CHAPTER 6

MULTINATIONAL CORPORATIONS, TAX AVOIDANCE AND EVASION AND NATURAL RESOURCES MANAGEMENT

Non-renewable natural resources are an important source of revenue for many African countries. Challenges in government oversight, loopholes in national tax policies and the challenges of applying the arm's length principle have led to widespread tax avoidance and engagement in illicit financial flows by multinational corporations, which dominate the sector. Generous tax incentives and fiscal stability clauses further undermine government revenue from natural resources.

African countries need to strengthen their oversight of the natural resources sector, consider shifting from corporate income taxation towards formulary apportionment (allocation of multinational corporation profits across countries based on sales, payroll and capital base in each country) and close loopholes to prevent base erosion and profit shifting. Elimination of base erosion and profit shifting alone could boost tax revenue by an estimated 2.7 per cent of GDP.

INTRODUCTION

Natural resources production in Africa has expanded in the past decade. Africa's production of 15 important metals was forecast to rise by 78 per cent over 2010–2017, more than double the 30 per cent forecast for the Americas and Asia (US Geological Survey, cited in AfDB, 2013). As Africa's subsoil remains relatively underexplored, increased investment can only enhance discovery rates (Knebelmann, 2017).

The natural resources sector is dominated by multinational corporations and state-owned enterprises, which are the only firms that have the ability to raise the necessary capital and manage the associated high risks (IMF, 2014a; Mullins, 2010). However, multinational corporations also have the ability to undertake complex international tax avoidance strategies that shift profits from where the underlying economic activities take place to low- or no-tax jurisdictions, a behaviour referred to as base erosion and profit shifting. This can significantly reduce fiscal revenue in countries that rely heavily on natural resources revenue (UNDP, 2017; OECD, 2015).

Multinational corporations have engaged in tax avoidance running into the tens of millions of dollars for individual companies and billions of dollars a year for individual countries (ActionAid, 2015; Africa Progress Panel, 2013, Bloomberg, 2012; Oxfam, 2015). In 2015 base erosion and profit shifting led to an estimated $240 billion annual revenue loss for countries around the world in all sectors (Solheim, 2016).

The impact of base erosion and profit shifting as a percentage of tax revenues is higher in developing countries than in developed countries (OECD, 2015, 2014). In 2013 base erosion and profit shifting cost Africa an estimated 2.7 per cent of GDP in lost revenues (Cobham and Janský, 2018).[1] Other estimates of losses through base erosion and profit shifting ranged from 1 to 6 per cent of GDP (Moore, Prichard and Fjeldstad, 2018). Natural resources taxation will continue to present critical fiscal concerns for developing countries, particularly in resource-rich countries (OECD, 2014).

1 This estimate treats Africa as a single unit and is based on estimates for 42 African countries for which data were available. The median loss among countries for which data were available was 2.3 per cent, and the mean loss was 0.5 per cent (based on data from Cobham and Janský, 2018).

This chapter explores the challenges of natural resources taxation in Africa and how to respond to them, including the complex problem of illicit financial flows. It focuses on non-renewable natural resources. Most of the country examples draw on the mineral, oil and gas sectors, but much of the analysis is relevant to all extractives. The key questions addressed in this chapter are:

- How important is revenue from non-renewable natural resources for government budgets in Africa?
- Why do non-renewable natural resources need to be taxed differently?
- What are the key policy challenges?
- How do illicit financial flows by multinational corporations, including tax evasion and aggressive tax avoidance, affect non-renewable resources?
- How can African countries counter tax evasion and avoidance in the non-renewable resources sector?

This chapter builds on work on illicit financial flows in the natural resources sector by the Economic Commission for Africa (ECA) to provide original insights into tax avoidance, tax evasion and other illicit financial flows.

THE CONTRIBUTION OF NATURAL RESOURCES TO GOVERNMENT REVENUE

The International Monetary Fund (IMF) classifies natural resources revenue as:

> [R]eceipts collected by governments from the natural resources sector through diverse tax and non-tax fiscal instruments. For example, natural resources revenues include "common" taxes, such as the corporate income tax and value added tax; special taxes on the sector, such as the resource rent tax; and other quasi-tax or non-tax instruments, such as royalties, profits, and bonuses. (IMF, 2014a: 1)

Rising exports signal the sector's potential to contribute to government revenue to finance investments in physical and social infrastructure for development (Chuhan-Pole, Dabalen and Land, 2017; IMF, 2013).

In 2016 natural resources rents contributed some 13.4 per cent to GDP in Africa, with forests contributing the highest rents, at 8.2 per cent of GDP (table 6.1). The mineral sector was also an important contributor to GDP, with rents of 3.2 per cent. Other natural resources contributions

TABLE 6.1. CONTRIBUTION OF NATURAL RESOURCES TO GROSS DOMESTIC PRODUCT IN AFRICAN COUNTRIES, 2016 (PER CENT OF GDP)

COVERAGE	*TOTAL NATURAL RESOURCES RENTS*	*OIL RENTS*	*NATURAL GAS RENTS*	*COAL RENTS*	*MINERAL RENTS[a]*	*FOREST RENTS*
Africa[b]	13.4	1.8	0.2	0	3.2	8.2
Median for individual African countries[b]	11.8	0	0	0	0.3	4.2

a. Covers rents from tin, gold, lead, zinc, copper, nickel, silver, bauxite and phosphate, not from the entire mining industry.

b. Eritrea and Libya are excluded from the analysis because of missing data.

