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INFORMATION PAPER:

TRANSFER PRICING AND AGGRESSIVE TAX PLANNING BY MULTINATIONALS

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Purpose

This publication has been prepared as general information on practical transfer pricing issues, and does not constitute professional advice.

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1.0 Overview

The disruptions we are seeing today and changing business models including centralised supply chains, increased reliance on intangible assets, all mean that physical presence is no longer required. The world is becoming one big global village, where trade and commerce have become highly digitised and increasing usage of big data for decision making. This increasing globalization of business and technological advances have given rise to a large number of multinationals, and these have the flexibility to set up activities anywhere in the world.

The term multinational today not only covers large corporate groups, but also smaller companies with one or more subsidiaries or permanent establishments in countries other than those where the parent company or head office is located. Parent companies of large multinational groups usually have intermediary or sub-holdings in several countries around the world.

A significant amount of global trade today consists of international transfers of goods and services within these multinational groups. According to the World Trade Organization[1], a third of the total volume of world goods and services trade of about $22.5 trillion in 2018 — you would get some $7-9 trillion (or more) in cross-border trade that happens inside multinational corporations. Such transfers are called ‘intra-group’ transactions.

The structure of transactions within a multinational group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group. It therefore becomes important to establish the right price, called the ‘transfer price’, for these intra-group transactions, as well as cross-border transfer of goods, intangibles and services.

Transfer pricing is a term used for the pricing of intra-group transactions between related parties. In general, transfer pricing implies that the prices charged between related parties/ associated enterprises operating in different countries should be compliant with the ‘arm’s length principle’. An arm’s length price for a transaction is what the price of that transaction would be in the open market. This basic notion is laid down in the OECD Transfer pricing guidelines for multinational enterprises and tax administrations (OECD guidelines)[2], which define procedures on how to adhere to this principle and how to support it with appropriate documentation.

[1] WTO 2018: https://www.wto.org/english/news_e/pres18_e/pr820_e.htm

[2] OECD: http://mneguidelines.oecd.org/ accessed 14 July 2021

Transfer pricing by itself does not necessarily involve tax avoidance. But, where the pricing does not agree with applicable norms internationally or at domestic law, then issues such as 'mispricing', 'incorrect pricing', 'unjustified pricing' or similar issues of tax avoidance and evasion may arise.

The prices paid for goods or services delivered or received have a direct impact on the profits of the seller and buyer, and by implication on tax. And where it is cross border, the tax authorities become even more concerned because effectively, any mispricing would mean a shift of tax base from one jurisdiction to another or worse still, to tax havens.

The UN Tax Committee on Transfer Pricing provided some guidance[3] in the following examples to illustrate these issues:

a. *Take an example of a profitable computer group in country A that buys "flash-memory drives" from its own subsidiary in country B: how much the parent country A company pays its subsidiary country B company (the "transfer price") will determine how much profit the country B unit reports and how much local tax it pays.*

   If the parent pays below normal market prices, the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.

b. *From the perspective of the tax authorities, country A's tax authorities might agree with the profit reported at their end by the computer group in country A, but their country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the computer company in country A bought its flash-memory drives from an independent company in country B it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimizing its tax incidence.*

What does this mean? The illustration above means that when various parts of a group are under some form of common control, the transfer prices are not subject to the full play of market forces and the correct arm's length price, and an arm's length range of prices needs to be arrived at. This is further illustrated using the example below:

c. *Taking another example of a watch manufacturer in country X that distributes its watches through a subsidiary in country Y. Let us say the watch costs $1400 to make and it costs the country B subsidiary $100 to distribute it. The*

[3] UN Tax Committee on Transfer Pricing: An Introduction to Transfer Pricing, 2011.

manufacturer sets a transfer price of $1500 and the subsidiary unit in country Y retails the watch at $1600 in country Y. Overall, the manufacturer has made $100 in profit, on which it is expected to pay tax.

