The African Tax Administration Forum (ATAF)

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Venue: Livingstone, Zambia

Date: 3 March 2014

Conference: 3rd International Association of Prosecutors, African-Indian Ocean Regional conference

Theme: Financial crime and environmental degradation – What are the issues in Africa?

CURRENT TAX ISSUES ON THE AFRICAN CONTINENT

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Overview

- **Key risks and challenges facing African tax administrations from issues relating to global taxation**
  - The granting of inappropriate and wasteful tax incentives
  - Ineffective natural resource taxation regimes
  - Profit shifting through cross border related party transactions ("controlled transactions")
- **Challenges faced by African countries in effectively addressing the above risks**
  - Putting in place the appropriate legislation and rules to effectively address these risks
  - Having access to the relevant information to i) identify the risk and ii) address the risk
  - Building the capacity within the tax administration to effectively implement the country's legislation and rules and to effectively use the information obtained by the administration.

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Global Taxation: Key Risks and Challenges facing African Tax Administrations

- African countries facing a wide range of challenges in the effective taxation of the different business segments of the economy
  - Taxation of the informal sector, small and medium enterprises (SMEs) and multinational enterprises (MNEs) are very different.
  - Important to develop a *coherent evidence-based tax policy* that balances *revenue raising* and *robust governance* with providing a *climate to encourage business and economic growth*.

Global Taxation: Key Risks and Challenges facing African Tax Administrations

- ***Focus of this presentation***: risks and challenges to African countries in the effective taxation of MNEs.
- **Why MNEs?**
  - Recent increased attention of mainstream media on corporate tax affairs
    - Recent scandals involving Amazon, Ikea, Google, Starbucks, Glencore, etc.
  - Spreading perception that MNEs dodge taxes all around the world
  - Wide range of issues that enable MNEs to avoid paying their fair share of tax and thus undermine efforts to tackle poverty and inequality, especially in developing countries.

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Global Taxation: Key Risks and Challenges facing African Tax Administrations

Why MNEs?

- MNEs control an estimated 40% of global trade
- MNEs contribute most to the domestic revenue
- Rapid advances in technology, transportation and communication have given rise to a large number of MNEs which have the *flexibility to place their enterprises and activities anywhere in the world*.

Global Taxation: Key Risks and Challenges facing African Tax Administrations

- **The key risks:**
  - African tax bases may be significantly eroded by:
    - 1. The granting of inappropriate and wasteful tax incentives
    - 2. Ineffective natural resource taxation regimes
    - 3. Profit shifting through cross border related party transactions (“controlled transactions”).

1. Granting of Wasteful Tax Incentives

- Significant evidence that many African countries grant incentives to large MNEs, *primarily in the extractive industry, without undertaking a proper cost/benefit analysis*.
  - In many cases, countries do not assess whether the expected benefits from granting of the incentive have materialised.
- Empirical evidence indicates there is significant revenue lost in developing countries through the granting of tax incentives.
  - Example: 6.13% of GDP in 2011 of revenue loss attributable to special tax provisions and exemptions in Ghana (*Country review by the OECD Task Force Tax & Development*).

2. Ineffective Natural Resource Taxation Regimes

- Many African countries are resource rich
  - These resources are usually *non-renewable resources*
  - For decades, developing countries have suffered the consequences of an unfair and ineffective international tax system
  - It is therefore critical that these countries obtain an *appropriate share of the profits from the exploitation of their natural resources*.

2. Ineffective Natural Resource Taxation Regimes

- Taxation of these natural resources is different to most other taxes:
  - It is essentially a means of splitting the profits from the exploitation of the natural resources between:
    - The country that owns the natural resource and,
    - The company (usually a MNE) that has the capacity to extract the mineral from the ground, refine it and sell it.
  - If the tax regime does not split the profits appropriately there may be a significant loss of revenue for the country.

