired economic conditions and attain sustainable economic growth and development by boosting productivity through private sector development, increasing trade, attracting international or Foreign Direct Investment (FDI)[5] and development assistance, and reducing capital flight. Increased productivity and trade will bulge the domestic revenue base. Africa has however had a

1 *In 2000, the world's political leaders adopted eight Millennium Development Goals (MDGs) under the UN umbrella, which are eradicating extreme poverty and hunger; achieving universal primary education; promoting gender equality and empower women; reducing child mortality; improving maternal health; combating HIV/AIDS, malaria and other diseases; ensuring environmental sustainability; and developing a global partnership for development. The UN set 2015 as the target year for achieving these MDGs, and this is acknowledged as the hitherto most successful anti-poverty global effort. There is however is growing consensus that Sub-Saharan Africa is the only region in the world that will not be able to attain the MDGs by the agreed date. st successful global effort through the*

2 *World Bank (2013): Least Development Countries Report*

3 *See UNDP (2012): Africa Human Development Report 2012. The survey is predicated on Human Development Index (HDI) that is an informative and composite measure sponsored by the United Nations Development Programme which is primarily determined on dimensions of socio-economic development and standard of living such as health, education, food security and income that describes the level of human development as an indication of development in African countries. It is used as a yardstick for comparison with other countries and regions in the world. There are four classes of HDI Groups, each with about 47 countries: (1) Countries with an index over 0.800 are categorized as Very High Human Development group; (2) Countries with an index between 0.700 and 0.800 are categorized as High Human Development,(3) Countries with an index between 0.500 and 0.700 are categorized as Medium Human Development and (4) Countries with an index below 0.500 are categorized as Low Human Development group. 4 African countries are in the High Development category and 8 countries are in the Medium Development group. No African country is in the Very High Development countries.*

4 *UN (2013): The Millennium Development Goals Report, 2013*

5 *FDI is defined as "...an activity in which an investor resident in one country obtains a lasting interest in, and a significant influence on the management of, an entity resident in another country. This may involve either creating an entirely new enterprise (so-called "greenfield" investment) or, more typically, changing the ownership of existing enterprises (via mergers and acquisitions). Other types of financial transactions between related enterprises, like reinvesting the earnings of the FDI enterprise or other capital transfers, are also defined as foreign direct investment.' (OECD, 2003). International Monetary Fund (IMF) guidelines consider an investment to be a foreign direct investment if it accounts for at least 10 % of the foreign firm's voting stock of shares"*

token role in the global trade and is primarily a supplier of raw materials, natural resources and low-skilled manufactured products that are processed and refined in the Western world. Africa's share of the global output is nominal and has fluctuated from 2.6% in 1970, decreasing to 1.7% in 2002 before recovering to 2.5% in 2009. African countries have also not been able to attract as much FDI as other regions of the world; this is principally dependent on their low competitive score[6] . Africa's share of global FDI inflows fell from 9.5% in 1970 to 5.3% in 2009, compared to 27% for developing Asia. In 2011, FDI to Africa was US$42.7 billion, which was 2.5% of the African GDP, which then recovered in 2012 to US$ 49.7 billion. Domestic revenue in Sub-Saharan Africa has been rising and is estimated to be over US$ 185 billion[7] , representing nearly six times the volume of net Official Development Assistance (ODA)[8] . This coupled with the evolving drift towards the globalization and regional economic integration have underscored the critical position and contribution of international capital flows to increasing tax revenue in the individual Sub-Saharan African countries.

One vehicle of capital flight through which Africa has been bruised is TP. Multinational Enterprises (MNEs) deny Africa its due revenue through practices such as profit shifting, mispricing of intra-firm transactions, goods and services. For example, in the period from 2000-2008 abusive transfer pricing accounted for an average of 54.7% of cumulative illicit flows from developing countries (GFI, 2011). Africa lost about US$ 854 billion in illicit financial flows over the 39 year period (1970-2008); corresponding to a yearly average of about US$ 22 billion (Kar &Carthwright-Smith, 2010). The trend has been increasing over time and especially in the last decade, with annual average illicit financial flows of US$ 50 billion between 2000 and 2008 against a yearly average of only US$ 9 billion for the period 1970-1999 (Kar & Carthwright-Smith, 2010). The last decade showed a substantial leap in the outflow with the five year period of 2006-2010 showing illicit financial flows from Africa amounting to US$ 300 billion, which amounted to more than 75% of the flow for the decade from 2001-2010 (Mevels, Ofa & Karingi, 2013).

