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Improving Transfer Pricing Audit Challenges in Africa through Modern Legislation and Regulations

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1. Introduction

African countries, like the rest of the world, form part of the global community. This global community is constantly evolving and innovating with new trends and technologies introduced at a very rapid rate. It is without saying, that the global community's evolution is spearheaded by businesses and a consumer appetite to make things easier and more convenient. The conundrum this has made for the relationship between businesses and the state is tense, due to the calls to collect more revenue while encouraging foreign direct investment (FDI).

As such, the structuring of companies takes into account the most efficient and most cost-reducing methods to ensure profit maximisation but equally wealth maximisation. No truer is this scenario than on the African continent, where resources are plentiful across its 54 countries. Whilst transfer pricing (TP) is legal and necessary, it can be abused by Multinational Enterprises (MNEs) to shift profits and avoid tax liability in African countries.

When members of multinational groups of companies undertake transactions with each other, such as buying and selling goods and services, one member of the MNE charg-

Abstract

Auditing multinational enterprises often involves a broad range of complex technical issues, and transfer pricing (TP) is often the most important one. This policy brief looks at some of the key aspects of the modern TP legislation and illustrates how different drafting of regulations can assist in additional revenue collection as well as increased compliance. It further provides practical examples from real cases to show where poor legislation has given rise to tax planning and to profit shifting. Lastly, the brief offers practical solutions to some of the transactions illustrated through the African Tax Administration Forum (ATAF) Suggested Approach to Drafting Transfer Pricing Legislation.

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De nombreux aspects techniques particulièrement complexes sont en jeu lorsque l'on aborde la question des audits des entreprises multinationales, dont l'un des plus importants concerne le prix de transfert. La présente note de synthèse examine certains des aspects clés des législations modernes en matière de prix de transfert et illustre à quel point l'adoption d'une approche différente s'agissant de la rédaction des normes peut permettre la perception de recettes supplémentaires et favoriser un meilleur respect de la législation. Elle fournit en outre des exemples pratiques tirés de cas réels qui montrent qu'une mauvaise législation encourage la planification fiscale et contribue à la réorientation des bénéfices. Enfin, elle propose des solutions pratiques concernant certains types de transactions sur la base de l'Approche suggérée pour la rédaction de la législation sur les prix de transfert du Forum africain de l'administration fiscale (ATAF).

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*La auditoría de empresas multinacionales a menudo entraña una amplia gama de cuestiones técnicas complejas, y la fijación de precios de transferencia suele ser la más importante. Este informe de políticas analiza algunos de los aspectos clave de la legislación moderna en materia de fijación de precios de transferencia y explica cómo una elaboración de los reglamentos diferente puede ayudar a recaudar ingresos adicionales y lograr un mayor cumplimiento. Asimismo, ofrece ejemplos prácticos de casos reales para mostrar en qué situaciones la legislación deficiente da lugar a la planificación tributaria y al traslado de beneficios. Por último, el informe aporta soluciones prácticas para algunas de las transacciones ilustradas mediante el enfoque sugerido por el Foro Africano de Administración Tributaria (FAAT) para la redacción de legislación relativa a la fijación de precios de transferencia (*Suggested Approach to Drafting Transfer Pricing Legislation*).*

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es a price to another member (i.e. the "transfer price"), which is reflected in their accounts and forms the basis for the computation of their accounting and taxable profits. The transfer prices used by MNEs influence a number of profits that they report (and pay tax on) in each country in which they operate. An example of a transfer pricing transaction between companies belonging to the same MNE and operating in three different jurisdictions is illustrated below.

This method of conducting business across multiple jurisdictions requires capacity, both in the business but possibly more in revenue administration. The latter requires a large amount of audit capacity based on the number of companies present either through a permanent establishment (PE) or through a subsidiary in the country. The auditing of a multinational is a process that needs to be followed carefully as, ultimately, the multinationals are taxpayers and contributors to other taxes in the fiscus and, therefore, play a significant role in the economies of some countries. This is highlighted in the findings from a report by the Organisation for Economic Co-operation and Development (OECD), where Rwanda reported that 70% of its tax base comes from MNEs and in Burundi, one company contributes nearly 20% of total tax collection. Lastly, Nigeria, which is the largest economy in Africa, reported that MNEs represent 88% of the tax base.[1]

It is in this light that African countries should identify transfer pricing risk, as well as have sufficient transfer pricing audit capacity. Skill development and risk identification have become topical issues for African countries as revenue administrations are still undergoing various forms of transformation at various levels including taxpayer segmentation.

This policy brief will look at two factors that are essential in collecting revenue in an already under-capacitated environment. The first aspect is determining the amount of capacity building and training conducted for auditors working on transfer pricing by focusing on the audit processes, questions and fact-finding; this is discussed in the next section. Thereafter, the brief will look at the hurdles some audit processes experience due to ineffective legislation and regulations. This section will offer some solutions that have been proposed in innovative legislation and regulations. The primary aim of improving legislation is of course to increase revenues collected, but at the same time, countries are committed to implementing Agenda 2063 and the Sustainable Development Goals (SDGs).

2. Increasing compliance and building a positive relationship between tax administration and taxpayers

Challenges for African countries are generally classed under capacity. While this may sound like a broad and wide problem, this brief will look at one specific area which has challenged the capacity of auditors to achieve their targets effectively. The African Tax Administration Forum (ATAF) is carrying out 'Country Programmes in Transfer Pricing' to improve audit capacity and provide advice and direction on the drafting of new legislation and regulations.[2] The aim of these programmes is to ensure that an audit is well equipped and has the legislative tools it needs to effectively identify transfer pricing risks and audit those risks efficiently and effectively.

