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Transfer pricing is a significant tax issue and lies at the core of international trade and globalisation. This brief raises contextual issues and challenges surrounding the experience of transfer mispricing in Africa. The brief comes at a time when African countries have consistently exhibited high real Gross Domestic Product (GDP) growth rates in the past two decades, and increased FDI inflows and technological upgrades have aided their high participation in global trade. Despite the profitability of MNEs operations in Africa, the investing firms are paying less in terms of tax. This has created a problem for African countries to raise their revenue base for financing development and poverty reduction programmes. Therefore it is important for Africa to stay abreast with transfer pricing rules and issues worldwide. The brief recommends the way forward for African countries in developing capacity to understand and resolve transfer pricing issues and disputes.

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1. Introduction

The Tax Justice Network – Africa and the Strathmore Tax Research Centre Round Table Meeting on Curtailing Transfer Mispricing in Africa was held at the Strathmore Business School, Nairobi, Kenya in November 2013. The meeting provided a platform to share knowledge and experiences in the global trends in Transfer Mispricing (TP). It focused on the TP problem in Africa and Africa's response to the rising challenges. Experiences from different stakeholders were shared. These ranged from civil society, revenue authorities, academia, parliament, the private sector, the Organization of Economic Cooperation and Development (OECD) and African governments. This brief has been prepared by drawing on the presentations and discussions at the 2013 Round Table Meeting and other related materials and resources.

2. The Context

During the past two decades African countries have consistently exhibited high real growth rates. Between 2004 and 2013, the average real Gross Domestic Product (GDP) growth rate was at 5.3% per annum. Much of this growth was on the back of expanded resource output from resource-rich countries in Africa. This was boosted by increased global trade. Africa's growth has been supported by high commodity prices and strong economic activity in resource rich countries. Increased agricultural production has produced good harvests in many countries and helped to mitigate adverse effects of high international food prices on consumers. Further, internal structural changes that have spurred the broader domestic economy have also contributed to the rapid growth of African countries.

Most African economies have continued to grow and to exhibit an increased ability to withstand global economic turbulences. While global growth remains weak, the growth momentum in African economies continues to be stable with high rates at the individual country level. In 2013, Libya, the Ivory Coast, the Democratic Republic of Congo (DRC), Angola and Ghana stood out as the fastest growing countries in the region. Libya and the Ivory Coast were the region's leaders with real GDP growth at 15% and 8.9% per annum respectively. Angola and DRC grew at 8.2%, while Ghana recorded a real GDP growth rate of 8% (ADB, 2014).

Furthermore, African countries have recorded robust growth in capital inflows. High commodity prices and location advantages have for the past two decades induced large foreign direct investment (FDI) inflows. These are mainly in the extractive industries and the services sector. FDI inflows grew by 16.2% to US$43 billion in 2013 (World Bank, 2014). This scenario of increased FDI inflows, increased global trade and globalisation, along with advanced information technology, have increased the number of Multi National Enterprises (MNEs) expanding into African markets. The increased numbers of MNEs have expanded transfer pricing risks for most African countries. Furthermore, the globalisation and digitalisation of African economies has led to increased mobility of capital. This environment has facilitated ways and means for MNEs to engage in aggressive transfer pricing actions. This has led to the erosion of the tax base and increased profit shifting.

The global advances in the way that MNEs are organised have exacerbated the TP risks. Globally most MNEs are now, more than ever before, organised as a collection of entities rather than a single entity. They are divided into operating entities and a hub entity. The locations of the operating entities which bear routine functions and bear subordinate risks are based on business and tax considerations. The operating entities receive low and controlled profits. The residual profits are shifted to the hub entity located in a low tax jurisdiction. The hub entity bears the business risk and receives residual profit in the form of intangibles such as management fees, royalties, etc.

