“Getting a fair bargain for Africa and the developing world: The role of the Prosecutor in combating financial crime including tax evasion and environmental degradation in the extractive and other significant industries.”

Illicit Financial Flows and Tax Dodging:
Mechanisms and Facilitators

Savior Mwambwa

Tax Justice Network -Africa

Nairobi, Kenya.

3rd International Association of Prosecutors African-Indian Ocean Regional Conference Livingstone, Zambia

2nd – 6th March 2014

Illicit Financial Flows (IFFs)

tax justice network — Africa

Definitional Issues:

- *'...a form of illegal capital flight and occurs when money is illegally earned, transferred, or spent. This money is intended to disappear from any record in the country of origin, and earnings on the stock of illicit financial flows outside of a country generally do not return to the country of origin'. (Wikipedia)*

Definitional Issues:

tax justice network — Africa

- IFFs can be generated in a variety of ways that are not revealed in national accounts or balance of payments figures, including trade mispricing, bulk cash movements, and smuggling.

Definitional Issues:

tax justice network — Africa

An "illicit financial flow" ranges from something as simple as a private individual transferring funds into his/her account abroad without having paid taxes on the funds, to highly complex money laundering schemes involving criminal networks setting up multi-layered multijurisdictional structures to hide ownership and transfer stolen funds. Some multinational companies take advantage of <u>weak legal frameworks, low technical capacity or corrupt officials</u> to avoid paying their full share of taxes.''- **(OECD)**

IFF vs Capital Flight

tax justice network — Africa

- *Illicit financial flows* differ from *capital flight.*

- *Capital flight is an expression that places virtually the whole of the problem upon the developing countries out of which the money comes. It suggests that it is almost entirely developing country's responsibility to address and resolve the concern.*

- *The term illicit financial flows clarifies that this phenomenon is a two-way street.*

The Problem

tax justice network — Africa

- In spite of Aid and NR endowment Africa remains poor
- Africa is net creditor to the rest of the world
- Africa lost up to **$1.4tn** in IFF :1980-2009 (AfDB & GFI)
- 3 regions accounted for 95% of total
- West & central Africa- ($494bn): Nigeria, Congo-Brazzaville and Ivory Coast
- North Africa- ($415bn) :Egypt, Algeria and Libya
- Southern Africa - ($370bn) :South Africa, Mauritius and Angola.

Methods of Measuring IFF

tax justice network — Africa

Two most common methods:

- **World Bank Residual Model**
- **DOTS-based Trade Mispricing Model**, (*uses the IMF's Direction of Trade Statistics (DOTS) database*)

Other Methods;

- **IPPS-based model,(** *developed by John Zdanowicz of Florida International University.)* uses individual import and export transactions of the US with the rest of the world to find inconsistencies in export and import prices.
- **Hot money(Narrow**) Method and *the Dooley Method*

GFI Methodologies

tax justice network — Africa

GFI Recent Report: *'Illicit Financial Flows from Developing Countries 2002 -2011'*

- Does not measure all IFFs.
- 2 main primary methodologies to estimate two different methods for illegally transferring funds across borders.

Method1:Hot Money Narrow (HMN):

- looks at money that has disappeared from the balance of payments. (kickbacks, bribery, unrecorded wire transactions etc).
- Mineral rich Countries tend to have higher HMN numbers relative to others.
- HMN accounts for about 20.3% of illicit financial flows estimated in this report.

Method 2: Gross Excluding Reversals (GER)

tax justice network — Africa

- GER Looks at trade misinvoicing
- Often, this will involve re-invoicing the goods through a *secrecy jurisdiction.*
- The result is that a certain sum of money disappears on one side of the border—either from the importer or exporter.
- Detected by comparing what a country says it is exporting, and what the rest of the world says it imports from that country, and vice versa.