The availability of legislative standards poses a unique opportunity to face off with aggressive taxpayers, leading to an aggressive audit process. The lack of clear and effective legislation and of the necessary audit skills can lead to a confrontational approach to the audit for both the tax administration and the taxpayer, which does not achieve any positive gains for either party. The aim of innovative regulations is to encourage compliance while attracting investment.[3] The compliance model is an essential aspect of revenue administrations, and African administrations are working to develop compliance risk models. The Tax Administration Diagnostic Assessment Tool (TADAT) Performance Indicator 2 is at the core of the design of the interaction with taxpayers. In the same TADAT assessment, 4 African countries have scored low levels.[4] This is not a direct reflection on the transfer pricing compliance levels. However, noting that African countries, as highlighted above, rely on MNEs and corporate income tax (CIT), it is worth considering how compliance can be improved. In its rollout of technical assistance interventions, ATAF has established that much of the compliance challenges in transfer pricing can be overcome by simplifying legislation and regulations. To this end, ATAF has developed the 'Suggested Approach to Drafting Transfer Pricing Legislation', which is a guide for developing countries on how to develop appropriate legislation and regulations in the post-Base Erosion and Profit Shifting (BEPS) world.

African countries have adopted various approaches to collecting information from taxpayers on their transfer pricing practices. The most commonly used are obligations to submit a transfer pricing schedule. This ideally should be submitted together with the annual tax return and transfer pricing documentation should be prepared and maintained (with penalties imposed for inadequate documentation). However, as illustrated in this brief, many countries do not have strong documentation requirements. Those that do have impose a penalty in line with international best practices. The disclosure requirements also play an important role in raising awareness and promoting taxpayers' compliance with the transfer pricing rules.

In order to illustrate the positive effect that modern legislation can have on compliance, one can look at the case of South Africa. The changes in the South African Income Tax Act Section 31 on international taxation (which deals with transfer pricing) is one such case. A recent GIZ (Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH) paper makes the link that the new law in South Africa had a positive increase in the collection for the State.[5] The South African Revenue Service (SARS) noted that TP posed a major compliance risk and therefore set in motion a change of regulation to increase compliance and generate revenue. Under these new TP rules, SARS has been able to combat BEPS tax avoidance more effectively.

This brief will look at some of those key aspects of the modern TP legislation and additionally illustrate how different drafting of regulations can assist in additional revenue collection as well as increased compliance. Use of practical examples from real cases, which have been adapted to conform with secrecy provisions of each tax jurisdiction will illustrate where poor legislation has given rise to tax planning and to profit shifting. Lastly, the brief will offer practical solutions to some of the transactions illustrated through the ATAF Suggested Approach to Drafting Transfer Pricing Legislation. This is a practical tool that has been developed by the ATAF Secretariat and the members of the ATAF Cross Border Taxation (CBT) Technical Committee[6].

3. Auditing a multinational is a different ball game

A general auditor in a revenue administration would be tasked with overseeing all taxes such as value added tax (VAT), pay as you earn (PAYE), corporate income tax (CIT) etc. After assessing the various tax risks, the auditor can easily flag it for additional support such as in transfer pricing. This is assuming that the auditor looking at the taxpayer can spot a transfer pricing transaction.

Auditing MNEs often involves a broad range of complex technical issues. Transfer pricing is often the most important one and is the focus of this brief. However, linked to transfer pricing is the need to analyse other technical issues such as permanent establishments, treaty abuse – including withholding tax issues, and 'treaty shopping'. Excessive interest deductions by MNE taxpayers are often a significant risk to the tax base, leading to discussions on thin capitalisation and the introduction of legislative measures to counter excessive interest deductions. Lastly, international tax planning using, for example, hybrid instruments and entities also poses significant risk to the tax base. These kinds of risk have also been noted in the BEPS Actions 2 and 4 as African countries still largely use debt to equity rules which are generally reported to be largely ineffective and easy to circumvent.

Taking into account the significant resources available to multinationals, including access to advice from auditing firms, it is prudent that auditors at revenue administration take into account a number of key factors. The auditing of MNEs is not simple and requires careful considerations to be made. At the core of it, there has to be a clear understanding of how the business is organised. This includes understanding the commercial and economic reality of business operations such as the generation of incomes, profits and which functions of the business are essential to generating the profits.

Issues in an MNE audit may include:

- Understanding how businesses are organised and how they function;
- Transfer pricing concepts such as 'risk';
- Understanding benchmarking exercises for transfer pricing comparability analyses;
- Valuation of assets (e.g. plant, share disposals);
- Profit shifting through transfer pricing and interest deductions;
- Other international issues: residence, permanent establishments, treaty issues;
- Mismatch instruments;
- Accounting treatment.

Auditing MNEs rarely involves:

- Checking figures in accounts against books and records.

Auditing MNEs needs careful administration, including:

- Selection of right cases - As issues are often complex and tax administration resources to deal with these issues are often limited;
- The consistent approach, in line with domestic law and international principles;
- Closing cases when appropriate – This requires an effective and robust governance process;
- Settling cases appropriately – Once more, this is where an effective and robust governance process is required;
- Taking the right cases into the judicial processes;
- Ensuring the right skills are available and used;
- Ensuring treaty provisions are correctly administered: mutual agreement procedure (MAP), advance pricing agreements (APA), corresponding adjustments, exchange of information;
- Encouraging good communication with taxpayers to encourage voluntary compliance[7].

4. Approaches available to tax administrations for TP audits

This section will briefly discuss the possible approaches tax administrations might take to address the above issues. Recently, in the technical assistance and in-country interventions carried out by ATAF, auditors are being introduced to the ATAF Risk Assessment Tool for Transfer Pricing. This is coupled with the training of auditors on how to compile their audit cases as well as the setting up of 'Settlement Committees' for the closing of audit cases. It is worth noting that every transfer pricing case is unique and each country and its audit teams will have to exercise their own discretion on the validity of the process to follow.

Therefore, case selection is probably the most important aspect of transfer pricing, and this has to be based on a number of factors[8]. As highlighted above, ATAF member countries currently engaged in transfer pricing country programmes are using risk assessment methods to improve their case selection. Below is an example of risk factors to be considered when selecting a case for transfer pricing audit:

- Significant transactions with related parties in low tax jurisdictions;
- Transfers of intangibles to related parties;
- Business restructurings;
- Specific types of payments;
- Loss-making including Year on Year loss-making;
- Poor results;
- Effective Tax Rate;
- Poor/Non-existent documentation;
- Excessive debt[9].