This environment has produced a great tax challenge for most African countries. Most of them get less than 17% of their GDP from taxation (IMF, OECD, UN and World Bank, 2011: 8). This can be compared to the 35% of GDP that most developed countries get from taxation (Fuest and Riedel, 2009: 1). Although the profitability of MNEs in Africa is extraordinarily high, they are paying less in terms of tax due to TP (Mold, 2004). This has created a problem concerning how to raise their revenue base for financing growth and development. This also implies that poverty reduction efforts in African countries may continue to be hampered because governments are denied resources to fully exploit their financial capacity to implement poverty reduction programmes.

Globalisation and growth have increased the level of inter-company transactions tremendously. It is estimated that more than two thirds of all business transactions worldwide take place within groups (OECD, 2013: 8). Africa and most developing countries are experiencing immense growth in intra-group transactions because their economies are still opening up and attracting large amounts of FDI inflows.

The implication of the above context is that African countries are or might continue to grow very fast. It is estimated that African countries might soon surpass Asian countries. This has meant increased FDI inflows and MNE dominant presence in Africa. Fuelled by the global changes in the way that MNEs organise their production, African countries are, more than ever before, faced with aggressive TP practices from MNEs. These practices erode the tax base and severely constrain the capacity of most African countries in mobilising additional resources for development.

Meanwhile MNEs are making huge profits through manipulative TP. African countries are losing huge amounts of local revenue through tax evasion and avoidance. These resources are needed for spending on health, education and infrastructure. The harmful effects of TP practices and the consequent tax avoidance of MNEs is a major problem and policy issue facing all African countries (Wayne, 2014).

African countries face problems in dealing with TP issues. Most revenue authorities are inexperienced and lack capacity in dealing with TP issues. Most of them do not have legal frameworks to deal with TP, consequently their understanding of TP issues is rudimentary. On the other hand, there are currently global initiatives at rule-making for TP. Africa is likely to be left out of these initiatives because of its lack of capacity.

3. Challenges to Transfer Mispricing

TP is the price at which goods, services or intellectual property are transferred between company entities within one country or between related entities of an MNE across international borders. In other words any scheme used to shift profit from one jurisdiction to another, usually from tax jurisdictions where the effective tax rates are higher to jurisdictions where the effective tax rates are significantly lower. TP takes various forms. There is underpricing of exports from high tax jurisdictions to a low tax country resulting in less profit being earned in the high tax jurisdiction. It also happens when exports from low tax jurisdiction to high tax jurisdiction are overpriced resulting in more profits being recorded in the low tax jurisdiction. TP can also take place where trade is channelled through third countries, in intra-company transactions, through transfer of royalties and through ownership of intangible assets. It is estimated that 60% of trade transactions into or out of Africa are mispriced by an average exceeding 11%, resulting in a capital flight component of 7% of African trade. This totals about US$10-11 billion annually (Kazibwe, 2013: 15).

The loss of revenue from TP practices by MNEs has various implications for African countries striving to improve the quality of life and eradicate poverty. These include the erosion of the tax base through profit shifting, loss of revenue for public expenditure programmes, reduced investment in social capital, switching of tax burden between factors of production and increased tax administration costs. It is, therefore, urgent for policy makers in African countries to address the TP issues at both the individual country level and regionally. It is also important for African countries to participate in the global TP rule-making process. However, in this process they face a number of challenges. Among these are:

<u>Lack of a legal framework:</u> Most African countries lack appropriate rules and legislation on TP. Most countries have adopted the OECD guidelines but have not gone further to build legal institutions to implement them. The judicial system has presented problems in TP cases brought before the courts. In most cases, as was pointed out in the Round Table meeting deliberations, courts have dismissed such cases as lacking merit.

<u>Lack of resources and expertise:</u> There are skill gaps in Africa with regard to TP issues. This makes it important to build capacity. This can be done through training and sharing experiences and knowledge in TP issues. Such organisations as Tax Inspectors without Borders (TIWB) are useful for sharing information. Others are the African Tax Administration Forum (ATAF) and the Tax Justice Network-Africa (TJIN-Africa). The revenue authorities lack auditors, economists, and lawyers experienced in TP, financial databases used in TP analyses and sufficient staff to process TP compliance and disputes.

