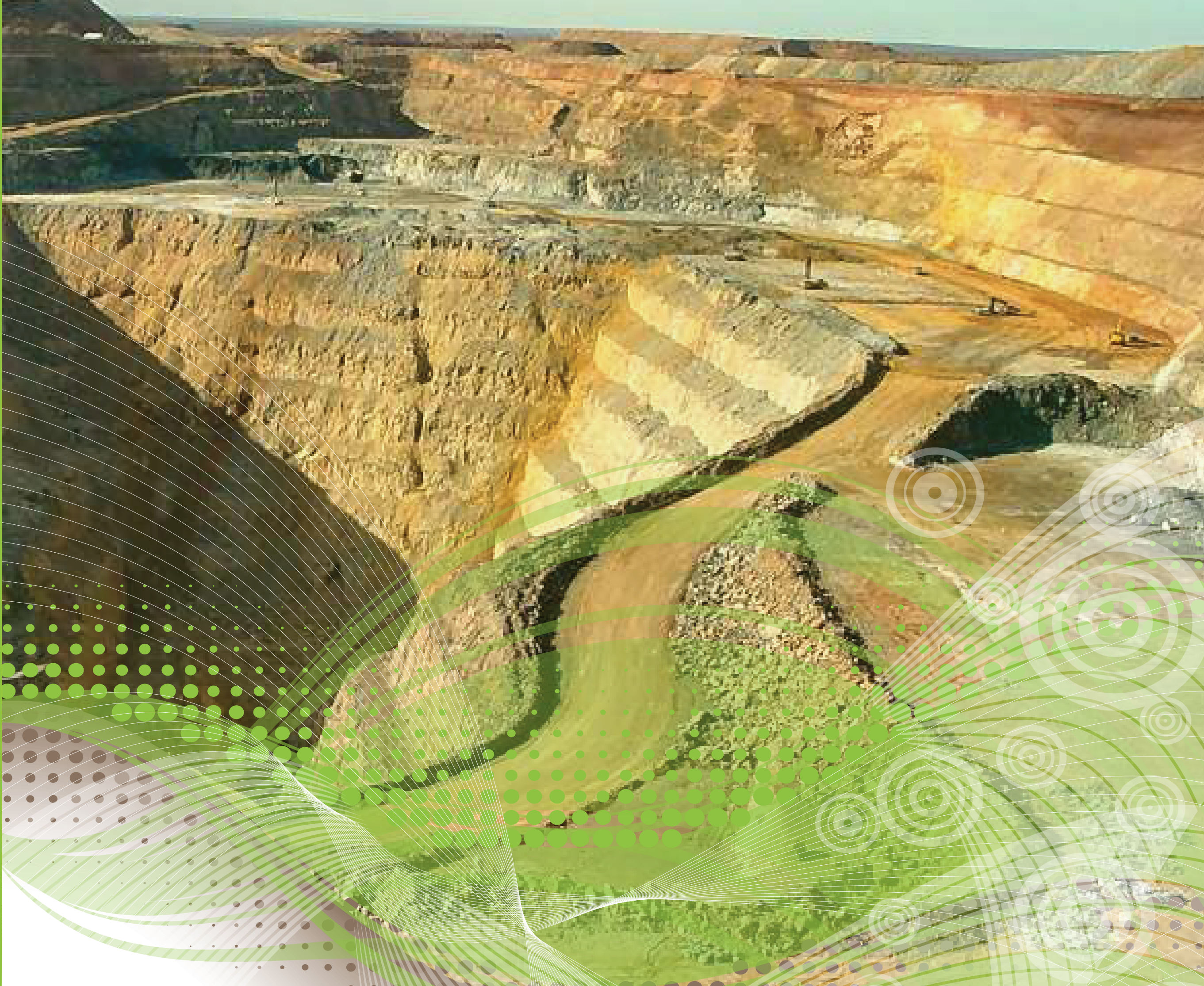
A POLICY SYNTHESIS PAPER

ADDRESSING TRANSFER PRICING ISSUES IN AFRICA



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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Transfer Pricing in Perspective

On account of the heavy dependence of many African economies on trade, transfer pricing (TP) continues to be one of the most significant issues to their sustenance and development. Economies anchored on the exploitation of natural resources expect the proceeds from such resources to enhance growth, which will stimulate long overdue post-colonial social and economic transformation processes and reduce poverty. It is in this respect that a connection is often drawn between governance and the attainment of the Millennium Development Goals (MDGs).

Progressive management of trade should also facilitate mutually beneficial integration of African countries, initially at the sub-regional level, and eventually across the continent, partly by escalating the level of intra-African trade, while raising the prospects of improved terms of trade with developed economies. International taxhas been identified as being critical to the contribution of trade to the growth of African economies. A recurrent theme is that the equitable taxation of multi-national enterprises (MNEs) involved in and benefiting from trading in natural resources will increase domestic resources available, specifically by reducing abusive transfer pricing.