Africa's precarious situation has also been exacerbated by the 'revolving door' problem. There is evidence that without the illicit financial flows such as transfer pricing Africa

[6] *Competitiveness is measured by the Global Competitiveness Index (GCI), and Africa has a dismal score on this count. GCIis sponsored by the World Economic Forum and is determined based on 12 pillars to benchmark and measure the competitiveness of a given country. The 12 pillars are divided into 3 groups: (1) Basic requirements (institutions, infrastructure, macro-economic stability, health and primary education); (2) Efficiency enhancers (higher education and training, goods market efficiency, labour market efficiency, financial market sophistication, technological readiness, market size); and (3) Innovation and sophistication factors (business sophistication, innovation). The groups predicate the 3 stages of competitiveness: factor-driven, efficiency-driven and innovation-driven economies. 148 countries, including 38 African countries, participated in the 2010-11 survey; only 4 African countries were in the first 74 countries starting at position 45 with the remaining 34 African countries spread in the last 74 countries, and 27 African countries in the last 48 countries.*

[7] *Weeks (2009): Forty Years of ODA and Conditionality in Africa.*

[8] *ODA is projected to reach US$57 billion in the year 2013, and has remained at about 38% of the global ODA. Sub-Saharan Africa received ODA amounting to about US$ 26.2 billion (UN, 2013: The Millennium Development Goals Report, 2013, pp.53).*

would have sufficient funds to finance its national development programmes ((Mevels, 'Ofa & Karingi, 2013). For example, over the period 1970-2010, 33 Sub-Saharan African countries suffered an outflow of US$ 814 billion which outstrips the official development aid (US$659 billion) and foreign direct investment (US$ 306 billion) received by these countries over the period (Ndikumana and Boyce, 2012 as cited in Mevels, 'Ofa & Karingi, 2013). . Through the 'revolving door' phenomenon indicates that up to 80% of the funds borrowed by Sub-Sahara Africa countries is siphoned out of the country through capital flight or illicit financial flows (Ndikumana and Boyce , 2008 as cited in Mevels, 'Ofa & Karingi, 2013). Africa is actually a net creditor of illicit financial flows to the developed countries that is begging for ODA (Mevels, 'Ofa & Karingi, 2013). Finally, Africa's burden through the loss of illicit funds flow is higher compared to other regions in the World. One notable comparison is with Latin America which lost 22% of its Gross Domestic Product compared to Africa which had an astronomical 61% of its GDP (Hermes and Lensink, 2000, as cited in Mevels, 'Ofa & Karingi, 2013).

1.2. Statement of Purpose

There is universal realization that Africa is in an untenable and unsustainable position, with its population mired in poverty and failing to attain basic human needs. The situation can only be changed by the national governments attaining adequate domestic revenue to fund socio-economic programmes in areas such as agriculture, health, and education. This has, however, been made difficult by the subsisting global economic environment, where multi-national enterprises who contribute a lion's share of the domestic revenue are engaged in substantial abusive TP practices which erode the revenue base and shift taxable profits to low tax jurisdictions out of Africa. African governments would therefore need to institute measures to stem this trend of abusive TP practices, and related activities that sustain these practices.

1.3. Current Policy

Currently, there is no uniform continental position and policy on management of TP in Africa. There has, however, been some deep-seated apprehension that instituting stringent transfer pricing regulatory framework may affect Africa's attractiveness as a destination for FDI[9] . African countries have also engaged in tax competition in a bid to attract FDI[10] , and transfer pricing regulations may seem to negate the objectives in this regard. Cool (2003, as cited in Mevels, Ofa & Karingi, 2013) indicated institution of the TP regulatory

[9] *Eurodad (2011): Exposing the lost billions; How financial transparency by multinationals on a country by country basis can aid development*

[10] *In Morisset J & Pirnia N (2000): How Tax Policy and Incentives Affect Foreign Direct Investment-A Review, it is indicated that African countries are forced to maintain a competitive tax system through principally granting potential investors incentives such as tax holidays, import duty exemptions, investment allowances and accelerated depreciation.*

regimes brings on board compliance activities by revenue administrations such as audits and penalties; and these come into play when MNEs are making decisions on investment. Research has however indicated a negative correlation between FDI and illicit financial flows in all developing countries including Africa (Kant, 1996, as cited in Mevels, Ofa & Karingi, 2013)

There are three different stages of Transfer Pricing development in Africa[11]:

(a) Stage 1: countries with no TP legislation;

(b) Stage 2: countries on the verge of implementing TP legislation;

(c) Satge3: countries that have existing TP legislation.

The features of the countries at the different stages in introducing Transfer Pricing Reform are shown in the Table below.

