CLOSING THE FLOODGATES: AFRICA'S RESPONSE TO THE IFF SCOURGE

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WHAT ARE ILLICIT FINANCIAL FLOWS?

- “refers to cross-border movement of capital associated with ***illegal*** activity or more explicitly, money that is ***illegally*** earned, transferred or used that crosses borders.” (World Bank)
- “Illicit financial flows (IFFs) are ***illegal*** movements of money or capital from one country to another. GFI classifies this movement as an illicit flow when the funds are ***illegally*** earned, transferred, and/or utilized.” (Global Financial integrity)
- “generated by methods, practices and crimes aiming to transfer financial capital out of a country in ***contravention of national or international laws***.” (OECD)
- “money that is illegally earned, transferred or utilized.” UNECA HLP on IFF
- Dictionary definition of **'illicit’- 'forbidden by law, rules or custom' – covers illegal activities such as tax evasion but also immoral/unethical activities such as tax avoidance.**

DICTIONARY DEFINITIONS OF "ILLICIT"

- Cambridge Dictionary: "illegal or ***disapproved*** of by society
- Merriam Webster: "***not permitted***; unlawful"
- Oxford Dictionary: "***forbidden by law, rules or custom"***
- Other meanings: not legally permitted or authorized; ***unlicensed;*** unlawful; ***disapproved of or not permitted for moral or ethical reasons.***
- ***QUESTIONS TO PONDER ON:***
- ***WHO SHOULD DEFINE A THING? IS IT THE VICTIM OR THE OPPRESSOR? ARE DEFINITIONS IMPORTANT AND WHY ARE THEY IMPORTANT? ARE DEFINITIONS STATIC, IMMUTABLE, SINGULAR, UNANIMOUS?***
- ***THE HLP ON IFF REPORT ELECTS A BROAD DEFINITION, COMPRISING TRANSFER MISPRICING, IS THIS ACCEPTABLE AND SHOULD BE RELIED ON?***

IFFS EXPLAINED (CONTD.)

- Could be: money laundering, bribery by international companies, tax evasion, trade mispricing.
- UNECA highlights other techniques used as: operating of millions of disguised corporations, shell companies, anonymous trust accounts, and fake charitable foundations. Other techniques used include money laundering and ***transfer mispricing***.
- Origin: These funds typically originate from three sources: commercial- tax evasion, trade misinvoicing and abusive transfer pricing; criminal activities, including the drug trade, human trafficking, illegal arms dealing, and smuggling of contraband; and bribery and theft by corrupt government officials. (UNECA HLP on IFF)
- Effects: draining of foreign exchange reserves, reduced tax collection, cancelling out of investment inflows and a worsening of poverty. Such outflows which also undermine the rule of law, stifle trade and worsen macroeconomic conditions. (UNECA)

CHALLENGES TO ADDRESSING ILIICIT FINANCIAL FLOWS

- The global economy
- The digital age: cryptocurrencies, e-commerce, new banking models
- Technical capacity and political will
- Absence of price information
- Absence of judicial support, non-penalization of defaulters; and lack of funding to address IFFs
- Reliance on foreign assistance in combating IFFs largely caused by foreign countries: unpredictability and bias
- ***Arm's length standard and transfer mispricing***

THE ARM'S LENGTH PRINCIPLE AND MULTINATIONAL COMPANIES (MNCs)

- Intra-firm transfers central to profits of an affiliate
- The Separate entity treatment of members (affiliates) of MNCs
- Article 9 of Tax Treaties:
  - "Where
  - A) an enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or
  - B) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state,
  - And in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

THE ARM'S LENGTH PRINCIPLE AND MULTINATIONAL COMPANIES (MNCs)

- ***Transfer mispricing is the manipulation of transfer prices to minimize tax liabilities.***
- Other reasons for transfer mispricing include: improvement of wage bargaining with local labour units, exchange rate and nationalization risks; circumvent restrictions to the transfer of profits from those host country(ies) which pose strict ceilings and constraints to such transfers. See Grazia Letto-Gilles (**Transnational corporations and the globalization process)** and Roger Wesley (Problems in Regulating the Multinational Enterprise—An Overview)
- Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. (OECD TP Guidelines 2017).
- Transfer pricing arises as a result of the taxation of the affiliates of a multinational enterprise in different countries on the basis of separate accounts, treating them as independent entities

TRANSFER (MIS)PRICING

- Transfer pricing determines a large part of the income and expenses, and therefore taxable profits of associated enterprises in different tax jurisdictions. It is vulnerable to manipulations and could lead to transfer mispricing.
- Five accepted transfer pricing methods: CUP; Cost Plus; Resale Price Minus; TNMM; Profit Split. Sixth method (use of publicly quoted prices for commodities), needs adjustment to take into account, critical determinants of prices such as geography, volume and trade terms- World Bank 2017.
- All require analysis of functions of the affiliate, and attribution of profits based on ***"comparables".***

SIMPLIFIED DIAGRAM OF INTANGIBLES-BASED BEPS ARRANGEMENT (MIKE DURST)

Hub company licenses use of trademark to in-country operating company (distribution company)

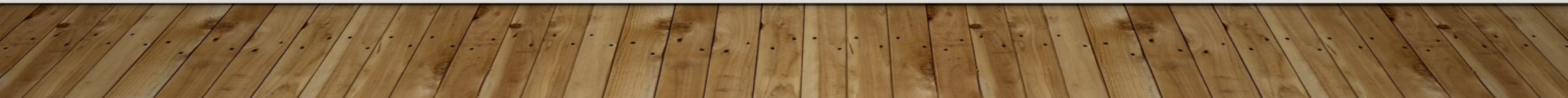
Parent of group contributes valuable trademark (e.g., of branded beverage)

Tax-haven "Hub" Company

In-country operating company

In-country operating company distributes beverage, potentially generating locally taxable income.