Source: Based on data from World Bank (2017a, 2017b) and ECA (2018a).

included oil rents, at 1.8 per cent of GDP, and natural gas, at 0.2 per cent (World Bank, 2017a, 2017b). The contributions vary by country, with oil-rich countries having a higher contribution of oil rent to GDP.

POLICY CHALLENGES IN NATURAL RESOURCES TAXATION

MULTIPLICITY OF FISCAL INSTRUMENTS AND FRAGMENTED INSTITUTIONAL AND REGULATORY OVERSIGHT

Because of the distinct stages that are part of the process of natural resources extraction and commercialization, a country usually has several ways of extracting revenues. In practice, countries adopt a combination of fiscal instruments to cover all potential tax bases, thus creating complex, overlapping fiscal regimes that can be a challenge for revenue collection and administration (table 6.2).[2]

2 For a more elaborate description of the fiscal regimes, see IMF (2012) and IMF and World Bank (2014).

Although most countries adopt a mix of fiscal instruments, some countries are shifting from easier-to-administer royalties (based on the gross value of natural resources extracted or sold) towards levies based on net income (Durst, 2016). These include application of the standard corporate income tax regime to extractive companies, taxes that apply after an extractives company achieves a threshold level of profitability or recovers its costs (resource rent taxes) and income or production sharing from a project (production sharing contracts).

Income-based taxes may dis-incentivize excessive risk-taking for limited liability companies (companies might otherwise prefer risky investments as they stand to reap the full benefit of any financial upside while having limited liability for the downside). However, income-based taxes are more difficult for countries to administer because, unlike royalties which are based on gross values, income-based taxes take into account incurred costs (deductions). That raises the possibility of income understatements, so income-based taxes are more susceptible to base erosion and profit shifting (Durst, 2016; Brooks, 2013; ECA, AMDC and AUC, 2016).

Historically, regulation of the natural resources sector has been fragmented, with responsibilities

TABLE 6.2. TAX BASES AND FISCAL INSTRUMENTS IN THE NATURAL RESOURCES SECTORS

TAX BASE	*FISCAL INSTRUMENT*
Transactions	Licence fees and signature, discovery and production bonuses
Volume or value of production	Royalties or production sharing
Profits or gains	Corporate income taxes and capital gains
Excess profits	Resource rent taxes and variable income taxes intended to capture rents.
Others	Area rentals, minor "nuisance taxes", surface and rental payments

Source: IMF (2014a) and ECA, AMDC and AUC (2016).

TABLE 6.3. RECOMMENDED NATURAL RESOURCES ORGANIZATIONAL FRAMEWORK

POLICY AREA	*INSTITUTION RESPONSIBLE*	
	Policy formulation	*Policy implementation*
Fiscal	Finance ministry	Tax and customs administration
Natural resources management and operations	Natural resources ministry	Natural resources inspectorate
Commercial	Natural resources or finance ministry	Natural resources company

Source: Adapted from IMF (2014a).

distributed across different ministries and government agencies. The IMF recommends a division of responsibilities along the lines shown in table 6.3.

A fragmented institutional and regulatory framework can impede taxation of multinational corporations in the natural resources sector. The ministry of petroleum or mining usually leads in negotiating exploration, development and extraction agreements, which can mean that agreements are negotiated and concluded without sufficient participation by the ministry of finance or the tax administration. Government departments need to work together in policy design and implementation to effectively manage revenue from extractive industries (IMF, 2018).

A natural consequence of fragmented regulatory oversight is that government agencies may operate in silos and fail to share data and information, which undermines fiscal management of the sector (IMF, 2018). Some agencies may cite confidentiality as the reason for withholding information, even though all the agencies are part of the government that signed the contract. As a consequence the tax administration may not have access to information that would enable it to ensure compliance with tax laws by fully assessing and dealing with the risks posed by multinational corporations.

These challenges are apparent in Africa. For example, opaque management of the natural resources sector has been a long-standing challenge in Sudan. Problems include the non-disclosure of agreements entered into between the central government and extractive companies; ambiguous policies on managing oil, land and water resources; outdated and poorly enforced laws governing the oil industry and land administration; and inadequate environmental impact assessments, particularly in the oil industry, which has contributed to environmental damage and led to confrontations between local communities and the oil industry.

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An additional problem in Sudan is the multiplicity of fees, charges and royalties, some not supported by law, that are imposed, collected and even retained by various government agencies. This situation persists because multiple agencies have oversight roles without an effective coordination framework. With no law governing the collection and management of this revenue, institutional challenges arise, preventing the Ministry of Finance from effectively overseeing and coordinating natural resources revenue.

