The taxation of Multinationals in Africa

FISCAL COMPETITION AND PROFIT REPATRIATION (including transfer pricing)

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1. Introduction

This paper has been specifically written for the conference "Public Resource Mobilization & Aid In Africa" for the theme "Fiscal Competition and Profit Repatriation (incl. transfer pricing)". The views presented in this paper is the authors and does not necessarily coincide with the views of Econ Pöyry in all instances, and the views presented here may also be qualified by the author when going from a high level presentation and focussing on individual countries and situations. It is the view of the author after years of working with theorethical and practical sides of fiscal design that todays environment is overfocusing on implementing the theoretically best tax mechanisms and tax systems and underfocusing on the operational aspects of handling the implemented tax systems by tax administrations. The views in this paper is mainly a summing up of the various problem areas connected to fiscal competition and profit repatriation (including transfer pricing) and are open for discussion. Some of the views presented may not fit with the theoretically best tax system (if ever such a system exists), but has been presented in order to open up ways of reducing the conflict areas between host countries and MNEs wishing to establish themselves in host countries, and some views on how base countries can assist host countries (and OECD) in this endeavour.

Fiscal competition and profit repatriation is a challenging theme, particularly when transfer pricing is defined as part of the theme. In many ways it can be viewed as three entirely different themes, whereby

> fiscal competition can broadly and loosely be seen as the view of the lawmaker and others on how much tax can be levied on businesses in general and specific industries in particular.

> profit repatriation would be the legal repatriation of after-tax funds as defined by accounting regulation. Taxes in this definition constitutes both payable and deferred taxes and does not correspond with government take which a government receives in cash. The payment of taxes is heavily influenced by how a tax system is designed.

> transfer pricing can be defined in two steps:

- transfer pricing proper (TP PROPER) is any transactions between affiliated companies that will move goods or services one way and funds the other way. The transfer can involve profit or not. As long as any profit is checked to be within a so-called arms length intervall, ie there is no benefit to one or the other side over and above what third parties would have been able to negotiate, most countries treat these as bona fide transactions for tax purposes. Those countries that do not treat it as bona fide transactions usually have introduced a cap on various types of expenses.
- illicit transfer pricing (ILLICIT TP) is any transactions that moves profits over and beyond what third parties would have been able to negotiate. No countries treat these as bona fide transactions, but these transactions are a significant challenge for the tax administrations to uncover.

Fiscal competition and profit repatriation including transfer pricing thus covers almost the entire spectrum of taxation, from the lawmaking via the operations of the companies and all the way to the morality of the MNEs and the efficiency of the tax administrations.

Chapter 2 gives some background on how to view fiscal competition and also looks into current trends in fiscal competition. Chapter 3 looks at the legitimate needs of MNEs, including legal profit repatriation. Chapter 4 draws up the major lines of conflict between host countries and MNEs and in some cases base countries. Chapter 5 is a critical review of fiscal competition and legal repatriation in light of experiences from Africa and makes some recommendations for both host countries and base countries. Chapter 6 reviews TP PROPER versus ILLICIT TP and makes some specific recommendations there for host countries in particular, but also some remarks on base countries. Chapter 7 will outline conclusions and the major recommendations in light of the discussions on the individual elements.

2. An introduction to fiscal competition

In order to understand fiscal competition it is essential to have a certain understanding of the various tax systems that are in place around the world. Fiscal competition is a concept that arises out of uncertainty with regard to the level of taxation in a country's own tax system relative to the level in other ("competing") tax systems. It is possible to distinguish between the following tax mechanisms used worldwide[1] (example is from extractive industries which tends to have the most varied tax mechanisms):

[1] Van Meyr Corporation, 2005

A. Payments to governments defined, investor gets the rest
- signature bonuses (bidding, negotiation, legislation)
- production bonuses (discovery, development, predetermined production)
- rentals (fixed, negotiated, % of bonus)
- royalties (per unit, %-age, sliding scale)
- corporate income tax
- production sharing (profit oil fixed %-age or sliding scale; cost oil fixed %-age, sliding scale on production or price, or no cost oil limit)
- government participation (joint stock companies, joint operating agreements)
- profit sharing and special taxes
- value added tax
- import duties, sales taxes, turnover taxes
- property taxes
- excise taxes

B. Payments to investor defined, governments gets the rest
- service fee systems

The various fiscal systems could then broadly be grouped into the following distribution:
1. Consessions (Royalty, CT, profit sharing) - 59 countries
2. Prod-Sharing Contracts (production sharing + royalty, CT, profit sharing) - 40 countries
3. Participation agreements (participation + royalty, CT, profit sharing) - 31 countries
4. Hybrid systems (prod sharing + participation + royalty, CT, profit sharing) - 16 countries
5. Service fee arrangements - 2 countries

Table 1 show the details of the various combinations of mechanisms in tax systems around the world. The data supporting this table is from 2005 but it is still a reasonably good picture of the current situation based on extractive industries. Tax rates may change, but fundamental aspects of tax systems tend to be very stable. When one combines this picture with variety in tax rates and with different treatment of pre-tax elements like tax depreciation, it is no wonder that many countries working to change their tax systems are wondering how to put together the tax mechanisms in order to attract investments. That is what it boils down to - attract investments in order to promote development, and in order to understand that one needs to understand what makes the MNEs tick. This will be the theme for chapter 3 below.