In-country operating company pays deductible royalty under license, reducing in-country taxable income



LIMITATIONS OF TRANSFER PRICING METHODOLOGIES

- Absence of comparables: due to lack of data, but also MNCs' unique technologies
- Absence of domestic resources and no African-developed database- reliance on Amadeus and Orbis.
- Requires detailed audit analysis of company's business model: subjective and discretionary.
- Dearth of resources, especially human capital, and lack of experience in applying transfer pricing regimes.
- Integrated production of highly specialised goods; unique intangibles; and the provision of specialised services- (OECD TPG 2017).
- Overemphasis on the contractual allocation of "functions, assets, and risks", encouraging tax minimisation by fragmentation of functions .

SOCIO-ECONOMIC IMPLICATIONS OF TRANSFER PRICING ABUSES

- Taxation is key to the character and functioning of the state, the economy and society as a whole- Solomon Picciotto
- Zambia- 74% of the population live on less than a $1.25 a day and 6 million people are undernourished; health care and schools suffer.
- Denial of basic economic, social and cultural rights of African countries.
- Shifts the tax burdens to individuals, who are the poor ones.
- Erodes inter-nation and inter-taxpayer equities.

WHAT SHOULD BE AFRICA'S RESPONSE?

- ***Is the arm's length standard of income allocation suitable for developing countries?***
- Are there alternatives to the arm's length standard and should they be considered?
- In terms of the search for comparables, should we revert to the use of the ***"reasonable man's test (hypothetical uncontrolled transaction)?"- Canadian Supreme Court's decision in GlaxoSmithKline Inc.'s case.***
- Alternative minimum tax based on gross revenue?
- Potential Advantages of Gross-Based AMT (Michael Durst): Since no deductions are allowed, a gross-based AMT is *almost entirely immune to haven-based tax avoidance*. (The gross-based AMT would be vulnerable to underpricing of outbound sales of goods and services, but the quantitative effects of this underpricing should be small compared to the effects of deduction-based profit shifting); Tax should be relatively easy to administer; Arguably, the AMT would result in revenue collections at levels that are politically realistic given the pressures of tax competition for inbound investment

WHAT ARE SAFE HARBOURS?

- Broad Definition:
  India Income Tax Law: "circumstances in which the Tax Authority shall accept the transfer price declared by the taxpayer".
  Similar approach in Nigeria: Regulation 15 of the TP Regulations, 2012.
- OECD Narrow Definition: "a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules" (OECD TPGs 2017).
- OECD's exclusions: APAs, thin capitalization rules

FEATURES OF SAFE HARBOUR REGIME

- An opt-in option by taxpayers who are bound to the safe harbour regime for a period of time (usually 3-5 years). For taxpayers who refuse to opt-in, requirement to present detailed TP documentation.
- Provides assurance that the prices fixed and returns filed will be accepted by the tax authority.
- Covers specific group of taxpayers or transactions, for example, manufacturing sector or low transfer pricing-risk sectors
- Attempts to set margins for transactions that are in line with the arm's length principle? How do you achieve this? Industry consultation is an option, however, there is fear of capture by influence-wielding corporations.

BENEFITS OF SAFE HARBOURS

- Reduces the need to find data on comparables and to perform benchmarking study
- Addresses the issues of unavailability or unreliability of information
- Simplifying compliance and reducing compliance costs for eligible taxpayers
- Provides predictability for both taxpayers and the revenue authorities
- They reduce the possibility of litigation and could increase FDI into a country.
- Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations
- Limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with the safe harbor provisions
- Permitting tax administrations to redirect their administrative resources from the examination of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers
- Summary: Safe harbours achieve increased revenue collection, tax efficiency, certainty, simplicity and convenience

ISSUES TO CONSIDER

- May lead to taxable income being reported that is not in accordance with the arm's length principle
- May increase the risk of double taxation or double non-taxation when adopted unilaterally
- Potentially opens avenues for inappropriate tax planning and may raise issues of equity and uniformity
- Unilateral, bilateral or multilateral safe harbours? Issues of fiscal sovereignty, negotiation, time management, cost of negotiations, potential for corresponding adjustments by other tax authorities.
- Scope of safe harbours: for developing countries, should it be limited to low transfer pricing-risk sectors or based on importance of the sector to the economy? Should the guarantee of revenue collection be the influencing factor?
- Exclusions? For example, India excludes the application of safe harbour to transactions or taxpayers with connection with tax havens- no-or-low tax country/territory. See S. 94A of the Income Tax Law of India.

GENERAL REMARKS:

- Effective exchange of information: information exchange upon requests; automatic exchange of information; and spontaneous exchange of information
- Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum)
- The Foreign Account Tax Compliance Act (FATCA): improves tax compliance involving foreign financial assets and offshore accounts. Mandates US taxpayers and foreign financial institutions (FFI) to report foreign financial assets above certain thresholds to the IRS. Adoption and Adaptation by African countries?
- Strengthen institutions and systems to prevent tax evasion
- Technical capacity and political will to actively pursue international tax evasion through exchange of information

GENERAL REMARKS (CONTD.)

- A continent-wide or regional cooperation in the collection of taxes; bilateral or multilateral framework empowering foreign tax authorities to collect and remit taxes on behalf of a sovereign.
- Base Erosion and Profit Shifting Project of the OECD.
- Alternatives to the Arm’s Length Standard
- Tax Inspectors Without Borders

- THANK YOU.