In some countries, production and export data are controlled by different government agencies, or extractive companies provide different reports to different agencies. Thus, the tax administration may have to reconcile multiple data points to effectively assess taxes. In Zambia, for example, there were large discrepancies in the statistics on copper production reported by different government agencies. The differences were ultimately explained as double counting of intermediate production as both intermediate and finished product, but the fragmented regulatory oversight and coordination challenges made it difficult for the revenue authority to reconcile these figures to properly assess tax and non-tax revenue (Readhead, 2016).

The multiplicity of tax bases and fiscal instruments means that different agencies administer different aspects of the fiscal regime. Licence fees, royalties, production bonuses and income from the government's share of production may be collected under the sector ministries; corporate income taxes, resource rent taxes and capital gains taxes are collected by the tax administration; and customs duty and value-added taxes on imports are collected by customs authorities. The variety of fiscal instruments, compounded by the administrative fragmentation of oversight and revenue collection roles, can make it difficult for countries with low capacity to efficiently administer their fiscal regime,[3] deal adequately with the risks of tax evasion and avoidance, and track all revenue collected from the natural resources sector.

Incentives play a limited role in attracting investments to the resource sector.

TAX INCENTIVES

Tax incentives are favourable departures from general tax treatment granted through agreements or legislation to all investors in specified categories of corporations (IGF and OECD, 2018).

Incentives play a limited role in attracting investments to the resource sector.[4] Rather, the investment decisions of mining companies are influenced by resource quality; economic factors such as location (cost of transport and routes to export), ease of extraction and price outlook; and the host country's policy climate (contract protections, tax regime, infrastructure, political stability, labour and security; IGF and OECD, 2018).[5] Multinational firms in the natural resources sector often negotiate contract-based tax benefits. Often, weak governance systems and inadequate consultation among agencies result in overly generous tax incentives that reduce revenue (African Union and ECA, 2014).

3 See IMF (2014a), which also suggests that a concentration of revenue in a single sector or in a few companies may give rise to integrity and transparency issues.
4 See chapter 2 for results of investor survey.

5 See also ECA, AUC and AMDC (2017), which ranks geology as the decisive criterion for investors, with a key focus on mine grade quality.

TAX CERTAINTY AND FISCAL STABILITY CLAUSES

Tax certainty encourages private investment by enabling potential investors to accurately assess the tax and compliance costs associated with an investment over its lifetime. Tax certainty can help reconcile the expectations of taxpayers and governments while providing a tax environment that is conducive to foreign direct investment (FDI) and growth. Congo, Equatorial Guinea and São Tomé and Príncipe have received more FDI in natural resources sectors in part because of the greater tax certainty in their extractives sector than in other countries in the region (OECD, 2018a).

> The variety of fiscal instruments, compounded by the administrative fragmentation of oversight and revenue collection roles, can make it difficult for countries with low capacity to efficiently administer their fiscal regime.

Tax certainty is strengthened by fiscal stability clauses in contracts, which are designed to prevent excessive changes to the tax code. However, fiscal stability clauses may undermine revenue collection, since they prevent host governments from renegotiating contracts to reflect improving fiscal regimes or to benefit from rising commodity prices. Multinational corporations often have the advantage of information asymmetry, technical expertise and negotiating power, which can result in contracts that unduly benefit firms while reducing government revenue (AU and ECA, 2014; ECA, 2018a).

For example, in Democratic Republic of the Congo, Article 276 of Mining Code of 2002 contained a fiscal stabilization clause that prevented transfer pricing rules enacted after negotiated contracts from being applied to potentially mispriced transactions. As a result, the transfer pricing rules could apply to existing mining contracts only 10 years after implementation (ECA, AUC and AMDC, 2017).

Tanzania has also experienced adverse impacts from stability clauses. Article 10(4a) of the 2010 Tanzania Mining Act allows mineral agreements to contain binding provisions that "guarantee the fiscal stability of a long term mining project, by reference to the law in force at the effective date of the agreement, with respect to the range and applicable rates of royalties, taxes, duties and levies and the manner in which liability in respect thereof is calculated and, for that purpose and not otherwise, may contain special provisions relating to the payment of any such fiscal impost which shall take effect in the event of change in the applicable law." Following a tax dispute between Acacia Mining and the Tanzanian government, the Tax Appeal Tribunal ruled that the company, a subsidiary of Barrick Gold, had employed a "sophisticated tax evasion scheme" that included transfer mispricing and generated losses. The Tribunal ordered the company to pay the government $41.25 million in unpaid taxes over four years. As part of its defence, Acacia had argued (unsuccessfully) that its contract with the government provided for deductions of its $3 billion capital investment in the three mines operated in the country, leading it to consistently declare no profits (ECA, AUC and AMDC, 2017: 67).

Stability clauses should benefit both parties, in addition to maintaining economic equilibrium when economic circumstances change. Additionally, they should protect government interests when the changes in fiscal position are the result of non-compliance with regulatory requirements—for example, economic sanctions for environmental damage as a result of a company's operations (Oshionebo, 2010).

MULTINATIONAL CORPORATIONS AND ILLICIT FINANCIAL FLOWS

TAX AVOIDANCE AND EVASION

Tax avoidance is an elusive term. The Organisation for Economic Co-operation and Development notes that it is "generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow." Defining tax evasion is more straightforward; it is "generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities" (OECD, n.d.a).[6]

6 For more on using empirical evidence on the main channels of international tax avoidance, see Beer, de Mooji and Liu (2018), including transfer mispricing, strategic location of intellectual property, international debt shifting and intercompany loans, and tax treaty shopping.