However, when the company in country Y is audited by country Y's tax authorities, they notice that the distributor itself is not showing any profit: the $1500 transfer price plus the country Y unit's $100 distribution costs are exactly equal to the $1600 retail price. The country Y's tax authorities want the transfer price to be shown as $1400 so that the country Y's unit shows the group's $100 profit that would be liable for tax.

But, this poses a problem for the parent company, as it is already paying tax in country X on the $100 profit per watch shown in its accounts. Since it is a group, it is liable for tax in the countries where it operates and in dealing with two different tax authorities, it is not possible to just cancel one out against the other. Nor should it be made to pay the tax twice.

While the above illustrations of transfer pricing issues sound logical, arriving at an appropriate transfer price is a complex task. For example, intangibles could be of various different types including industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know-how, or trade secrets. Sometimes such intangibles are reflected in the company accounts and sometimes not. Consequently, there are many complexities involved, which have to be taken into account while dealing with transfer pricing, mainly in cross-border transactions between multinationals.

2.0 Evolution of Transfer Pricing

Transfer pricing has become such an important phenomenon over the last couple of decades. Some of the reasons for this include among others: the ongoing and continuous relocations of production of components and finished products in particular countries with low production costs and conducive economic climate; the rise of e-commerce and web business; and trading in financial instruments and other such commodities.

For countries to keep their tax bases intact, they have introduced equally challenging transfer pricing regulations in their countries. The three dominant international players that have and will continue to affect the transfer pricing policies of many African countries are the:

1. Organization for Economic Co-operation and Development (OECD), EU and the IMF,
2. United Nations (UN), and
3. African Tax Administration Forum (ATAF).

OECD, EU, and IMF are leading the cause for greater tax transparency and are instrumental in the capacity building of tax authorities in Africa. The OECD Transfer Pricing Guidelines[4] provide guidance on the application of the "arm's length principle", which represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between related parties/ associated enterprises. In today's economy where multinational enterprises play an increasingly prominent role, transfer pricing continues to be high on the agenda of tax administrations and taxpayers alike. Governments need to ensure that the taxable profits of multinationals are not artificially shifted out of their jurisdiction and that the tax base reported by multinationals in their country reflects the economic activity undertaken therein and taxpayers need clear guidance on the proper application of the arm's length principle.

The OECD guidelines as well as domestic legislation of various countries have provided examples for the creation of transfer pricing legislation by nation states worldwide, as a response to increasing globalization of business and the concern that this may be abused to the detriment of countries without such legislation. Since 1994, approximately two thirds of OECD countries and many non-OECD countries have introduced rules governing transfer pricing documentation requirements. OECD reports that the number of countries which have introduced transfer pricing documentation requirements in local legislation has been increasing at an accelerated pace every year: in 1994 only six countries had transfer pricing documentation requirements, while in 2013 a total of 77 countries had adequate requirements.
The United Nations (UN) for its part published an important report on "International Income Taxation and Developing Countries" in 1988, which discussed significant opportunities for transfer pricing manipulation by multinationals to the detriment of developing country tax bases. It recommended a range of mechanisms specially tailored to deal with the particular intra-group transactions by developing countries. The UN has developed a Transfer Pricing Manual, with updated global transfer pricing guidelines which can be used by countries all over the world in developing their transfer pricing regulations.

ATAF brings together tax authorities in Africa to enable them pool resources and pursue tax issues of interest to them. The Forum[5] is mandated to build effective and efficient tax administrations on the continent, recognizing that it is a critical element in boosting revenue mobilization and building capable states that are able to meet the needs of their citizens.

[4] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 | en | OECD accessed 14 July 2021

[5] https://www.ataftax.org/ accessed 14 July 2021

2.1 Transfer Pricing Methods

Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. However, no single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

All these transfer pricing methods rely directly or indirectly on the comparable profit, price or margin information of similar transactions. This information may be an internal comparable based on similar uncontrolled transactions between the entity and a third party or an external comparable involving independent entities in the same market or industry.

The five major transfer pricing methods are:

(i) Comparable Uncontrolled Price

This method compares the price charged for a product or service transferred in a controlled transaction to the price charged for a comparable product or service transferred in a comparable uncontrolled transaction in comparable circumstances.