Mechanisms/Facilitators of Illicit Financial Flows

tax justice network — Africa

1. Secrecy Jurisdictions also known as;

- *International Financial Centres (IFCs)*
- *Tax Havens*
- *Off shores Centres*

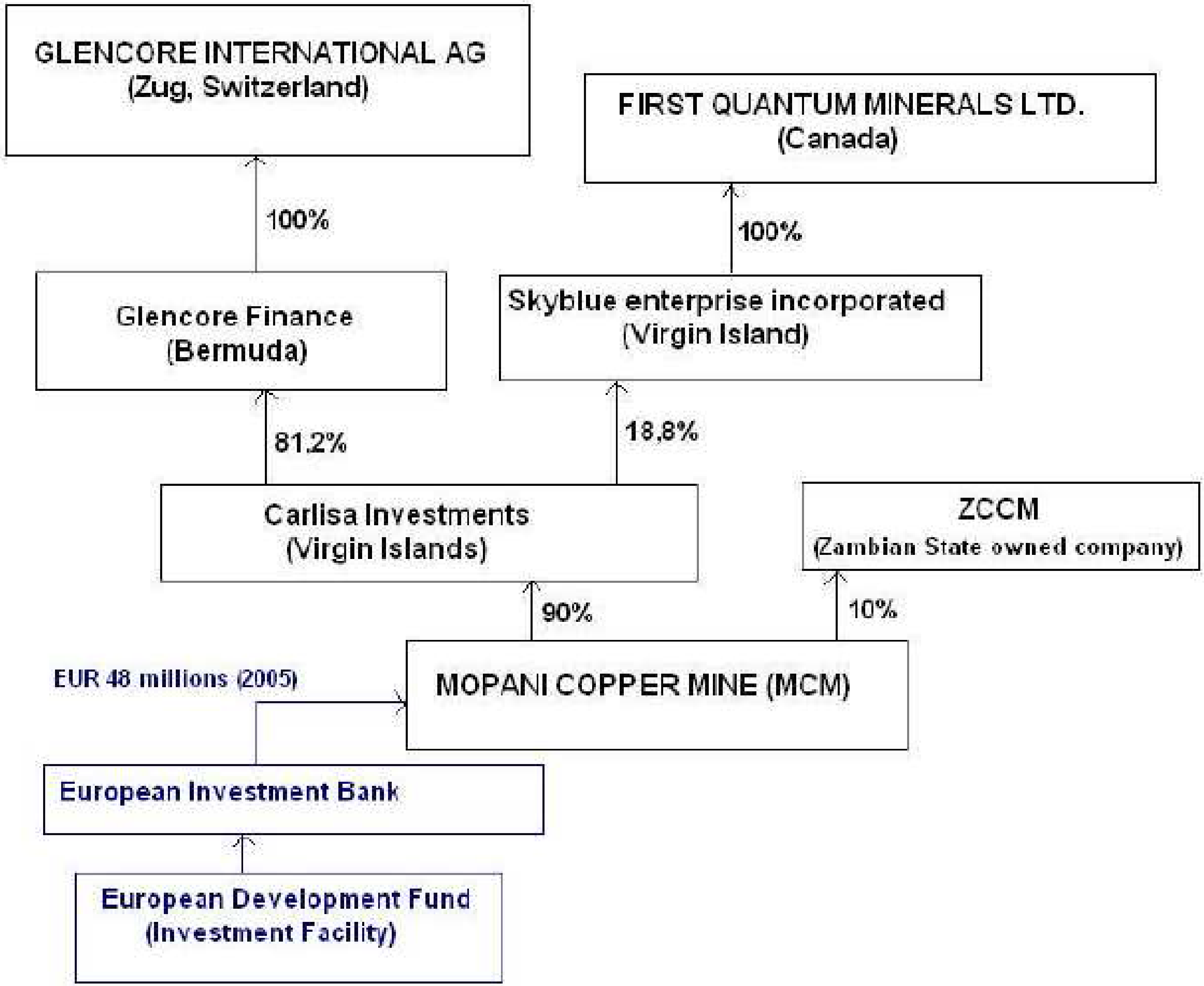
2. System of International system of financial rules and structures *that facilitates;*

- *‘Tax Planning’*
- *Shell/Phantom companies*

3. MNCs via transnational and intra company transactions;

- *Transfer (Mis)pricing*
- *Trade Misinvoicing*

Structure of Mopani Copper Mine (MCM)



Transfer Pricing

- *Transfer pricing is not illegal*. But *transfer mispricing*, also known as *transfer pricing manipulation* or *abusive transfer pricing* is.