3. Profit Shifting Through Controlled Transactions

- Risks from controlled transactions can be split into three broad categories:
  - **Risks arising from large MNES with global operations**
    - They are likely to be in the nature of tax avoidance, some of which might be sophisticated – e.g. involving complex but well documented, transfer pricing design.
    - The risk of illegal or fraudulent activity is relatively low.
  - **Risks arising from medium or small MNEs perhaps based in the country or the region**
    - Risk associated with more aggressive and poorly documented transfer pricing may be greater in these controlled transactions.

3. Profit Shifting Through Controlled Transactions

- Risks from controlled transactions can be split into three broad categories:
  - **Use by individuals (including directors of private companies) of controlled companies in low tax jurisdictions**.
    - There is evidence that business receipts due to individuals or smaller businesses may be diverted to privately owned companies in tax havens, with little or no justification or documentation.
    - Such practices may be closer to evasion than avoidance.

3. Profit Shifting Through Controlled Transactions

- Many African countries will face risks from all 3 categories:
  - However, greater risks may come from the 2nd and 3rd category, and they may be more significant than for many developed countries.
  - The approach to auditing these types of risks, and the skills and information needed, will be different from those in the first category.
- This suggests that different approaches may be needed, perhaps supplemented by *anti-avoidance measures*.

Challenges Faced by African Countries in Addressing these Risks

- A. Putting in place the ***appropriate legislation and rules*** to effectively address these risks
- B. Having access to the ***relevant information*** to identify the risk and address the risk
- C. Building the ***capacity within the tax administration*** to effectively implement the country's legislation and rules and to effectively use the information obtained by the administration

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A. Legislation and Rules

1. Tax incentives

- Often granted by govt departments other than the tax administration or Ministry of Finance
  - who are often not even aware that the incentives have been granted
- Important to put in place *appropriate transparency and governance procedures for the granting of tax incentives*
  - to ensure that all *interested parties, including its citizens*, are fully aware of the incentives being granted and why they are being granted.

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A. Legislation and Rules

❑ *1. Tax incentives*

- The inconsistencies in the granting of such incentives creates an *uncertain and unclear investment climate* in the country
- It may cause legal difficulties particularly if the agreement contains a *stabilisation clause* that guarantees no change in the tax that would be payable by the company under the Development Agreement.

A. Legislation and Rules

❑ *2. Taxation of natural resources*

- Critical that African countries introduce rules for the taxation of natural resources that *the tax administrations have the capacity to implement effectively*.
- There are a wide variety of natural resource taxation regimes in resource rich countries and these often change on a frequent basis.
- It is important that African countries share both experiences and best practices on the continent but also with other resource rich countries on setting long term effective policies for the taxation of natural resources.

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A. Legislation and Rules

3. International tax rules

- Existing international tax rules have not kept pace with the changing business environment
- They have weaknesses that create opportunities for MNEs to avoid taxes by:
  - Shifting their taxable profits out of the jurisdictions where those profits are created, into low or no tax regimes
  - Making taxable profits disappear altogether
  - This issue is being addressed through the OECD/G20 BEPS project.

A. Legislation and Rules

3. International tax rules

- The Base Erosion and Profit Shifting (BEPS) mainly focuses on:
  - moving profits to where they are taxed at lower rates and,
  - expenses to where they are relieved at higher rates (OECD 2013).
- The BEPS action plan calls for 15 actions organised around the following three main pillars:
  - The ***coherence*** of corporate tax at the international level
  - A realignment of taxation and ***substance***
  - ***Transparency***, coupled with certainty and predictability

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A. Legislation and Rules

❑ *3. International tax rules*

- The BEPS action plan calls for targeted work in the area of the ***digital economy***, which cuts across all three of the main pillars but also presents a number of specific features
- It also calls for the development of a ***multilateral instrument*** to implement the measures developed under the action plan.

A. Legislation and Rules

❑ *3. International tax rules*

- It is essential that African countries facing issues related to BEPS take into account the *specificities of their national legal and administrative frameworks*.
- In this respect, the OECD's Task Force on Tax and Development has recognised the need for international action and has acknowledged that **developing countries must have a voice in the development of the work to address BEPS**.