Table 1: Stages of Transfer Pricing Development in Africa

Stage 1	Stage 2	Stage 3
Countries with no Transfer Pricing Legislation	***Countries on the verge of implementing Transfer Pricing legislation***	***Countries that have existing Transfer Pricing legislation***
• Initial mapping exercise: evaluation of country-specific situation • Technical assistance to foster understanding of TP • Training and secondments • Drafting and testing of legislation	• Implementation of phased approach for TP legislation • Collection and processing of taxpayer information and data • Improvement of communication channels between tax administration and taxpayers • Risk based audit approaches	• Review and revision of existing legislation (differentiation between legislation/circulars) • Discussion and implementation of APA and simplified compliance procedures • Improve access to comparability data • Physical training infrastructure and ongoing training programmes
Examples	**Examples**	**Examples**
o Libya and Sudan have no Transfer Pricing regulations or plans for enacting them in the near future.	o Some countries like Uganda have passed the legislation. o Others are about to pass the law such as Nigeria and Zimbabwe. o While others have Transfer Pricing in the tax code but lack elaborate regulations like Algeria and Mozambique.	o Egypt; Morocco; South Africa and Kenya. o These countries can serve as the model for other African countries

11 *This information and Table 1 are adopted, in both substance and form from EuropeAid: Transfer pricing and Developing Countries; pp. 40; and PriceWaterHouse (2012): Spotlight on Africa's Transfer Pricing Landscape; pp.8. 2.*

1.3.1. Transfer Pricing Models

In developing TP policy and legislation, the individual African countries will be guided by the following three TP models:

(a) **OECD Guidelines,** which have a rich history from the 1970s and have been continually updated and improved. They have been widely adopted by the developed countries but African countries lack the capacity and resources to exclusively rely on these guidelines.

(b) **UN Guidelines,** which weredesigned to address the concerns of developing countries over the complexity of the OECD guidelines.

(c) **ATAF[12] approach,** which stems from indigenous effort to promulgate an African TP framework.

These TP dispensations are premised on the "Arm's Length Standard" as the "guiding principle for allocating income not only among related entities (group companies) but also among cross-border units of a single entity[13]" . The practical implication of this Standard is that when determining taxable income and arising tax liability for a given taxpayer the Tax Administration will reconstruct non-arm's length transactions as if they were arm's length transactions.

Well-thought out TP regulatory framework will not hamper FDI and international trade, but rather will lead to a positive, legitimate and certain environment that will beneficially promote foreign direct investment and world trade[14].

1.4. Statement of Necessity for Change

It is only four countries in Africa that have fully functional TP regulations. A scenario where majority of the African countries barely have a framework to stem abusive Transfer Pricing practices in the era where up to 60% of the global trade is controlled by the MNEs who are the institutional perpetrators of transfer pricing is not only untenable but also self-defeating for the continent. Secondly, Africa has engaged in economic integration efforts which are to be realized through increased cooperation in trade and investment, regional infrastructural projects, and harmonization of fiscal policies and practices.There are also some declining but significant tax competition ventures. All these factors however

[12] *This is the African Tax Administration Forum which was formed in 2010 with the aim of harnessing joint efforts and cultivating mutual cooperation among African tax administrations to improve tax legislator and administrative framework.*

[13] *UN (2011): Transfer Pricing Practical Manual for Developing Countries, pp. 61.*

[14] *UN (2011): Transfer Pricing Practical Manual for Developing Countries.*

the urgent need for Africa to institute robust legislative and administrative measures to tackle Transfer Pricing to protect the continent's revenue/tax base and in the same vein ensure fitting facilitation of FDI and international and/or cross-border trade.

1.5. Context

The policy is to be set in an African environment that is not only enveloped by globalization and is affected by a string of emergent factors that will have far reaching impact on its socio-economic set-up. For example, in the last decade many African countries have attained one of the highest economic growth rates, beaten by only the leading Asian countries such as China and India (UNDP, 2012). The impressive economic growth rates have however had minimal impact on structural changes that are necessary to create robust increases in productivity, incomes, technology and high value added products in the economy (UNCTAD, 2013). African economies will also be challenged by the spiraling population growth rates, with some Sub-Saharan African countries expected to double their population in the next 30 or so years; this is because their annual population growth rate is projected to range between 2.4-2.7% (World Economic Forum, 2012) and the high fertility rate which though declining remains twice the global average (UNCTAD, 2013). The UN (2012) has indicated that the LDC population will grow from 858 million in 2011 to one billion by 2020 and 1.7 billion by 2050 (UN, 2012).The African continent is also plagued by growing unemployment caused by the structure of the growing population with a high youth ratio, increasing urbanization spurred by rural-urban migration. Africa requires substantial investment in the training, education and employment of its youth (UNCTAD, 2013) in addition to the substantial outlays in the dilapidated infrastructure.

One other critical aspect is the markedly low performance level on governance and functioning regulatory systems. This has been revealed through the high level of corruption, revenue leakages and lax enforcement of laws and regulations. It has been suggested that corruption and weak regulatory systemsfuel the black economy and propel the illicit funds flow (Kar and Freitas 2012 and UNDP 2011, as cited in Mevels, 'Ofa & Karingi, 2013).