ILLICIT FINANCIAL FLOWS

The High Level Panel on Illicit Financial Flows from Africa defines illicit financial flows as international financial transfers that are illegally acquired, transferred or used, as well as aggressive tax avoidance. Illicit does not necessarily mean illegal, but the harm that base erosion, profit shifting, aggressive tax avoidance and aggressive tax planning do to development justifies considering them illicit flows because they are morally wrong (ECA, 2018b, 2018c). Anyone who facilitates such flows (including the jurisdictions that attract them) has an obligation to act to prevent them.

CHANNELS FOR ILLICIT FINANCIAL FLOWS

Multinational corporations and other economic actors in the natural resources sector may generate illicit flows in a number of ways, as discussed below. Additional methods are described briefly in box 6.1.

Aggressive tax planning

Tax treaties may enable multinational corporations in the natural resources sector to structure their operations to minimize tax liabilities. One way is to set up a complex network of offshore companies

BOX 6.1. INTERNATIONAL CORPORATE TAX PLANNING: FURTHER TOOLS OF THE TRADE

In addition to the methods described in the main text, multinational firms also use the following techniques:

- **Taking deductions in high-tax countries.** For example, firms may borrow in high-tax countries (with interest payments being tax-deductible) and lend to affiliates in lower-tax jurisdictions, where the interest payment received will be taxed at a lower rate
- **And doing so repeatedly.** Passing funds raised by loans through conduit companies (that serve solely as intermediaries within a corporate group) may enable double dipping—taking interest deductions twice (or more) without an offsetting tax on receipts—that may lead to thin capitalization (high debt ratios)
- **Risk transfer.** Firms may operate in high-tax jurisdictions on a contractual basis, limiting the profits that arise there
- **Exploiting mismatches.** Tax arbitrage opportunities can arise if different countries classify the same entity, transaction or financial instrument differently.
- **Deferral.** Companies operating worldwide systems can defer home taxation of business income earned abroad by delaying paying it to the parent.
- **Inversion.** Companies may be able to escape repatriation charges or controlled foreign corporation rules by changing their residence.

Source: IMF (2014b).

to facilitate intra-company trade (Mullins, 2010). This network of offshore companies can be used to circumvent public disclosure requirements and create an avenue for tax avoidance by enabling multinational corporations to report more of their profits in low-tax jurisdictions.

Abusing transfer pricing

Multinational corporations can also manipulate the prices of goods and services traded between different parts of the multinational group in order to shift profits to jurisdictions where corporate income taxes are low. Such abuses of transfer pricing by multinational corporations can result in major losses of public revenue (Readhead, 2016).

Undertaking exploration, extraction, refining, marketing and distribution of resources in different jurisdictions offers multinational corporations many opportunities for abusive transfer pricing. Unprocessed resources can be transferred to affiliated companies at prices that are not at arm's length. Intellectual property can be licensed to affiliates in low-tax jurisdictions, enabling multinational firms to shift intellectual property-related income to these affiliates. Inputs and services such as managerial and technical services are often sourced from affiliates in low-tax jurisdictions, which can lead to excessive deductions for fees related to such services (Mullins, 2010). The capital-intensive nature of natural resources–based economic activities may also lead to excessive debt financing, which can erode the tax base of resource-rich countries (Mullins, 2010).[7]

In addition to avoiding taxes, abusive transfer pricing can also be used to enable multinational corporations to transfer funds to jurisdictions with a high degree of financial secrecy. This can allow them to use these funds to engage in corrupt transactions (such as paying bribes to government agents in exchange for favourable treatment) while avoiding detection because of the financial secrecy surrounding the part of the company dealing with the relevant financial resources (Africa Progress Panel, 2013; OECD, n.d.a).

Misclassifying the quantity or quality of extracted resources

Taxes are levied on the value of extracted natural resource, so countries have an interest in ensuring that reported quantities and qualities are accurate. Royalty rates for mineral products generally depend on their composition or quality, which may vary. Companies may take advantage of this process of royalty calculation by declaring that extracted minerals are of lower quality than they truly are. Where companies export unprocessed minerals such as ores, it may be difficult for government authorities to assess the mineral content of the exports.

Firms may also underreport the quantity produced. The lack of data on the pricing of certain commodities in many resource-rich African countries makes it easier for multinational corporations to underreport the volumes produced (Platform for Collaboration on Tax, 2015). The High-Level Panel on Illicit Financial Flows from Africa found evidence of "extensive underreporting of the quantity and sometimes quality of natural resources extracted for export…, yet none of the countries we studied … had its own independent means of verifying the precise amount of natural resources extracted and exported" (African Union and ECA, 2014: 67).

Misinvoicing trade transactions

Natural resources and commodities are susceptible to the intentional manipulation of invoices of goods or services exports or imports to disguise their true value and evade taxes and customs duties. Misinvoicing and mispricing

7 For more on these issues, see United Nations (2017: 145–190).

are also done to facilitate the shifting of profits to low-tax jurisdictions (African Union and ECA, 2014; Baker et al., 2014; Save the Children UK, 2015; UNCTAD, 2016).