What are then the trends in tax mechanisms? It is not easy to discern with so many different combinations of tax mechanisms, but the following is probably holding true for many parts of the world:
- almost all tax systems (except service fee arrangements) have a Corporate Tax on net profits, and there seems to be a worldwide convergence towards 30% being led by Europe.
- almost all tax systems (except service fee arrangements) have a royalty on extractive industries, and there seems to be a worldwide convergence towards going away from royalty on netback values.
- almost all tax systems (except service fee arrangements) have some form of profit sharing (taxes above Corporate Tax), but there is discernable trend in how these are designed. A strong tax administration favours using special taxes on net profits over and above Corporate Tax while weak tax administrations favours tax mechanisms that can more easily be controlled, like gross revenue taxes.

Eventhough not a trend, it seems like the countries that have the highest government take have participation, and then in the form of paid interest and not carried interest. This is due to that for part of the industry, the government in question receives the entire profit for a portion of the industry profits and not only taxes. Vice versa, countries without participation seems to have less government take from extractive industries, but then they usually have very diverse industries making up for the non-participation. This does mean that extractive industries in these countries have more attractive terms than in countries where this sector is a larger part of the countrys economy.

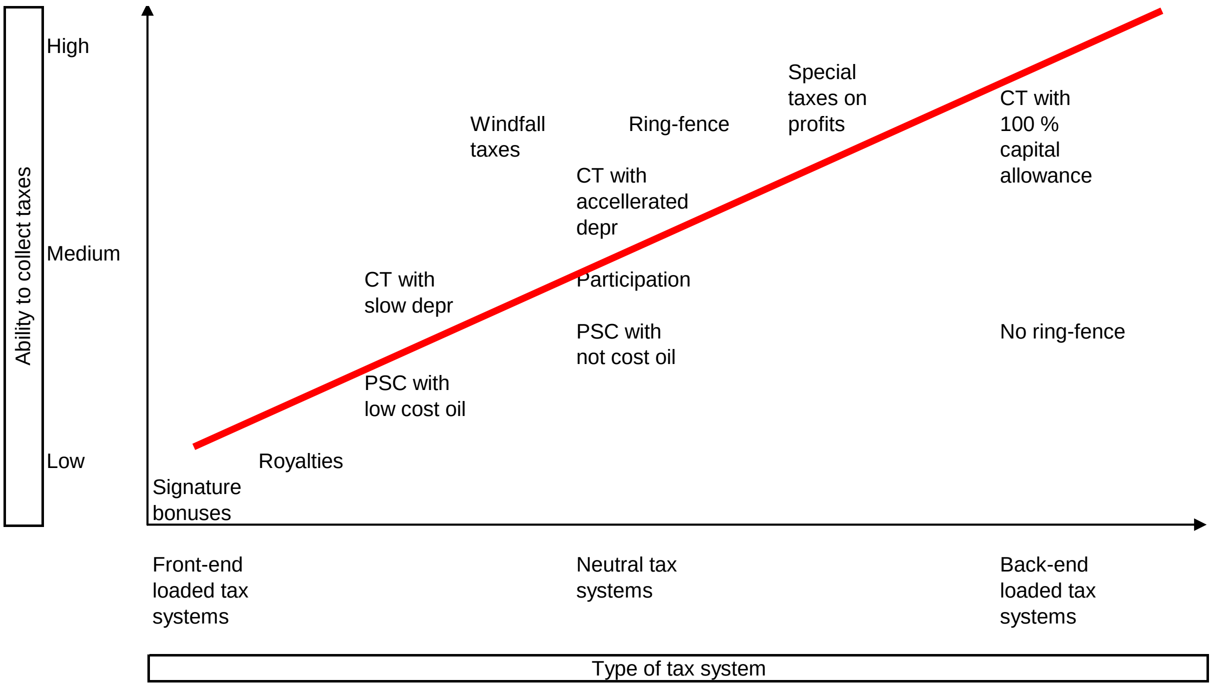
Table 1: Combinations of fiscal mechanisms in tax systems

# OF FISCAL SYSTEMS	ROY	CT	PROF SH	PSC	PART
3	X				
5		X			
38	X	X			
4		X	X		
9	X	X	X		
13				X	
11		X		X	
15	X	X		X	
1		X	X	X	
20	X	X			X
3	X		X		X
8	X	X	X		X
3				X	X
2		X		X	X
3	X			X	X
7	X	X		X	X
1	X	X	X	X	X
146	**107**	**120**	**26**	**56**	**47**

ROY= royalties, CT= corporate tax, PROF SH= profit sharing, PSC= production sharing contracts, PART= participation. See page 3 above for details.
Source: Van Meyr Corporation, 2005

The last thing we need to look at is how these tax mechanisms are working with respect to timing and to tax rate levels. We can broadly distinguish between front-end loaded tax systems, neutral tax systems and back-end loaded tax systems. These categories are tied to the timing of tax revenues to the governments, and through that to the distribution of risk between MNEs and the governments. The earlier an MNE pays taxes the more risk it takes, and vice versa, the later an MNE pays taxes the more risk is kept with the government. This then has a direct impact on how much taxes that can be collected. This can be summarized in figure 1.