The promulgation of the Transfer Pricing Policy and regulations will accordingly only have effect if they are sensitive to and designed to respond to the salient issues in the context

2.0. Policy Options to Address Current Political and Policy Processes Affecting Transfer Pricing in Africa

2.1. Governance and Regulatory Framework

As previously indicated, African countries are at varying degrees in their development and institutionalization of a Transfer Pricing governance and regulatory framework. Whereas some countries like South Africa and Morocco have a regulatory framework that may rival some OECD countries, others like Sudan have no functioning framework. A regulatory framework will include elements such as a TP policy, legislation and accompanying regulations, and a strong and functioning tax administration.

African Tax Administrations are, however, not strong enough as they cannot even recoup the subsisting domestic revenue potential. For example, considering the period 2006-2008, the countries in the East African Community had tax-to-GDP ratios that ranged from 12.3% to 22.1%, which was not comparable to the average ratio of the OECD countries of 35.6%[15] . The tax effort[16] in some countries is less than 60%, and this is an unsustainable position. During the period 2001-2005, the three EAC countries of Tanzania, Uganda and Rwanda had a tax effort ratio ranging from 48-61%. Countries with tax administrations in such a dire state, or countries in a state of war would not be able to institute appropriate governance and regulatory framework in the complex area of TP.

The recent revelations[17] in developed countries though confirming that transfer pricing challenge is not a preserve of developing countries, have also shown that tackling the challenge is a monumental task. If developed countries with more robust and strong tax administrations are ripped apart by MNEs' transfer pricing machinations, then the degree of abuse and unrepentant depletion of government revenue sources in regions with moribund and weak tax administrations such as Africa must be far greater especially in

[15] *African Development Bank (2011):Domestic Resource Mobilisation for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration*

[16] *See African Development Bank (2011):Domestic Resource Mobilisation for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration; Tax effort refers to the actual tax revenue realised as a proportion of estimated potential tax revenue of a given tax jurisdiction.*

[17] *The UK is losing up to £120 billion per year to transfer pricing manipulations, and the most conspicuous cases being (1) Starbucks paid no corporate tax over 3 years despite sales of £1.2 billion in UK. (2) Google paid only £3.4 million over sales of £2.5 billion. (3) Amazon paid no taxes with sales of over £3.3 billion. The US also had similar eye-raising cases where (1) Microsoft dodged payment of taxes amounting to \$4.5 billion in the years 2009-11; (2) Apple did not pay taxes on \$34.5 billion; (3) Google did not pay taxes on \$24 billion; (4) GlaxoSmithKline PLC had to pay taxes amounting to \$3.4 billion to settle abusive transfer pricing allegations for the years 1989 to 2005; a payment equal to about 40% of the company's operating cash flow. See Gillespie P (2012): Tax Troubles: How TNCs enhance profits by avoiding taxes. Third World Resurgence, December 2012, 268, 14-17.*

natural resources sector where it is only MNEs with the financial muscle to operate.
The merits of establishing elaborate TP governance and regulatory framework in regions such as Africa are accordingly:

(a) Currently, Africa is losing a significant amount of domestic revenue that is estimated to be in the region of US$ 60 billion per year[18] through transfer pricing, which would almost be equivalent to a third of the current revenue realised. This situation can only be reversed through establishing a functioning regulatory framework.

(b) Establishing a TP regulatory framework will contribute to fiscal certainty and stability, as investors in Africa will know in advance the circumstances and environment in which they will operate. This is critical in facilitating the flow of FDI to Africa.

(c) There is currently existence of rich and well-developed international sources of information and efforts to fight transfer pricing abuses. The major sources and avenues used currently to handle transfer pricing manipulations are:

   (i) United Nations has designed Guidelines on Transfer Pricing and a model double taxation treaty that focuses on the unique and shared challenges of the developing countries. The UN has also been mandated to support developing countries in increasing their tax revenues, through an arrangement code-named "Financing for Development" supported by a "Committee of Experts on International Cooperation in Tax Matters".

   (ii) OECD is working actively on the issue of how states can prevent aggressive tax planning, tax avoidance and tax evasion. In addition to regulation, in the form of the OECD Guidelines for Multinational Enterprises, models for double tax agreements and guidelines for transfer pricing, the organization has a division for taxation which investigates, writes reports and provide recommendations to the international community on how the international regulatory framework can be strengthened.

   (iii) The G20 group of nations is focusing on efforts to stem TP, tax avoidance and tax evasion, and are seeking multi-lateral ways to respond to these challenges to economic development.

   (iv) ATAF has also worked on developing TP guidelines for African Tax Administrations primarily drawing from the OECD and UN models.

