Transfer Mispricing as a Non-Tariff Barrier to the African Continental Free Trade Agreement

By:

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The African Continental Free Trade Agreement (AfCFTA) negotiated by African countries, seeks to create a single market, akin to the European Single Market. The AfCFTA will remove tariff and non-tariff barriers to intra-African trade of goods and services. It also seeks to promote the development of regional and continental value chains. While the AfCFTA represents an important development in the industrialisation and enrichment of the African continent, its expected benefits may not be achieved if the potential transfer mispricing opportunities created by the AfCFTA are not addressed. Transfer mispricing is part of the global tax avoidance architecture. It occurs when transfer pricing goes wrong. Transfer pricing refers to the pricing of goods and services transacted between related entities. Transfer mispricing, for its part, refers to the wilful manipulation of the transfer price by related entities, either to return high taxable profits in low-tax jurisdictions or return low taxable profits in high-tax jurisdictions. This is a common way of shifting profits from one jurisdiction (in most cases, the jurisdiction where the economic activities occur, and value is created) to one used as conduit for tax minimisation purpose.

Transfer pricing arises out of the global and national treatment of companies in a group as independent from each other, alongside the added requirement that they transact at arm's length. Simply put, the present international tax system, which has been adopted in most national tax laws and practice, prescribes that related entities in a corporate group, for tax purpose, must be treated as independent and separate from other entities in a group, while also requiring them to achieve price and terms unrelated entities would achieve, when transacting with related entities. The impracticality of this tax system is well documented in the literature and its limitations affect both developed and developing countries. I refer you to a November 2018 publication by Sol Picciotto for a comprehensive discussion of the limitations of the separate entity and arm's length principles. Suffice it to say, that this treatment of entities in a corporate group as separate from each other, contributes significantly to illicit financial flows out of countries as it provides the enabling environment to erode tax bases and shift profits out of countries. The AfCFTA hopes to promote regional value chain development and attain sustainable and inclusive socio-economic development. Under the current global tax architecture, the tax benefits which arise from such value chain development may not accrue in the states where they are created. There is the potential for the taxable profits arising therefrom to be shifted from jurisdictions where the economic activities occur, and value is created, to low tax jurisdictions. The notoriety of these low-tax jurisdictions is that no real economic activities occur, or value is created there. They are simply organisational circuits to minimise the tax liability of companies, at the detriment of the taxing jurisdictions where the economic activities occur, and value is created. The Paradise Papers (series of publications by the International Consortium of Investigative Journalists) chronicle the complex structures used by companies to shift and hide profits, away from the jurisdictions with legitimate claim to them.

The High Level Panel Report on Illicit Financial Flows from Africa reveals the governance and development impact of these shifts of taxable profits out of jurisdictions where they rightly belong. Mauritius, an African country, has over the decades earned the reputation of being a tax haven on the continent and accused of depriving taxing jurisdictions taxes due to them. Some taxing jurisdictions such as India, Rwanda and South Africa have renegotiated their tax treaties with Mauritius, with the goal of protecting their tax revenue. Tax revenues are important to governments. They provide the revenues needed to provide physical and social infrastructure. They are also an important return for the exploration and exploitation of the resources of the state. As such, transfer mispricing could constitute non-tariff barriers to the trade of goods and services where countries fear they will be unfairly gamed out of the taxes due to them. The AfCFTA, as presently negotiated, fails to address the potential tax avoidance likely to arise from the proposed single market. The tax-related non-tariff barriers mentioned in the AfCFTA are limited to subsidies and tax benefits granted by governments to countries. In the absence of any express provision on the allocation of taxable income among countries in the AfCFTA, it may be argued that the AfCFTA has adopted the global tax system, which treats companies in a group as separate from each other. There are two reasons that provide an opportunity for companies to minimise their tax liabilities through base erosion and profit shifting activities very appealing. First, because countries subject to the AfCFTA will trade goods and services in other countries, otherwise referred to as host countries, through subsidiaries particularly in countries like Nigeria that make the incorporation of companies by foreign entities who intend to carry out business compulsory, and/or second, in countries where such companies have permanent establishment. An ideal alternative would be a system which guarantees that taxable profits are returned where economic activities occur, and value is created. Such a system guarantees that taxable income is fairly allocated among countries with claims to it. One viable alternative is unitary taxation. Unitary taxation treats members of a corporate group as a single entity for tax purpose. Having achieved this, consolidating all accounts of the related entities to produce a global profit, it apportions the global profit using a formula. Factors adopted as part of the apportionment formula usually reflect the contributing factors to the global profit. For instance, in some cases, factors such as asset, labour and sales are adopted, and part of the global profit apportioned to countries which have contributed any of the factors to the actualisation of the global profit. The approach could be to split the global profit equally to all factors or prioritize one factor over the other. This system of profit allocation exists within national boundaries such as Canada, the United States and Switzerland. At a regional level, the European Union is finalizing arrangements to adopt this system of income allocation under the description, Common Consolidated Corporate Tax Base(CCCTB). A reason given by the European Commission for the considered adoption of the CCCTB, relevant to the AfCFTA, is the adoption of an effective tool for attributing income to where the value is created. Another objective for the considered adoption of the CCCTB is to support the proper functioning of the internal market, by shaping the corporate tax environment in the European Union in accordance with the principle that companies pay their fair share of tax in the jurisdiction(s) where their profits are generated. Africa can learn from its European counterpart as it seeks to go down a road its European friends have trodden for decades. In conclusion, as African countries rush to sign and ratify the AfCFTA, it is imperative that the tax implications of doing so are considered. Under the present global tax system, African countries are likely to lose significant tax revenues, which may accrue to them from participating in the single market. To prevent this, I offer two recommendations:

1. First, that the African Union adopt parallel to the AfCFTA an African-wide tax regime along the lines of the European Union's CCCTB. This will ensure that income arising from cross-border economic activities among related entities carrying out business on the African continent are taxed in line with the principle that companies pay their fair share of taxes to countries where the economic activities occur, and value is created.
2. Second, that tax avoidance, especially arising from transfer mispricing, be treated as a non-tariff barrier to trade and addressed accordingly by the AfCFTA.

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