Figure 1: Type of tax system and the inherent ability to collect taxes (illustration)



Source: Econ Pöyry

The only changes from a front-end loaded tax system to a back-end loaded tax system is (1) the amount of information available (uncertainty) and (2) the change in risk distribution between companies and governments. The above figure assumes no ILLICIT TP and thus does not take into account the strength of the tax administration.

3. The legitimate needs of MNEs

It is necessary in order to progress the theme to consider what the legitimate needs of the MNEs are. Let's first consider what MNEs are looking for:

a. Markets
b. Resources for producing goods and services for markets

A market can be either individual people, businesses or the government. Resources can either be natural resources used to produce goods or human capital whereby an MNE can produce goods or services cheaper than in other locations (including logistics costs between producing country and the market).

To the extent that there is no market, and there are no resources that can be utilized for producting something there is a market for, there is no obvious reason for an MNE to enter a country. Thus, a tax system cannot in itself entice an MNE to enter a country unless conditions (a) and/or (b) is present. The next obvious conclusion is that to the extent that conditions (a) and/or (b) IS present, then there is hardly any tax system that can turn them off either getting access to a market or to a resource. Thus, as was pointed out in the brief for this session on taxation of multinationals in Africa, MNEs does not consider tax as a very important element when establishing themselves in a country. They will make do with whatever tax system is present, UNLESS the host country actually opens up for negotiating terms and conditions whereupon the MNE will try to negotiate the best possible terms for its activities. Their main concern will be to get the most favourable treatment that they can get within the tax system of the country they enter as well as getting maximum stable conditions for their investment.

Their primary concern can thus be summed up in the following items:

1. Minimum uncertainty=Maximum stability of factors influencing the investment, including the fiscal system
2. Shortest possible payback-time for the invested amount including profits
3. Least costly way of repatriating investment and profits

In most tax systems you have to make profits (except with royalties) or have the capability of making profits in the medium term (3-7 years) with the current price levels before you pay taxes. Any investor will thus first investigate whether it can make profits before tax. To the extent that a project makes money pretax, then the rest of the equation is how the profits are going to be distributed between the company and the government. This is where the concept of front-end loaded vs back-end loaded tax systems comes into consideration from a lawmakers perspective.

A front-end loaded tax system, ie where the government takes in early revenues for example in the form of signature bonuses, is a tax system that is very much at odds with three concerns of the MNEs. A front-end loaded tax system is inherently unstable in the sense that there will be a public demand for increased taxes as soon as the MNE starts making good profits. All the front-end taxes will then be forgotten. MNEs will therefore try go avoid signature bonuses, royalties and slow tax depreciation etc as much as possible. This should also be in the best interest of the host country, because front-end loaded tax systems are generally able to collect low levels of government take due to the high uncertainty with respect to profit levels at the early stage when front-end taxes are being paid. Coupled with the inherent instability it creates it is a bad move to try and design tax systems that are very front-end loaded. The host country and the MNEs should have a common interest in avoiding these tax systems, and unless someone is personally rewarded through for example signature bonuses, it should be easy to do away with these systems. MNEs faced with front-end loaded tax systems tend to want stability clauses to ensure that their benefit is not taken away later in the life of their project or business.

A back-end loaded tax system, ie where the government waits with taxation until the investor has recouped his entire investment (and potentially more), on the other hand is very much to the benefit of the MNE, fulfilling at least 2 out of the 3 main concerns of the MNEs outlined above. If the tax system is stable throughout the project/business life it makes for minimum uncertainty and shortest possible payback-time. However, also back-end loaded tax systems are inherently unstable in the sense that there is usually public demand for tax changes in order to bring in tax revenues earlier. This creates both a threat to the MNE, increasing the risk of negative tax changes, as well as posing a threat to the political stability of the host country in question. MNEs will thus most often want to protect themselves against future tax changes by getting agreements with stability clauses included against adverse tax changes. The fact that an MNE want a stability clause for the tax system is the best possible sign that a tax system is inherently unstable. The MNE in fact shows by its behaviour that it believes the tax system is "too good to be true", and it seeks to lock in the benefits received through a generous (but unstable) tax system.

The only tax systems that MNEs should not need to seek stability clauses under are the neutral tax systems, ie tax systems that gives investors a reasonably quick payback-time on the investment, but still gives some revenues to the government early. An MNE would normally recognize these tax systems and the demand for an agreement with a stability clause will be less.