[18] *It is estimated that over the period 2000-2008 Africa has been losing at least US$ 50 billion per year through illicit financial flows (Kar & Carthwright-Smith, 2010); whereas for the period 2006-2010, the figure is posted at US$ 300billion (Mevels, "Ofa& Karingi, 2013), which averages US$ 60 billion per year. This is a substantial loss compared to the current annual domestic revenue realized from Sub-Saharan Africa of US$ 185 billion (Weeks, 2009).*

There are also efforts by the International Accounting bodies to ensure fair reporting of information, and encourage country by country specific reporting. Individual countries in the West such as US have also developed more stringent transfer pricing and tax evasion legislation and regulation.

African countries are therefore obliged to engage the various stakeholders including multilateral institutions such as the UN, OECD, World Bank and International Monetary Fund, to ensure that they can take benefit of these global efforts to face transfer pricing. It would, however, be necessary to take on these efforts rationally and selectively to ensure that the African countries bring on board measures that are applicable to their environment. African countries have used model guidelines such as those of OECD that are more appropriate for the developed world.

The governance and regulatory and legal frameworks will only be relevant if there are easily administered and support the taxpayer/investor to incur minimal compliance costs. It has been noted that the investor's ability to provide the proper documentation is one of the principal avenues used by the revenue authorities to affirm whether arm's length principle is complied with[19] . Given that preparing documentation is one of the most expensive compliance costs for MNEs, it would be prudent for African countries to harmonize and align documentation requirements, especially within the same region such as ECOWAS or EAC. If it is economical and especially in light of the fact that the MNES operate across the continent, it would be better to design a continental regulatory framework following on the format of the European Union to make fiscal compliance a relatively manageable venture in Africa. The point of caution is that the structure of taxation in Africa is varied: For example, whereas a country like South Africa relies on direct taxation, as the principal source of tax revenue, countries like Senegal and Uganda are biased to indirect taxation. Kenya and Mauritania show a relatively balanced mix of different types of taxes[20] . Secondly, most African countries have a skewed and unbalanced tax mix as they tend to rely on a narrow set of taxes to generate revenues. All these factors need to be taken into account when developing a continental regulatory framework.

The challenges of this effort are essentially about the substantial resources required to establish a functioning transfer pricing governance and regulatory framework with a capacity to fight abuses perpetrated by well-resourced entities with global connections. Secondly, if African tax administrations are currently weak, they need to be strengthened first before they can be built into sturdy institutions to face off MNEs.

There is no doubt that this is the core policy proposal that all African countries need to adopt depending on their level of development in implementing transfer pricing reform.

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[19] *See UN Practical Manual on Transfer Pricing, 2011.*

[20] *African Development Bank (2010): Domestic Resource Mobilization across Africa: Trends, Challenges and Policy Options*

2.2. Building Transfer Pricing Capacity

This policy option is ancillary to the governance and regulatory framework. MNEs are more often well-resourced, having competent and professional manpower handling their tax affairs, and the most recent technology and information management systems. More often the MNEs do not meet their equivalent in the tax administration. African tax administrations can only be able to stand up to the MNEs if they build a pool of transfer pricing professionals who are well motivated to handle the complex matters.

The tax administrations need to have capacity in terms of appropriate information and databases on the operations of the MNEs, which operate in diverse areas and functions. The due tax obligation of the MNEs can only be determined if the tax administration has both the financial and operational database, and attendant capacity to analyze and interpret the data. The Tax Administration requires the capacity to collect the data, and the competent staff, especially economists, lawyers and auditors, and appropriate software applications. All these require substantial resource outlays including time to bring on board.

The operationalization of the proper TP regulatory framework requires capacity within the tax administration to carry out mandatory audits on all the documentation submitted by MNEs. It is neither plausible nor feasible to audit all the operations of MNEs, and the tax administrations in developing countries should instead develop and effect risk-based audit procedures. The general risk assessment could consider factors such as the size, structure and complexity of the business and its financing, the effective tax rate, the complexity of legal arrangements, openness and transparency and the history of cooperation with revenue bodies. The risk-based selection criteria for Transfer Pricing audit purposes could, for instance, include transactions with tax havens and low-tax jurisdictions, back-to-back operations, structural losses, business reorganizations and management fees.The local economy and industry sectors should be taken into consideration when developing a system for choosing high-risk transactions and taxpayers that should then be considered as targets for TP audit purposes. It is important to ensure that the tax officials carrying out the TP audit are specialized and aware of potentially problematic TP transactions in advance and comply with agreed time limits for audit procedures. The tax audit approach will always need to be tailored to the specific taxpayer (e.g. profit/loss situation, kinds of transactions, industry sector). However, general aspects such as materiality thresholds and the information that should be provided or requested for audit purposes can form part of a more-general TP audit strategy.

All these factors highlight the importance of adopting a deliberate policy to develop a pool of professionals across the whole stretch of the different arms of government, including tax administration, policy and legislation, and judiciary to support the effective operation of the transfer pricing regulatory framework. All the different arms of Government, including the Revenue administration and Judiciary, need to have an international division to handle issues out of FDI, transfer pricing and other issues that emerge from the MNEs' operations in Africa. In addition, it is critical to ensure that all the other resources are provided to support government efforts to fight transfer pricing while at the sametime facilitatingthe investment climate.

