

## Illicit financial flows and tax avoidance in Africa

**African Union Finance Ministers Meeting, Abuja, Nigeria 25 – 30 March 2014**

Illicit financial flows deprive Africa of billions of dollars each year, more than is received in overseas development aid or foreign direct investment combined.

The African Union High-level Panel on Illicit Financial Flows is charged with developing recommendations to end this flight of much-needed capital from Africa. The panel will present a progress report to the African Union finance ministers meeting in Abuja. The final report from the panel, chaired by former South African president Thabo Mbeki, will be presented at the AU Summit in late June.

Illicit financial flows are commonly associated with criminal activity like drug dealing, smuggling or human trafficking. But according to the African Union panel, two-thirds of illicit movements involve multinationals and commercial transactions like corporate tax evasion and avoidance. Criminal activity and bribery make up 30 percent and five percent respectively.

Multinational companies are extracting resources or selling their goods and services in Africa while contributing little in the way of taxes. They are depriving some of the world's poorest countries of money vitally needed to pay for schools, hospitals and other essential services.

A new paper from the UNESCO-sponsored Education for All Global Monitoring Report makes clear the potential of increased tax revenue in improving the quality of education for millions of children. The report found that increasing tax collection in 67 countries and devoting a fifth of government budgets to education could raise an additional \$153bn for education in 2015. In 34 countries in sub-Saharan Africa an extra \$4.5bn would be raised for education.

Multinationals often defraud countries of tax revenue by using mechanisms like trade or transfer mispricing, or by exploiting tax treaties to stash their profits in places offering very low tax rates or harmful tax incentives. This is also unfair on smaller domestic businesses that are typically responsible for the majority of employment in Africa.

International development agency, ActionAid is calling on the African Union and its member governments to review tax treaties which are one of the major routes by which tax avoidance takes place. African governments should look to renegotiate or, if necessary, to cancel the treaties to ensure that more money is available to help improve the lives of the majority of their citizens. African governments should also review their tax incentives and cooperate at a regional level to develop a coordinated approach to tax competition.

### **Double taxation treaties**

Multinational companies often rely on the global network of double taxation treaties or agreements to avoid or reduce the tax they need to pay.

There are perfectly legitimate reasons to have such agreements: citizens who earn their income in a country other than their home country should not have to pay tax twice. The same goes for companies. But double taxation treaties go well beyond stopping double

taxation and such treaties between rich and poor countries or between poor countries and tax havens are usually bad deals for the majority of people in poor countries. In many cases treaties to prevent double taxation are now facilitating non-taxation.

Double taxation treaties usually reduce or eliminate source taxes (tax payable where the business takes place) and withholding taxes (tax payable as the money crosses borders), allowing the movement of finance to go ahead unchecked.

Multinational companies often take advantage of different double taxation treaties to shift profits from country to country to country, exploiting the treaties with the lowest withholding tax rates.

Routing financial flows through a number of different tax jurisdictions allows companies to avoid tax on cross-border transfers whether or not there is a bilateral treaty between the country in which the income is generated and the final destination country.

This strategy, known as 'treaty shopping' is particularly problematic when it involves a tax haven, like Mauritius.

### Mauritius and double taxation treaties

Tax havens are characterised by low tax rates, high levels of secrecy and extensive tax treaty networks. High levels of secrecy mean Mauritius is highly exposed to the risk of illicit transfers; its extensive treaty network increases exposure for other African countries too.

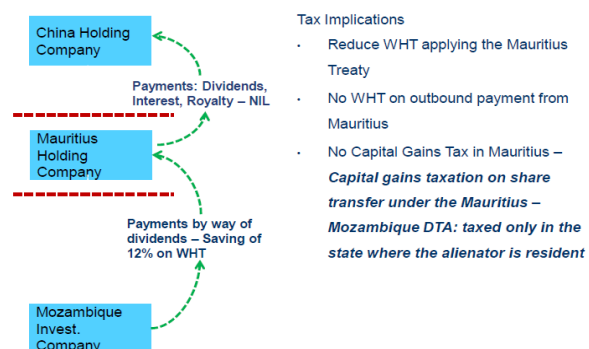
Fifty-six percent of foreign direct investment into Africa flows through Mauritius, which has signed double taxation treaties with 14 African countries and is in the process of negotiating another 11. Mauritius is well known for negotiating treaties that reduce or eliminate withholding taxes and that prevent its treaty partners from collecting capital gains tax.

In 2013, ActionAid uncovered a presentation prepared by the major international accountancy firm, Deloitte that illustrates how tax can be avoided in African countries by structuring business through Mauritius.

The presentation uses Chinese investment into Mozambique as an example, but can be applied in the case of many other African countries. If a Chinese company invests directly in Mozambique, standard tax treatment of international investments applies. Profits from the Mozambique subsidiary are subject to a 20 percent withholding tax when they are remitted to the Chinese parent company as dividends. If the Mozambique company is sold to another investor, any capital gains is taxed at 32 percent.

The diagram illustrates what would happen if a company routed the same investment through a Mauritius holding company. In such a scenario the company could reduce withholding tax (WHT) paid when dividends are remitted from Mozambique from 20 percent to eight percent. It would also pay no capital gains tax if it sold on the Mozambique subsidiary, because the treaty prevents Mozambique from charging capital gains.