<u>Limited access to information:</u> Most revenue authorities are faced with lack of access to information. There is need for African countries to share knowledge and experience. They can use existing international networks and regional networks. Bilateral agreements on information sharing among African countries can be enhanced.

<u>Lack of political will to address the issue of transfer pricing:</u> Some of this lack of political will comes from the lack of appreciation or understanding of the issues. There is, therefore, need to actively promote awareness among political leaders in various fora. This will ensure that TP issues are addressed at policy and legislative levels.

<u>Lack of a uniform and consistent regional approach to prevent tax avoidance:</u> Regional institutions, like, the Common Market for Eastern and Southern African States (COMESA), the Economic Community of West African States (ECOWAS), the East African Community (EAC), the Southern African Development Community (SADC), and ATAF, among others, lack a regional approach to TP issues. The importance and complexity of TP risks have increased as a result of growing globalisation, cross-border mergers and the increased sophistication of the financial sector (OECD, 2012). Concerted efforts at the regional level are necessary to deal with these challenges.

Lack of local comparisons and access to databases: There is a serious problem of the lack of comparable data. Comparables are selected from European and Asian markets. These do not resemble African markets. African comparatives are not useful because most companies are subsidiaries of the same MNEs. Given the lack of comparable data, there is need to put in place measures that equip tax officers with proper data and tools for analysis. This can be done through capacity building activities in African revenue authorities in cooperation with global tax initiatives such as the TIWB.

The role of intangibles such as trademarks and brands, royalties and management fees in TP has become unprecedented. African subsidiaries pay MNEs for brands. How are these valued? The greatest abuses in TP are in the area of intangible rights (Christensen, 2013). Here, there are practical difficulties of following up the issue of pricing. There might be need to look elsewhere for solutions e.g. increasing use of profit-split arrangements.

Allocation of capital: The question begs whether subsidiaries based in low tax jurisdictions are over capitalised based on their operations. African countries should encourage MNEs to use equity rather than debt so as to reduce the opportunities available for TP.

Tax avoidance schemes: Many MNEs use off- shore or safe havens to avoid paying tax. Tax avoidance techniques have worked to create a financial services sector geared to rent-seeking activity. In addition, tax authorities find themselves outnumbered by lawyers and accountants of MNEs. The complexities of the tax avoidance schemes take up much of the tax authorities' resources and time. Furthermore, the tax avoidance techniques create a complex and secretive environment that breeds crimes of evasion, money laundering, embezzlement, fraud and bribery, among others.

4. Legal Framework

Most African countries apply the OECD Guidelines on TP to determine the appropriate TP policy for MNEs operating in Africa. The arm's length (ALS) principle is the central feature of the OECD Guidelines. However, the implementation of the ALS principle is resource-intensive and costly for many African countries (PWC, 2012).

The guidelines outline five methods to determine the arm's length nature of transfer prices. These are the comparable uncontrolled price, resale price, cost plus, transactional net margin and the profit split methods (OECD, 2013: 11). The OECD has developed draft TP legislation for developing economies which African countries can look at (OECD, 2013: 12). To have an idea of how much African countries have done in setting up TP regimes, we show in Table 1 a summary of TP regimes among selected Southern African countries from available evidence.

Table 1: Summary of Transfer Pricing Regimes in Selected Southern African Countries

Country	1	2	3	4	5	6	7	8
Angola	Yes	Yes	Yes	Yes	Yes	Yes	No	No
DRC	Yes	Yes	No	Yes	No	No	No	No
Malawi	Yes	Yes	Yes	Yes	Yes	No	No	No
Mozambique	Yes	No	No	Yes	No	No	No	No
Namibia	Yes	Yes	Yes	Yes	No	No	No	Yes
South Africa	Yes	Yes	Yes	Yes	No	Yes	Yes	No
Zambia	Yes	Yes	Yes	Yes	Yes	No	No	No
Zimbabwe	No	No	No	No	No	No	No	No

Notes: 1=Tax code provides some guidance on TP, 2=TP regulations, 3=TP methods, 4=ALS, 5=Document requirement, 6=Thin capitalisation rules, 7=Safe harbours, and 8=APA programme

Source: PWC (2013: 8)

African countries' TP regimes are based principally on the arm's length principle and loosely on OECD rules. The OECD rules express values of the OECD member states. Africa must therefore evaluate whether these guidelines serve their purpose within the African context.