5. The challenges of auditing commodity transactions

African countries face challenges when dealing with transfer prices. These can be summed up as follows:

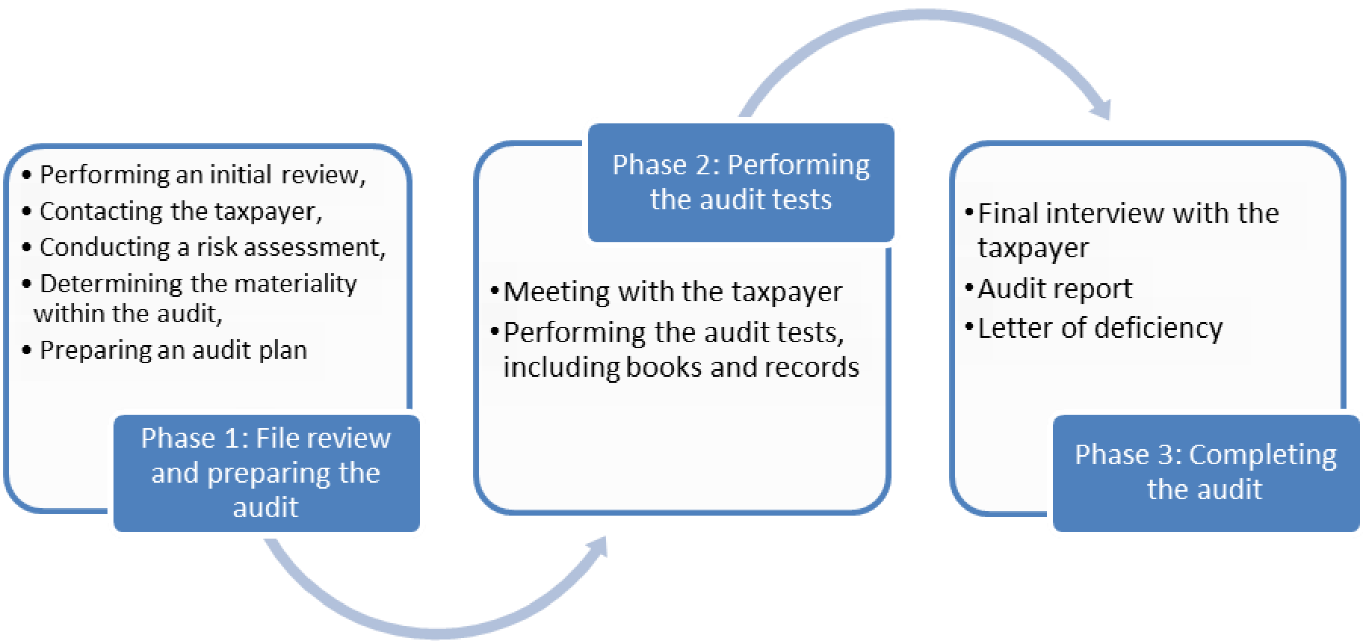
- Weak legislation;
- Limited tax administration capacity; and
- Limited access to information.

Commodities form a large base of many African countries' gross domestic product (GDP) and revenue. The industry though provides complexities that challenge revenue administrations in collecting revenue, particularly in auditing. With a large range of commodities across many jurisdictions, each commodity has cost components. These cost breakups provide a starting point for a tax administration to consider potential issues that may arise in transfer pricing auditing as they carry activities of related transactions that may be of financial importance of different types of mines for different commodities[10].

Africa has a great number of minerals, including precious metals and stones. In Nigeria alone, there are about 62 different types of minerals spread across the country. However, due to the recent reforms in the sector, eight strategic minerals have been identified by the Nigerian Ministry of Mines and Steel Development as economically viable and the most promising solid mineral assets that exist in commercial quantities in the country[11].

The starting point in understanding the magnitude of the issues faced by tax administrations is the tax risk of undervaluing the exports and difficulties in pricing due to routing through related party marketing hubs. A prime example of this was seen last year in the Australian Tax Office (ATO) assessment of BHP Billiton Australia. The ATO claimed that BHP avoided its tax obligations by funnelling some of the profits made from mining Australian commodities and selling them to a Singaporean company. Essentially, the dispute is the price at which BHP sold these commodities to the company in Singapore before these were then sold off to the final customer in Asia[12]. An example of this follows later in the brief, where legislation and regulations can assist in the pricing of such commodities.

Audit Process outline



Source: ATAF & OECD Training on auditing MNEs, Burundi, 2013

Additionally, MNEs also use profit stripping through interest, royalty and technical fee payments to related parties. Recognising that some MNEs are highly leveraged with third party debt for non-tax reasons, tax administrations need to consider various options to ensure profit stripping does not take place.

An example of this is inter-company debt – the subsidiary receives debt from a parent or an affiliated company, often a corporate treasury located in a low tax jurisdiction, to finance geological exploration or mine development. Debt generates interest payments, which are tax deductible. Most African countries currently limit the maximum amount of debt on which deductible interest payments are available, by way of a debt-to-equity ratio. However, the cost of related party debt (i.e. interest rate) is difficult for tax authorities to price, leaving the tax base vulnerable to excessive interest deductions.

Moreover, commodities tend to prove complex for developing countries as some countries have a variety of commodities exploited by a number of mining companies. Therefore, the capacity of the tax administration requires sufficient resources to identify transfer pricing and risks thereof.

6. New legislation and regulations: A new ball game

In 2010 the National Treasury and SARS identified transfer pricing as one of its main areas of tax loss risk and made extensive reforms to its transfer pricing legislation to address those risks. The changes to South Africa's legislation became effective from 1 April 2012 and resulted in additional revenues for South Africa amounting to ZAR 29 billion. Interestingly, this additional revenue was not due to increased audit activity but rather due to the certainty and clarity of the tax law[13]. Therefore, the need for new and modern legislation and regulations is a path that every African country should take where there are capacity challenges in audit and tax administration in general.