(ii) Resale Price Method

The resale-price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

(iii) Cost Plus

The cost-plus method is used to determine the appropriate price to be charged by a supplier of a product or service to a related purchaser. The price is determined by adding to costs the supplier incurred an appropriate gross margin so that the supplier will make an appropriate profit in light of market conditions and functions they performed.

(iv) Profit-based methods

Two classes of transactional profit methods are recognized: *profit-comparison methods* and *profit-split methods*.

(a) Profit comparison methods

These methods seek to compare the level of profits that would have resulted from controlled transactions with the return realized by the comparable independent enterprise. The method compares the net profit margin realized from the controlled transactions with the net profit margin realized from uncontrolled transactions.

(b) Profit-split methods

Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide the profits using a defined basis that is aimed at replicating the division of profits that would have been anticipated in an agreement

made at arm's length. Arm's length pricing is therefore derived from both parties by working back from profit to price.

The first three methods above are often called "the traditional transaction methods" and the last two are called "profit-based methods".

2.2 Pillars of Transfer Pricing

There are two pillars of transfer pricing:

- The functional analysis; and
- Comparability.

Functional analysis is the mapping of economically relevant facts and characteristics of intercompany transactions with regard to their functions, assets and risks. The outcome is an allocation of these activities between those entities involved in the transaction so that each entity can be fully characterized.

Entities are characterized in order to determine the correct transfer pricing method to apply and to select the party whose profitability should be tested. The most common types of entities include:

i. **Manufacturing entities:** Toll; Contract; Fully-fledged manufacturer/developer
ii. **Sales:** Commission agents; Limited risk distributors; Marketers/ distributors.
iii. **Service Providers:** Administrative and support services; management services; technical services; strategic services
iv. **Entrepreneurs:** Own valuable IP; Manage commercial exploitation of its IP; May contract out relevant business functions

The characterization exercise gives an in-depth understanding of the business and if done properly, it provides:
-Guidance on the choice of the transfer pricing method
-Parameters for establishing comparability
-Determination of an arm's length transfer pricing policy for the company

Comparability

The application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.
There are five comparability factors that can be considered:

- Business strategies
- Economic circumstances
- Characteristics of the product/ service

- Functions
- Risks

To be comparable means that none of the differences (if any) between the transactions being compared could materially affect the price /margin or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

2.3 Basic issues underlying Transfer Pricing

Transfer prices serve to determine the income of both parties involved in the cross-border transaction. The transfer price, therefore, tends to shape the tax base of the countries involved in a cross-border transaction.

In any cross-border tax scenario, the three parties involved are the multinational group, taken as a whole, along with the tax authorities of the two countries involved in the transaction. When one country's tax authority taxes a unit of the multinational group, it has an effect on the tax base of the other country. In other words, cross-border tax situations involve issues related to jurisdiction, allocation, and valuation.

(i) Jurisdictional issues

Which government should tax the Multinational's income and what if both claim the same right? If we consider the case where the tax base arises in more than one country, should one of the governments give tax relief to prevent double taxation of the multinational's income, and if so, which one? These are some of the jurisdictional issues which arise with cross-border transactions.

An added dimension to the jurisdictional issue is the danger of transfer pricing manipulation as some Multinationals engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through transfer pricing in order to reduce the aggregate tax burden of a multinational group. It must be noted that the aim of reducing taxation may be a key motive influencing an international enterprise in the setting of transfer prices for intra-group transactions, but it is not the only factor contributing to the transfer pricing policies and practices of the multinational.

The aim in such cases is to usually reduce a multinational group's worldwide taxation by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under-charging or over-charging the associated entity for intra-group trade. The net result is to maximize an international enterprise's after-tax profits.

For example, if an international enterprise has a tax rate in the residence country of the parent company of 30% and it has a subsidiary entity resident in another country with a tax rate of 20%, the parent has the incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts

$100 million of taxable profits to its subsidiary, it will make a tax saving of $10 million. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.