Many African countries have their own tax avoidance provisions in their laws. These are focused on the substance of a transaction or an arrangement so that tax benefits flow only to the intended beneficiary. This is done by giving power to the revenue authorities to reject claims for benefits that are regarded as artificial or contrived (Ernst & Young, 2013). However, these provisions are not adequate. Some of the provisions that are needed are the mandatory requirements on document presentation, the mandatory declaration of all tax planning methods employed in the MNE and the mandatory declaration of transfer pricing methods used by the MNE.

TP regulations need a strong and robust legal framework. Many African countries have weak legislative frameworks and judicial systems. The OECD model is suited for developed countries with well-developed infrastructure. In Africa, the transformative role of taxation is more important than in developed countries (Tax Justice Network-Africa and Strathmore Tax Research Centre, 2013). That is why an Africa specific method that addresses African objectives must be developed.

Although there are significant challenges associated with the implementation of the TP legal frameworks based on the ALS principle in African countries, the benefits are likely to outweigh the perceived risks especially as African countries have now developed their own unique TP frameworks and there is no universally agreed framework. Also in the sense that a stable TP framework is likely to increase tax revenues and attract FDI.

5. Global Transfer Pricing Rule Making

TP is a product of globalisation and international trade. Globally revenue authorities are focused on TP as a mechanism for the protection of their tax bases and as a means of ensuring that a reasonable basis is used to identify and extract economic benefits from economic entities operating in their jurisdictions.

The pace of global rule making in international taxation gained momentum after the 2008 global financial crisis. The focus has been on monitoring national and global fiscal trends, delivering expert advice and setting standards which national states are free to adopt or not. The prominent actors have been the United Nations and the OECD. The OECD Guidelines were first issued in 1979, revised and updated in 1995 and 2010 (PWC, 2013: 6). The centre piece of the guidelines is the ALS principle. Although the OECD has been prominent, it lacks representativeness. It has an exclusive membership of the leading industrial countries. Africa is not represented. It might, therefore, not be an appropriate forum for global rule making (Wouters and Meuwissen, 2011: 9).

The United Nations has sought to create a TP framework designed to address the concerns of African countries. It has produced a United Nations Practical Manual on TP to assist developing countries in dealing with TP legislation, databases, setting up TP units and on how to implement the ALS principle. The United Nations provides an inclusive forum for global tax policy. However, it lacks the resources and the institutional capacity to lead and guide the process. In most cases it has to draw its expertise and advice from the OECD (Wouters and Meuwissen, 2011: 10).

African countries need to increase their efforts to have African input on these global processes of TP rule making. ATAF presents a good opportunity and platform to advance African interests. One of these interests is to push for multilateralism rather than bilateralism in global rule making. In that situation African voices are likely to be heard.

African countries must work with other countries and institutions in rule making. If they work on their own, there is a danger that there will develop a large diversity in TP rules in various countries around the globe. This will work to their disadvantage. There is need for a set of TP rules that can be adhered to globally.

During this process, there is need to adopt international tax instruments and for Africa to engage with global standards. The need for the exchange of information within Africa is not as great as the need to exchange information with states where these MNEs are based. Still more, African revenue authorities have a lot to share through information networks and capacity building activities among themselves.

There have been other efforts at the global level aimed at addressing the challenges of TP. The United Nations has developed a model double taxation agreement to be used by developing countries when entering into tax treaties with developed countries. OECD has established a task force on Tax and Development. International Financial Reporting Standards Foundation (IFRS) and International Accounting Standards Board (IASB) are investigating opportunities to include country by country reporting as a standard for companies in the extractive industry. African countries must actively seek inclusion and participation in these global policy making processes on TP issues. So far discussions have not effectively included Africa. They can use regional vehicles such as ECOWAS, SADC and EAC to express their concerns and interests.