During the recent work done by ATAF to assist many of its members to build more effective transfer pricing regimes, the ATAF International Tax team identified similar deficiencies in current transfer pricing legislation in Africa to those faced by South Africa prior to the 2012 changes[14].

African countries have traditionally either not updated their laws or have narrow definitions in their laws that allow MNEs to structure transactions either with aggressive transfer pricing mechanism or through excessive debt structuring to shift profits to low tax jurisdictions[15]. This is further compounded by the narrow wording on the treatment of commodity transactions provided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations prior to their latest release in July 2017. It is therefore prudent to review the types of wording that have given the opportunity for aggressive transfer pricing and have resulted in tax losses for African countries.

Why is there a need for changing legislation and regulation?

As the global tax agenda has shifted significantly in the last few years, it is essential for African countries to take note that outdated legislation leaves them at risk. In illustrating the need for modern legislation, below is a table that shows how old rules and new rules are essential in dealing with various transactions.

In many African countries, primary rules on transfer pricing lack clarity and risk being ineffective in addressing complex transfer pricing arrangements. Where this exists, it gives rise to tax planning and further creates an unfavourable investment climate. Lastly, this then gives the immediate challenge to tax administrations to enforce the transfer pricing rules, and it is difficult for auditors to deal with transfer pricing cases effectively. Some Economic Community of West African States (ECOWAS) countries have adopted a definition of 'related party' that has the potential to either not deem a relationship to be related in circumstances that pose a transfer pricing risk, or deem a relationship in circumstances where there is little or no real risk.[16] Once more, this is a clear illustration of where redrafting of rules is required.

Old Rules	New Rules	Reason for change
Each transaction was looked at in isolation from the other transactions between the connected parties	Focus on the overall arrangement between connected parties so that all the transactions between the connected parties can be considered holistically	The old rule was too narrow; it required each transaction to be looked at separately, which meant more complex arrangements involving a series of transactions were not caught
Emphasis on the price of the transaction	Emphasis on all the terms and conditions of the transaction	Focusing only on the price of a transaction creates opportunities for abusive transfer pricing by taxpayers adding terms and conditions to the transaction that would not occur at arm's length resulting in profit shifting through inappropriate pricing
The onus of proof with the tax administration	The onus of proof with the taxpayer	Taxpayers should be required to return on an arm's length basis and provide evidence that the pricing is arm's length
No or limited requirement for taxpayers to keep transfer pricing documentation	The legal requirement for taxpayers to keep transfer pricing documentation	As set out in international standards taxpayers should keep adequate documentation to demonstrate that transfer pricing of transactions between connected parties is arm's length

Source: ATAF and Joshua Stadler

7. Pricing commodities and the challenges faced by auditors

During the second year of the BEPS Project, the ATAF was invited to observe the Committee for Fiscal Affairs (CFA). Through this, ATAF was also invited to participate in the working party meetings. Of particular interest to this brief is Working Party 6 (WP6) which deals with the Taxation of Multinational Enterprises. The ATAF interaction with the OECD Secretariat, OECD member countries, Group of Twenty (G20) countries and other invited observers was regarding the minimal content attached to the pricing of commodities for transfer pricing purposes. Therefore, some wording proposals were put forward to ensure that African countries benefit from the guidelines' interpretation of commodities.

To provide protection against base erosion from the under-valuation of commodity exports, WP6 proposes to revise the OECD Transfer Pricing Guidelines (TPG) on the transfer pricing of commodities.

Many ATAF members report that commodity exports are very significant to the economies of many African countries and the potential loss of tax to African countries where those commodities are exported to another company in the MNE group at undervalue is a major risk to their tax base[17].

At the WP6 meeting in May 2017, the ATAF working closely with the OECD Secretariat and other interested countries was successful in getting WP6 agreement to a revised draft which will assist ATAF members and other commodity-rich countries to address the risk of commodity exports being underpriced. This revised guidance will assist ATAF members in the introduction of domestic legislation, as such legislation will be aligned with international standards.

The challenge faced by many African tax administrations in relation to commodity pricing is the information asymmetry between the tax administration and the taxpayer, particularly in respect of information held outside the tax administration's jurisdiction. This is further exacerbated by the fact that there are few treaties in African countries. The table below illustrates a number of treaties in African countries.

The identified challenges to African countries can be summed up as follows:

- Adjustments to the quoted price or the charging of high fees to the taxpayer in the commodity producing country by other group companies in the supply chain (e.g. processing, transportation, distribution, marketing); and,
- Supply chain entities which do not have much of a function and in many instances are located in low tax jurisdictions.

For the second point, many African countries have serious concerns that the interposition of such entities in the supply chain represents a major risk to their tax base and they encounter significant challenges in effectively addressing these risks.

In addressing the issue of information challenges, the Guidance now proposes that, in respect of the difficulties in obtaining the necessary information to establish the pricing date, tax administrations, in certain circumstances, may be able to deem the pricing date. This will be illustrated in a later example.

8. New legislation for commodities

Through participation in the OECD/G20 BEPS Project, ATAF was able to achieve the rewriting of Chapter II of the OECD Guidelines for Transfer Pricing under the section on commodities. This was primarily done due to the lack of guidance from the previous editions of the Guidelines, but also as a means of highlighting the abuse that happens in the sector.

Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions[18]. At the core of the changes is a new provision on the determination of the pricing date for commodity transactions. This provision should prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price. It allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction.