In addition to wanting minimum uncertainty/maximum stability and the shortest possible payback-time on the investment, an MNE needs to be able to have a legal way of repatriating after-tax funds back to the base country. This is both in the interest of the MNE and in the interest of the host country. Having at least one legal way of repatriating after-tax funds will help limit both TP PROPER and ILLICIT TP. The reason is that operational efficiency makes for putting the (human) resources where they are least costly, which more often than not is with the business. This is of course under the assumption that the MNE is trying to maximize profits and not minimize taxes. Transfer pricing will be covered more deeply in chapter 6 below.

4. The major lines of conflict between host countries and MNEs/base countries

The major lines of conflict between host countries and MNEs can be summed up in 4 areas:

A. What to include in business income?
B. Which taxes apply to the business income?
C. How fast can capital expenditures be depreciated for tax purposes?
D. How costly is it to repatriate funds to the base country?

Between host countries and base countries the conflict areas are items A (tax treaties), B (tax treaties) and D (tax treaties) above. Here I do not consider the possibilty of MNEs having an intermediary company in a low-tax jurisdiction incerted between the host country and the base country. This is looked more into in chapter 6 below. The base countries of MNEs are in this case generally in the industrialized countries and these countries are working to amongst other limit the cost (in the form of withholding taxes) of repatriating funds from the host country to the base country. This is actually good, since it opens up a legitimate way of getting repatriation of funds from the host country subsidiary to the base country MNE. However, some base countries are better at negotiating down the withholding tax rates, and it creates different levels of withholding taxes on the same type of business and makes for some MNEs to have to resort to doing operations through other countries with better tax treaties (treaty shopping) in order to be at the same terms as competing MNEs. It would probably be better if dividending after-tax revenues were made legitimate without cost (without withholding tax) except where the dividend went to a low tax jurisdiction, whereby host countries could still keep up withholding taxes as a disincentive towards establishing subsidiaries out of low tax jurisdictions.

If we look at the 4 major areas of conflict between host countries and MNEs, these can be further broken down into the following major items of conflict:

A. What to include in business income

A.1 Ring-fence investments or not?

Extractive industries is a significant part of the MNEs establishing themselves in Africa. For extractive industries it is a highly relevant question to ask whether individual investments should be ring-fenced or not. Industrialized countries like Canada and UK are ring-fencing investments in extractive industries to a greater or lesser extent while others are not. The interesting thing to note is that the accounting regulations around the world, IFRS, USGAAP etc, are converging towards "ringfencing" investments. This means that new investments are ring-fenced for financial depreciation purposes and are only starting depreciation when the assets are taken into commission (start of production). There are therefore no obstacles on the accounting side to ring-fencing new investments for tax purposes. The best reason for ring-fencing new investments is that new investments are decided upon based on isolated economics, ie the MNE does not take into account the economics of existing activities when they *decide* new investments. If they did, that would be to subsidize the investment. The typical process is that new investments must make economic sense (meet profit targets) and are *decided* in their own right on a stand-alone basis, but when they have been decided the *financing* is *optimized*, including looking at how tax systems are impacting the profitability of the investments. This is however "icing on the cake", because the investment needs to meet profit objectives before financing. Thus, without ring-fencing for tax purposes these investments will get a huge subsidy ("icing on the cake") from being deductible against revenues from earlier investments. MNEs presenting business cases for new activities within extractive industries are thus not showing the full economic effect of the investment on a countrys government take from that company. Ring-fencing new investments for tax purposes means that the economic effects for both the government and the company will be as predicted if the assumptions used in the economics of both old and new investments holds true.

A.2 Is interest a legitimate deductible expense after assets are depreciated to zero?

Interest is a deductible expense in almost all countries, but some countries reduce deductibility based on how much of the assets that have been depreciated for tax purposes relative to the book value of investment. The theory behind this is that interest is only a valid expense for tax purposes as long as there is a need to finance the tax value of the asset. To the extent that a government has allowed part or full deductibility for the tax value against revenues, there is no reason why the funds thus protected from taxation should not be used to pay down the loan associated with the asset. The interest on the "equity part" of the loan, ie any interest incurred on loans over and above the remaining tax value of the asset, would under such a rule be non-deductible. This would automatically solve any thin capitalization issues where the company finances more of its investments with internal debt than a third party would be able to do through external financing. The company would still be allowed to finance the equity part of the investment with debt, but the interest would not be tax deductible. A host country government would thus, with such a rule, become neutral to which type of financing a company would choose and it would be up to the company and the base country whether the interest would become ultimately deductible or not. If the loan were external, interest would still normally be deductible, while an internal loan would be a zero-sum game that would not give rise to either taxation or deductibility. MNEs needing external financing would then avoid being located in low-tax jurisdictions if they wanted tax deduction for any external interest.

A.3 Is "hedging"/derivatives trading a separate business income?

Derivatives trading (often called hedging in order to link it to the business activities) is an area where the host country (or any country except maybe the base country) has little or no control over the total picture. A company may enter into derivatives creating losses in one country and profits in another country through back-to-back agreements. A tax administration will normally become concerned if a company show losses year after year, because third parties would not be able to carry on its business with consequtive losses. The same should be the case where companies are taking (sometimes very large) losses on derivatives trading year after year. No third party business would accept such losses year after year without changing its strategy trying to limit such losses. What would be the rationale for treating hedging/derivatives trading gains and losses as a separate business income?