6. African Responses

Many African countries have implemented or are working on implementing TP rules that allow their revenue authorities to adjust the prices of related-party transactions. These include South Africa, Kenya, Uganda, Egypt, Ghana, Benin, Zambia and Tanzania. They have worked on the regulations and set up units within revenue authorities to deal with TP issues.

TP enforcement has provided governments with a means of reducing fiscal deficits through the collection of TP adjustments and taxes e.g. in Kenya and Tanzania. This allows governments to raise additional revenue to finance education, health and infrastructural programmes.

Most African countries that have enacted TP rules and regulations have based them on the OECD model. However, the current laws are inadequate. There is need to develop adequate legal frameworks to address TP issues in most African countries. This needs political will which is currently lacking. There will, therefore, be need for lobbying to policy makers to take the issue of TP more seriously.

Some African countries such as Kenya, Rwanda and Tanzania have improved their TP legislation. In such cases MNEs are required to develop TP policy documents. The documents are available to auditors. They are also required to disclose the global organisation structure, details of transactions under consideration, all related parties, their shareholding and management structure. There is resistance from MNEs arguing that the process is time-consuming and costly.

African countries are at different levels with regard to addressing TP issues. The signing of bilateral and multilateral information sharing agreements among African countries would help reduce the existing information gap.

Furthermore, the OECD transfer pricing methodologies are not easy to apply in African countries. There is need to design a model that suits Africa. The data available for accessing TP does not provide good comparisons for Africa. For this reason, the arm's length principle may not be the best for Africa. And without proper comparisons, it is very difficult to apply the OECD model.

Since there is no African approach to TP, can OECD and UN come up with guidelines that will serve Africa without an African input? For Africa, tax is not only for revenue but must be transformative (Tax Justice Network-Africa and Strathmore Tax Research Centre, 2013). Where should the global level discussion take place? These are the issues which should underpin African discussions on TP.

6.1 Advanced Pricing Agreements

An Advance Pricing Agreement (APA) is an agreement between the MNE and the revenue authority, specifying the pricing method that the MNE will apply to its related company transactions. This is usually for a period of time. Some African countries, such as Uganda, have used APAs. It has been argued that African countries should approach APAs with caution. They should not enter into APAs until they have the capacity to have those agreements. Premature entry into APAs before capacity building will lead to adverse effects on tax generation. Players from other markets have access to huge information networks, which Africa does not have. If African countries enter into APAs before there are enough guidelines, these countries will lock themselves into the wrong value. Capacity building before entry into APAs is crucial.

6.2 Double Taxation Agreements

Many African countries have entered into double taxation agreements (DTA) with several developed countries. This has been done as a means of avoiding double taxation but also for the purposes of sharing information. However, before entering into DTAs African countries should analyse their impact on revenue collection, especially in economies that are dominated by MNEs. The impact of the DTAs might challenge the legitimacy of tax regimes, legal institutions and democratic processes.

7. Policy Recommendations

It is clear that African countries need to do a lot of work to catch up with what is happening globally as a result of the increased presence of MNEs in their economies. Several policy recommendations flow from the discussions at the Round Table and from TP related literature.

There is great need for public transparency by MNEs in the African countries that they operate in regarding information on TP. Civil society organisations and the media can assist in promoting this public transparency. One way to increase transparency is to encourage subsidiaries of MNEs to incorporate as public limited companies. There is need to encourage subsidiaries of MNEs to have some local ownership by listing them on the local stock exchanges. This will not only create an incentive for the growth of local capital but will open the companies to increasing public transparency and scrutiny.

Given the complexity of TP issues, there is need for information exchange. This can begin with information exchange between revenue authorities within Africa. It is proposed that an information-sharing network involving all African countries be developed. The ATAF would be a good forum to address this issue. TIWB would also be a useful forum in addressing TP issues within Africa. Furthermore, collaboration and co-operation among African countries is very important because MNEs have great capacity within themselves. A collaborative effort to curb TP would greatly improve Africa's effectiveness in combating the practice.