Overvaluing deductible expenses

Another channel for illicit flows is inflating deductible expenses, again through relationships of multinational corporations with affiliates. For example, firms may inflate costs on loans and technical services acquired from related parties and overstate deductible expenses for equipment and other supplies. While under-declaration of the quantity and quality of resources affects royalty payments to the government, cost inflation usually affects income-based taxes, which are becoming more common in many countries.

Treaty shopping has reduced corporate income tax revenues in Sub-Saharan Africa by around 15 per cent in countries that have signed a treaty with an investment hub.

Treaty shopping and locating asset sales in low-tax jurisdictions

Treaty shopping has reduced corporate income tax revenue by above 15 per cent in African countries that have signed a treaty with an investment hub (Beer and Loperick, 2018), a particular blow to countries with a high dependence on corporate income taxes. Mauritius, which has received attention recently for facilitating treaty shopping, took steps to address this by revising its double taxation agreements with India and South Africa in 2015. Multinational corporations in the natural resources sector can also avoid taxation in resource-rich countries by routing asset sales through low-tax jurisdictions.[8]

8 In response to the concerns of developing countries, the Platform for Collaboration on Tax, a joint undertaking of the IMF, OECD, United Nations and World Bank, has drafted a report and toolkit providing analysis and options for the tax treatment of offshore indirect transfers (Platform for Collaboration on Tax, 2018); see also International Consortium of Investigative Journalists (n.d.). See ACDE (n.d.) for an example of a case in Uganda.

TABLE 6.4. MAIN TYPES OF ILLICIT FINANCIAL FLOWS AND BENEFICIARIES

FLOWS AND BENEFICIARIES	CORRUPTION	ILLEGAL EXPLOITATION	TAX AVOIDANCE AND EVASION
Main financial flows	Facilitation payments (bribes) paid by companies, money embezzled from tax collection and budgetary allocation	Undeclared corporate revenues from illegal resource exploitation	Inflated costs deducted from taxable revenues, smuggling of resources
Main beneficiaries	Companies gaining undue advantage, and corrupt government officials	Domestic companies, local subsidiaries of foreign companies	Parent or holding companies, exporting companies

Source: Based on le Billon (2011).

Administrative corruption and illicit financial flows

Administrative corruption also contributes to the prevalence of illicit financial flows in the natural resources sector in Africa (table 6.4). Weak governance systems and lack of transparency give government officials too much discretionary power, making them susceptible to bribes or theft of natural resources or associated revenue (African Union and ECA, 2014). Officials' discretionary power can also be used to award contracts to multinational corporations that cede or limit some taxation rights in return for bribes, thus undermining competition. Multinational corporations often encourage the corruption that facilitates illicit financial flows (ECA, 2016).

Because illicit financial flows benefit both multinational corporations and corrupt officials, it can be difficult to introduce more transparency to stop illicit financial flows in Africa. This may explain why organizations dealing with illicit financial flows are often underfunded and lack the power to prosecute cases related to illicit financial flows (African Union and ECA, 2014; and ECA, 2018c).

Actions that disrupt any part of this vicious cycle of illicit financial flows and poor governance can help to tackle illicit financial flows. African countries may wish to strategically plan for which parts of the chain to address first, focusing on those that are easier to achieve and that will make it easier to target others later. For example, if the customs authority is a pocket of efficiency in a national administration, strengthening its capacities to prevent illicit financial flows through trade may cut off the resources used by corrupt officials to prevent improvements in public transparency. This, in turn, can make it easier politically to pursue anti-corruption measures.

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CONTENDING WITH ILLICIT FINANCIAL FLOWS

CHALLENGES IN ENDING ILLICIT FINANCIAL FLOWS

African countries face several challenges in fighting illicit financial flows from the natural resources sector. First, many countries lack the skills and resources (including laboratories for testing the composition and quality of extracted resources) needed to verify the submissions of multinational corporations. Countries need to build capacities in this area, in some cases with international assistance. Efforts to build national administrators' capacities in tax audit, such as the Tax Inspectors without Borders initiative, have experienced challenges. In some countries, national administrations have been sidelined, while the external auditors assigned to the project have had conflicts of interest (ECA, 2018b).

Second, in light of the complex network of offshore companies used by multinational corporations, weak public disclosure requirements and enforcement may jeopardize efforts to curb the abuse of tax provisions and illicit financial flows.

Third, the form that illicit financial flows take depends on individual country characteristics. Many government officials in Africa are unfamiliar with how such flows operate in their national context, and estimates of the extent of such flows and their sources are scarce. Learning more about them should be a priority (ECA, 2018c).

Fourth, as with natural resources taxation, there is little information sharing and coordination on illicit financial flows among relevant government agencies within or between countries. Coordination is a relatively inexpensive yet effective way to counter illicit financial flows (ECA, 2018b, 2018c; Institute for Austrian and International Tax Law, n.d.).