2.3. Tax Competition

One of the contradictory and fallacious fiscal policies pursued by a number of African countries is the active participation in tax competition. This involves granting of generous tax incentives and exemptions and investor friendly regulatory frameworks to potential investors on the assumption that this 'soft' offer will influence the investors' decision to bring FDI in the country. African governments have focused on attracting FDI through outcompeting each other in providing tax incentives and policies intended to reduce the cost of business and make it easy for investors to repatriate profits. IMF has identified this policy as misguided which will lead to the "race to the bottom" that will hurt the competing African economies[21] . These measures ultimately lead to loss of revenue. A classic example is Tanzania which for the period 2008-09, granted tax exemptions and incentives that amounted to 6% of the GDP[22] . This is a very high cost of revenue foregone for a country that can only raise tax revenue amounting to 14% of the GDP.

It is therefore puzzling that despite the long held finding that though government forego so much revenue, the MNEs do not consider tax incentives as the principal consideration in investing in a given country. This underlies the strength of this policy option that governments need to cease to provide tax exemptions and other policy offers that make them forego tax revenue. This is a futile cost to their socio-economic development. The factors that influence investment decisions include market size and real income levels, availability of well-skilled personnel, the existence of infrastructure and other resources that supports efficient specialization of production, trade policies, and political and macroeconomic stability of the host country[23] . Governments have opted to engage in tax competition instead of focusing on other factors to make the economies competitive and attractive to FDI.

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21 *For example in a 2006 Report, the IMF noted that "Increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract investors could result in a 'race-to-the-bottom' that would eventually hurt all three [i.e. Kenya, Uganda and Tanzania] EAC members. Left unchecked, the contest could result in revenue loss, especially in Tanzania and Uganda, and threaten the objective of improving revenue collection" (IMF, Kenya, Uganda and United Republic of Tanzania: Selected Issues, 1 December 2006, p.5).*

22 *See AfDB (2011): Domestic Resource Mobilisation for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration, pp. 242.*

23 *Barthel F, Busse M &Neumayer E (2009): The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence From Large Dyadic Panel Data; Contemporary Economic Policy (ISSN 1465-7287); doi:10.1111/J.1465-7287.2009.00185.X © 2009 Western Economic Association International*

2.4. Rethinking Liberalization

The liberalization policy as adopted by African countries is premised on an actively functioning economic globalization, which presupposes greater economic transnational interdependence, rolled out through increasing amount of cross-border trade in goods and services, increasing volume of international financial flows, and increasing migration of labour. Both liberalization and globalization were presented as panacea to Africa's economic stagnation and underdevelopment, and were adopted wholesale by Africa with no consideration of the unique circumstances within the continent. The expected results were accordingly, that poverty will be part of history replaced with economic prosperity evidenced with tremendous improvement in human welfare and standard of living to be a reality. This would only be possible if the following conditions subsist: free trade with no or minimal regulation; free movement of resources or factors of production; market forces determine resourcing flow; and governments extricated from doing business. Even in taxation, Tax Authorities introduced Self-Assessment regimes.

Evidence abound showing that for Africa the unfettered liberalization and globalization is not the positively transformational magic bullet that the continent had hoped for. Africa is the only region that will not meet the MDG target of 2015, and where the absolute number of people enveloped by extreme poverty is just increasing. We are not persuaded that unleashing more active liberalization policies will provide the elusive response.

The substance of this policy option is that market forces on their own are not adequate to guide flow of resources and support African countries to stem abuses by MNEs through avenues such as transfer pricing. The clawing back of Liberalization will for example involve encouraging local participation in major private sector projects taken over by MNEs. The local entrepreneurial class will buy shares and invest in the agreed investment project to such a level that they influence management and strategic direction. This participation and engagement will give information and control to the local shareholders and may cause changes to the firm's policy including influencing intrafirm policies on matters such as transfer pricing.

This policy option presupposes existence of foreign investors who are willing to participate with local participating investors, and to surrender their control of the firm's policy, operations and practices. It will also involve major and taxing government policy shifts, from the current open liberalization to a more directive and interventionist policy. The level of entrepreneurial and financial capacity in most African countries is low and getting participation may involve initially funding the concerned individuals.

2.5. Exchange of Information between Countries and Revenue Authorities

One of the critical considerations in developing a framework to manage TP is the availability of information. The tax administration would primarily seek three types of information: *enterprise-related, transaction-specific and computation-related documents*[24] .

The information is required to be able to effect comparison and establish the efficacy of the prices used by MNEs. If data cannot be used to compare one company to another, within countries, industries or regions, the data is more or less useless[25].