Besides African countries sharing and exchanging information between countries and tax authorities, they should invest in more research and sharing of information on MNEs seeking to invest in Africa. Because of global interdependence, it is no longer plausible to consider TP as a country specific problem. There is need to share information and exploit resources from international organisations such as the UN, OECD, European Union and other countries in the world.

Currently TP issues are not on the top of the political agenda in Africa. It is important to raise political awareness of these issues since Africa is losing and will continue to lose huge amounts of tax resources annually through TP. There is need to sensitise politicians on these issues so that they can become part of the agenda. Sensitisation can be done through training, coalition building and advocacy by civil society and the media.

Capacity building is fundamental in addressing TP issues. There is need for capacity building among revenue authorities, the judiciary, academia and professionals. Many African courts are unable to meaningfully adjudicate cases of TP. It is important to train the judiciary so as to appreciate the repercussions of the practice. There is also need to engage parliament. It has a role to play in legislation. Capacity building should include politicians, parliamentarians and parliamentary committees such as the budget and finance committees. Increased and continuous training of revenue authority staff, judiciary and prosecutors on issues of TP is important because the issue of TP practice is an art and not a science. Capacity building activities should include research by universities and research institutes. This should focus on the context of TP and bring out concrete practical policy proposals and recommendations. This should bring on board such professionals as tax consultants, lawyers and accountants.

African countries must work together to make sure that the incentive structures among countries within Africa are harmonised. An effort must be made in this direction. African countries offer location benefits to investors. The advantages range from natural resources, young growing markets and high returns on capital, among others. As a result of this, African countries do not need to offer high tax incentives to attract FDI into their countries. Rather like China, African countries need to recognise that the location advantages they offer are enough to attract investment into Africa. In this regard, African countries should analyse annually the costs of the tax incentives given.

There is need to review the provisions of DTAs and any incentives granted to ensure that countries are not losing out on their fair share of taxes. African countries must act to stop reckless tax competition which involves attracting FDI through tax breaks, exemptions and other incentives even when research has conclusively shown that investment decisions are only minimally based on taxation regimes. There is need for a common policy which is mutually beneficial and takes into account the harmonisation of policies.

African countries should adopt country-by-country reporting. There should be a common template developed for country-by-country reporting to be used by MNEs. This will increase transparency. Country-by-country reporting will allow each tax administration to have access to information on the profits being created in each country. Such reporting will reduce the disincentives for cross-border investments and also reduce the expenses for compliance. It will reduce TP problems. It can further reduce disputes and may reduce or increase revenue depending on the country and formula used. Country-by-country reporting is what African countries need to tackle TP by MNEs. Information available from country-by-country reporting should be made available to all tax stakeholders, such as media and civil society.

MNEs should be treated as a single large entity and not as a collection of entities. All members of the consolidated group should be treated as engaging in a common purpose. The taxable income of each entity in a particular country should be a proportion of the total taxable income of the consolidated business as determined by an apportionment formula. The apportionment is based on the country where the entity carries out its economic activities. The advantage of this approach is that it overcomes the problem of double taxation. If there is a single set of combined accounts and profits are attributed based on economic substance, there will be no scope for double taxation.

African countries should introduce a continuous review process on tax and investment policies. This will enable them to continuously review their legislation so as to make it effective. Perhaps, they should consider a peer review mechanism on tax and investment legislation.

TP requires a strong and robust legal framework. Countries should introduce, develop and strengthen TP regulations and the legislative framework to enable them to adequately tackle the TP problem. The laws, guidelines and rules enacted should be relevant to the African experience. The judicial and court systems need to be sensitised on TP issues so that African justice systems support the efforts of tax authorities. This can be done through legislation and training. Good legislation and policies will not be effective if corruption is not eradicated. This is currently manifested at all levels of government. There is need for a focused and concerted effort to eradicate corruption especially in tax administration matters.

African countries should participate in global rule making so that African voices, interests and experiences are reflected in emerging global rules. To this effect, it is essential to evaluate to what extent the OECD guidelines apply to the African situation. Guidelines can then be formulated more suitable to the unique challenges that TP poses to Africa.

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