While the most obvious motivation may be to reduce an international enterprise's worldwide taxation, other factors may create an inducement for transfer pricing manipulation, such as imputation tax benefits in the parent company's country of residence. Another motivation for an international enterprise to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases an international enterprise may wish to take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the international enterprise has an incentive to use the losses as quickly as possible. In other words profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

(ii) Allocation issues

Multinationals are global entities which share common resources and overheads. From the perspective of the multinational, these resources need to be allocated with maximum efficiency in the most optimal manner.

From the tax authorities' perspective, the allocation of costs and income from the multinational resources needs to be addressed to calculate the tax. There sometimes tends to be a "tug-of-war" between countries in the allocation of costs and resources aimed towards maximizing the tax base in their respective nation states.

From the multinational's perspective, any trade or taxation barriers in the countries in which it operates raise the multinational's transaction costs while distorting the allocation of resources. Furthermore, many of the common resources which are a source of competitive advantage for the multinationals cannot be disentangled from the global income of the multinationals for tax purposes – this is especially true in the case of intangibles and service-related intra-group transactions.

(iii) Valuation issues

Mere allocation of income and expenses to one or more members of the multinational group is not sufficient; the income and expenses must also be valued. This directly leads to a key issue of transfer pricing, the valuation of intra-firm transfers.

With the multinational being an integrated entity with the ability to exploit international differentials and utilize economies of integration not available to domestic firms, transfer prices within the group are unlikely to be the same prices unrelated parties would negotiate.

3.0 The Transfer Pricing Environment in Uganda

Background and Commencement

The 2000s saw increased activity in the transfer pricing space by African tax administrators. Many countries in Africa have adopted or updated transfer pricing rules in line with the OECD Guidelines. African tax administrators have always harbored the notion that multinationals are not paying the right amount of tax in Africa. The High-Level Panel (HLP) report[6] notes that a number of African countries that depend to a large extent, on the extraction of natural resources for their exports and tax revenues are very prone to the generation of illicit financial outflows by way of transfer mispricing among others.

Uganda's key sectors of the economy Manufacturing, Information & Communication, and Financial and Insurance Services are all dominated by multinationals. Multinationals in Uganda contribute over 30 % of the tax revenue collected by URA annually. In the FY 2019/2020[7], these contributed almost 40% of the total revenue for the year.

The transfer pricing regulations in Uganda came into effect on 1 July 2011 (Transfer Pricing Regulations, 2011), and are based on the OECD model hence the adoption of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"). A practice note on Transfer Pricing documentation was released in May 2012 to aid taxpayers in compliance. The implementation of the new regulations meant that documentation was now required from taxpayers.

Although the transfer pricing regulations came into effect on 1 July 2011, S.90 and 91 of the Income Tax Act had been in place requiring taxpayers with related party transactions to deal at arm's length. The transfer pricing rules apply to transactions between associated enterprises; both cross-border and local/ domestic transactions; as well as branches and their head offices deemed separate legal entities. The items covered under the rules include:

- Tangible property;
- Intangibles;
- Intra-group services; and
- Financial.

The rules require pricing of related party transactions using any of the above transfer pricing methods described above. For documentation purposes, only a local file is required, and for in-country transactions, a filing threshold of USD135,000 applies. The rules apply to controlled transactions for multinational enterprises or controlled transactions in aggregate equal to or exceeding 25,000 currency points in a year of

[6] Take it Stop it Get It, Report of the High-Level Panel on Illicit Financial Flows from Africa, Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development

[7] URA: Annual Revenue Performance Report FY 2019/2020

income (500 million Uganda shillings UGX). This relates to transactions between related parties within Uganda. There is no threshold for transactions across borders.

4.0 Considerations for Tax Practitioners

4.1 Documentation requirements

At every stage of the transfer pricing process, varying degrees of documentation are required. Broadly, the information or documents that the taxpayer needs to provide can be classified as:

(i) *enterprise-related documents, such as* ownership and shareholding pattern of the taxpayer, the business profile of the multinational, industry profile, etc.