In this era of globalization, MNEs operate across borders and continents, and it would accordingly be necessary to have frameworks for accessing and sharing information. The information involved includes in-country and foreign data for determining 'comparable transactions' that underlie the 'Arms' Length Standard'.The operationalization of the Arm's Length Standard presupposes the existence of pricing for 'comparable transactions'. The UN Guidelines[26] highlight the challenge of finding comparable transactions in developing countries, and this is primarily due to the following factors:

(i) Normally, the number of organized operators in any given sector in developing countries is limited and this naturally makes it hard to identify appropriate comparable data;

(ii) Even when the information on comparable transaction in developing countries is found, it may be in a form which is incomplete and probably incomprehensible, or in the extreme cases, the data may be non-existent.The Tax Administration which does not have the resources, capacity and developed processes and procedures to handle such a complex matter will find it hard to analyze and interpret the data. More often the 'straight jacket solutions' proposed of using data from developed countries are both inappropriate as the data is not relevant to the local scenario, and prohibitively expensive to access, as the process would more often require resource and information-intensive adjustments.

(iii) There are also unique cases in the transition economies where some enterprises are pioneers in their area of operation, and identifying comparable transactions would be a pipedream. This explains the need to widen the scope of information andto build a strong framework for sharing information within Africa. This is primarily because MNEs operate within different countries in the region, and the nature of business dealt in is either similar or closely related.

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[24] *UN (2011): Transfer Pricing Practical Manual for Developing Countries.*

[25] *Eurodad (2011): Exposing the lost billions: How financial transparency by multinationals on a country by country basis can aid development*

[26] *UN (2011): Transfer Pricing Practical Manual for Developing Countries.*

2.6. Labour and Skills

As noted earlier, more often than not, African countries lack the required skills and knowledge necessary to interpret the operations of MNEs. More often this can be presented as intellectual property. The value attributed to Intellectual Property, which is also called intangible economy, can be abused to shift taxable income from developing countries. The application of Arm's Length Standard is however not in the interest of developing countries as most corporate value is attributable to intellectual property. Whereas it is widely agreed that for very profitable companies, ownership of intellectual property is one main reason for their sustained profits and therefore it is reasonable for the owners of intellectual property to retain profits associated with their investment, the lack of intellectual property in Africa makes gaining support for use of the Arm's Length Standard more difficult. Resource rich countries have expressed particular concern regarding the applications of Arm's Length Standard that attribute significant value to intellectual property. In the context of mining, and oil and gas sectors, there has been significant debate surrounding appropriate share of revenues between MNEs and African governments. Most African governments (e.g. Republic of South Africa, Nigeria and Ghana have passed Transfer Pricing legislation with protectionist provisions for their national natural resources.

2.7. Transparency

One of the greatest challenges to the operation of MNEs and international trade in Africa is the lack of transparency. Not only is the expected revenue eroded by excessive granting of tax preferences and inefficient taxation of extractive activities but also the inability to fight abuses of transfer pricing committed by MNEs. This is primarily because contracts between MNEs and governments are often subject to confidentiality clauses by the MNEs/ investors, governments, and banks. Matters are compounded by the fact that African governments often lack capacity to negotiate contracts that allow them to generate fair share of rents from natural resource extraction.

2.8. Double Taxation Agreements

Double taxation treaties are designed to enable the treaty participating/contracting countries to mutually modify the exercise of their respective taxing rights to prevent double taxation. Tax treaties modifying the operation of domestic tax law through waiving the operation of the domestic tax law of a participating/contracting country or by obliging a participating country to provide a credit against its domestic tax for tax paid in the other participating/contracting country. Though double tax treaties may not explicitly provide for the transfer pricing governance arrangements, they play a crucial role in developing economies, providing a framework that increases information exchange and also allows for standardization. The double taxation treaties would support participating nations to gain experience in treaty negotiations and develop expertise on common issues that arise based on competing interests

It should however be noted that many African countries lack comprehensive tax treaty networks. The typical African country has a handful of treaties with African and several with non-African countries. This lack of comprehensive treaty network places Africa at a disadvantage compared to other developing countries. Treaties are crucial in developing economies; they reduce double taxation, increase information exchange and allow standardization.

Countries need to be encouraged to engage in developing and negotiating double taxation agreements. The treaties promote local investment climate by providing a legal mechanism to address potential cases of double taxation and support exchanges of information. It would be prudent that African countries join multi-lateral cooperation structures and processes such as the OECDs Global Forum on Transparency and Exchange of Information.

3.0. Transfer Pricing Recommendations.

3.1. Objectives of the Recommendations on TP Policy and Practices

The ultimate objective of the transfer pricing efforts is to maintain a delicate balance between attracting investment and ensuring sustainable flow of domestic revenue to meet the national development objectives. This can only be realised if both governments of the host country and the home country of the MNEs, together with the MNEs as the principal stakeholders ensure that these competing objectives are attained cost-effectively.