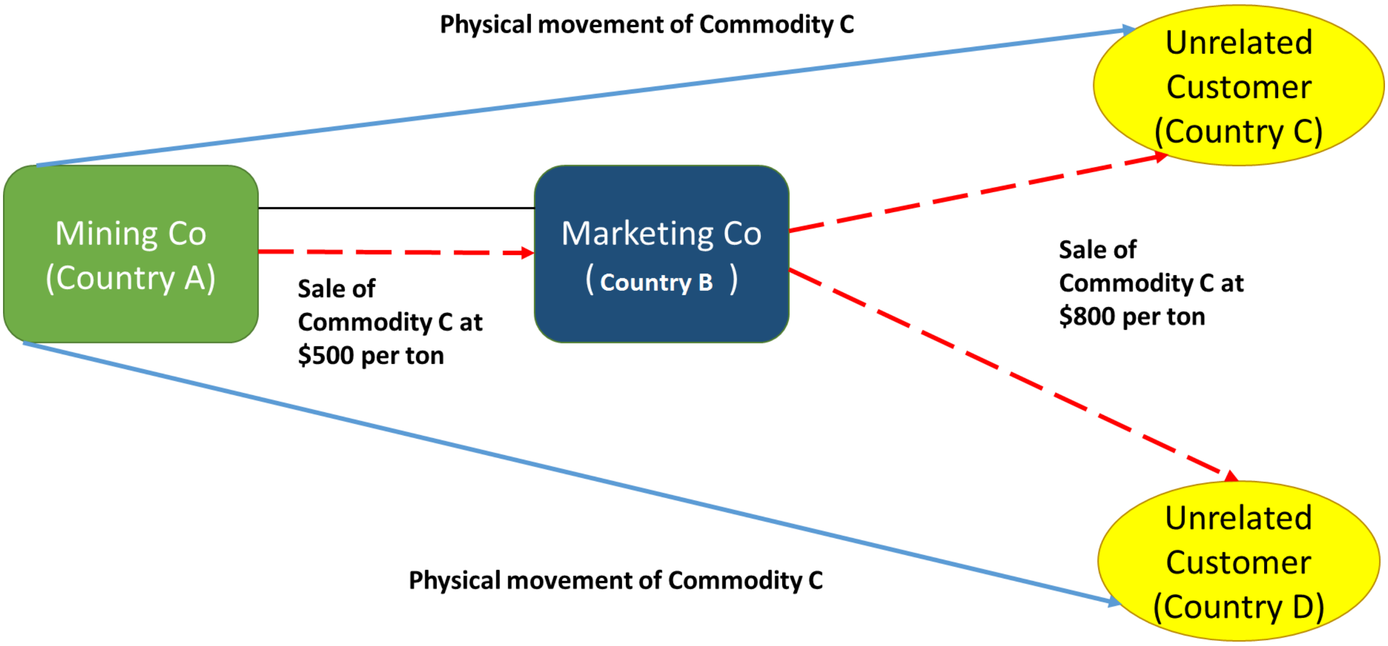
When assessing the transaction, the guidelines provide for the following:

- The Controlled Unrelated Party (CUP) method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises;

Country	**Number of Treaties**
Egypt	**55**
Kenya	**8**
Nigeria	**12**
Senegal	**More than 10**
South Africa	**92**

Source: ATAF

Example 1 - A marketing hub transaction with illustration



- Quoted prices can be used under the CUP method, subject to a number of considerations, as a reference to determine the arm's length price for the controlled commodity transaction; and;
- Reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable[19].

Example 1—Marketing arrangements – A related company, for example, a marketing hub, buys mineral products from the mine. The key issue is whether the mineral products are transferred to a fully-fledged related party marketer that takes ownership of the product, performs value-adding functions and assumes entrepreneurial risk, or, more commonly, a hub that merely provides a support function.

Such a hub imposes a risk to revenue: marketing arrangements and intercompany debt are of significance; even 1 per cent of these transactions are likely to be a big amount for developing country revenues. For example, BHP Billiton is currently in a dispute with the Australian Tax Office (ATO) over a USD 755 million tax bill relating to its use of a marketing hub based in Singapore to sell commodities to Asia[20].

How does the new rule "catch" the marketing hub? – It is the quoted price provision that addresses the marketing hub issue as it gives none of the value of the exported commodity to the hub unless the taxpayer provides all the evidence that at arm's length it should retain part of the value. This addresses the information asymmetry issue between taxpayers and tax administrations.

ATAF Recommendation:

[W]here a resident person engages directly or indirectly in a transaction with a connected person or a non-resident person engages directly or indirectly in a transaction relating to a permanent establishment in [Country] with a connected person for the export or import, involving. . . goods where prices can be obtained at the date of the transaction from an international or domestic commodity exchange market, or from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, or from any other index that is used as a reference by unrelated parties . . . that quoted price on the date on which the goods are shipped . . . shall be, without considering the price that was agreed upon with the connected person, the sale price used for the purposes of computing the taxable income of that person unless the person provides all of the evidence needed to show that adjustments are appropriate to that quoted price to be consistent with the arm's length principle[21].

Example 2 - Shifting the burden of proof

The combination of shifting the burden of proof from the tax administration to the taxpayer and the TP Documentation Regulations can provide tax administrations with the information they need to test the taxpayer's pricing. For example, the Documentation rules require details of comparables used and why they were used. If there is no rule, then the taxpayer can simply assert that the price is arm's length with no legal requirement to evidence it or to have to prove that it is arm's length, as the burden to show that the actual price is not arm's length falls on the tax administration.

ATAF Recommendation:

Paragraph 9: Every person who engages in a transaction to which subsection (1) applies shall keep the documentation required under ***[Insert Transfer Pricing Documentation Regulation reference]***[22]**.**

This is included in the primary legislation, thereby making it an essential part of the reform of legislation in a country. The recommendations have an entire approach to the drafting of Documentation Regulations.

ATAF Recommendation:

Proposed Transfer Pricing Documentation Regulation

1. These Regulations may be cited as the Income Tax (Transfer Pricing Documentation) Regulations, [20XX].

2. (1) A taxpayer must have in place contemporaneous documentation that verifies that the conditions in its controlled transactions for the relevant tax year are consistent with the arm's length principle[23].