Firstly, hedging/derivatives trading fulfills ALL the criterias for being recognized as a separate business income:

- it needs its own strategy for creating profits and avoiding losses
- it needs its own work force for doing the transactions
- it needs its own decision processes and management with experience with derivatives
- it needs its own contracts over and above normal sales contracts for the other products or services the company have
- it needs its own accounting processes

Subsequently it should also have its own tax treatment.

Secondly, treating hedging/derivatives trading as a separate business income would force a company to always have gains and losses in the same country in order not to have non-deductible losses accumulating in a country.

Thirdly, treating hedging/derivatives trading as a separate business income would force companies to think more clearly through their strategies for hedging/derivatives trading.

Fourthly, it would protect a host country from being liable (through reduced tax revenues) for business decisions being done in other entities in the MNE - typically decisions related to speculative trading made in the base countries.
Fifthly, it would help businesses concentrate the hedging/derivatives trading in the countries where the overview and insight are greatest, typically in the base country at group level.

If hedging/derivatives trading were treated as a separate business income in all countries, it would also automatically reduce the amounts of financial transactions going on because no country would subsidize losses through allowing losses to be deductible in other business income.

B. Which taxes applies to the business income

B.1 Normal profit taxes - corporate tax rate

Current trends seems to be corporate tax rates in the range 28-35%, with 30% as the level most countries changing their tax system are moving towards. There seems to be no reason for a host country to go below 30% corporate tax rate for reasons based in fiscal competition.

B.2 Measures to attract investments

The most common measures in the tax system for attracting investments are (a) tax holidays, (b) reduced corporate tax rate, (c) agreements with tax stability clauses or (d) a combination of (a), (b) and (c). As noted in chapter 3 above, MNEs wanting to establish themselves in a country is usually interested in a market or in resources to produce goods or services. In which cases would fiscal competition have any impact on the decision to establish a branch/subsidiary in a host country?

If the MNE is interested in a market in a host country, the market will usually be attractive enough and getting access to the market usually entails that it is economically beneficial to establish a business close to the market. Only to the extent that a company can cover a market from another country would it be reasonable to consider which measures that would be attractive in ensuring that the MNE is establishing a presence in a particular country. Most often other measures than making changes to the tax system are available and may be more effective.

If the MNE is interested in resources, taxation becomes very dependent on which resources it is interested in. If the MNE can get access to the same resources in other countries, for example "cheap" labour, then the competition may be real. Again, most often other measures than making changes to the tax system are available and may be more effective. In the example with "cheap" labour, it may be more effective to look at easy repatriation of profits to the base country as well as targeted education efforts in the localisation area improve access to the correctly trained labour force. If one uses tax measures, it would be to reduce withholding taxes on dividends to zero (keeping up other withholding taxes on interest on internal loans, management fees etc). If the MNE needs access to a physical property, for example a mining or an oil & gas license, then the host countries need to be aware of that there is a limited number of such resources available and that most countries are taxing such MNEs over and above the general corporate tax level. Fiscal competition should therefore not be an argument for changing the tax system to attract MNEs to these resources. Most often the resource in itself is enough. What resource-driven MNEs want is financial and operational stability. Financial stability can be given through stability clauses in agreements, but they should then have to accept a higher tax rate, for example a 5%-points higher corporate tax rate, in order to get the benefit of a stability clause. Operational stability is about whether the host country is able to provide sufficient infrastructure (power, water, roads/railroads/ harbours, sewage, telecommunication services etc).

B.3 Additional taxes

In the case of some industries, in particular extractive industries exploiting non-renewable resources, it is normal to have additional taxes on the industry based on that the company gets access to economic rent/superprofits over and above what a company would normally get access to. The theory is then that "normal" profits are taxed "normally" while superprofits have taxes on top of "normal" taxes in order to capture the additional economic rent from the resource and that the host country is the original resource owner. The level of additional taxes will depend on the industry, the size of the resources in the country relative to other countries and the operational stability in the country. While fiscal competition is normally not an element to consider when it comes to normal corporate taxes, it does affect how high a country can go when levying additional taxes on an industry. This of course depends on the tax system chosen, the difference between the marginal tax rate and the average tax rate etc. Most countries will want to benchmark itself against comparable countries in order not to discourage sound business investments in the country. However, we are here talking about limiting how HIGH additional taxes may be, and NOT which INCENTIVES to give to the industries in question. A country can choose between gross revenue taxes and net profit taxes on top of the general corporate tax rate. The following general rules of thumb can be a guide in what taxes to consider:

- net profit taxes are the taxes most countries would choose because of (1) the good systemic properties and (2) the ability to increase the tax rate due to a good fit with the "ability to pay"-principle. However, net profit taxes with a high tax rate over and above the corporate tax rate demands that the tax administration is highly professional due to the significant increases in transfer pricing issues with a tax rate significantly above the corporate tax rate.
- gross revenue taxes can be divided in two. Most countries would consider a royalty for industries where those are applicable. The trend is towards limiting the level of royalty and levying it on the gross revenue and not on any netback revenue. Windfall taxes is an alternative to consider for those countries that have a weak tax administration in order to (a) simplify tax collection and tax control, (b) avoid considerable transfer pricing issues and (c) avoid having to put significant resource into building up tax administration capacity (and risk losing it when people are trained and are attractive for private companies). Windfall taxes must have kick-in levels above the long-term prices used by investors to invest in new activities in order to fulfill the "ability to pay" principle.