Transfer pricing occurs in the context of trading transactions between or among two or more related corporate entities, one of which might be the parent company and the other a subsidiary. The transacting entities could be two subsidiaries controlled by a common parent. The price set and usedfor the transaction is a transfer price. The parent companies, generally referred to as MNEs, are distinguished by their capacity to determine the level of intra-group transfer prices. The impact of transfer pricing has precipitated the raging debate, particularly as intra-group trading transactions are broader than just the transfer of tangible commodities. They include payment for services, such as management, insurance, marketing or information technology. They also include the provision of financial services, by one subsidiary lending to another, as well as payment for intellectual property rights, such as the use of a brand. The phenomenal growth of the telecommunications sector in several African countries has attracted significant participation by MNEs, some of which are based in Africa – specifically in South Africa, Kenya and Nigeria. Over time, mobile 'phone services have diversified into ancillary services such as banking, insurance and general on-line entertainment. The telecommunications companies concerned have either established subsidiaries to offer such services or contracted with companies providing them. They have thus become a conduit for the transfer of funds to offshore centers with no adequate arrangements for such transfers to be taxed.

It is contended that TP determinations are motivated by profit maximization, done through tax avoidance and evasion. MNEs transfer income derived from productive activities in developing countries to developed countries and secrecy jurisdictions. The resulting shifting of profit, achieved through transfer mispricing, continues to erode African tax bases. Furthermore, it perpetuates a mismatch between the escalating inflow of foreign direct investment over the past two decades and the lack of development of the intended beneficiary jurisdictions. Kabala-Litana and Ndulo argue that:

Although the profitability of the operations of the investing firms in Africa is extraordinarily high, MNEs are paying less in terms of tax due to transfer pricing (Mold, 2004). This has created a problem for African countries to raise their revenue base for financing development programmes.

Issues specific to Africa

The basic challenge for many African countries is to map the transactional relationships relevant to the business activities of the subsidiary of an MNE. The family to which a given corporate entity belongs is not always evident to the regulatory authorities. Without being familiar with the extent of the group within which suspect transactions may occur, it is difficult to detect transfer pricing. Modern MNEs have established corporate structures that are complex and are quite difficult to understand without studying detailed organograms. The issue is therefore to establish the beneficial ownership or interests in a corporation being examined, as a prelude to tracking potentially taxable income flows between or among them.

The expected growth of urbanization in Africa will increase pressure on many governments to grow economies and provide opportunities, particularly for the youth. As in other parts of the world, African countries are bound to examine possibilities to harness the potential drivers of economic growth. These drivers include natural and human resources, competitiveness and technology, and food production. In the area of resources, there are growing callsfor resource nationalism in countries such as Zambia, Zimbabwe and South Africa. This resurgence of resource nationalism occurs at a time when the supremacy of territorially defined sovereignty has been seriously challenged by the impact of globalization. In Africa, as in the rest of the world, the global market has been replacing the state as the referent of sovereignty. While the jurisdictional autonomy of nation states is under pressure, each is expected to respond in a manner that is specifically sensitive to the demands of its constituency – particularly its nationals. The tendency to be competitive should be understood in that context.

Competition for scarce investment capital has been inspired in no small measure by the City of London Corporation, which was foundedas a tax haven on the eve of the demise of the British Empire in the 1950s. The labyrinth of tax havens established with its guidance, which offer secrecy to investments of questionable origin, has assumed high relevance to illicit financial flows from Africa. As Shaxson puts it:

By the 1980s, the City was at the centre of a great, secretive financial web cast across the globe, each of whose sections - the individual havens - trapped passing money and business from nearby jurisdictions and fed them up to the City: just as a spider catches insects. So, a complex cross-border merger involving a US multinational might, say, route a lot of the transaction through Caribbean havens, whose British firms will then send much of the heavy lifting work, and profits, up to the City.

The mushrooming of tax havens beyond the City of London and its satellites has magnified the capacity of MNEs to assume greater sovereignty in various commodity markets, simultaneously shrinking that of nation states.

The benefits from the commodity price boom of the last decadeto African economies have largely been disappointing as the bulk of the revenues went the MNEs.

The absence of formal legislation to regulate TP presents challenges. It means there is no guidance to regulators and MNEs alike on the scope of TP transactions within the economy. The emerging standard approach is to consider whether there is any income arising or potentially arising from the transaction.