INITIATIVES TO COMBAT TAX AVOIDANCE AND EVASION

OECD Base Erosion and Profit Shifting package

The OECD's Base Erosion and Profit Shifting (BEPS) report set out a 15-point action plan to equip governments with the domestic and international tools they need to combat base erosion and profit shifting (OECD, 2014). The report recognised that greater transparency and improved data are needed to uncover and stop the divergence between where profits are made and where they are reported for tax purposes. With multinational corporations dominating the natural resources sector, cross-border transactions between related parties abound and create multiple opportunities for abusing transfer pricing. The OECD's BEPS (in particular Actions related to transfer pricing outcomes and value creation, and Country-by-Country Reporting) can provide a starting point for countries in Africa to deal with transfer mispricing. Country-by-Country Reporting is a risk profiling tool that can be used to flag discrepancies between where economic activity by multinational corporations takes place and where the corporations pay taxes (OECD, 2014). Other priorities for tackling base erosion and profit shifting, such as non-strategic tax incentives, governance of tax administration and tax competition, are not included in the OECD package. African countries will therefore need to consider additional policies that are outside of the OECD BEPS package. For example, the "sixth method", pioneered and used successfully in Argentina, calls for commodities traded within a multinational group to be priced according to publicly quoted prices to simplify transfer pricing administration and settle disputes (Grondona, 2018).

Another method for preventing abusive transfer pricing that is not included in the OECD package is administrative pricing, in which the tax administration rather than the taxpayer sets the value of the commodity. This method shifts the burden of proof to the taxpayer and frees the tax administration from having to determine whether sales between related parties are at arm's length (Durst, 2016; Readhead, 2018).

Formulary apportionment and moves away from income-based taxation

While the OECD BEPS actions can be a useful starting point for African countries to reduce base erosion and profit shifting, some of the proposed solutions may be difficult to apply. Taxing multinationals on the income of their local branches or subsidiaries is inherently vulnerable to the manipulation of profits, even with the OECD BEPS package. And manipulation of reporting of

While the OECD BEPS actions can be a useful starting point for African countries to reduce base erosion and profit shifting, some of the proposed solutions may be difficult to apply.

firm revenues or costs has a larger relative impact on corporate income and profit-based taxes than on royalties (Durst, 2016).

In particular, for corporate income taxes, multinational corporations can use transfer pricing of imported inputs, intra-company loans and other techniques to manipulate profits and reduce tax liability. It can be difficult to apply the arm's length principle in determining the prices of goods and services traded within a multinational group. Tax administrations are at a disadvantage in gathering information about comparable transactions between unrelated parties and market conditions at the time of the transaction.[9] In Africa, in particular, information on comparable transactions is hard to come by. And in the case of services or intangibles, which are beginning to dominate economic transactions and which may be specific to the company in question, comparable transactions simply may not exist (Chen et al., 2017; Pagano, 2014, cited in Durand and Milberg, 2018). Moreover, even when comparable transactions are found, to be truly comparable they need to be adjusted for differences in the circumstances of the transactions, such as differences in products, quality, economic conditions and geography.

The paucity of reliable information therefore makes it onerous for tax administrations, especially those in developing countries, to apply the arm's length principle. This is further complicated by timing, since tax administrations usually review taxpayer information long after the transaction occurred. Thus, tax administrations are disadvantaged when challenging transfer pricing, enabling multinational firms to manipulate intra-company transactions to shift profits (see OECD, 2010; Faccio and Fitzgerald, 2018).

9 Article 9(1) of the OECD Model Double Tax Convention is the starting point for the arm's length principle, which has formed the basis of all bilateral tax treaties involving both OECD member countries and an increasing number of non-member countries. See also Avi-Yonah and Tinhaga (2017).

Given the arguments about the role of income-based taxation in balancing risk, a good approach might be to use a variable that closely tracks corporate income but is less easy to manipulate.

The OECD BEPS project foresees a number of methods to tackle the manipulation of corporate income reporting. These approaches broadly aim to ensure that intra-company transactions (and financing arrangements) respect the arm's length principle.[10] Yet these solutions (as well as the sixth method and administrative pricing, mentioned earlier) face challenges in addressing trade in unique services and intangibles, where comparable prices are not available and the proposed methods to estimate the arm's length price may require access to information on the entire corporate group (such as the transaction profit split method) or place excessive burdens on tax administrations (ECA, 2018b).

This suggests that there may be advantages to a shift away from income-based taxation, which may be easier to manipulate, towards taxation based on variables that are more difficult to manipulate. Given the arguments about the role of income-based taxation in balancing risk, a good approach might be to use a variable that closely tracks corporate income but is less easy to manipulate. This would seem to rule out any variable that is based on intra-company transfers (including sales and

10 Some of these methods (transaction profit split method, cost plus method and transactional net margin method) imply inferring the profit that should be attributed to the local branch or subsidiary of a multinational group on particular transactions, based on other variables (OECD, 2017a). Instead of applying this method transaction by transaction, it could be applied in bulk to all transactions between a multinational branch or subsidiary and the rest of the group to reduce the administrative burden of producing multiple estimates, or it could be applied to all of the branch or subsidiary's activities.