C. How fast can capital expenditures be depreciated for tax purposes?

C.1 Depreciation of the asset value

The main tax depreciation mechanisms are

(a) linear depreciation

(b) declining balance

In addition one find unit-of-production depreciations for financial purposes, but these depreciations are typically too long for use as a tax depreciation.

The typical time period for tax depreciations are minimum 3 years and usually no more than 8 years before most of the investments are depreciated (except extremely long-lived assets like office buildings). The normal tax depreciation would usually be in the range of 3-6 years.

Length of tax depreciation has been a significant element in fiscal competition, and many countries in Africa south of Saraha have used 100% capital allowance as a way to attract investments.

C.2 Investment shields ("depreciation" over and above the asset value)

To the extent that additional taxes over and above the corporate tax rate is levied on an industry, it is very common in fiscal competition to use investment shields in order to avoid having the additional taxes affect the investors' economic return. This is usually done by having an amount deducted in the basis for the additional tax before calculating any additional taxes, often calculated as a %-age of the investments done. This will improve the payback time on the investment, and although additional taxes are levied, the mechanisms employed to shield the investments are usually sufficient to ensure that the initial investment have a quick payback time. Investment shields in case of additional taxes are a significant element in the fiscal competition. They are employed by developing and industrialized countries alike.

D. How costly is it to repatriate funds to the base country?

D.1 Withholding taxes on dividends versus other withholding taxes

MNEs and other investors are making investments in order to get a return on the investment. To the extent that it is difficult or costly to repatriate funds from the host country to the base country, MNEs are bound to look at other ways of getting money out of the host country. This is the main link besides operational needs for transfer pricing practices. If there is a legal way to get profits back to the investor, it becomes less attractive to "invest" in transfer pricing. Making sure that MNEs and other investors at least have one legal way, dividends, to repatriate profits, will help reducing transfer pricing somewhat. What then about other withholding taxes? A country would normally want to tax profits before they are transferred back to the investor. Interest on internal loans, management fees, technical fees, marketing fees, royalties and licensing fees are all potential candidates for transferring untaxed profits out of the host country. In many cases they can be legitimate expenses. However, it is very easy to err on the high side without being challenged by the tax authorities. It thus becomes very tempting to utilize such payments to repatriate funds back to the base country. While making sure that repatriating after-tax dividends has not cost, ie no withholding tax, there is cause for arguing that a certain level of withholding taxes should be upheld on other payments between affiliated companies.

A complicating factor in repatriating funds to the base country is inequalities in tax levels between host counties and base countries. If host countries use fiscal competition and reduce their tax rates or makes more generous deduction opportunities, it will have a direct effect on the ability of the MNE to repatriate profits through dividends. If there is no paid tax associated with the dividend from the host country, all base countries that have tax credit systems will calculate base country tax on the dividends. To the extent that the tax payment in the host country is only a timing issue, this can lead to double taxation if the tax treaty between the host country and the base country or internal legislation in the base country does not take care of the potential double taxation. This is especially the case if the delay in taxation in the host country is long. This situation in itself gives rise to three reflections:

- it is unwise to use fiscal competition to attract new investor companies since time delays in tax payments relative to dividends could mean a potential double taxation for the MNE, forcing the company to utilize other mechanisms to get funds out of the country, for example transfer pricing
- it is particularly unwise for host countries to use fiscal competition and reduce the general tax level below the tax level in the base countries because this will either (a) permanently transfer tax capacity from host countries to base countries or (b) if companies want to pocket the difference in tax rates between host country and base country they will have to move base country (at least for intermediate companies) to low-tax jurisdictions.
- using fiscal competition may thus in itself increase transfer pricing practices

5. A critical review of fiscal competition and legal repatriation

Table 2 summarizes the general expectancy with regard to the fiscal mechanisms and the major lines of conflict between MNEs and host countries. The following can summarize this picture:

- host countries using fiscal competition are usually harmed by their move because the inequality created towards the base country taxes promotes use of transfer pricing and tax havens, and it has little effect with regard to drawing investments unless the inequlity becomes very large which means the host country looses a lot of tax revenue
- host countries using additional taxation are wise to include investment shielding in order not to loose investments due to the reduced attractiveness for the investor if such shielding is not included.