Legislation is important to harmonize the multiplicity of interests and perspectives likely to be involved in what has become a crowded sphere. The most significant TP transactions involve more than just the domestic public sector on the one side and MNEs on the other. Within the public sector,government institutions with potentially contradicting motivations include revenue authorities, departments of trade and central banks. It is important for the leadership and coordinating functions to be streamlined and clearly defined to prevent the state from taking contradictory positions in specific transactions. Beyond the public sector are the MNEs concerned, other tax paying constituencies in business, legal and financial advisory intermediaries, and civil society.

The secrecy surrounding negotiations for major investments to exploit natural resources has tended to yield long term agreements that are potentially prejudicial to some producing countries, in that they are permissive of abusive profit shifting. Allegations of corruption have characterized many of these negotiations. The importance of incumbent governments being restrained from abusing their contact with competing MNEs for contracts to engage in corruption cannot be over-emphasized. The allocation of rights to mine for diamonds in eastern Zimbabwe from 2008 was plagued by patronage and corruption allegations. Transparency would reduce opportunities for rent seeking and dissuade public authorities that negotiate major investment contracts from making irresponsible commitments.

Theperception that MNEs operating in Africa "regard operations in African countries as less valuable than those of the parent or other foreign group companies" is widely held. It is argued that this attitude is reflected in the level of costs allocated to African subsidiaries for intangible commodities, for instance the use of intellectual property rights. Action Aid's report on SAB Miller Calling Time uses the example of a wholly owned brewery in Ghana to highlight apparently glaring inequities in income distribution and consequent tax liability, between the brewing subsidiary and its related intellectual property warehousing subsidiary located in the Netherlands. An audit report on income distribution practices by Glencore in respect of its copper mining subsidiary at Mopani in the Zambia's Copperbelt, revealed a similar tendency. The same could be said of the under-invoicing of unprocessed timber "sold" by DR Congo-based Siforco, which a subsidiary of the Danzer furniture group, to another subsidiary based in Switzerland, trading under the name Interholco AG.

While nationalization of the resource extraction sector is unlikely to receive universal acceptance, these inequities are likely to support growing pressure to grow a domestic private sector sensitive to the imperative to provide secure employmentand food security in the medium term. MNEs operating in Africa may be compelled to become 'more domesticated' and to disclose the distribution of income which accrues to them. One method of domestication suggested is for their subsidiaries to list on local stock exchanges, presumably opening them up to shareholder pressure to make such disclosure.

An enduring issue is the disproportionate share of investment in capital, technology and training by MNEs in comparison to state institutions. This impacts on the leverage of resource-endowed economies to dictate the terms on which MNEs engage.

The vertical integration of large MNEs raises a significant issue. Glencore Xstrata presents an example of an MNE that is more vertically integrated than most others. It is active in upstream mining and resource extraction as well as downstream marketing. Its marketing and logistics activities give Glencore Xstrata the advantage of strategic intelligence and the ability to understand the cycle and underlying supply and demand issues. The same could be said of oil giants Shell BP, Exxon and Chevron.

One of the consequences of such highly vertical integration operation is to grossly tilt the scales in favour of MNEs. This is graphically illustrated in the imbalance in access to strategic intelligence on current and future trends in global markets and prices. When advance pricing agreements are negotiated, the imbalance can yield significant prejudice to the interests of the taxing authority. Another is to make it problematic to establish arm's length fees by which to assess intra-group pricing. Such fees are typically determined using the cost plus method, which involves the addition of an appropriate mark-up to the costs incurred by the supplier of goods or services. The mark-up should provide for an appropriate profit to the supplier, to take account of the functions performed, assets used and risks assumed. It is often used where the controlled transaction is the provision of a service.

However, the margins in respect of a particular service are difficult to establish and information in this regard on international databases fluctuates significantly. MNEs could thus use the upper range to determine a fee for intra-group services, enabling them to extract high margins from production subsidiaries. In the case of royalties for the use of intellectual property owned by the parent company, levels tend to be high enough to significantly affect the profitability of the subsidiaries, as was alleged to be the case with SAB Miller's subsidiary in Ghana. This pertains to brand logos, patents and trademarks. The absence of market comparisons complicates any challenge by tax authorities of the rates used. Some MNEs allege that, even with the best intentions, the arm's length measure is quite difficult to implement.

How the issues could be addressed

Transfer pricing raises issues that require to be addressed through appropriate policy changes, strategies and effective measures. The African Tax Administration Forum (ATAF) seeks to identify the priority policy innovations and get them to be adopted among its membership of over thirty tax administrations. Acknowledging the low level of TP skills and experience in many member countries, ATAF has committed itself to building capacity as quickly as possible, combining input from researchers, technical specialists from the public and private sector, and non-governmental organisations such as the Tax Justice Network-Africa (TJN-A). Experts from the Organisation for Economic Co-operation and Development's Forum of Tax Administration (OECD-FTA) provide strategic oversight.