(ii) *transaction-specific* documents, such as the details of each international transaction, functional analysis of the taxpayer and related parties, record of uncontrolled transactions for each international transactions, etc, and

(iii) *computation-related* documents, such as the nature of each international transaction and the rationale for selecting the method for each international transaction, actual computation of the arm's length price, factors and assumptions influencing the determination of the arm's length price, etc.

Usually this documentation, should be already existing and not created after the transaction is effected, and should have the characteristics of completeness, accuracy and timeliness.

Uganda's documentation/policy, usually done for compliance purposes involves reviewing existing related party transactions, policies and testing for consistency with the arm's length principle. Transfer Pricing documentation is required to be in place prior to the due date for filing the income tax return. The May 2012 Practice Note prescribes constituents of a TP documentation report;

- Company details
- Industry overview
- Controlled transactions details
- Functional analysis - functions performed, risks assumed and assets employed
- Financial analysis, and
- Economic analysis - selection of the most appropriate TP method, application of the selected TP method and conclusions on compliance with the arm's length principle.

The penalties for non-compliance include:

- Non-compliance with the arm's length Principle - Liable on conviction to imprisonment for a term not exceeding six months or to a fine not exceeding five hundred thousand Uganda shillings ~USD130 or both.
- TP documentation report not in place prior to the due date for filing the income tax return for that year - Liable on conviction to imprisonment for a term not exceeding

six months or to a fine not exceeding five hundred thousand Uganda shillings ~USD130 or both.
- Failure to provide records in respect of transfer pricing within 30 days after the request - A penal tax equivalent to fifty million Uganda shillings approximately USD13,000
- Back taxes from TP audit - Simple interest of 2% per month.

However, one concern regarding transfer pricing documentation is the risk of overburdening the taxpayer with disproportionately high costs in obtaining relevant documentation. Ideally, the taxpayer should not be expected to provide more documentation than is objectively required for a reasonable determination by the tax authorities whether or not the taxpayer has complied with the arm's length principle. Cumbersome documentation demands may affect how a country is viewed as an investment destination and may have particularly discouraging effects on small and medium enterprises.

4.2 Intangibles

BEPS Action 8-10 Report defined an intangible as:
"Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances", paragraph 6.6.

Intangibles are divided into 'trade intangibles' and 'marketing intangibles'. Trade intangibles such as know-how relate to the production of goods and the provision of services and are typically developed through research and development. Marketing intangibles on the other hand include trade names, trademarks and client lists that aid in the commercial exploitation of a product or service.

Intangibles are unique and valuable, and for transfer pricing purposes may not necessarily be shown in the financial statements (i.e. in the balance sheet). For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalized for accounting purposes and therefore the intangibles resulting from such expenditures are not always reflected on the balance sheet.
Such intangibles may nevertheless be used to generate significant economic value and may need to be considered for transfer pricing purposes. This is because intangibles can create a monopoly for the owner, allow the owner to command a significant market share, and allow owners to command above market returns and prices.

The arm's length principle often becomes difficult to apply to intangibles due to a lack of suitable comparables; for example intellectual property tends to relate to the

uniqueness of a product rather than its similarity to other products. This difficulty in finding comparables is accentuated by the fact that dealings with intangible property can also occur in many different ways such as by: license agreements involving payment of royalties, outright sale of the intangibles, compensation included in the price of goods e.g. selling unfinished products including the know-how for further processing or package deals consisting of some combination of the above.

In cases where both parties own valuable intangibles, typically the profit-split method is used. In cases involving sub-licensing of intangibles by related parties to other third parties, the cost plus method can be used. In case of a sale of an intangible, the comparable uncontrolled pricing method may be used if there exists an internal comparable.

4.3 Intra-group services

An intra-group service is a service provided by one entity to another in the same multinational group. There are different types of services that can be considered here: administrative/support services, management services, technical/ professional services, other strategic services.