- *Transfer mispricing* is a form of a more general phenomenon known as trade mispricing, which includes trade between unrelated or apparently unrelated parties - an example *is reinvoicing.*

- 60% of international trade happens within, rather than between MNCs- across national boundaries but within the same corporate group.

Transfer Mispricing

tax justice network — Africa

- *A <u>transfer pricing arrangement</u> occurs when two or more businesses which are owned or controlled directly or indirectly by the same group trade with each other.*

- *If a transfer price can be shown to be the same as the market price then it is acceptable for tax.*

- *<u>Challenge</u>: most traded goods& services across boarders have no market price , especially if they are never sold to third parties.*

Trade (mis)invoicing used for different purposes:

tax justice network — Africa

- To launder money,(drug cartels)
- To evade customs duties (Importers and exporters)
- To hide wealth and ill gotten gains (corrupt public officials

Current International approach to confronting transfer mispricing.

- **Arms Length principle**: Endorsed by OECD & UN and widely used as the basis for bilateral treaties between governments.

- Arm's length principle very hard to implement, (e.g. specialised products, intangibles etc.)

Alternative proposals

tax justice network — Africa

Unitary taxation/ formula apportionment:

- This prioritises the economic *substance* of a MNC and its transactions, instead of prioritising the legal *form* in which it organises itself.

- *The unitary taxation approach*: *taxing the various parts of an MNC based on what it is doing in the real world* *vs* *Arm's length principle*: gives MNCs leeway to decide for themselves where to shift their profits

- *Unitary taxation* is entirely compatible with country-by-country reporting

- *Country-by-country reporting* would require each multinational corporation to provide specific disaggregated information about the various aspects of their activities where ever they operate.

The BEPS Project

tax justice network — Africa

Base Erosion Profit Shifting (BEPS): refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.

The BEPS Project

tax justice network — Africa

The BEPS Action Plan proposes **15 Action Points**.

9 substantive issues & 6 on coordination or procedures:

- [Incl. study on the Digital Economy & collection of better data on the extent of international tax avoidance]
- Two (2) Concern **transparency**:
- Devt. model provisions for disclosure of `*aggressive tax planning*' strategies and improving transfer pricing documentation requirements.
- Proposals to strengthen the `*mutual agreement procedure*' to help deal with conflicts between states.
- Devt. Of a *multilateral instrument*, as a means of more rapid implementation of proposals which would otherwise require renegotiation of many bilateral treaties.

BEPS & Developing Countries

- Only OECD members and the G20 countries are to participate in the BEPS project on an equal footing.

- non-OECD G20 member countries (*Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia and South Africa*) have been accepted as full members of OECD working parties on BEPS.

- OECD has failed to envisage broader representation of developing countries. *[Interests of Brazil, India, South Africa or Indonesia, are not synonymous with those of smaller non-G20 countries.]*

- African Governments to ensure that their interests and specific context and features are taken into account.

Indispensable measures to tackle BEPS but not included in t the BEPS action plan

African countries should work together with other Developing Country Governments for a multilateral adoption and implementation of the following additional measures:

- **Automatic information exchange.**
- **Public disclosure of beneficial owners of companies, foundations and trusts.**
- Enhanced transparency in MNCs tax practices through worldwide combined tax reports and public **country-by-country reporting**.

Key Message: *Africa and Developing countries should stand together to enforce multilateral adoption and implementation of measures to end financial and corporate secrecy.*

End.

Thank You for your attention

Follow our **TJN-A Google group**.

Like us on **Facebook**, Follow us on Twitter;@taxjusticeafric

Watch our videos on YouTube