Implementation of international standards for the exchange of information for tax purpose can help African countries fight tax avoidance and evasion and illicit financial flows.

imports), particularly those for which comparable prices are not available, as these may be more susceptible to manipulation. Other variables may be less susceptible to manipulation, such as gross sales of minerals, payments to factors of production (capital, labour and land) that are located in country or domestic utility payments. Though gross sales of minerals, for example, can be manipulated by multinationals, in many cases this may be more difficult than manipulating corporate income, since the prices at which minerals are traded can be compared with global market prices.[11]

One of the arguments against such an approach is the risk of double taxation. If different countries apply such criteria in different ways for inferring corporate income, the portions of a multinational group's corporate income that countries consider taxable in their jurisdiction would overlap. There are many countries in the world that are not linked by double taxation agreements, and most African countries have few such agreements, yet multinational corporations still operate in those countries. Indeed, so long as countries do not place excessive tax burdens on multinational corporations, and other factors to attract investment are strongly positive, the risk of double taxation should not prevent countries from pursuing this kind of approach to the taxation of multinationals.

While it can be argued that such an approach should be implemented at the global level, to ensure a fair distribution of global profits, OECD countries are opposed to pursuing alternatives to the arm's length principle (OECD, 2017a). Therefore, African countries may wish to pursue such an approach at a bilateral or regional level or with other groups of interested countries.

Transparency initiatives

Transparency is often lacking in the natural resources sector, which enables rent-seeking behaviour by government officials and tax avoidance and evasion by firms. Fiscal transparency is a pillar of good natural resources management. The IMF emphasizes that "being transparent about mining and petroleum fiscal terms and contracts, revenue collections, and the ultimate use of revenues through the budget builds public trust. Internal transparency by sharing information between government agencies also is critical for effective fiscal management" (IMF, 2018). The High Level Panel on Illicit Financial Flows from Africa quoted US Supreme Court Justice Louis Brandeis in asserting that "The best disinfectant is sunlight" (African Union and ECA, 2014: 45).

The High Level Panel on Illicit Financial Flows from Africa and others recommend increasing tax transparency, expanding networks for the exchange of information and participating in the automatic exchange of information between countries, and ensuring the availability of ownership information to reduce illicit financial flows (ECA, 2018b; Mullins, 2010).[12] There is now a burgeoning movement towards greater transparency in tax matters which may change the way that multinational corporations operate.

To facilitate the detection of aggressive tax planning, a new global standard for the Automatic Exchange of Information for Tax Purposes,

11 As noted earlier in the chapter, there is an important exception for minerals exported in unprocessed form, as ores.

12 Nigeria has also begun participating in the automatic exchange of country-by-country reports (OECD, 2019).

endorsed by the OECD in July 2014, calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions. The standard is intended to "strengthen international efforts to increase transparency, cooperation and accountability among financial institutions and tax administrations and enable governments to recover tax revenue lost to non-compliant taxpayers. The new standard will generate secondary benefits by increasing voluntary disclosures of concealed assets and by encouraging taxpayers to report all relevant information" (OECD, n.d.b).

This common reporting standard can help tax administrations clamp down on companies that hide or withhold information relating to undeclared offshore funds. Implementation of international standards for the exchange of information for tax purpose can help African countries fight tax avoidance and evasion and illicit financial flows (Owens and McDonnell, 2018).

However, African countries face challenges in implementing tax transparency standards (OECD, 2017b). Participation in the system is based on full reciprocity. Most African countries lack the capacity, infrastructure and resources to meet the administrative requirements (data protection legislation) and bear the costs (secure information infrastructure, data collection from all affected financial institutions) of participation in the system (Monkam et al., 2018). To date only three African countries (Mauritius, South Africa and Seychelles) are participating in the system, and only one other country (Ghana) has passed the legislation needed as a first step towards participation (ECA, 2018b; OECD, 2018b, 2018c).

Noting the challenges that African countries face in the exchange of information for tax purposes, the Global Forum and its partners launched the Africa Initiative in 2014. The initiative is intended to use technical assistance and political engagement to enable African countries to take advantage of improvements in international tax transparency that can increase domestic resource mobilization and fight illicit financial flows (OECD, n.d.c). The original three-year mandate was renewed for three more years (2018–2020) at the Global Forum plenary meeting in November 2017 (OECD, n.d.d).

There is also a move towards public and centralized registers of the ultimate owners of trusts, foundations and other opaque vehicles used by multinational corporations. Advances in this effort will improve transparency in the natural resources sector and illuminate instances where "apparently unrelated parties" are engaged in base erosion.

In addition, due diligence from purchasers of natural resources may be required to ensure that the resources were not acquired illegally and to prevent the sale of conflict minerals (minerals whose sale proceeds are helping finance conflict). In particular, it may be helpful for foreign buyers of natural resources to apply "know your customer" rules when purchasing natural resources from Africa. This may help to ensure that the natural resources considered for purchase have not been stolen or smuggled out of their countries of origin. The Kimberly process for diamond origin verification is an example.

The High Level Panel on Illicit Financial Flows from Africa and others recommend increasing tax transparency, expanding networks for the exchange of information and participating in the automatic exchange of information between countries.