Among the policy innovations that could be considered is the introduction of combined reporting, with formulary apportionment and unitary taxation. This prioritizes the economic substance of a multinational and its transactions, rather than the legal form in which a multinational organizes itself and its transactions. In terms of unitary taxation, income accruing to an MNE is allocated to the different countriesin which the MNE has a business presence according to an agreed formula. Each can apply its own domestic tax rate to whatever portion of income was apportioned to it. The main strength of the formula is that profits accrue to a jurisdiction on the basis of its footprint as determined by factors such as employment levels (either calculated by headcount or by salaries), the value of physical assets located in each country where the multinational operates and the average income within the sector in which the MNE operates. As each country has a right to design its local taxes, unitary taxation accommodates their competitive inclinations. They can still grant concessionary terms to attract industries to locate within their borders and provide employment, on the understanding that this will be considered in determining the total tax allocated to that country. The unitary tax principle has gained acceptance in the United States since 2004.

As indicated above, establishing the structure of MNEs is a monumental and costly challenge. Indeed MNEs have become adept at restructuring themselves so regularly that it is nearly impossible to keep up. It has been argued that this might obviate the need for MNEs to "set themselves up as highly complex, tax-driven multi-jurisdictional structures," and might also "simplify their corporate structures, creating major efficiencies."

Implementing unitary taxation depends on the implementation of accurate and verified country-by-country reporting. Such reporting is receiving increasing support, since it was initially mooted by, among others Richard Murphy. Murphy argues that country-by-country reporting would require each MNE to provide the following information:

(1) The name of each country in which it operates;

(2) The names of all its subsidiaries and affiliates in each country in which it operates;

(3) The performance of each subsidiary and affiliate in every country in which it operates;

(4) The tax charge included in the accounts of each subsidiary and affiliate in each country in which it operates;

(5) Details of the cost and net book value of its fixed assets located in each country in which it operates.

(6) Details of its gross and net assets for each country in which it operates.

Self-reporting would be verified by reference to data prepared by each of the host countries, using various sources including tax authorities, deeds and company registries, stock exchanges, the public media, financial institutions and civil society structures. Deliberate material mispricing of inputs, outputs or services across international borders might become easier to detect. The formula to be used in allocating taxable income should be arrived at by all the countries in which the MNE has a presence.

In accounting for transfer prices, MNEs should be required to preserve and submit the documents used, as well as declare the tax planning methods and transfer formulae used.

The literature suggests that transfer mispricing is not an end in itself, but only one of the means by which funds are illicitly transferred from African countries. It would be simplistic to treat it in isolation, while not simultaneously paying attention to related fault lines. The policy innovations being pursued by the OECD have the prospect of achieving positive change in identifying and reducing suspect transactions. One should caution against passive reliance on the OECD prescriptions.

A global coalition of governments and civil society organizations, the Task Force on Financial Integrity and Economic Developed, renamed the Financial Transparency Coalition 2013 advocates for improved transparency and accountability in the global financial system, guided by several priorities:

(i) To curtail mispricing in import-export trade;

(ii) To achieve country-by-country accounting, and automatic exchange of sales, profits and taxes paid by multinational organizations;

(iii) To confirm beneficial ownership in all banking and securities accounts;

(iv) To harmonize predicate offences to which money laundering law can be applied.

As money laundering involves the concealment of the illicit means used to create value, through trade transactions, tax evasion or corruption, it follows that effective anti-money laundering frameworks provide an opportunity to secure transparency in illicit capital flows-related activities. This suggests that the structures leading anti-money laundering initiatives across Africa – specifically financial intelligence units (FIUs), should be involved in tracking transfer pricing. It is tempting to suggest that FIUs should lead the implementation of anti-transfer mispricing measures, but this may not be appropriate in every case. At the very least, each FIU should be the repository of data on transactions between related corporations originating from or terminating in their jurisdiction.

In the long term, African countries need to beneficiate raw exportable resources to enhance intra-African trade as well as retain value on the continent. For instance, more crude oil originating from African sources should be refined in the source countries, for direct export to other African countries. The same applies to precious minerals such as platinum and gold. It is contended that this will make country by country reporting viable, and reduce the cost of importing fuel. There is a growing contingent of African based players in the major sectors, such as mining and oil to justify this view.

Regional integration is intended to curb the unhealthy tendency of countries to act unilaterally, disregarding the concerns of, and the impact of some decisions on neighbouring countries. African countries seem to easily accept the argument put forward by MNEs that it is not feasible to achieve a common regulatory position, given the differences in the costs of conducting business in various countries in Africa. If it is to impact on transfer mispricing and illicit financial flows, regional integration has to mainstream international taxation into all stages of planning and implementation.

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