A hypothetical example of shifting the burden of proof – Shifting the burden of proof where the country has a self-assessment regime will require the taxpayer to compute their taxable income based on the arm's length principle. If they fail to do so, then there could be a penalty for any tax collected due to a transfer pricing adjustment by the tax administration. Failing to retain adequate TP documentation is likely to constitute neglect. The case for such a penalty will be significantly increased if there are statutory TP documentation requirements through TP Documentation Regulations. In addition, it is also recommended that countries have a penalty for failure to retain the TP Documentation stipulated in the Regulations. This will apply whether or not there is a TP adjustment made, meaning there could be two penalties.

In **Example 3**, the African taxpayer is being over-charged for the specialised machinery and claiming excessive tax depreciation charge. The tax risk here is that the equipment is purchased by the low tax jurisdiction company from the third-party manufacturer for its true market value – say $10 million but sold to the African company by the related party for an inflated price, say $15 million and this means the African company can claim an inflated tax-deductible depreciation charge (which may be capital allowances) on the $15 million purchase that should have been $10 million.

The tax administration finds it difficult to prove that the price has been inflated as they cannot access the in-

Example 3 - Third party loans and exploiting capital allowances

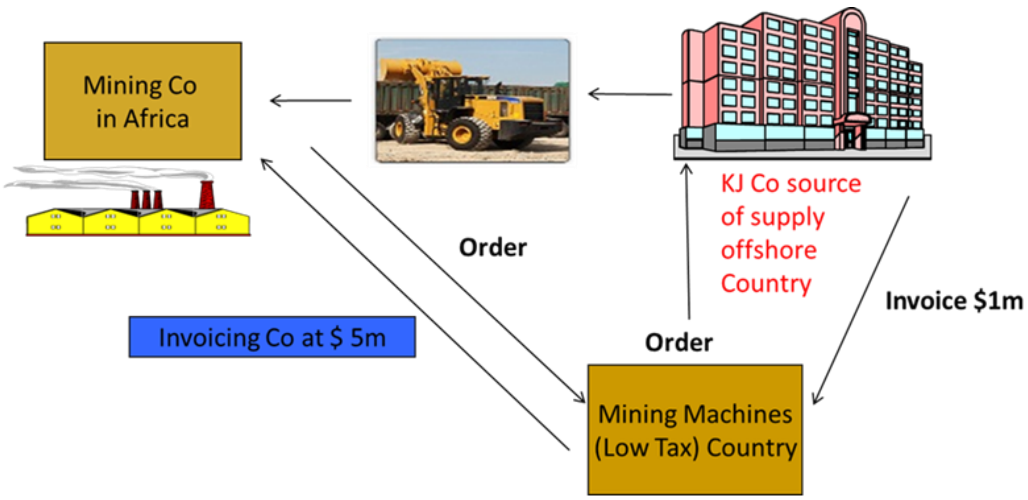


Figure 1: Mining Companies procurement from Manufacturing Companies

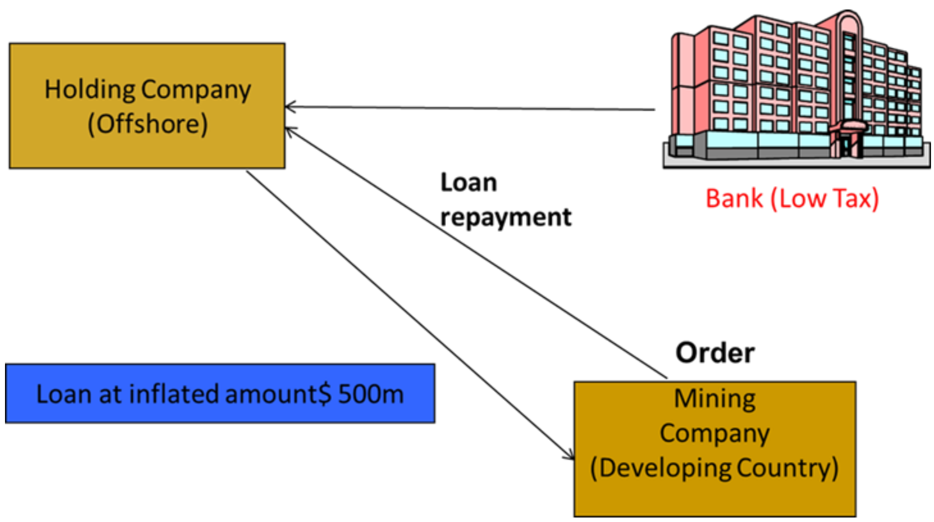


Figure 2: Mining Companies management and engineering (M&E) financing from Offshore Companies

voice from the third-party manufacturer to the related party in the tax haven. The link to tax incentives is that there would often be import duties on the imported machinery which would deter such inflation being used, but tax incentives often exempt these types of imports from such duty. In some cases, the issue was made worse because the African company took out a related party loan to pay this inflated price and therefore benefitted from a second tax deduction for the interest expense.

9. ATAF Suggested Approach to Drafting Transfer Pricing Legislation and some examples of its practical use

As part of providing solutions to some of the complex challenges faced by member countries, ATAF has developed a number of products to address risks. At the core of this was the formation of the Cross Border Taxation Technical Committee after the first Africa Consultation on cross-border taxation held in March 2014 in Johannesburg, South Africa, which identified the gap between tax administration and tax policy as one of the key risk elements of taxation.

With the international tax landscape moving to implement the outcomes of the OECD/G20 BEPS process and with Africa losing billions to ill-conceived tax incentives, illicit financial flows and inappropriately formulated laws on natural resources, it is essential that tax policy and tax administration collaborate optimally.