POLICY RECOMMENDATIONS

Overly generous incentives and fiscal stability clauses, fragmented government oversight and illicit financial flows by multinational companies have reduced government revenue from the non-renewable natural resources sector. African countries lose about 2.7 per cent of GDP through base erosion and profit shifting by multinational corporations. Some estimates put losses at between 1 per cent and 6 per cent of GDP (Moore, Prichard and Fjeldstad, 2018).

Heavy reliance on corporate income tax and the dominance of multinational firms in the natural resources sector have exposed African countries to the harmful effects of base erosion and profit shifting and illicit financial flows. To address these issues, African countries may consider the following actions.

DEVELOP EVIDENCE-BASED NATIONAL ACTION PLANS AND COORDINATING FRAMEWORKS TO TACKLE ILLICIT FINANCIAL FLOWS

- Deepen understanding of how illicit financial flows operate at the national level.
- Develop a national action plan that addresses key vulnerabilities.
- Develop a coordinating framework for tackling illicit financial flows that specifies the responsibilities of each government agency for each aspect of the plan to combat illicit financial flows.

ENHANCE CAPACITY FOR ASSESSING TAXES

- Build capacity in relevant agencies to verify the quality and quantity of extracted natural resources—for example, by investing in laboratory and testing facilities.
- Consider using benchmark prices for valuation, as in the "sixth method" use of publicly quoted prices.
- Consider alternative means for assessing the value of natural resources, such as administrative pricing, to prevent transfer mispricing between related parties.
- Consider engaging external experts to verify the quality and quantity of extracted natural resources and the cost of equipment imported from related parties.
- Enhance the skills and capacity of tax administrations to understand tax issues in the natural resources sector, using toolkits for transfer pricing risk assessment.

INTRODUCE POLICIES TO COUNTER BASE EROSION AND PROFIT SHIFTING

- Focus on transfer pricing, which is one of the biggest challenges affecting the natural resources sector.
- Use the OECD's BEPS package to review and update tax treaties to close loopholes that enable abuse. Consider the opportunities offered by the Multilateral Instrument for the natural resources sector.
- Consider going beyond the OECD's BEPS package and applying the "sixth method" for trade in commodities for which price information is publicly available.
- Consider placing less emphasis on taxing corporate income, or use formulary approaches to tax a share of a multinational group's profits.
- Discuss alternatives to the arm's length principle with interested countries through bilateral, plurilateral or regional agreements—such as allocating taxes based on variables that are less easy to manipulate than reported local profits, and seeking legally enforceable agreements to limit tax competition, such as those in the European Union on state aid.
- Consider introducing tax coordination into negotiations on the African Continental Free Trade Area. Reaching agreement on tax issues could offer guarantees against base erosion and profit shifting that countries need in order to pursue deeper integration.

ENHANCE TRANSPARENCY AND ACCOUNTABILITY TO COUNTER TAX AVOIDANCE AND ILLICIT FINANCIAL FLOWS

- Require legislative approval of the award of rights to explore and extract natural resources.
- Require more transparency by extractive companies and accountability by governments, for example, by joining the Extractive Industries Transparency Initiative and implementing its recommendations and joining other transparency initiatives.
- Consider national legislation requiring disclosure of contracts by extractive companies and monitoring and enforcement mechanisms.
- Require politicians and others involved in managing natural resources to disclose their wealth and their interests in companies engaged in extractive activities or in companies that deal with them.

MAKE GREATER USE OF INFORMATION EXCHANGE

- Sign on to international efforts to improve tax transparency.
- To the extent that the OECD approach to information exchange is not appropriate to African countries' needs, pursue alternatives at the pan-African and South–South levels, where partners are more likely to share their perspectives, such as the pilot on information exchange being undertaken by the African Tax Administration Forum.
- Update the article on exchange of information in tax treaties, or negotiate tax information exchange agreements with key trading partners.
- To the extent possible, prepare to use new information sources, such as automatic exchange of information for tax purposes and the Country-by-Country Reporting risk profiling tool.
- Adapt the Country-by-Country Reporting tool to the needs of African countries by lowering the $750 million threshold to one that is better adapted to African economies, and broaden its scope.

ENHANCE COLLABORATION AMONG GOVERNMENT AGENCIES IN NATURAL RESOURCES POLICY MAKING AND IMPLEMENTATION

- Encourage closer coordination of government agencies for a consistent approach in negotiating bilateral investment treaties, stability clauses and agreements to explore, develop and produce natural resources to ensure that they do not impede taxation. (Ideally, these non-tax agreements should not include tax provisions.)
- Encourage closer cooperation among government agencies engaged in natural resources management, tax administration and customs authorities to enhance data and information sharing.

REVIEW POLICIES RELATING TO TAX CERTAINTY AND TAX INCENTIVES

- Engage stakeholders in tax policy formulation and implementation and ensure that legislation is clearly drafted to avoid ambiguity.
- Issue public guidance and rulings to clarify ambiguous provisions.
- Avoid becoming locked in to agreements with stability clauses that are unduly generous to multinational corporations
- Consider revising existing agreements that are not in a country's best interest over the long term, balancing the potential gains against any temporary reduction in investment that might be associated with reduced taxed certainty.

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