TABLE 2: Fiscal competition element *Source: Econ Pöyry*	Promotes use of transfer pricing	Promotes use of tax havens	Effective to increase investments	Effective to increase government take
Fiscal systems/timing:				
- front-end loaded systems	No	Yes	No	No
- neutral systems	No	No	No	Yes
- back-end loaded systems	Yes	Yes	Yes	Potentially
Overall tax level (see differentiation on B below):				
- lower than base countries	Yes	Yes	Yes	No
- neutral to base countries	No	No	Yes	Yes
- higher than base countries	Yes	Neutral	No	Yes
Major lines of conflict:				
A.1 Ring-fencing?				
- no ring-fencing	Yes	Yes	Yes	No
- ring-fencing	No	No	Neutral	Yes
A.2 Interest deductible for "equity" part of investment?				
- yes	Yes	Yes	No	No
- no	No	No	No	Yes
A.3 "Hedging" as separate business income?				
- no	Yes	Yes	No	No
- yes	No	No	Neutral	Yes
B.1 Normal profit taxes				
- lower than base countries	Yes	Yes	No	No
- neutral to base countries	No	No	Yes	Yes
- higher than base countries	Yes	Yes	No	Yes

TABLE 2 (continued): Fiscal competition element *Source: Econ Pöyry*	Promotes use of transfer pricing	Promotes use of tax havens	Effective to increase investments	Effective to increase government take
B.2 Measures to attract investm.:				
- tax holidays	No 1)	No 1)	Yes	Neutral
- reduced corporate tax rate	Yes	Yes	No	No
- tax stability clause:				
* alone	No	No	Yes	No
* w/reduced tax rate	Yes	Yes	Yes	No
* w/increased tax rate	No	No	Yes	Yes
B.3 Additional taxes				
- without investment shield 2)	Yes	Yes	No	Yes and No
- with investment shield 2)	Yes	No	Yes	Yes
C.1 Tax depreciation				
- accellerated vs base country	Yes	Yes	Yes and No	No
- neutral vs base countries	No	No	Neutral	Yes
- slower vs base countries	Yes	No	No	Yes and No
C.2 Investment shield				
- general	No	No	Yes	No
- w/additional taxes	No	No	Yes	Yes
D.1 Withholding tax on dividend				
- yes	Yes	Yes	No	No
- no	No	No	Yes	Neutral

1) Assumes tax treaty allows tax credits for tax rate in years tax holiday is applicable
2) Assumes additional taxes are at level with comparable countries

TABLE 3: Recommendations vs experiences	RECOMMENDATION	EXPERIENCE FROM AFRICA
Fiscal system	Neutral	Very back-end loaded, especially in countries with 100% capital allowance
Overall tax level	Neutral to base countries except for extractive industries where resource rich countries should have additional taxes	Some countries with high tax rates, but many with lower than necessary and/or deductions that make nominally high tax rates not effective
A.1 Ring-fencing	Yes for extractive industries	Very few countries seems to have ring-fencing of any significance. Many countries are experiencing severe delaying with regard to timing of government take.

TABLE 3 (continued): Recommendations vs experiences	RECOMMENDATION	EXPERIENCE FROM AFRICA
A.2 Interest on depreciated tax assets	Introduce interest cap rules	Interest fully deductible. MNEs utilizing little regulation to uphold loans as long as possible.
A.3 Hedging/derivatives	Introduce hedging as separate business income	Hedging/derivatives has reduced some companies gross revenues with more than 10%. Validity of losses questionable.
B1. Normal Profit Taxes	Have at least 30% tax rate in order to avoid tax leakage to base countries	Some countries have reduced tax rates below 30% combined with 100% capital allowance, making their tax system severly back-end loaded
B.2 Measures to attract investments - tax holidays	Tax holidays for a limited period is better than other measures due to availability of tax credits in base country	Use of tax holidays seems limited compared to permanently reduced tax rates.
- reduced corporate tax rate	Avoid reducing the general tax level for an industry	Many countries seem to have done it by law or by agreement
- tax stability clause	If tax stability clause is given, combine with additional corporate tax rate of for example 5% for the benefit	Stability clauses given together with REDUCED corporate tax rates
B.3 Additional taxes	Consider for non-renewable industries, for example extractive industries, including mining	Very varied practice throughout Africa. Additional taxes most used for oil & gas companies.
C.1 Tax depreciation	Avoid 100% capital allowance. Consider 3-5 years deprecation period.	Many countries south of Sahara has 100% capital allowance and it is hurting a timely governmen take collection from the industries.
C.2 Investment shield	Consider only for additional taxes, not for ordinary corporate tax	Too little data to conclude. Experience from mining industry that it is little used.
D.1 Withholding tax on dividends	Put withholding tax on dividends to zero, ensuring that MNEs have one legal way of taking after-tax profits out of the host country	Highly dependent on country philosophy and tax treaties. Often negotiated away in agreements with individual companies.

Table 3 summarizes my recommendations on the tax mechanisms and conflict areas outlined in table 2, while at the same time contrasting the recommendation with what I have experienced in Africa. Here I have to say that this is grossly oversimplifying things in order to present a broad picture, and that individual countries may be very far from this description.