To date, the technical committee, together with the ATAF Secretariat has developed a range of products and specifically on transfer pricing. These are:

- ATAF Risk Assessment Model for TP;
- ATAF Suggested Approach for Drafting Transfer Pricing Legislation

The Suggested Approach has unique features adapted for developing countries, particularly ATAF members. The ATAF membership was consulted at the ATAF Workshop on Transfer Pricing Regimes in Nairobi, Kenya in July 2016[24]. Below is a highlight of some of these features and the wording thereof:

Subsection 4 (i). *The provisions of paragraph 1 shall also apply where a person resident in [Country] engages in one or more transactions with a person located in a tax jurisdiction that the Commissioner-General/Commissioner determines provides a beneficial tax regime, whether or not such a person is a connected person. All such transactions shall be deemed to be controlled transactions for the purposes of Section XX and* ***[Insert relevant secondary legislation/ regulation reference]***

Subsection 4 (ii). *The provisions of paragraph 1 shall also apply where a person located in a tax jurisdiction that the Commissioner-General/Commissioner determines provides a beneficial tax regime, engages in one or more transactions that relate to a permanent establishment of a non-resident person in [Country] whether or not such a person is a connected person. All such transactions shall be deemed to be controlled transactions for the purposes of Section XX and* ***[Insert relevant secondary legislation/regulation reference]***

This section enables the Commissioner-General to apply the transfer pricing legislation to a transaction where one of the parties is located in a tax jurisdiction which the Commissioner-General considers is a beneficial tax regime. Many African tax administrations have reported that they often face risks of tax loss where the local taxpayer has a transaction with a low or no tax jurisdiction, but they are unable to apply their transfer pricing legislation because the taxpayer contends that the person in the low/no tax jurisdiction is unrelated and the tax administrations are unable to obtain the evidence to show they are related. The section allows the Commissioner-General to apply the transfer pricing legislation in these circumstances. Clearly, if the taxpayer satisfies the Commissioner-General that the other person is not related then by definition, the transaction will be arm's length.

Subsection 13. *Where a person engages in a transaction with a connected person that involves the transfer of rights in an intangible, other than the alienation of an intangible, the deduction allowable for tax purposes in that transaction shall not exceed X% of the [tax EBITDA + plus royalties payable] derived from the commercial activity conducted by the person in which the rights transferred are exploited.*

Many African tax administrations have reported great difficulties determining arm's length prices for royalties and other consideration relating to intangibles and consider that they face a significant risk to their tax base from excessive royalty and other intangible related payments to non-resident related parties. Section 13 provides an alternative approach of the tax-deductible amount of the royalty being restricted to a percentage of the taxpayer's tax EBITDA (earnings before interest, tax, depreciation and amortization) plus the actual royalty payable for the year of assessment.

The following is an illustrative example of how mathematically the rule would work. The example uses a 1% ratio. However, this is for illustrative purposes only and is not an indication of where the percentage should be set.

The rule is 1% of EBITDA plus royalty payable	
EBITDA from activity relating to the intangible	1000
Plus royalty payable relating to the intangible	200
Total	1200
Royalty allowed as tax deductible (1%)	12
Disallowed royalty	1188

Note: Countries will need to decide the percentage level for this section.

In the TP Regulations, the ATAF Suggested Approach on Drafting Transfer Pricing Legislation has made some of these unique features:

> ***[Optional alternative wording for Para 7 (1)]:*** *An arm's length range is a range of relevant financial indicator figures (e.g. prices, margins or profit shares) produced by the application of the most appropriate transfer pricing method as set out in Paragraph 5 to a number of uncontrolled transactions, that are all comparable, and equally comparable to the controlled transaction based on a comparability analysis conducted in accordance with Paragraph 4 provided that the highest point in the range is no more than 25% greater than the lowest point in the range.*

> ***[Optional alternative wording for Para 7 (2)]*** *Where the application of the most appropriate method results in a number of financial indicators for which the degree of comparability of each to the controlled transactions, and to each other, is uncertain, or the highest point in the range exceeds 25% of the lowest point in the range, a statistical approach shall be used. Where such an approach is used, the interquartile range shall be considered to be an arm's length range.*

These provisions narrow the arm's length to remove outliers that may distort the results.

With the inclusion of options for wording, the document aims to give African countries their own choice in wording depending on other domestic law considerations. The several options presented are as a result of the consultations with various countries outside of the member countries in the CBT Technical Committee.

The suggested approaches can be used to address some of the challenges that have been highlighted throughout this brief. Member countries have reported the various transactions as illustrated, and the ATAF Secretariat has worked to ensure that through innovative legislation, these transactions can be treated in a fair manner that allows both taxpayer and tax administration to apply a reasonable approach with clarity.

10. Conclusion and Recommendations

With the changing global tax agenda and the quest to achieve domestic resource mobilisation, it is prudent for African countries to commence changing their legislation and regulations in relation to transfer pricing. MNEs form a significant part of the tax base of African countries, and while this may not be an ideal tax mix, it is the reality of some of the economies that are emerging as resilient. The logic behind strengthening tax rules is that where there is a weakness of regulation, the taxpayer will take advantage of this. Moreover, the weakness of these rules creates an uphill challenge for tax administrations in auditing.

Transfer pricing on its own requires an investment of huge resources from the side of the tax administration. This is further compounded by the changing nature of transactions. The introduction of new forms of business such as Uber, Airbnb and other online platforms creates challenges for the tax treatment of such transactions. There are also challenges on how to deal with these new forms of business from a VAT point-of-view. Therefore, this again highlights the need for coherent policy formulation.

Through formulation of new legislation and regulations, tax administrations, together with their ministries of finance, are presented with the opportunity of drafting legislation that is line with international best practices, and that is also in line with creating tax certainty. Noting that African countries would like to fulfil the objectives of Agenda 2063, the question is how will it be funded? Stronger policy and legislation that creates a fiscal environment that is both predictable and easy to interpret is a starting point.

New forms of legislation alone will not solve some of the challenges that are persistent. There will still be taxpayers who will run high-risk transactions and those who will have low levels of compliance. However, it is envisaged that the general reform of the tax administration will be working in tandem with the reform of international tax regimes.

ATAF has also commenced a nexus project where tax policymakers and tax administrations are brought together to discuss some of these key developments, identify where blockages occur and what practical solutions are available to ease them. This is a key feature of moving forward in a practical manner for African countries. The BEPS discussion is not over, it is only the beginning, and increasingly, African countries realise the inadequacies of their laws to combat TP abuses.