3.2. Recommendations on TP Policy and Practices

The principal recommendations that need to be implemented are accordingly the following:

3.2.1. Instituting an effective TP Governance and Regulatory Framework
This is a critical policy proposal that needs to be instituted for African countries to stem the exploding abusive transfer pricing practices.

African governments need to start by taking benefit and actively participating in the existing efforts to combat transfer pricing. This recommendation is informed by the following considerations:

(i) The recent revelations about abuse of transfer pricing has heightened the profile of the matter, and made developed countries to be as equally concerned as developing countries.

(ii) The global efforts are well resourced, have adequate database, an established lessons learnt systems, and will accordingly be able to provide the required data and information on transfer pricing.

(iii) It will be easier to pool resources and the shared costs make the process economic.

The development of Transfer Pricing Governance and Regulatory Framework is core to the realization of the ultimate objective of this policy goal and all other policy proposals hinge on the successful implementation of this recommendation. It will entail the following:

(a) Developing appropriate policy, based on consulting all the critical stakeholders.

(b) Enact appropriate legislation and regulations.

(c) Source for the required funding to ensure that staffing and other resources are procured.

(d) Institute a programme for developing human resources.

(e) Incorporate transparency in all the governance and regulatory framework.

(f) Institute a mechanism for exchange of information between countries and tax administrations

(g) Institute a system for Country-by-country reporting by MNES that will not only to preempt to preemptmanipulative transfer pricing and benefit tax administrations.

3.2.2 Transparency

There is accordingly need to develop and constitute a well-laid out procedure for negotiating contracts between Governments and MNES. This will include elements such as:

(a) Representation from different stakeholders in the negotiation process.

(b) Other than valuable business knowledge, the contracts with MNES should be placed in the public domain.

(c) Government negotiators and observers from the different stakeholders should be given training to position them to stand up to the MNEs in the negotiation process.

(d) Parliament should be gave competences and power to carry out oversight role in this area.

(e) There should be strong transparency rules and code of conduct.

3.2.3 Tax Competition

This is another policy option that will require a major policy rethink by some African countries. Governments will need to disabuse themselves of the fallacy that attracting FDI to the country depends on tax incentives. Government would accordingly need to exploit more effective vehicles to attract FDI such as using regional economic integration bodies to ensure tax harmonization across a region rather than considering individual more often economically unviable nation-states.

3.2.4 Double Taxation Agreements

African governments need to set out and ensure that they engage and sign double taxation treaties with countries that are home countries to the MNEs that invest in them. This is a medium to long term strategy that requires African governments to develop national capacity to enter into treaties that are beneficial to their populations. [How is the MNE's home country determined? With global transportation corporations, e.g. airlines, the DTAs need not be based on investment in the host country, just the generation of business from it.

3.2.5Rethinking Liberalization

This will be a major and radical policy shift that will require an extended engagement to persuade stakeholders that the policy of liberalization and globalization are not the only avenue through which African countries can attain socio-economic national objectives. They will need to build national entrepreneurial capacity, encourage development of private sector and public-private partnerships, and ensure that nationals can gain control and influence in the management of MNEs. This is a long term strategy that needs patience, and concerted sensitization and education of the populace, together with funding of the entrepreneurs.

3.2.6. Developing Advocacy Capacity

African governments and civil society organizations need to develop a strong and effective advocacy strategy to curb transfer pricing. African governments will need to create an environment that make MNEs engaged in manipulative Transfer Pricing to be shamed because of its adverse and inimical socio-economic impact on the economy and the populace on the continent. The local populace need to be given the relevant information about operations of MNEs through concerted sensitization.

4.0. Conclusion

African countries are enveloped by this era of globalization with increasing interdependence between nations, and the need to attract foreign direct investment, development assistance. Increasing international trade and investment has also raised the challenge of abusive transfer pricing by the MNEs. African countries that fail to institutean appropriate policy mix to stem abusive transfer pricing will have their revenue sources from international trade and investment eroded and unable to mobilize domestic revenue necessary to meet the MDGs.

In designing appropriate policy frameworks however, it is imperative that countries work together within their economic networks; re-think their investment and economic policies on liberalization and at the same time agree on the evils of tax competition and how that vice should be curbed since research has not established it as very crucial to attracting FDI. Capacity building at all levels of Government including the Legislature and Revenue Authorities cannot be over-stated. The quality and effectiveness of policies to support the necessary legislation and the tracking of operations of the MNEsfor ease of tax audits requires thorough understanding of transfer pricing mechanisms which calls for training, information sharing and effective tracking of their activities.

P.O. Box 25112, Nairobi 00100, Kenya
T +254 20 247 3373 C +254 728 279368
info@taxjusticeafrica.net
www.taxjusticeafrica.net

www.facebook.com/TaxJusticeNetworkAfrica

@TaxJusticeAfric

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