For a service to be considered an intra-group service it must be similar to a service which an independent entity in comparable circumstances would be willing to pay for in-house or else perform by itself. If not, the activity should not be considered as an intra-group service under the arm's length principle. The key issue to consider here is to establish whether the services were actually rendered. Evidence would be required to demonstrate that services were rendered i.e. *there was real substance in the entity providing the services; there was an agreement in place between the parties for the provision of services and that the parties are complying fully with the terms of the agreement; there was a need for the services - "need" is synonymous with "benefit"*

The logic is that if specific group members do not need the activity and would not be willing to pay for it if they were independent, the activity cannot justify a payment. Furthermore, any incidental benefit solely by being the member of a multinational group, without any specific services provided or performed, should be ignored.

The arm's length price for intra-group services can be determined directly or indirectly – in the case of direct charge, the comparable uncontrolled price method could be used if comparable services are provided in the open market. In the absence of comparable uncontrolled price the cost-plus method could be appropriate to apply in such cases.

If a direct charge method is difficult to apply, the multinational may apply the charge indirectly via cost sharing or incorporating a service charge or not charging at all. Such methods would usually be accepted by the tax authorities only if the charges are supported by foreseeable benefits and if the methods are based on sound accounting

and commercial principles and are capable of producing charges or allocations that are commensurate with the reasonably expected benefits to the recipient.

4.4 Cost-contribution agreements

Cost-contribution agreements are those agreements formulated among group companies to jointly develop, produce or obtain rights, assets or services. In such arrangements, each participant bears a share of the costs and in return is expected to receive pro rata benefits from the developed property without further payment. Such arrangements tend to involve research and development or services such as centralized management, advertising campaigns etc.

In a cost contribution arrangement, there is not always a benefit that ultimately arises; only an expected benefit during the course of the agreement. The interests of each participant should be agreed upon at the outset. The contributions are required to be consistent with what an independent enterprise would have contributed under comparable circumstances, given these expected benefits. The agreement is not a transfer pricing method, but a contract that may have transfer pricing consequences and therefore needs to comply with the arm's length principle.

4.5 Use of Secret Comparables

A secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer, who is often not given access to that information.

There is often concern expressed by entities over aspects of data collected by tax authorities and its confidentiality. Tax authorities are privy to, and need to be very sensitive and highly confidential with information about taxpayers, such as that relating to margins, profitability and business contacts. Confidence in the tax system means that this information needs to be treated very carefully, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies, etc.

Taxpayers may contend that use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark their controlled transactions with comparables not available to them and without the opportunity to question comparability.

5.0 Transfer Pricing and Aggressive Tax Planning

Aggressive tax planning involves taxpayers' reducing their tax liability through arrangements that may be legal but are in contradiction with the intent of the law. It includes exploiting loopholes in a tax system and mismatches between tax systems, which may lead to double non-taxation or double deductions.

5.1 Aggressive Taxation Planning Channels

Aggressive tax planning occurs through the following main channels:

(i) Debt shifting, where internal debt is used to artificially shift profit from a high tax to a low tax jurisdiction;

(ii) Strategic location of intellectual property rights and intangibles assets, where highly mobile intangibles assets are artificially relocated in low-tax jurisdictions;

(iii) Misuse of transfer pricing, where tax bases of low tax jurisdictions are artificially inflated at the expense of the tax base of high tax jurisdictions.

(iv) On top of these main structures, multinationals may also take advantage of bilateral tax treaty provisions to minimize taxes and the repatriation cost of dividends (treaty shopping).

5.2 Economic consequences of aggressive tax planning

1. Loss of tax revenues - Awareness of unfair practices may encourage other taxpayers to stop complying with their own tax obligations. Furthermore, the loss of revenues due to these practices may have an impact on social spending, such as access to quality education, healthcare or welfare services, and on redistribution. This in turn exacerbates inequalities and may fuel social discontent.
2. Lack of a level playing field – aggressive tax planning distorts the level playing field between companies that manage to avoid paying their fair share of taxes and other companies that do not have access to the same cross-border tax planning possibilities (mostly domestic and/or smaller firms). Studies indicate that multinational enterprises in high-tax countries pay around 30% less tax than comparable domestic firms[8]. A recent study shows that companies engaging in aggressive tax planning benefit from a potentially significant reduction in effective taxation to the detriment of society[9]. Multinational enterprises that engage in tax planning benefit from a competitive cost advantage that can allow them to gain market shares and raise entry barriers to the detriment of other firms. There is evidence of a link between tax planning and higher markups and increased industry concentration, which may lead to inefficiently high consumer prices.
3. Lack of fairness and impact on taxpayer morale – aggressive tax planning by big multinationals also has a negative impact on general taxpayer morale. Those who abide by their obligations and pay their taxes perceive this as a breach of the social contract.