B. Access to Relevant Information

1. *Tax incentives*

- Sharing best practices and improved inter-government agency co-operation will assist African countries to ensure:
  - Tax incentives granted in the country are appropriate
  - A consistent approach is taken to the granting of such incentives.

B. Access to Relevant Information

2. *Taxation of natural resources*

- Obtaining access to all *relevant information on when and where natural minerals are being exported* from a country is critical to enabling the tax administration to ensure compliance with its natural resource taxation regime.
- It also needs accurate information on the quantity and quality of the exports.
  - ***Example***: Zambia is currently undertaking a project in partnership with the Norwegian government to introduce a state of the art IT system *to record data regarding copper exports*.
  - The data will be available on a real time basis to all government agencies enabling more effective monitoring of exports in terms of quantity and quality.

B. Access to Relevant Information

❑ *3. International tax rules*

- Controlled transactions involve parties that are resident for tax purposes in different tax jurisdictions.
- African tax administrations often experience significant difficulties in obtaining access to information relating to the non-resident party to the transaction.
- This creates significant challenges in addressing issues relating to BEPs such as transfer pricing
  - Where it is necessary to take into account the function performed by each of the parties to the transaction.
  - It is therefore critical that African countries resolve the issue of access to information regarding the non-resident party to the transaction.

B. Access to Relevant Information

❑ *3. International tax rules*

- African taxpayers and tax administrations express concern regarding:
- The *availability and quality of financial data on transactions between unrelated parties that can be used for comparisons*
- The *availability and quality of information regarding the financial results of operations of comparable independent enterprises.*

B. Access to Relevant Information

❑ *3. International tax rules*

- Applying the *arm's length principle to review transfer prices set in transactions between associated enterprises* often requires:
  - A comparison to be made between these prices and the prices set in *similar transactions between independent enterprises in similar circumstances*.
  - Most African countries have transfer pricing rules that are *based on the arm's length principle and the lack of this data creates significant challenges for both taxpayer and tax administrations in African countries*.

C. Capacity within African Tax Administrations

1. *Tax incentives*

- African tax administrations *often not aware of which tax incentives have been granted* and *do not have the legal power to monitor adherence* to the terms of the tax incentive agreement:
  - Due to a lack of transparency and appropriate governance procedures in the granting of tax incentives.
  - Where they do have that legal power they often lack the *appropriate skills to audit adherence with the terms of the agreement.*

C. Capacity within African Tax Administrations

❑ *2. The taxation of natural resources*

- In most resource rich countries, specific taxation rules impose a royalty tax as a % of the value/price of the minerals at the specified point of transfer.
- Some African tax administrations have reported difficulties in establishing *either the point of the transfer or the value/price that should be attributed to the mineral at the point of transfer*.
- In some cases they experience difficulties in *ascertaining the quantity and quality of the minerals at the point of transfer*.

C. Capacity within African Tax Administrations

3. *The taxation of controlled transactions*

- Auditing transfer pricing issues is complex and time-consuming, requiring the deployment of skilled auditors.
- Many African countries lack the requisite skills and experience required to analyse these complex issues
- They lack the requisite skills and experience to face challenging issues relating to BEPS such as transfer pricing particularly when employed by well-advised MNEs.

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C. Capacity within African Tax Administrations

3. *The taxation of controlled transactions*

- The approach to transfer pricing audits taken in many developed countries may not be transferable to some African countries.
  - The nature of transfer pricing is such that it is very rare to find definitive answers in transfer pricing audits and disputes.
  - This means that resolution of audit disputes often requires negotiation and compromise.
  - In some developing countries *the legislation does not permit tax officials to enter into negotiations with taxpayers*.
  - Even if allowed under the legislation at least some African countries are ill-equipped to carry out, and lack experience of, such negotiations.

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Conclusions

- Africa faces considerable challenges on erosion of its tax base through:
  - The granting of wasteful tax incentives,
  - Ineffective taxation of natural resources and,
  - Profit shifting through controlled transactions.
- To meet these challenges African countries will need to:
  - Work together and with other countries to share best practices and experience on tax policy,
  - Improve the access they have to relevant information
  - Build their tax administration's capacity to identify and address these risks.

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