### Investing in Mozambique through Mauritius



There is no need for the company owners to actually live in Mauritius; many Mauritius-based companies, as with companies in many other tax havens, are little more than post boxes whose real ownership and control lies elsewhere.

ActionAid analysis of the new **Nigeria-Mauritius** double taxation treaty - which has been signed but is yet to be ratified by Nigeria - reveals that companies investing in Nigeria will be able to avoid tax by routing their investment through Mauritius as opposed to investing directly in Nigeria.

The Nigerian government was successful in negotiating some progressive terms in the treaty, including provisions to ensure that Nigeria can apply statutory tax rates to income not specifically referenced in the treaty and to prevent activities linked to the company's Nigerian branch escaping the tax net.

But the treaty features reduced withholding tax rates and prevents Nigeria from applying capital gains tax to Nigerian shares sold by a Mauritius-based company<sup>1</sup> - the most common problematic provisions in treaties between Mauritius and African countries.

Overall, the costs of the treaty appear to outweigh its benefits to Nigeria.

### **Weak multilateral action**

The G20 mandated the OECD to tackle tax avoidance by multinationals through a process known as the 'Base Erosion and Profit Shifting' (BEPS) Action Plan. But the recently published proposals to address tax treaty abuse are over-complicated and restricted to technically complex measures which place the burden on the state to prove wrong-doing and risk tying up countries – particularly less-well-resourced countries – in endless legal disputes with multinationals.

The draft ignores simpler, more straightforward measures that less well-resourced countries could use to prevent treaty abuse, particularly treaty measures simply permitting the application of higher withholding taxes. The draft also fails to consider the potential for rebalancing taxing rights between treaty partners, a reform crucial for African countries.

### **Renegotiating double taxation treaties**

However, governments do not have to wait for international processes to deliver; they can take action on problematic tax treaties themselves. Increasingly governments unhappy with the unfavourable arrangements are reconsidering their tax treaties with Mauritius.

**India** has been trying, unsuccessfully, to renegotiate the capital gains clause in their treaty with Mauritius for years.

**South Africa** was recently successful in renegotiating their treaties with Mauritius, introducing 10 percent withholding tax on interest flows and allowing South Africa to collect capital gains tax on shares sold by a Mauritius-based company, neither of which was possible under the previous treaty.

**Rwanda** also renegotiated their treaty with Mauritius, introducing 10 percent withholding tax on dividends, royalty and interest, and 12 percent for management fees, and allowing Rwanda to collect capital gains on shares sold by a Mauritius-based company. Rwanda's finance minister Claver Gatete said "We found that in terms of taxation, it was benefitting Mauritius more than ourselves". The new treaty has been signed, but not yet ratified.

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<sup>1</sup> At the moment, Nigeria does not apply capital gains tax to sales of shares, but this provision prevents the Nigerian parliament from doing so in the future if they change their mind.

**ActionAid calls on African governments to review their existing double taxation treaties. They should pay special attention to those with OECD countries and tax havens, and examine the scope for renegotiation or cancellation should the terms of the treaties facilitate illicit financial flows or give up too many taxation rights.**

**African countries should be very cautious about signing any new double taxation agreements. Transparency and public scrutiny is key.**

#### **Harmful and illicit tax incentives**

Tax havens like Mauritius are not the only shelters for illicit financial flows. Tax incentives provided by any domestic tax regime can also trigger the illicit movement of money from one country to another.

Tax incentives are special tax deals given to a company to encourage it to invest. The most common and best-known is probably “tax holidays” which exempt companies from tax (especially income tax) for a set period of time, often five or ten years.

In recent years, there has been a proliferation of tax incentives across Africa purportedly to attract investment, including many harmful or illicit incentives. But there is a lot of evidence that tax incentives are not required to attract foreign investment in most African countries.

ActionAid estimates that US\$138 billion is given away by governments in developing countries every year, just in corporate income tax exemptions. This is enough to put every primary school aged child in school, meet all the health-related Millennium Development Goals and leave enough money for the agriculture investment needed to end hunger.

In 2011, ActionAid published Rwandan government data showing that losses from tax incentives constituted a quarter of its potential tax revenue – over US\$234 million. ActionAid partner, the Malawi Economic Justice Network estimates that from 2008 - 12 over US\$300 million was lost through tax exemptions in Malawi, almost the same amount as the corporate income tax raised during that period.

ActionAid considers discretionary incentives, tax holidays, free zones and stability agreements to be particularly harmful and should be avoided.

Incentives are rarely subject to parliamentary or public scrutiny and often are granted by those without proper authority to do so. This is particularly the case when a tax incentive prevents parliament or future parliaments from revising the favourable tax regime granted to a particular company or industry. Such tax incentives are clearly illicit and provide a tax-free shelter for illicit financial flows. Recent European Court of Justice rulings show that many of these harmful tax incentives are considered illicit in the EU.<sup>2</sup>

**ActionAid calls on African governments to cost their tax incentives and open them to parliamentary and public scrutiny. They should also cooperate at a regional level in order to counter tax competition.**

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<sup>2</sup> [http://ec.europa.eu/competition/consultations/2014\\_state\\_aid\\_notion/index\\_en.html](http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html)