The most important experiences from Africa are unfortunately that:

- too little recognition by lawmakers (ministries of finance and parliaments) that MNEs will try to lobby for as good fiscal conditions as possible *if given the opportunity*, but that the MNEs will enter the country under any (reasonable) tax system in order to get access to markets and/or resources.
- too many institutions feel free to negotiate contracts giving improved fiscal terms to MNEs entering the host country. This is probably just as problematic as corruption.
- too many negotiators believe claims by the MNEs that they need improved fiscal terms in order to enter the host country. Preferably MNEs should be subject to a general tax system that is non-negotiable, but at least (a group instructed by) the ministry of finance needs to be heading any negotiations regarding fiscal conditions.
- too many weak tax administrations that are not able to follow up tax collection and tax assessment
- tax administrations that tries to collect money are too often hampered by political noise around the tax collection, supporting an environment where companies feel that they can negotiate down taxes

The best way to avoid this situation is to move towards general tax systems without individual contracts containing fiscal terms, and that the fiscal terms are non-negotiable. OECD and base countries can fasilitate this process by supporting fiscal mechanisms in host countries (and base countries) that promote political and fiscal stability, particularly promoting

- host countries to move towards neutral tax systems
- host countries being able to ring-fence investments without base countries supporting their companies against the host countries
- host countries having the same overall tax level as the base countries in order to reduce pressure for transfer pricing and moving companies to low-tax jurisdictions
- both host countries and base countries moving to have hedging/derivatives trading as a separate business activity in order to promote companies to have gains and losses in the same country, and promoting sound hedging practices and reduced the speculative derivatives trading.
- OECD, base countries and IMF to reduce the pressure towards net profit taxes, recognizing that host countries with weak tax administrations that want additional taxation for example of extractive industries may need to have windfall taxes in place until such time that they have been able to build up a tax administration capable of handling complex transfer pricing issues on a daily basis.

6. TP PROPER versus ILLICIT TP

TP PROPER is the legitimate need of an MNE to enter into business with affiliated companies at arms length prices. These transfer pricing transactions can be

- optimal use (and pricing) of corporate resources (management, accounting, legal, R&D, technical, commercial resources etc)
- utilizing internal supply chains (purchases)
- utilizing internal value chains and sales organisations (sales)
- utilizing human resources optimally (expatriates).

It is assumed under the OECD transfer pricing guidelines that such transactions can be done at a profit as long as the pricing is arms length, in order to promote a fair and equitable distribution of profits across companies and across borders.

If one could assume that all companies would use TP PROPER, one could have a general recommendation towards neutral tax systems based on net profit taxes. However, it is being estimated by various institutions and committees that there is a significant ILLICIT TP going on. ILLICIT TP can either be (a) that MNEs organise their activities purely out of tax motivations, for example by moving part of their activities to low-tax jurisdictions (inserting an administrative level between host country and base country) without any business motivation other than tax OR (b) that MNEs organise their activities such that they are unlawfully moving profits out of a host country by manipulating the pricing of costs and revenues such that they are outside the arms length intervall.

As we have seen from the tables in chapter 5, the following activities are those that most likely will promote the use of ILLICIT TP practices and/or use of low-tax jurisdictions:

- back-end loaded tax systems in host countries will have a tendency to create too little tax credits (through host country taxes) to avoid double taxation in base countries. MNEs will try to reduce profits through TP practises (PROPER or ILLICIT) or may move activities to low-tax jurisdictions to avoid the problem.
- not having a tax level in host countries that is approximately on par with base countries will create inequalities that promotes the use of TP practices with or without the use of low-tax jurisdictions to balance out the inequalities. If taxes are higher in host countries relative to base countries (typical where you have additional taxation of non-renewable resources), this promotes using TP practices to move profits to the base country. If taxes are lower in host countries relative to base countries a combination of TP practices and moving activities to low-tax jurisdictions may reduce taxable profits in the host countries at the same time as the profits are taxed at lower levels in the receiving country or not at all.
- hedging and derivatives trading lend themselves very much to moving profits from one country to another. Using back-to-back agreements not shown to tax authorities in the country in question, a company may move large amounts of profits from one jurisdiction to another, typically down the tax gradient.

These are the three typical situations created by either (a) fiscal competition or (b) ILLICIT TP that will legally or illegally reduce the tax basis and the tax collection in the host country.

7. Conclusion and major recommendations

My opinion is, based on the above discussions, that host countries can deal with fiscal competition by ensuring that their tax systems are neutral relative to base countries and that their tax levels are close to the tax levels in the base countries. Additional taxes to capture resource rent needs to be benchmarked towards comparable countries (not necessarily base countries) in order to ensure competitiveness to the degree that that is a consern of the host country. Both host countries and base countries can deal with ILLICIT TP by keeping higher withholding tax rates on (profit elements in) transfer pricing transactions going to low-tax jurisdictions (including withholding tax on dividends) and making hedging/derivative transactions a separate business activity such that companies are forced to have gains and losses in the same country, or at least that the host countries does not need to worry about hedging/derivatives losses reducing the tax base in the MNE subsidiaries in their country.

It would be a great achievement if host countries in addition moved away from agreements including fiscal terms with the individual MNE and towards open, general, transparent and non-negotiable fiscal terms enacted directly in the tax law as is the practice in most industrialized countries.