[8] Egger, P., W. Eggert and H. Winner (2010).

[9] See Center for European Economic Research, ZEW (2016)

6.0 Way forward

According to the World Trade Organization[10], a third of the total volume of world goods and services trade of about $22.5 trillion in 2018 — you would get some $7-9 trillion (or more) in cross-border trade that happens inside multinational corporations. This multi-trillion dollar figure highlights the potential for illicit financial flows by multinational enterprises engaging in tax avoidance.

The OECD's global project to curb base erosion and profit shifting (BEPS) is perhaps the biggest factor driving transfer pricing change in Africa and globally. Many African countries are putting in place new international tax rules and changing tax treaties in line with the OECD's recommendations.[11] Twenty-eight countries in Africa are among the 135 members of the OECD's Inclusive Framework. These and other countries have been keen to implement the BEPS minimum standards. But beyond these standards, countries in Africa, such as Uganda, Benin and Zambia, are imposing the OECD's new limitations on interest deductibility as a percentage of earnings before interest, deductions, taxes and amortization (EBITDA).

Despite the wide differences in the rate and state of adoption of international transfer pricing principles and practices, below are some of the common trends[12] that are affecting multinationals today:

- **Renewed focus and enhanced scrutiny**— while the focus of transfer pricing has traditionally been on documentation activities, tax authorities are now focused on reviewing the intricate details of the intra-group transactions.
- **Exchange of information** — Tax authorities are increasingly using exchange of information mechanisms to tackle illicit financial flows.
- **More tax authority collaboration** — Collaboration between tax authorities has increased across Africa through initiatives and organizations such as Tax Inspectors without Borders and the African Tax Administration Forum, among others.
- **Challenges identifying comparables** — Difficulty in accessing African comparables for setting transfer prices remains a persistent issue for African entities, especially for unique and hard-to-value intangibles.
- **Narrower thin capitalization rules** — In line with the OECD's BEPS project, some countries are revising thin capitalization rules, which may reduce the attractiveness of these countries as an investment destination. For example, Uganda, has adopted the OECD's interest deductibility recommendations.

[10] WTO 2018: https://www.wto.org/english/news_e/pres18_e/pr820_e.htm

[11] https://home.kpmg/xx/en/home/insights/2020/04/transfer-pricing-in-africa.html accessed July 2021

[12] KPMG Insights: https://home.kpmg/xx/en/home/insights/2020/04/transfer-pricing-in-africa.html accessed 16 July 2021

- **Rising tax controversy** – Tax disputes are rapidly increasing in Africa as tax authorities step up their scrutiny of international companies operating in the region. Project and service companies are seen as high risk.
- **Review of bilateral treaties** – the focus on BEPS is also prompting countries to review their tax treaties, especially for treaties signed with "tax haven" jurisdictions. Kenya's tax treaty with Mauritius was recently voided by a high-court ruling in Kenya for failure to follow the due ratification process.
- **Advancing tax technology** – Companies stand to improve their transfer pricing compliance by increasing their use of technology to effectively manage the transfer pricing lifecycle. Operationalizing transfer pricing with support from technology can help tax and transfer teams effectively manage intercompany activity and transfer pricing risks.
- **Identifying audit trends and triggers** – Revenue authorities in Africa tend to initiate audits on all companies operating in particular sectors or certain economic groups to examine industry- or sector-specific anomalies, such as cash transactions and offshore activities. Service transactions are routinely challenged by revenue authorities, who increasingly look for proof that services and benefits were actually provided.