Endnotes:

[1] OECD, *Report to G20 Development Working Group on the impact of BEPS in low income countries, Part 1* (July 2014), p. 11. Available from www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

[2] ATAF, Cross Border Taxation Country Programmes Marketing Brochure (2016), p. 3.

[3] United Nations Third International Conference on Financing for Development (13 July 2015), *ATAF Side Event – The African Agenda 2063: Finding the Money! – Developing African Tax Systems in Order to Mobilise Domestic Resources to Fund Africa's Development*, Briefing Document, p. 2.

[4] TADAT Secretariat. Available from www.tadat.org.

[5] Joshua Stadler, "Fighting Illicit Financial Flows - How Tightening South Africa's Transfer Pricing Rules Has Increased Tax Revenues", GIZ Discussion Paper (2016), p. 2.

[6] The CBT Technical Committee consists of 9 countries, namely, Botswana, Burkina Faso, Ghana, Kenya, Nigeria, Senegal, South Africa, Tanzania and Uganda.

[7] These steps are part of the ATAF Training Manual used for the training of auditors in detecting transfer pricing transactions and risk. The training schedule is applied in all the ATAF Country Programmes on TP. The Country Programmes are typically 3 years long and work to develop the core skills of auditors while

Annex – Transfer Pricing Legislation at the end of 2017

Country	**Implementing Regulations/ Guidance**	**Effective Documentation Requirements (with a penalty and/or the onus of proof)**	**Annual Disclosure Requirements (for related-parties transactions)**
Angola	Large Taxpayers Statute 2013 and Circular N.12/ DLT/DNI/2014	Yes	Yes, from 2015
Botswana	Transfer pricing (TP) rules currently being developed. Arms Length Principle (ALP) in General Income Tax Law	No	No
Burkina Faso	Art. 22 of General Tax Code	No. No Transfer Pricing (TP)-specific penalties	No
Burundi	No formal rules. ALP in General Income Tax Law	No	No
Cameroon	2012 Finance Law	Yes	Yes, on request
Côte d'Ivoire	Anti-avoidance rules in Art. 38 of CODE GENERALDES IMPÔTS (CGI)	Yes. No TP-specific penalties	No, on request
Ghana	Sec. 70 of Internal Revenue Act (IRA)	Yes	Yes
Kenya	C.470 of Income Tax Act (ITA)	Yes	Yes (but not yet widespread)
Lesotho	No formal rules. ALP in General Income Tax Law	No	No
Madagascar	Anti-avoidance rules in A.010115 of CGI	Yes	Not specific
Malawi[25]	C. 41 of ITA	Yes. No TP-specific penalties	No, on request
Mozambique	A. 58 of Corporate Income Tax Code	No. No TP-specific penalties	No
Namibia	Sec. 95(a) of the Income Tax Act	No. No TP-specific penalties	No
Nigeria	Income Tax (Transfer Pricing) Regulations	Yes. No TP-specific penalties	No, on request
Senegal	Art. 17 of CGI	Yes. No TP-specific penalties	No, on request
South Africa	Taxation Laws Amendment Act N.7	Yes	Yes
Tanzania	Anti-avoidance Sec. 33 of ITA Act	No. Discretionary penalty powers	Yes
Uganda	C. 340 of ITA	Yes	No, on request
Zambia	S. 97A of ITA	Yes. No TP-specific penalties	No, on request
Zimbabwe	TP provisions introduced in 2015 as part of the Income Tax Code	Yes	Yes

Sources: This study's TP questionnaires and recent TP Country Summaries by Transfer Pricing Associates, PWC, KPMG and Grant-Thornton. Additional information from the ATAF Secretariat.

addressing policy issues such as redrafting of legislation and regulations.

[8] OECD, "Selecting the right cases", in *Dealing Effectively with the Challenges of Transfer Pricing* (Paris, OECD Publishing, 2012). Available from https://doi.org/10.1787/9789264169463-en.

[9] ATAF Transfer Pricing Risk Assessment Tool

[10] Pietro Guj, Stephanie Martin and Alexandra Readhead, "Transfer pricing in mining with a focus on Africa: a briefing note (English)" (Washington D.C., World Bank Group, 2017) p. 99. Available from http://documents.worldbank.org/curated/en/213881485941701316/Transfer-pricing-in-mining-with-a-focus-on-Africa-a-briefing-note.

[11] Presentation by Mr. Ajayi Bamidele, Coordinating Director, Domestic Taxes, Federal Inland Revenue Service of Nigeria at the ATAF Experts Meeting on extractives, April 2016 in Johannesburg, South Africa.

[12] Jamie Smyth, "BHP to contest A$1bn Australia tax bill", *Financial Times*, 21 September 2016. Available from www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4.

[13] Stadler, *Fighting Illicit Financial Flows*, p. 4.

[14] ATAF Workshop on Transfer Pricing Regimes in Africa (Nairobi, Kenya, 27-28 July 2016), Outcomes Statement.

[15] Guj, Martin and Readhead, "Transfer pricing in mining with a focus on Africa", p. 94.

[16] Ibid.

[17] ATAF Secretariat, Report of the 4th Meeting of the CBT Technical Committee (Nairobi, Kenya, 28-29 July 2015), p. 6.

[18] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Final Reports, Actions 8 – 10 of the BEPS Project*, OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2015). Available from https://doi.org/10.1787/9789264241244-en.

[19] Ibid.

[20] Jamie Smyth, "BHP to contest A$1bn Australia tax bill", *Financial Times*, 21 September 2016. Available from www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4.

[21] ATAF, *Suggested Approach to Drafting Transfer Pricing Legislation*, p. 2

[22] Ibid., p. 4.

[23] Ibid., p. 14.

[24] ATAF Workshop on Transfer Pricing Regimes in Africa (Nairobi, Kenya, 27-28 July 2016), Outcomes Statement.

[25] The Malawi Revenue Authority engaged ATAF to amend its current TP regulations. These have been gazetted and signed by the President on August 2017.

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